FL MEMO

EXTRACTS

Company Law

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SECTION 1

How to become a shareholder

28000 The **two essential components** of membership are that a person agrees to become a shareholder in the company, and his name is entered in the register of shareholders (s 112 CA 2006).

Agreement

28005 The relationship between a shareholder and the company is a contractual one (¶3150+). Therefore, as with entering into any other contract, there must be an **offer** to become a shareholder which is **accepted** and there must be **consideration** for the contract.

28010 There are various **methods** by which a person can **agree** to become a shareholder:
– agreeing to purchase shares from an existing shareholder (in which case the company's rules on transfers must be adhered to (¶20100+));
– agreeing to accept an allotment of shares from the company;
– subscribing to the memorandum; or
– if a shareholder dies or is declared bankrupt, his personal representative or trustee in bankruptcy can take the shareholder's place by agreeing to have his name registered (see ¶46315).

In the case of an **allotment or subscription**:
– the shareholder can offer to become a shareholder by applying for an allotment of shares, which is accepted by the company when it makes the allotment; or
– the company can offer membership by allotting shares, which is accepted when the shareholder takes the shares.

The **company may specify** how a person can agree to become a shareholder, for example, by stating in the articles that a particular consent form must be signed, in which case these rules should be followed.

MEMO POINTS 1. A person can be **deemed to agree** to become a shareholder in two ways:
– through his conduct. For example, if a person's name is accidentally entered on the register and, rather than apply for rectification, he acts like a shareholder by voting, attending meetings, accepting dividends etc; or
– through the articles. For example, where they state that a director is deemed to accept qualification shares on taking up office.
2. Prospective shareholders can **communicate with the company** by sending any necessary documents or information in hard copy, electronic form or other agreed form (ss 1143, 1144, Sch 4 CA 2006). The rules for doing so are discussed at ¶45315.

There must also be **consideration** for the contract, which will be the price paid for the shares. Shares cannot be issued for less than their nominal value; see ¶13310+ for more on payment for issued shares. 28015

MEMO POINTS Shares can be given away, in which case no consideration will pass from the donee to the donor. See ¶20100+ for **gifts** of shares.

Formalities

Once a person has agreed to become a shareholder, there may be **further procedural steps** to take before his name can be entered on the register. Usually, the company specifies that the prospective shareholder must be **approved** by the board before his name is registered. Table A and the Model Articles effectively require the board's approval by giving it the power to refuse to register share transfers in certain situations (see ¶20435+). Once approved, the shareholder's name can be entered in the company's **register of shareholders**. The date of the entry is taken as the commencement of his membership, even if the shares were transferred to him earlier. 28020

The new shareholder will then be issued with a **certificate** (¶20530+).

MEMO POINTS 1. If shares are **transferred** but the transferee's name is **not recorded** in the register until a later date, the transferor remains the registered holder of the shares. He holds them for the benefit of the transferee and must deal with them according to the transferee's instructions (for example, regarding how to vote, deal with dividends, sell the shares, etc).
2. The register of shareholders is **evidence** of who is a shareholder in the company unless it can be proved that the register is wrong (s 127 CA 2006). However, it is not always conclusive and mistakes can be rectified, including adding and removing names of shareholders (¶46770+).

SECTION 2

Powers, rights and remedies

Shareholders' rights and powers principally **derive from** statute (applying to all shareholders) and the articles (which can vary between companies). Many shareholders also sign a shareholders' agreement, which further defines their rights and liabilities. These rights ensure that a balance is maintained between the board's general management of the company and the shareholders' control over significant decisions. The **status** and enforceability of these rights depend upon their source. 28120

Despite their rights and powers, shareholders may still feel that they are being **taken advantage of** in certain situations. Even minority shareholders have a number of options available to them if they feel that the company is being run, or decisions have been taken, to their detriment. They can **protect** their interests by taking preventative action such as blocking resolutions or restraining acts which are not within the company's powers. Statute provides added protection where shareholders could be particularly vulnerable, for example, by requiring the court to approve schemes of arrangement (¶76795+). Shareholders can also **take remedial action**, such as removing a director from office or objecting to specific 28125 decisions through the court. The last section of the table at ¶28175 summarises the remedies and actions available to shareholders when something has gone wrong.

It may be appropriate for shareholders to **take court action** on behalf of, or against, the company if, for example, the company has a claim against its directors for breach of duty which the board will not pursue on the company's behalf. The situations in which shareholders can take action in the company's name and in their own are dealt with at ¶59155+ and ¶28375+ respectively.

Sometimes these protections and remedies are not enough to shield shareholders (particularly those in a minority) from directors or more powerful shareholders taking advantage of their position. Therefore, statute provides three **remedies of** "**last resort**" which allow shareholders to:
– issue a **derivative claim** in the company's name where a director is in breach of his duties;
– bring an action in unfair prejudice where the company's affairs have been conducted in an unfairly prejudicial manner; and
– apply for the company to be **wound up** on "just and equitable" grounds.

A. Standard rights and remedies

28175 The table below **summarises** the rights and remedies granted to shareholders by statute, Table A and/or the Model Articles. Most of these impose qualification requirements (chiefly, to hold a certain percentage of the shares in the company) on the shareholder(s) exercising them. Each right/remedy is discussed within its appropriate topic at the cross-reference given. Companies often provide for **additional** rights, or **alter standard** rights where this is possible (marked with an * in the table) in their constitutions, shareholders' agreements or other contracts (such as the terms on which new shares are issued). Therefore these documents must be consulted for a full picture of the shareholder rights applicable to a particular company. Where additional or altered rights are set out, there may be conflict between different documents. The right that takes precedence depends upon the source document's status; this is discussed below (¶28225+).

Right	Qualification[1]	¶¶
Meetings		
Have an item placed on a public company AGM agenda	At least 5% with the right to vote at the meeting[2]	¶31550+
Refuse consent to a public company AGM being held on short notice	None	¶31615
Requisition a general meeting	At least 5% of the paid-up share capital with the right to vote at the meeting	¶29860+
Apply for a court order for a general meeting to be held	Any shareholder entitled to vote at the meeting	¶29980+
Refuse consent to a general meeting being held on short notice*	Private companies: more than 10% voting on the resolution (can be reduced to 5% in the articles) Public companies: more than 5% voting on the resolution	¶30275+
Receive notice*	None	¶30375+
Circulate a written statement before a general meeting	At least 5% with the right to vote at the meeting[2]	¶30180+
Vote*	Hold shares with the right to vote	¶30965+

Right	Qualification[1]	¶¶
Demand a poll	Table A, on most resolutions: – the chairman – at least one shareholder with at least 10% of the paid-up share capital on shares entitled to vote; – at least two shareholders with the right to vote; or – at least one shareholder having at least 10% of total voting rights of all shareholders having the right to vote. The Model Articles, on most resolutions: – the chairman; – the directors; – at least 2 shareholders with the right to vote; or – at least one shareholder having at least 10% of total voting rights of all shareholders having the right to vote. The right can be restricted on resolutions to appoint a chairman or adjourn the meeting	¶31110+
Block a special/extraordinary resolution*[3]	More than 25% voting on the resolution	¶29415+ ¶29455
Block an ordinary resolution	50% voting on the resolution	¶29355+
Block a written resolution (statutory procedure)	– Ordinary written resolution: 50% voting on the resolution – special written resolution: more than 25% voting on the resolution	¶29230+
Inspect general meeting minutes	None	¶31290
Shares		
Receive dividend*	As set out in the articles/dividend policy/shareholder agreement. Otherwise, shareholders have the right to receive any dividends declared on their shares	¶18710+
Benefit from any increase in the value of the shares*	None	-
Dispose of the shares subject to any restrictions*	None	¶20100+
Receive a share certificate	None	¶20530+
Have his name entered on the register	None (although the position is different for certain types of shareholder, e.g. personal representatives)	¶46265+
Receive a copy of the annual accounts	None	¶48690+
Requisition a public company to exercise its power to obtain information regarding interests in its shares	At least 10% of the paid-up share capital with voting rights	¶26950+
Obtain remedies/take action		
Remove a director from office*	More than 50% voting on the resolution (although this may be subject to weighted voting rights)	¶40370+
Apply for rectification of the register of shareholders	Person aggrieved	¶46770+
Object to a variation of class rights	– At least 15% of the issued shares in the relevant class; and – who did not approve the variation	¶15330+

Right	Qualification[1]	¶¶
Apply to court for a special resolution to re-register a public company as private to be cancelled	Did not approve the resolution and[4]: – holds at least 5% of the share capital; – holds at least 5% of the shares in any one class; or – 50 shareholders	¶4570
Restrain an act that is beyond the company's powers as set out in its constitution	None	¶34670
Not to be unfairly prejudiced	None, but usually used by minority or 50/50 shareholders	¶28445+
Have the company wound up	None	¶28610+
Bring a derivative claim	None	¶28375+
Apply to the CIB for inspectors to investigate the affairs or ownership of the company[5]	– Hold at least 10% of the issued shares[6]; – 200 shareholders; or – the company (i.e. the action is either approved by ordinary resolution, or the shareholders have instructed the directors by special resolution to make the application)	¶60350, ¶60630
Block approval of a loan to a director*	50% voting on the resolution	¶36380+
Declare an unauthorised loan to a director void	More than 50% voting on the resolution	¶36640
Declare an unauthorised transaction void	More than 50% voting on the resolution	¶37395
Declare an unauthorised transaction to which a director is a party void	More than 50% voting on the resolution	¶36240
Block the approval of a substantial property transaction/declare transaction void	50% voting on the resolution	¶36310+
Apply to the court to have a resolution approving a redemption/purchase of the company's own shares out of capital cancelled	Any shareholder who did not approve the resolution[7]	¶16870+
Be bought out where a takeover offer has been made for all of the shares in the company (minority shareholders only)	– Shareholder did not accept the offer; and – the offeror has acquired 90% of the company's shares, together with 90% of the voting rights carried by those shares[8]	¶79725+

* Companies can **change** these shareholder rights, but restrictions usually apply. See any cross-references for details.

Note:
1. Where a percentage shareholding is required, the shareholder(s) exercising the power must hold that percentage of the type of shares stated. If the company is not limited by shares, the figure should be read as referring to a percentage of the number of members, unless otherwise stated.
2. Alternatively, at least 100 shareholders who have the right to vote at the meeting to which the requisition/statement relates can have an item placed on the agenda, provided they have paid up an average of at least £100 each.
3. Extraordinary resolutions are no longer required by statute, but a company's articles or another agreement can still require a decision to be made in this form.
4. If the company does not have a share capital, at least 5% of its members can apply.
5. Anonymous complaints can also be made through the complaints section of the CIB website, in which case there is no qualification requirement.
6. If the company does not have a share capital, 20% in number of the registered members can apply.
7. An application can also be made by any creditor.
8. If the offer relates to different classes of shares, both thresholds will have to be met in relation to each class.

B. Sources and status

Companies often deal with additional shareholder rights or alter standard ones in their articles or shareholders' agreements. The **choice of source** can depend upon different factors, most importantly: 28225
– **publicity**: the articles are a public document, whereas shareholders' agreements are private;
– **enforceability**: shareholders' agreements can be enforced by and against whoever is made a party to them, whereas the articles bind the shareholders as shareholders but not in other capacities; and
– ease of **amendment**: altering the articles requires a special resolution, whereas altering a shareholders' agreement requires the consent of all of the parties to the agreement.

Often, the **articles** deal with more administrative and managerial matters, whilst a shareholders' agreement deals with personal rights (for example, to appoint a director, agreements between the shareholders as to how they will vote on certain matters and so on). **Shareholders' agreements** are therefore more common either in smaller companies which are run as quasi-partnerships, to ensure that personal interests do not impact on the company, or in joint venture companies where shareholders may have competing interests (¶5000+). Note that even certain matters in a shareholders' agreement will be a matter of public record if the company is under an obligation to notify them to Companies House, for example, class rights (¶13095, ¶15225), although in general the agreement itself can be kept private.

MEMO POINTS Rights attaching to particular classes of shares may be set out in the **terms of the share issue**. The usual share rights are dealt with at ¶10355+.

Shareholders' ability to **rely on, vary** and **enforce** their rights depends upon the status of the source of that right. There can sometimes be an overlap between a right that is, for example, originally contained in statute, but modified in the articles and further amended in a shareholders' agreement. Here, the issues relating to the status of the **articles and shareholder agreements** as they relate to shareholders are addressed; there is a wider discussion (including to what extent the company is bound) at ¶3100+. 28230

Some rights and remedies contained in **statute** can be modified by the company (marked with an * in the table at ¶28175), but many cannot. If a statutory right cannot be modified, any provision in the articles purporting to change it will be invalid. A provision in a shareholders' agreement which tries to modify such a right will not prevent the shareholder from relying on the right as set out in the legislation, but the other parties to the shareholders' agreement could still sue him for breach of contract.

Articles

A shareholder's **relationship with the company** is a contractual one, governed by the articles (*Prudential Assurance Co Ltd v Newman Industries Ltd* (No 2) [1982] 1 All ER 354). 28235

Once registered at Companies House, the articles contractually **bind** the shareholders as if they had all personally signed and sealed the document. Although the contract is between the company and its shareholders, the company is not deemed to have executed the articles in the same way. Therefore, the shareholders are bound to each other by the constitution, but the company and shareholders are only bound in relation to each person's rights as a shareholder of the company. This means that a shareholder can only rely on the articles to **protect** his rights as a shareholder; a director/shareholder, for example, could not rely on the articles to enforce his rights as a director (such as the right to be paid for his services).

The terms of the articles can be **varied by**: 28240
– special resolution (subject to any restrictions in the legislation and common law, see ¶3345+);
– the express agreement of all shareholders; or
– the acquiescence of all shareholders to a change over a period of time.

Therefore, if a **shareholders' agreement** which is executed by all of the shareholders **contradicts** a regulation in the **articles**, the amended version in the shareholders' agreement will take precedence over the articles, provided it would have been a valid alteration to the articles, because all of the shareholders have expressly consented to the change. The terms of such a change would still have to be registered at Companies House (ss 29, 30 CA 2006).

MEMO POINTS For examples of changes that companies often make to **Table A**, see ¶3285+.

28245 If the terms of the articles are breached, shareholders can take action to **enforce** the contract, provided their rights as shareholders have been affected (for example, pre-emption rights).

MEMO POINTS 1. The constitution cannot be enforced by a **third party**, even if he is affected by the breach.
2. Particular **rules** apply to **actions by shareholders**, whether brought individually or on behalf of the company (see ¶59100+).

Shareholders' agreements

28250 Many companies choose to have a shareholders' agreement as well as articles because it has a number of **advantages**. The main ones are:
a. certainty about who can enforce the agreement, as the normal rules of contract will apply. Therefore, shareholders will be able to enforce any term (whether it relates to their status as shareholders or not);
b. the company and/or individual directors can also be made parties, in which case the agreement can be enforced against (and by) them. This is useful if the agreement deals with managerial decisions, such as which decisions need to be referred to the shareholders;
c. it is not a matter of public record (unlike the articles), unless its terms alter the articles or it sets out class rights. If this is the case, companies will usually file the appropriate resolution or form at Companies House rather than the whole shareholders' agreement; and
d. it gives minority shareholders more power and security since they may have a better chance of negotiating matters into a shareholders' agreement than changing the articles.

MEMO POINTS 1. Shareholders' agreements are often used in **quasi-partnerships** and **joint ventures** to record the intentions of the parties as to how the business should be run and how much managerial involvement the shareholders should have. This can help where the parties are in dispute, particularly if one party applies for the company to be wound up or for relief from unfair prejudice, because it provides evidence as to whether the company is being managed as agreed.
2. **Alternatives** to a shareholders' agreement are irrevocable undertakings (which tend to be used in takeover situations to ensure that shareholders vote in favour of the takeover) and voting trusts (which are rare).
3. If the shareholders' agreement **creates or varies class rights**, Companies House must be notified (¶15225).

28255 A shareholders' agreement can **deal with** any matters at all, commonly addressing any combination of:
– management issues;
– corporate objectives, social responsibility and similar issues;
– funding;
– the rules of membership, such as qualification and exit routes;
– class rights, including weighted voting rights on resolutions such as altering the articles or removing a director;
– transactions which cannot be approved without shareholder consent. These will usually be significant matters such as acquisitions, mergers, borrowing and disposing of company assets;
– the appointment and remuneration of the directors and secretary;
– the appointment of auditors and bankers;
– pre-emption rights (whether in addition to those in the articles, or a statement as to how the shareholders will exercise those rights); and
– dividends (for example, regulating their payment at certain intervals).

The agreement **operates by** the shareholders agreeing to use their voting power in accordance with it, for example, to approve certain types of resolution, or to instruct the board to act in a particular way by passing a special resolution. 28260

Just as a shareholder is free to **use his vote** as he wishes (¶31000+), he is free to bind himself to use it in a particular way. An exception to this is where a **director/shareholder** binds himself to act in a manner contrary to the best interests of the company, as this would breach his fiduciary duties as a director. Similarly, if the **company is a party** to the agreement, it cannot bind itself to fetter its statutory powers (for example, by agreeing not to change the articles, or agreeing not to alter the share capital of the company) (*Russell v Northern Bank Development Corp Ltd* [1992] 3 All ER 161). Therefore, if such terms are included in a shareholders' agreement, the parties should be aware that they are not enforceable against the company or a director and should consider whether the company or directors need to be parties to the agreement.

Like other contracts, a shareholders' agreement only binds the parties to it. Therefore, **existing shareholders** are usually required to sign it. The **company** and/or its **directors** may also need to be parties to the agreement if it imposes obligations on them (however, note that some obligations will not be enforceable against them, ¶28260 above). 28265

The agreement should contain a provision which ensures that all **new shareholders** entering the company sign a "deed of adherence" before their shares are transferred to them, so that they are bound by the same agreement.

If the agreement is just between shareholders who are being allotted shares, the consideration paid for the shares can be valid consideration for the agreement and it can be **executed** as a contract. If there is any doubt as to consideration, such as where the company or its non-shareholding directors are parties, it can be executed as a deed.

MEMO POINTS Often **minor shareholders**, particularly employees who have received shares as part of their remuneration, do not sign a shareholders' agreement for practical and administrative reasons.

Shareholders' agreements can be **varied** with the consent of all parties to it, in the same way as other contracts. Therefore, a contract documenting the changes or a deed of variation should be entered into, or a new shareholders' agreement drawn up and executed by all of the parties. 28270

If the agreement is **breached**, the usual remedy sought is an injunction from the court, either to order the defaulting party to act in accordance with the terms or to prevent him from breaching the agreement. As with any other contract, if a breach has resulted in loss to the innocent party, damages may also be awarded (although a shareholder's ability to recover his losses will be limited if they merely reflect the losses of the company, see ¶37175). 28275

C. Remedies of last resort

The table at ¶28175 above summarises the remedies available to shareholders if actions are taken by the company to their detriment, or proper procedures are not followed. Most of these remedies can be employed by a shareholder with no need to apply to court (or only a simple application is required) and are therefore reasonably simple and cost-effective. However, there are **circumstances** in which these remedies will be inadequate. A shareholder, particularly one who is in the minority, may feel that he has been taken advantage of and has exhausted the relevant "self-help" remedies, or his relationship with the company may have deteriorated to the extent that the situation cannot be resolved. It may even be the case that he feels that the company has manipulated its legal powers to prejudice him, so it is not possible for him to object to the company's conduct via internal channels. In such cases, there are three remedies of last resort that can be relied on by the shareholder: 28325

– a **derivative claim**, by which a shareholder brings a claim that the company itself should have brought (for example, against a director for breach of duty). The remedy sought must therefore be for the benefit of the company, rather than the individual shareholder;
– an application for **relief from unfair prejudice**, by which a shareholder seeks the court's assistance to rectify the unfair treatment he has suffered. This often results in the court providing the aggrieved shareholder with a fair exit strategy, allowing the company to carry on without him; and
– **winding the company up**, by which the shareholder can ensure that the conduct of the company is investigated and that he receives anything to which he is entitled on exiting the company. However, the company will ultimately be dissolved.

These remedies are only used as a last resort because the court proceedings can be expensive, time-consuming and complex, and they often result in the disadvantaged shareholder leaving the company or the company ceasing to exist.

MEMO POINTS Applying for relief from unfair prejudice and to wind the company up are often referred to as "**minority shareholder remedies**". However, this term has not been used here because they are not specifically restricted to minority shareholders (for example, applications are just as likely to be made in the case of a deadlocked company in which the shareholding is split equally between two shareholders) and these are not the only remedies available to minority shareholders (most of those summarised in the table at ¶28175 can also be employed by them).

1. Derivative claims

28375 In certain circumstances, **proceedings that should be commenced in the company's name** (because the company suffered the wrong) can be commenced in the name of a shareholder or a group of shareholders. This is an exception to the proper claimant principle (see ¶59155).

These are known as "derivative claims" because the individual derives his right of action from the company. Whether a claim is a true derivative claim or whether alternative action should be taken instead (for example, for unfair prejudice, ¶28445+) will depend entirely on the circumstances of the case.

