CORPORATE

Shareholder disputes: What happens when shareholders disagree?

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Overview

This factsheet provides a brief overview of the legal options a shareholder may have should a dispute arise, namely, presenting an unfair prejudice petition under Section 994 of the Companies Act 2006; presenting a petition to wind up the company on just and equitable grounds as per Section 122(1)(g) of the Insolvency Act 1986 or bringing a derivative claim under Section 260 of the Companies Act 2006.

We describe here the main claims available when there is a shareholder dispute. However, a shareholder dispute does not always end up in litigation and consideration should also be given to opportunities such as share buybacks, splitting the business or variation of rights. It is worth noting also that shareholder disputes often involve wide ranging ancillary issues, such removal of directors and termination of employment contracts.

It is important therefore to consider getting advice from corporate or employment solicitors in tandem with any dispute resolution or litigation advice you receive in relation to a shareholder dispute.

How do shareholder disputes arise?

Like any relationship, there can be many reasons why a dispute may arise, and shareholder disputes are no different. More often than not, disputes come from a difference of opinion on strategy or deadlock between shareholders. Majority shareholders running a business to the detriment of minority shareholders is commonplace too.

What is clear is that shareholder disputes regularly happen when a detailed shareholder agreement or articles of association are not in place. These should set out a clear process to cover the transfer of shares where there is a dispute and when this is lacking, it is easy for matters to escalate.

- Common reasons for shareholder disputes include:
- Disagreement over company strategy
- Company cannot operate due to deadlock between shareholders
- A company being run to the benefit of individual members, excluding others
- Parties being excluded from management of the company
- Parties acting fraudulently or in breach of their duties to the company
- Parties wishing to go their separate ways

Shareholder disputes – the law

Unfair prejudice petition

Companies incorporated under the Companies Act 1985 and the Companies Act 2006 can be subject to unfair prejudice claims. This is a statutory remedy available to shareholders of a company pursuant to Section 994 of the Companies Act 2006.

Unfair prejudice petitions can be brought by members of a company (including shareholders) and persons to whom shares have been transferred to who are not yet registered as members. On rare occasions, the Secretary of State for Business, Innovation and Skills can bring a petition based on investigations or reports that reveal unfairly prejudicial conduct of the company.

A member can petition for relief on the basis that the affairs of the company have been, are being or will be conducted in a way that is unfairly prejudicial to its members. This involves demonstrating acts or omissions (or proposed acts or omissions) of the company which are both unfair and prejudicial against the petitioner.

Common examples include:

- Failure to pay dividends
- Payment of excessive remuneration
- Minority shareholding being diluted
- Directors' breaches of their fiduciary duties
- Non-compliance with the Companies Act 2006
- Making loans to directors in contravention of the Companies Act or without ratification
- Exclusion from management of the company
- Failure to consult with, or provide information to, a member despite a prior agreement to do so
- Breaches of provisions of the articles of association or shareholders' agreements
- Inequitable conduct including causing an irrevocable breakdown of trust and confidence in a quasi-partnership
- Mismanagement of the company resulting in financial loss

For relief to be granted, both prejudice and unfairness must be shown, and the court takes an objective approach, applying established equitable principles. The starting point is the basis on which the petitioner agreed to become a member of the company which is often shown in the articles of association or shareholders' agreement.

It is open to the court to grant an order as it thinks fit to remedy any unfair prejudice, taking into account the interests of other shareholders and creditors. The most common order, however, is the purchase of the petitioner's shares at a value determined by the court. Other relief can include regulating the conduct of the company's affairs or requiring the company to refrain from, or to carry out, a certain act which can involve amending the articles of association.

The court will take into account the seriousness of the unfairly prejudicial conduct and the interests of other shareholders and creditors as well as the solvency of the company. Bars to relief can include an express provision in the articles of association or shareholder agreement, or misconduct on the part of the petitioner or a refusal of a fair offer to purchase their shares.

It is worth noting that the company cannot or should not fund the claim or the majority's defence to the claim because although the company is usually made a party, it is not a claim made by or against it.