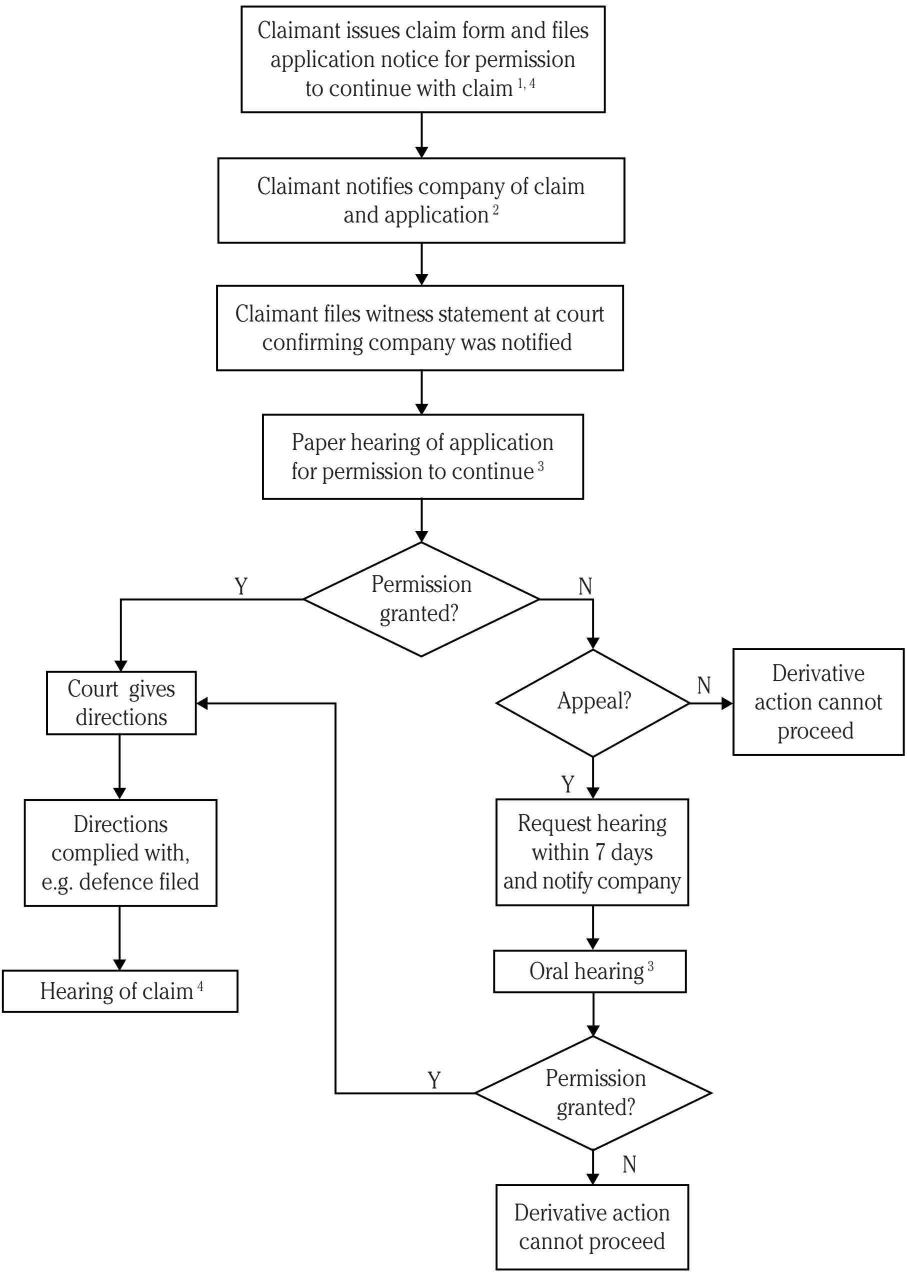
The right to bring a derivative claim and the procedure for doing so are set out in statute and the CPR.

28380 The statutory provisions cover the most common **situation** in which a shareholder may need to bring a derivative claim, that is, where the company has a right of action against a director for his (actual or proposed) negligence, default, breach of duty or breach of trust (s 260 CA 2006). The claim does not necessarily have to be brought against the director (it could be brought against a person who has benefited from the act or omission complained of as well as, or instead of, the director) and the claim can still be pursued even if the director has not benefited from his wrongdoing.

MEMO POINTS Derivative claims may also be brought in **other situations** under the Act, but only where a shareholder has applied to the court for relief from unfair prejudice (see ¶28445+). As part of its discretion to make any order that is appropriate in the circumstances, the court can order that proceedings are commenced in the name and on behalf of the company by any person, including a shareholder (s 996 CA 2006). In this case, there is no need for the shareholder to apply to court for permission to continue with the claim because such an order replaces the "filter" stage in the derivative claim procedure.

28385 The **conditions** for bringing a derivative claim under statute are that:
– the claimant is a shareholder of the company. This is widely defined to include those to whom shares have been automatically transferred or transmitted (for example, on the shareholder's death or bankruptcy) and those who were not shareholders when the cause of action arose (this is because the cause of action belongs to the company, not individual shareholders);
– the cause of action is vested in the company; and
– relief must be sought for the company's benefit and not the shareholder's.

In order to prevent shareholders using their right to bring a derivative claim in inappropriate circumstances, the **procedure** for these claims has a built-in "filter" stage that requires the shareholder to apply to court for permission to proceed with his claim (ss 260-264 CA 2006). The procedure is set out in the CPR, and is summarised in the following flowchart (r 19.9-19.9F CPR; CPR PD 19C). 28390



Note:

1. The **claim form** must be headed "derivative claim" and the company should be named as a defendant to the action.

2. **Copies** of all of the documents filed at court must be included with the notice, together with a copy of s 263(1)-(4) CA 2006, which sets out the factors the court will take into account when making its decision (see ¶28395 below).

The court can allow the claimant to **delay** notifying the company of the claim if it is satisfied that it would be likely to jeopardise part of the remedy sought. If the claimant wants to apply to court for permission to delay notification, he should do so at the same time as submitting the claim form and application for permission to continue to court (or as soon as possible after that). He does not have to give notice of the application to delay notification to the company.

3. A **paper hearing** means that the judge (either a Chancery Division High Court judge if the claim was issued in the High Court, or a circuit judge if it was issued in the county court) will decide whether the derivative claim should be allowed to proceed on the basis of the papers filed at court without the parties being present. Any **oral appeal hearing** will take place in court.

4. The court has the power to order the company to indemnify the claimant for his **costs** of bringing the claim (including the costs incurred in making the application for permission to continue). The claimant should state that he wants such an order to be made on his claim form. If a court makes such an order at the "filter" stage, the order should place a **cap** on the amount of costs for which the indemnity is granted or be **limited to** a specified stage in the derivative proceedings (*Stainer v Lee and others* [2010] EWHC 1539 (Ch)). This is because it is difficult for the court to assess the reasonableness of costs in advance of them being incurred. For example, a reasonable offer for settlement could be made at any time, which might render the costs of continuing the proceedings unreasonable. The claimant could then make applications for further orders as necessary as the derivative proceedings progress.

MEMO POINTS 1. This procedure **applies to** derivative claims:
– brought by a shareholder;
– taken over by a shareholder after the company has already commenced proceedings;
– that arise during the course of other proceedings; and
– that are not taken under the Companies Act (against bodies corporate to which the derivative claims provisions do not apply, or against trade unions).

The procedure **does not apply to** a derivative claim that is brought as part of the remedy awarded by the court for relief from unfair prejudice (see ¶28445+). This is because permission to commence a derivative claim is given by the court in the order made in the unfair prejudice proceedings, so there is no need for the "filter" stage.

2. Normally, the decision as to whether permission will be granted is made without **representations** (written in the case of a paper hearing, and in person in the case of an oral second hearing) from the company. If the company decides to make representations to court without being invited to do so, it will not usually be allowed to recover the related costs.

28395 In deciding **whether or not the claim should** be allowed to **continue**, the court will look at each of the following **factors**, to the extent that they are relevant (s 263 CA 2006):
– whether the shareholder is acting in good faith;
– the importance that a hypothetical director, acting in accordance with his duty to promote the success of the company, would attach to continuing the claim. This should encompass the likelihood of success of the claim, as a director acting to promote the success of the company would not pursue a claim that was unlikely to succeed (*Kleanthos v Paphitis and others* [2011] All ER (D) 33 (Sep));
– whether the act or omission giving rise to the cause of action could (and would be likely to) be authorised or ratified by the company;
– whether the company has decided not to pursue the claim;
– whether the act or omission gives the shareholder the right to pursue court action in his own right instead; and
– evidence of the views of other shareholders without a personal interest in the claim.

This list is **not exhaustive** and the particular circumstances of the case may require additional factors to be considered too, for example the potential effect of the proceedings on the company's employees or former employees (*Stimpson and others v Southern Private Landlords Association* [2009] EWHC 2072 (Ch)).

Where a **majority shareholder** wishes to pursue a derivative action, permission to continue the claim will only be granted in exceptional circumstances. It is difficult to envisage what such exceptional circumstances might be, since a majority shareholder has control of the company and so should be able to ensure that the company itself pursues the action, or remove the directors who are refusing to act on the majority shareholder's instructions to do so (*Cinematic Finance Ltd v Ryder and ors* [2010] Ch D 21/10/2010 (unreported)).

The claim will **not** be **allowed to continue** if:
– a person acting in accordance with the duty to promote the success of the company would not pursue the claim; or
– if the act or omission complained of has been authorised or ratified by the company.

EXAMPLE Mr S was a member and director of SPLA (a company limited by guarantee). He sought permission to bring a claim in SPLA's name against other directors for breach of duty. SPLA was, in reality, a not-for-profit trade association whose members paid an annual subscription to obtain the benefit of various services. Mr S alleged that the other directors had breached their statutory fiduciary duties in appointing a further director and transferring all of SPLA's assets to another larger company, NLA, as part of an amalgamation. The court considered **whether a hypothetical director** acting in accordance with his duty to promote the success of the company **would seek to continue the claim**. The court concluded that he would not because:
– only one of the alleged breaches of duty was realistically arguable;
– the value of the claim was modest;
– the costs of the litigation would be relatively substantial and partly irrecoverable; and
– if unsuccessful the claim would expose SPLA to the risk of insolvency.
Furthermore the court commented that it would have refused permission to continue the claim because there was no evidence that the merger was not beneficial to SPLA's members, which suggested a lack of good faith on Mr S's part (*Stimpson and others v Southern Private Landlords Association*, above).

MEMO POINTS The explanatory notes to the Act state that claims should only be allowed to proceed **against third parties** in limited circumstances where the third party was somehow involved in or at least aware of the director's breach, such as knowingly receiving property transferred in breach of trust (Para 494 Explanatory Notes to CA 2006).

2. Unfair prejudice

Shareholders can apply to court for a remedy if they have suffered "unfair prejudice" to their interests as shareholders because of the way in which the company has been run (s 994 CA 2006). This remedy **protects** shareholders who do not have the power to rectify or object to unfairly prejudicial conduct internally. **28445**

These applications are **most commonly used** where disputes arise in small owner-managed companies, since the success of the company depends on the personalities involved. Such companies are often run on a quasi-partnership basis by directors/shareholders who had some kind of agreement (whether in writing or not) that each "partner" would be involved in running the business. When one "partner" is excluded and he does not have a majority shareholding (or there is a deadlock), he may have no choice but to apply to the court for a fair resolution of the dispute. Court action tends to be expensive and time-consuming, and so this shareholder remedy is only used as a last resort when relations have broken down between the parties. Therefore, the remedy usually awarded by the court is to provide the excluded director/shareholder with a fair exit route from the company.

MEMO POINTS 1. Applications can also be made by **personal representatives** and **trustees in bankruptcy** (s 994(2) CA 2006). Since the remedy can be used by those to whom shares have been transferred by operation of law, they do not have to elect to have their names registered as shareholders in order to make the application. A case decided under the CA 1985 provision held that even a **transferor** of shares which have been transferred but not registered has standing to petition for unfair prejudice, since he still falls within the statutory definition of "shareholder", and the **transferee** on the other side of the transfer also has standing for a period between the transfer and registration (now s 112 CA 2006; *Re McCarthy Surfacing Ltd*, *Hecquet v McCarthy* [2006] EWHC 832 (Ch)).
2. **Majority shareholders** are not usually protected by this remedy because they have the power to correct unfair prejudice, for example, by removing a director or declaring an unauthorised transaction void.
3. The **secretary of state** can also make such an application if the company has been investigated by the CIB or FSA (s 995 CA 2006).

a. Elements of the application

28465 A shareholder's application must **establish** three aspects in order to succeed:
– that he has been unfairly prejudiced;
– that the unfair prejudice relates to the conduct of the company's affairs; and
– that the unfair prejudice affects his interests as a shareholder (or the interests of the shareholders generally).

The conduct **must be both** prejudicial (in the sense of causing prejudice or harm to the relevant interest) and unfairly so. Conduct may be unfair without being prejudicial, or prejudicial without being unfair, and it is not sufficient if the conduct satisfies only one of these tests (*Re a Company (No 005685 of 1988), ex parte Schwarcz (No 2)* [1989] BCLC 427).

Unfairly prejudicial conduct

28470 The interpretation of what is unfairly prejudicial conduct has evolved through case law, with **two main types** emerging (*Re a Company (No 00709 of 1992)*, *O'Neill v Phillips* [1999] 2 All ER 961):
– **breach of an agreement** as to how the company was to be run; and
– usage of the rules governing the company in **bad faith**.

An application can be based on **proposed** unfairly prejudicial **acts**, although it should not be made prematurely (for example, where there are still internal methods of opposition that the shareholder can pursue, or where the proposed act is just a possibility) (s 994(1) CA 2006; *Re Astec (BSR) plc* [1998] 2 BCLC 556; *Re a Company (No 005685 of 1988), ex parte Schwarcz (No 2)* [1989] BCLC 427). An application can also be based on unfairly prejudicial conduct that **occurred in the past**, even if it has been remedied by the time of the petition (*Re Kenyon Swansea Ltd* [1987] BCLC 514).

The court will take the **conduct of** the **petitioner and** the **respondent** into account when assessing whether or not the conduct complained of has been unfair. For example, where the parties agreed that the petitioner would contribute to the management of the company but he failed to do so, the company was justified in excluding him from running the business and his petition failed (*Re RA Noble & Sons (Clothing) Ltd* [1983] BCLC 273). The court is not confined to considering conduct which took place prior to the petition, as it is entitled to look at the past, present and future circumstances of the case (*Grace v Biagioli* [2005] EWCA Civ 1222).

MEMO POINTS In addition to these two main types, conduct which can be found to be unfairly prejudicial includes:
– **removal of an auditor** from office because he disagreed with the company on a professional matter (i.e. regarding accounting treatments or audit procedures) or for another improper reason (s 994(1A) CA 2006). This is to ensure that statutory auditors may only be dismissed on proper grounds. An application using this ground must still be brought by the shareholder(s) whose interests have been prejudiced by the auditors' removal (and not the auditor); and
– **criminal offences** being committed (*Bermuda Cablevision Ltd v Colica Trust Co Ltd* [1998] AC 198).

Breach of an agreement

28475 Cases falling into this category usually involve the **directors abusing their powers** resulting in:
– an infringement of the company's constitution;
– breach of the directors' duties;
– an infringement of the shareholder's statutory rights; or
– mismanagement.

In many companies, the situation can be resolved by removing the director in question, or by the company taking action against him for breach of his duties (¶40215+, ¶36790+). However, where the majority shareholders are also the directors who commit the abuse, the minority will not have enough voting power to invoke such action and will have to resort to an unfair prejudice application.

EXAMPLE

Breach of the company's constitution
Where the conduct complained of is not in accordance with the constitution and unfair prejudice has been suffered by the shareholder as a result (where the shareholders have agreed to informally

relax the articles, unfairness will be assessed against what they actually agreed, rather than against the written articles (*Fisher v Cadman and others* [2005] EWHC 377 (Ch))).

Breach of directors' duties
1. Where the company's assets are misappropriated, such as where the director/shareholder majority runs the business down to devalue the minority's shareholding, and/or transfers the business and/or assets to a separate company run by the majority.
2. Where the board makes improper allotments of shares in order to dilute the minority's shareholding further (*Re Coloursource Ltd*, *Dalby v Bodilly* [2004] EWHC 3078 (Ch), in which a director/50% shareholder allotted himself shares to dilute the other 50% shareholder's holding).

Breach of shareholders' statutory rights
Not laying accounts before the shareholders, or not following the statutory pre-emption procedure where necessary. If a shareholder is to obtain relief from unfair prejudice on this footing, the infringement must be significant (i.e. more than a technical infringement of the legislation) and not curable by the minority (for example, if a general meeting has not been called because it was impractical, a shareholder can apply to court to order a meeting instead (¶29980+)).

Mismanagement
Where serious mismanagement (for example over a number of years) results in financial loss thereby devaluing the shares (*Re Macro (Ipswich) Ltd*, *Re Earliba Finance Co Ltd*, *Macro v Thompson* [1994] 2 BCLC 354).

MEMO POINTS 1. Failure to comply with **non-statutory codes** relating to **public companies** (for example, the Listing Rules and the City Code on Takeovers and Mergers) has been held, in the circumstances of the case in question, not to amount to unfair prejudice (*Re Astec (BSR) plc* [1998] 2 BCLC 556).
2. **Poor management** is not, in itself, enough to form the basis of an application for unfair prejudice because the court will not resolve commercial decisions for the company, and poor management is part of the risk of being a shareholder (hence the shareholders' powers to deal with this problem, ¶26360+, ¶26420+). On the other hand, if poor management amounts to a breach of the director's **duty to exercise care**, **skill and diligence**, his actions can form the basis of an application (*Re Elgindata Ltd* [1991] BCLC 959).

Bad faith

If one or more of the director/shareholders uses his position to **take advantage** of the other(s), the injured party may be able to claim that he has been unfairly prejudiced. This type of unfair prejudice can be distinguished from breach of an agreement, because the director's/shareholder's actions are legal and technically proper, but his bad faith makes them inequitable in the circumstances. Usually, in such cases, the petitioner claims that the articles have been qualified by an agreement or understanding between the parties (typically in **quasi-partnership** companies), which was then unfairly breached. **28480**

The most common basis for these applications is that one of the **directors/shareholders** has been **removed from office** by other shareholders using their statutory power (¶40370+) in contravention of an agreement that all or certain shareholders would be involved in the management of the company. The shareholder will be unfairly prejudiced if he has been excluded from management and **cannot give up his membership** because he has not been given a fair offer for his shares (¶28555 below) and, usually, cannot transfer them freely because of restrictions in the articles or a shareholders' agreement (*Re a Company (No 00709 of 1992)*, *O'Neill v Phillips* [1999] 2 All ER 961; contrast with *Re Phoenix Office Supplies Ltd*, *Phoenix Office Supplies Ltd v Larvin* [2003] 1 BCLC 76, in which the petitioner had not shown that he had been unfairly prejudiced, since he had severed his connection with the company voluntarily for personal reasons). Although the shareholders are legally entitled to remove a director and insist on compliance with any restrictions on the transfer of shares, the court may grant the excluded shareholder a remedy on the equitable ground that it was unfair for the shareholders to behave in this way.

EXAMPLE
1. Mr L and Mr H were the sole directors and shareholders of HGC Ltd, a small joint venture company. After a period of illness, Mr L claimed that Mr H had embarked on a course of conduct to seize control of HGC Ltd. Mr L alleged that Mr H had (amongst other things):
– changed the registered office address of HGC Ltd from its accountant's office to Mr H's home address without consulting Mr L and had subsequently run the company's business from his home without reference to Mr L; and;

– informed Companies House of Mr L's purported removal as a director, even though the resolution removing Mr L was invalid (because the general meeting at which it was considered was inquorate). Mr H also subsequently informed HGC Ltd's bankers and other relevant parties that Mr L was no longer a director.
The court had no doubt that these, and the other allegations, were unfairly prejudicial to Mr L's interests as a shareholder (*Re Hedgehog Golf Company Ltd*, *Lantsbury v Hauser and another* [2010] EWHC 390 (Ch)).
2. MDL Ltd was established as a quasi-partnership between four brothers. It was later converted into a plc and renamed MDI plc. After a long period of disputes, the relationship between CS and his three brothers had seriously broken down. CS was unwilling to allow them to continue to perform any work in the company's business and sought to keep the running of MDI plc to himself. His brothers turned up at MDI plc's premises and were refusing not to work. Discussions commenced regarding the sale of the three brothers' shares to CS, but one of the brothers, DS, was unwilling to sell his shares to CS without an independent valuation being carried out, which CS was not prepared to agree to. Thereafter, CS gave no further offers to buy DS's shares and acted to remove him from his functions as a director of MDI plc and sideline him from overall decision making regarding its business by:
– changing the bank mandate, effectively removing DS;
– moving MDI plc's bank accounts without consulting DS; and
– appointing a new company secretary without reference to DS.
The High Court found that the exclusion of DS without an appropriate offer to buy his shares was in itself sufficient to constitute unfair prejudice (*Shah v Shah and others* [2010] EWHC 313 (Ch)).

MEMO POINTS Another way in which a shareholder can be excluded is if he has effectively been **denied dividends** because the board has not been declaring them whilst the remuneration packages of the director/shareholders have been structured so that they receive what would have been dividends as salary/bonuses, in contravention of an agreement that all shareholders would share equally in the profits (*Quinlan v Essex Hinge Co Ltd* [1996] 2 BCLC 417).

28485 For this argument to succeed, the prejudiced party must **show that**:
– the company is, or was at the time in question, run as a quasi-partnership company;
– there was an agreement as to how the company was run (which can be evidenced by a shareholders' agreement, for example, or the parties' conduct);
– which he relied upon; and
– the other "partner(s)" breached that agreement by using his/their legal powers in a certain way.

The court will determine whether or not the company is, or was, run as a quasi-partnership company by examining the circumstances, looking in particular for one or more of the following **characteristics**:
a. the business relies on a personal relationship between the parties which is based on mutual trust and confidence;
b. there is an agreement, or at least an unwritten understanding, that all or some of the shareholders will play an active role in managing the business and will benefit from its profits; and/or
c. there are restrictions on transfers of shares, preventing a shareholder from selling them to an outsider.

EXAMPLE A director had (amongst other things) failed to adhere to his **agreed management role** and had improperly asserted rights to take control of the board, thereby:
– destroying the relationship of trust and confidence between himself (as a shareholder) and the petitioning shareholder;
– destroying the chance of accepting much needed funding under a finance proposal; and
– disrupting and distracting the management of the company.
Although in this case the conduct of the petitioning shareholder could also be criticised, the court found that its misconduct was, in comparison, very minor. To meet the overall justice of the case it ordered the director to sell his shares in the company to the petitioning shareholder (*Oak Investment Partners XII, Limited Partnership v Boughtwood and others* [2009] EWHC 176 (Ch)).
The director appealed against this decision requesting a reconsideration of the order so that it was the other way around (namely, the petitioning shareholder selling its shares to the director). His appeal was based on the arguments that:
– the company's business was originally his;
– he had invented the technology which was being represented by the company; and
– the petitioning shareholder was purely a commercial investor.

His appeal was dismissed by the Court of Appeal, which found that the High Court judge had been correct in carrying out the balancing exercise required where each party alleged unfairly prejudicial conduct by the other (*Boughtwood v Oak Investment Partners XII, Limited Partnership* [2010] EWCA Civ 23).

MEMO POINTS 1. Factors which would indicate to the court that the company is **not** run on a **quasi-partnership** basis are those which demonstrate a more commercial outlook, such as very detailed directors' service agreements which have been drafted on legal advice (*Re a Company (No 005685 of 1988), ex parte Schwarcz (No 2)* [1989] BCLC 427).
2. It would not be sufficient to claim unfair prejudice simply because the **relationship** of trust and confidence between the parties has **broken down**, without some further abuse of the rules and the lack of a fair offer to buy the prejudiced party out. The appropriate remedy in this situation would be a winding up by the court on the just and equitable ground.