Presenting a petition to wind up the company on just and equitable grounds

Companies incorporated under the Companies Act 1985 and the Companies Act 2006 (as well as certain foreign companies operating in the jurisdiction) can be subject to a petition to wind up the company on just and equitable grounds. The circumstances where a court will order this can be similar to those in which the court would grant relief on an unfair prejudice petition.

This remedy is available to the company, directors, prospective or contingent creditors and shareholders of a company pursuant to Section 122(1)(g) of the Insolvency Act 1986. Those that can present a petition extends beyond shareholders, but the nature of the just and equitable grounds mean they are normally presented by a minority shareholder.

The categories of just and equitable grounds can be wide ranging but the most common categories that petitions rely on include:

- Loss of substratum – this is where the original purpose of the company has been achieved or is no longer viable. The petitioner is usually required to show that the sole remaining purpose of the company is to be wound up to get its assets in.
- Deadlock – this is where there is a breakdown in relations which means that decisions concerning the company's business can no longer be reached.
- Mismanagement – this is where conduct of directors of the company leads to a justifiable loss of confidence in the management. They must be serious actions, for example fraud.
- Exclusion from management – if a quasi-partnership exists or there is an understanding that a shareholder is entitled to participate in management, then exclusion from this may be grounds for presenting a petition.

The only relief available is to wind up the company and the court will take into account the seriousness of the just and equitable grounds identified and the interests of other shareholders and creditors. It will also consider whether there should instead be an orderly winding down of the company's affairs. The bars to relief include the availability of an alternative remedy or the absence of any tangible benefit to the making of a winding up order.

It is worth noting that these petitions are not an insolvency procedure, and it must be shown that there would be a substantial surplus on a winding-up. As with unfair prejudice, the petition it is not a claim against the company so the company's assets should not be used to fund the claim or the defence.

Bringing a derivative claim

Companies incorporated under the Companies Act 1985 and the Companies Act 2006 can be subject to derivative claims pursuant to section 260 of the Companies Act 2006.

A derivative claim is a statutory remedy available to members of the company and persons to whom shares have been transferred who are not yet registered as a member. The size of the shareholding is relevant as to whether the court will permit a derivative claim. A derivative claim is brought on behalf of the company and for the benefit of the company.

A claim can be brought against directors (as well as third parties alongside directors) arising out of acts or omissions which constitute negligence, default, breach of duty or breach of trust.

When a derivative claim is issued, permission of the court to continue the claim must be sought. This will not be granted it the court finds that it is not in the company's interests, or the conduct has been authorised or ratified.

Forms of relief available include permission to continue a claim on behalf of the company commenced by the applicant, by the company or by another member. The member applying may also be indemnified for costs. The court will consider several factors including the good faith of the applicant, the likelihood of authorisation or ratification of the act or whether the company has decided not to pursue the claim

Potential claims for breach of contract

Although it will not be dealt with in detail here, there is potential for contractual remedies to be sought (such as damages or equitable remedies such as an injunction) for breach of a company's articles of association or a shareholders' agreement. Articles of association are considered binding and enforceable contracts between companies and their members and a shareholders' agreement is a contract between all or some of the shareholders.

How to prevent shareholder disputes

Prevention is the best cure in avoiding a shareholder dispute. Effective communication between parties is essential to preventing disputes and a vital part of this involves solid drafting of shareholder agreements and articles of association so that everyone knows where they stand.

The advice of a corporate lawyer should be sought from the outset to diligently draft shareholder agreements and articles of association which contain provisions that anticipate the possibility of a future dispute. They should set out ways to manage any potential future disputes in the best interests of the company. If there are no shareholder agreements or articles of association in place, it is a good idea to get these sorted sooner rather than later.

Following on the from drafting of the above documents, in terms of day-to-day ways of preventing shareholder disputes it is good practice to keep detailed and proper records and it is vital to understand the risk of exclusion of shareholders from management of the company. A good rule of thumb is that the interests of the company should always be put ahead of any personal interests.

As before, it is hard to underestimate early and effective communication with transparency to avoid matters escalating into full blown disputes. If it looks like things are going that way, seek legal advice at an early stage.

If you would like to discuss any of the aspects of this factsheet, please get in touch

For further information or to a arrange a free, no obligation consultation, then please contact our team on: