

**The effectiveness of shareholder dispute resolution in private  
companies under UK companies legislation: an evaluation**

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requirements of Nottingham Trent University  
for the degree of Doctor of Philosophy**

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## Abstract

The aim of the research is to evaluate the effectiveness of the legal means of resolving shareholder disputes in private companies. The principal means are *ex ante* contracting in shareholders' agreements and court-based dispute resolution mechanism in sections 994-996 of the Companies Act 2006. Private companies are often formed on the basis of mutual trust deriving from personal relationships between shareholders. The breakdown of these relationships termed "relational breakdown" commonly precipitates squeeze-out behaviour that causes disputes over the terms of exit. *Ex ante* contracting in shareholders' agreements cannot eliminate the underlying factors that cause relational breakdown, but can only mitigate the effects of relational breakdown by qualifying the powers of the majority and providing an exit to the minority on fair terms. Moreover, due to a range of limitations associated with *ex ante* contracting in shareholders' agreements, shareholders need recourse to a legal mechanism such as sections 994-996 of the Companies Act 2006 (formerly sections 459-461 of the Companies Act 1985) to resolve their disputes. In a Consultation Paper and subsequent Report published in October 1997 the Law Commission criticised the length, cost and complexity of proceedings under these provisions which were said to diminish their effectiveness as a tool for resolving shareholder disputes. After the Law Commission Report there have been significant developments both in terms of substantive law and procedure which have sought to streamline the remedy and make it more effective.

The present research is the first attempt to consider from a legal perspective the effectiveness of sections 994-996 of the Companies Act 2006 as a court-based dispute resolution mechanism, in the decade since the Law Commission produced its Report on shareholders' remedies. The research draws extensively on empirical evidence derived from a series of semi-structured interviews that were carried out with fifteen barristers experienced in this area of work. It concludes that (i) substantive law developments have enhanced legal certainty in the area and influenced shareholders to settle early; (ii) procedural developments, in particular, the use of mediation, has also contributed to earlier settlement; and (iii) in sum these developments have improved the effectiveness of these proceedings for shareholders, companies and the administration of justice by the courts.

## Chapter 1

### Introduction

One of the main governance mechanisms provided by company law is the application of the principle of majority rule: decisions regarding a company's affairs will be made according to the wishes of the majority of the shareholders of the company. As the Law Commission in its final Report on shareholders remedies stated, the guiding principle of company law is that "an individual member should not be able to pursue proceedings on behalf of a company about matters of internal management, that is, matters which the majority are entitled to regulate by ordinary resolution".<sup>1</sup> The principle provides a sensible and logical approach to corporate decision making.<sup>2</sup> Shares are the property of the shareholder who holds them, and a right to vote is usually attached to ordinary shares. Due to the proprietary nature of shares, the possibility always exists that shareholders may exercise the voting power attached to their shares for their own personal benefit and may ignore the adverse effects of the use of power upon minorities.<sup>3</sup> Disputes often arise among shareholders when the majority exploit majority rule in an opportunistic manner against the interests of minority shareholders. As a counterbalance to the principle of majority rule, company law also provides minority shareholders with legal means to protect their interests.

The aim of the research is to evaluate the effective means of resolving shareholder disputes in private companies.<sup>4</sup> The principal means are *ex ante* contracting in shareholders' agreements and court-based dispute resolution mechanism under the company law. Under the present law in England and Wales, the 'unfair prejudice' provisions in what are now sections 994-996 of the Companies Act 2006<sup>5</sup> (formerly sections 459-461 of the Companies Act 1985)<sup>6</sup> are the principal mechanism for

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<sup>1</sup>The Law Commission Report, 'Shareholders' Remedies' (Cm 3769, Law Com No 246, 1997) can be accessed at [www.lawcom.gov.uk/](http://www.lawcom.gov.uk/) (hereinafter *The Law Commission's Report*) [1.9].

<sup>2</sup>Hollington, R., *Minority Shareholders' Rights*. (Sweet and Maxwell, London 1990) 3.

<sup>3</sup>See *North-West Transportation Co Ltd v Beatty* (1887) L.R. 12 App. Cas. 589.

<sup>4</sup>For the meaning of the term "effectiveness" as it is used in this thesis see para 1.2 below.

<sup>5</sup>Hereinafter, CA 2006.

<sup>6</sup>Hereinafter, CA 1985.

resolving shareholders' disputes in private companies. However, problems have been identified by the courts and the Law Commission, with the operation of this court-based dispute resolution mechanism in practice such as cost, delay and complexity of proceedings. It was claimed that these problems have diminished the effectiveness of this mechanism. Measures have been taken on both the substantive and procedural levels since the Law Commission's Report in 1997 to streamline this mechanism in order to improve its effectiveness. The main objective of the research is to evaluate how effective the mechanism under section 994-996 of the CA 2006 is in resolving shareholders' disputes in private companies in the light of those later developments. This chapter discusses the background to the research, the nature of the research process and the structure of the thesis.

### ***1.1 Background:***

The significance and benefits of the corporate form as a medium of business to the national economy cannot be underestimated in any developed economy such as the United Kingdom.<sup>7</sup> The Company Law Review stated that "a failure to provide the right form of company structure for carrying on business will, in time, be reflected in a drift towards those countries which offer what is required".<sup>8</sup> Hence, the successful promotion of business through the corporate medium must be a primary goal of company law. To meet this goal after providing the basic framework of the company, the function of corporate law - according to one influential view - is to deal effectively with the situations where a conflict of interest arises between different corporate constituencies such as directors, shareholders, creditors and employees of the company. In a company's life, conflicts of interest often arise between these constituencies that may cause dispute when one constituency behaves in an opportunistic way towards another constituency. A conflict of interest may arise (i) between shareholders who are owners of the company and directors or managers who run the affairs of the company where there is a separation of ownership from control; (ii) between the majority and minority shareholders of the company; and (iii) between the company and 'outsiders' such as creditors, employees

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<sup>7</sup> See Copp S., and Astbury N., 'ADR and Shareholder Disputes- An Alternative to Using CA 1985, s 459' (2001) 1(1) Journal of ADR Mediation and Negotiation 51, 51.

<sup>8</sup> Company Law Review 'Modern Company Law for A Competitive Economy' (March 1998) [4.7].

and customers.<sup>9</sup> One significant feature of the successful promotion of the company's business is harmony among these constituencies. But "it is probable that disputes between shareholders have been a feature of corporate life ever since the development of the modern company".<sup>10</sup>

A company limited by shares is initially formed by individuals but obtains its status as a legal person from the state.<sup>11</sup> English company law provides two principal types of corporate form as a medium of business namely private and public companies limited by shares. The annual report of DTI (now BERR)<sup>12</sup> in 2005-06 showed a number of total 2,130,200 GB registered companies of which 99.5 per cent are private companies and only 0.5 per cent are public companies.<sup>13</sup> The research conducted for the Company Law Review showed that over 70 per cent of companies have only one or two shareholders and 90 per cent have fewer than five shareholders.<sup>14</sup> The same research indicates that a significant proportion of companies would fall into the category of owner-managed companies, that is companies where all shareholders are directors and vice versa. These figures regarding private companies also include so-called quasi-partnership companies, a type of corporate form that is not a statutory invention but has been developed and recognized in case law.<sup>15</sup> A quasi-partnership company is a company where one or more of the following elements are present: (i) an association formed or continued on the basis of a personal relationship involving mutual confidence; (ii) an agreement or understanding that all or some of the shareholders shall participate in the conduct of the business; (iii) legal restrictions (usually in the articles of association) on share

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<sup>9</sup> For detailed discussion of these conflicts of interests situations, see Kraakman R. and Hansmann H., *The Anatomy of Corporate Law* (Oxford University Press, New York 2004).

<sup>10</sup> See Copp S., and Astbury N., 'ADR and Shareholder Disputes- An Alternative to Using CA 1985, s 459' (2001) 1(1) *Journal of ADR Mediation and Negotiation* 51, 52.

<sup>11</sup> See now CA 2006, ss 3-16.

<sup>12</sup> BERR- Department for Business Enterprise and regulatory Reform can be accessed at <http://www.berr.gov.uk/>.

<sup>13</sup> DTI - *Companies in 2005-2006* (October 2006), Table A2 can be accessed at <http://www.berr.gov.uk/files/file34501.pdf>

<sup>14</sup> Company Law Review 'Modern Company Law for a Competitive Economy: Developing the Framework' (URN 00/656, March 2000) [6.9] can be accessed at <http://www.berr.gov.uk/>.

<sup>15</sup> See *Ebrahimi v Westbourne Galleries Ltd* [1972] 2 All ER 492, 500.

transfers.<sup>16</sup> Private companies in the UK are similar to close corporations in the United States the shares of which are not publicly traded and are largely family-owned.<sup>17</sup>

In private companies or close corporations where often there is no separation of ownership from control and shareholders are also directors of the company, disputes between majority and minority shareholders arise from the application of majority rule. It has been asserted that in close corporations disputes between minority and majority shareholders give rise to potentially destructive problems including loss of management time and costs and can cause business failures.<sup>18</sup> In the event of shareholder disputes the situation becomes more devastating for shareholders in private companies who may have invested large amounts of human as well as financial capital in the company compared to shareholders in public companies, because there is no ready market available to them for selling their shares comparable to that available to shareholders in listed or quoted public limited companies. Even if they find a buyer for their shares there will often be restrictions on the transfer of shares in the articles of association of private companies. Even if there are no restrictions on the transfer of shares to a willing external buyer, the value of a minority shareholding will commonly be discounted to reflect lack of control. Furthermore, to withdraw his investment, a minority shareholder cannot wind up the company unilaterally in the way that a partner can dissolve a partnership at will by giving notice to his fellow partners.<sup>19</sup> Owing to the existence of the principle of majority rule; the lack of an organized market for selling shares; the often substantial investment of time and money and to protect their expectations as to the conduct of the company's business, minority shareholders, in private as opposed to listed companies, are more closely concerned with opportunistic conduct by majority shareholders. This problem is known as a "close corporation problem" and is considered a universal

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<sup>16</sup> See *Ebrahimi v Westbourne Galleries Ltd* [1972] 2 All ER 492, 500.

<sup>17</sup> Most businesses in the US are closely-held corporations and approximately fifty percent of the US population is employed by these close corporations. See Miller, S. K., 'Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French "Close Corporation Problem"' (1997) 30 *Cornell Int'l LJ* 381, 383.

<sup>18</sup> *Ibid* 383-84.

<sup>19</sup> See the Partnership Act 1890, s 32.

problem in private limited companies.<sup>20</sup> Accordingly, the research is generally only concerned with private companies that conform broadly to the “close corporation”, “owner-managed” or “quasi-partnership” typologies – in other words, companies the operation of which is premised on close interrelationship between the various participants.

In private companies the majority may behave opportunistically towards the minority by virtue of the voting power attached to their shares hence the minority need protection from the opportunistic conduct of majority. The relationship between majority and minority shareholders can be explained by reference to economists’ agency cost theory.<sup>21</sup> One writer has described the economic conception of ‘agency’ in the following terms:

For the economist, a principal/agent relationship arises out of a purely factual dependency. If the furtherance of A’s interests depend upon the actions of B, then A is the principal and B is the agent. In this situation A has an incentive to take steps to secure that B acts in a way which is favourable to A.<sup>22</sup>

This view of the principal/agent relationship derived from the field of economics differs from and is wider than the legal definition of the principal/agent relationship, where the agent has authority from the principal to act on his or her behalf.<sup>23</sup> The economic model of the principal/agent relationship based on factual dependency is an accurate and applicable way of capturing the relationship between the majority (agent) and the minority (principal) in a company. Hence, “to assure the quality of the agent’s performance, the principal must engage in costly monitoring of the agent” that would result in ‘agency costs’.<sup>24</sup> There are different strategies available for regulating this principal/agent relationship “no matter who is the principal and who the agent”.<sup>25</sup>

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<sup>20</sup> See Miller, S. K., ‘Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French “Close Corporation Problem”’ (1997) 30 *Cornell Int’l LJ* 381, 382.

<sup>21</sup> Davies P., *Introduction to Company Law* (Oxford University Press, New York. 2002) 216.

<sup>22</sup> See *ibid* 118.

<sup>23</sup> See *ibid* 118.

<sup>24</sup> Kraakman R. and Hansmann H., *The Anatomy of Corporate Law* (Oxford University Press, New York 2004) 21.

<sup>25</sup> Davies P., *Introduction to Company Law* (Oxford University Press, New York. 2002) 217.



These strategies either enhance the principal's control over the agent or constrain the agent's discretion or decision making power.<sup>26</sup> The confidence of the principal in the agent's performance may, in theory, result in greater rewards for the agent.<sup>27</sup> According to this theory, in the absence of any protection minority shareholders will demand financial compensation for the risks involved which may increase the company's cost of outside equity capital<sup>28</sup> and work against the interests of agents and those of the company as a whole. In private companies minority shareholders are often involved in the management of the company along with the majority shareholders but to protect their interests against the misapplication of majority rule, minority shareholders will need to monitor the majority shareholders since, the strict application of majority rule leaves minority shareholders with no power to protect their interests as company shareholders. As stated above minority shareholders in private companies are more concerned regarding opportunistic conduct of majority shareholders. Law can play an important role in reducing agency costs that can be beneficial for the principals as well as for agents. Regulatory intervention was warranted to provide adequate protection for minority shareholders so that investor confidence might be maintained.<sup>29</sup>

Minority shareholders buy shares in a company with the prior knowledge of the existence of majority rule in company law and therefore with the expectation that the majority will use their voting power in good faith. Historically company law sought to regulate the exercise of majority power in various ways. In *Allen v. Gold Reefs of West Africa, Ltd*<sup>30</sup> where fraud on minority was alleged, it was held that a power to alter a company's articles of association must like all other powers, be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities. It must be exercised not only in the

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<sup>26</sup> For details see *ibid* 120.

<sup>27</sup> See Kraakman R. and Hansmann H., *The Anatomy of Corporate Law* (Oxford University Press, New York 2004) 22.

<sup>28</sup> See Davies P., *Introduction to Company Law* (Oxford University Press, New York. 2002) 216 and *ibid* 22.

<sup>29</sup> See Chiu, I.H., 'Contextualising Shareholders' Disputes – A Way to Reconceptualise Minority Shareholder Remedies' (2006) *Journal of Business Law* 312, 330-331. It is further stated that "the lack of protection for minority shareholders may inhibit investor participation in companies and therefore result in a contraction of capital availability and corporate finance options for enterprise".

<sup>30</sup> [1900] 1 Ch. 656, 670.

manner required by law but also *bona fide* for the benefit of the company as a whole.<sup>31</sup> The ‘interests of the company as a whole’ in this context is a formula which is employed to achieve the underlying purpose of protecting the minority from unconscionable conduct by the majority.<sup>32</sup> Moreover, now company law provides a mechanism under sections 994-996 of the CA 2006 to protect minority shareholders and to resolve their disputes in private companies. The present research evaluates the current effectiveness of this dispute resolution mechanism as a means of resolving shareholders’ disputes in minimum time and cost.

### ***1.2 The research process:***

To protect minority shareholders from opportunistic conduct of majority shareholders, shareholders’ remedies in company law include derivative action, personal action to enforce the rights under the articles of association, just and equitable winding up and unfair prejudice remedy.<sup>33</sup> The unfair prejudice remedy under section 994 of the Companies Act is the most attractive and widely used remedy available to minority shareholders in private companies and therefore has lessened the use of other remedies.<sup>34</sup> The provision was initially introduced by the legislature under section 9 of the Companies Act 1947 which became section 210 of the Companies Act 1948. Section 210 is a statutory predecessor of the present unfair prejudice remedy, formerly section 459 of the Companies Act 1985 and now re-enacted as section 994 of the CA 2006.<sup>35</sup>

As stated above, problems have been identified by courts and the Law Commission such as cost, delay and complexity of proceedings regarding the principal minority shareholders’ dispute resolution mechanism under sections 459-461 of the CA 1985. As Harman J in *Re Unisoft Group Ltd*<sup>36</sup> stated petitions under section 459 have become

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<sup>31</sup> The principle is now codified in section 260 of the CA 2006. See also below chapter 5.

<sup>32</sup> *Peter’s American Delicacy Co v Heath* (1939) 61 CLR 457 H Ct Aust as quoted by E. Ferran, *Company Law and Corporate Finance* (Oxford University Press, Oxford 1999) 149 n 191.

<sup>33</sup> These remedies are discussed below in chapter 5.

<sup>34</sup> See below para 5.4 Section 459 of the Companies Act 1985.

<sup>35</sup> In fact ss 459-461 of CA 1985 have been re-enacted as ss 994-996 of CA 2006 without any material difference but for the purposes of my thesis I have decided for convenience given that this change is recent and the vast majority of the cases and literature refers to s 459, consistency and ease of usage to refer to old section numbers.

<sup>36</sup> *Re Unisoft Group Ltd (No 3)* [1994] 1 BCLC 609, 611.

notorious in the Companies Court for their length and enormous costs. The Law Commission in its final Report stated that section 459 cases that go to trial often last weeks rather than days.<sup>37</sup> It is claimed that these problems have diminished the utility of this mechanism to resolve shareholders disputes. Moreover, in investment terms, the lack of any simple, cheap procedure to resolve disputes may also cause investors to be more cautious before putting money into such companies.<sup>38</sup> However, the courts have taken measures through case law to streamline the effectiveness of this remedy especially in *O'Neill v Phillips*<sup>39</sup> and *Grace v Biagioli*.<sup>40</sup> On the procedural level the Law Commission in its final Report in 1997 proposed *inter alia* that section 459 would continue to be construed broadly as it was intended to give the court a wide discretion to remedy conduct which may fall short of actual illegality<sup>41</sup> but recommended that proceedings under section 459 should be dealt with primarily by active case management by the courts as contemplated in the Woolf Report for the civil justice system as a whole and later implemented under the Civil Procedure Rules 1998.

In the light of the available legal literature the impression is that substantive law developments through case law have increased legal certainty and may possibly have encouraged early offers to settle section 459 disputes.<sup>42</sup> Moreover, following the adoption of the Civil Procedure Rules 1998,<sup>43</sup> section 459 disputes would settle more readily especially with the greater emphasis on ADR mechanisms such as mediation and that in cases where court proceedings were issued, proceedings would be more focused and therefore shorter and less costly, because of the civil courts' enhanced case management powers.<sup>44</sup> The question that was not addressed by the available literature and which therefore remains to be answered was whether these developments have in practice improved the effectiveness of this mechanism by resolving the identified

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<sup>37</sup> *The Law Commission's Report* [1.6].

<sup>38</sup> The Law Commission Consultation Paper, 'Shareholders' Remedies' (Law Com No 142, 1996) [11.2] can be accessed at [www.lawcom.gov.uk/](http://www.lawcom.gov.uk/), hereinafter *The Consultation Paper*.

<sup>39</sup> *O'Neill v Phillips* [1999] 2 BCLC 1.

<sup>40</sup> *Grace v Biagioli* [2006] 2 BCLC 70.

<sup>41</sup> *The Law Commission's Report* [2.2, 4.9-4.13].

<sup>42</sup> See Hannigan B., *Company Law* (Lexis Nexis, UK 2003) 437, 438.

<sup>43</sup> Hereinafter 'CPR'.

<sup>44</sup> *Ibid.*

problems? The present research is the first attempt to consider from a legal perspective the effectiveness of section 459 of the CA 1985 as a court-based dispute resolution mechanism in the decade since the Law Commission produced its Report on shareholders remedies.

So it is necessary here to define the meaning of the term “effectiveness” for the purposes of my thesis. The Law Commission stated that one of the guiding principles for the law on shareholder remedies was that all shareholders’ remedies should be made as efficient and cost effective as could be achieved in the circumstances.<sup>45</sup> It was stated that one of the major problems which had been highlighted, especially in recent years, when considering proceedings brought under section 459, was the length and cost of such cases.<sup>46</sup> The length and costs of such proceedings were not the only problems of which the courts and prospective parties to such proceedings needed to be aware; the presentation of section 459 petition might also have a damaging effect on the business of a company.<sup>47</sup> The Law Commission stated that in small companies, the management time used in litigation rather than running the business was more likely to damage the business than in larger companies.<sup>48</sup> Therefore for the purposes of the present thesis, effectiveness of section 459 means ability to resolve shareholders’ disputes in minimum time and cost to shareholders, companies and the administration of justice by the courts.

The present research has endeavoured to explore the following main research questions.

1. What has been the impact in practice of any substantive law developments made since the Law Commission’s final Report upon the identified problems?
2. Have the procedural developments including alternative dispute resolution (ADR) implemented under the CPR regarding the civil justice system ameliorated or

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<sup>45</sup> *The Consultation Paper* [14.11].

<sup>46</sup> *The Consultation Paper* [11.1].

<sup>47</sup> *The Consultation Paper* [11.2].

<sup>48</sup> *The Consultation Paper* [1.7] *The Law Commission’s Report* [1.6]. The Company Law Review stated that minority rights and remedies were principally of concern to private companies, as it was believed clarity, accessibility and cost-effectiveness were of prime importance, particularly in relation to smaller companies as their members and directors might have limited financial resources. See Company Law Review ‘Modern company law for a competitive economy: completing the structure’ (Company Law Review Steering Group, URN 00/1335, Nov 2000) Chapter 5 Corporate Governance: Shares and Shareholders, [5.60].

resolved the problems associated with section 459 of CA 1985 identified by the Law Commission and courts prior to 1999?

It was realized at the outset during the literature review that an analysis of the present effectiveness of section 459 proceedings would be premature without some consideration of the potential of formal shareholders' agreements as a tool for protecting minority shareholders against unfairly prejudicial conduct by majority shareholders in private companies. Not only is there a considerable literature which champions greater use of shareholders' agreements to protect minority shareholders' and to resolve their disputes in private companies,<sup>49</sup> the Law Commission also endorsed the benefits of such agreements although it did not explore their actual utility in any empirical sense. My hypothesis was that *ex ante* contracting might prevent the need for minority shareholders to have recourse to section 459 and so reduce the need for lengthy and cumbersome litigation. In order to explore the scope and potential of *ex ante* contracting it was necessary first to consider the nature and underlying causes of shareholder disputes in private companies through the study of case law. Identification of these conflicting situations and their causes also underpinned the study of the effective resolution of shareholders' disputes: unless we could understand the nature and dynamics of these disputes we could not hope to understand how best to resolve them be that by contractual or statutory means.

A study of the reported cases indicates that human factors such as conflict in personalities and management style are often the underlying causes of these disputes. A common pattern is for a dispute to arise which (i) leads to a breakdown in the personal relationship of the parties; (ii) ends their mutual trust; (iii) subsequently precipitates "squeeze-out" behaviour by the majority shareholder that exacerbates the situation and transforms a personal disagreement into a legal dispute. An analysis of the available precedent shareholders' agreements established that, minority shareholders might seek to protect themselves against opportunistic conduct through *ex ante* contracting either by declaring their rights in advance or by enhancing their voice through veto powers to

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<sup>49</sup> See below chapter 4.

reduce the impact of majority rule. It is thought that advance consideration by the parties may minimize the scope for disputes and in theory, lead to swifter, more cost-effective resolution if the means of addressing future problems have been predetermined. However, shareholders' agreements cannot completely prevent and resolve shareholders' disputes in these companies owing to a range of theoretical and practical limitations. Accordingly, shareholders need to have recourse to the courts to resolve their disputes. Statute therefore fills a 'gap' that arises from incomplete contracting.<sup>50</sup>

Hence, in the light of the available legal scholarship, a qualitative empirical evaluation of the current effectiveness of the dispute resolution mechanism under sections 459-461 of the CA 1985 was conducted to address this question in a manner designed to fill the gap identified in the existing literature. A secondary aim of the empirical research was to evaluate the current validity of the Law Commission's criticisms of this dispute resolution mechanism in the light of later substantive and procedural law developments. The research also investigated the nature of shareholder disputes and the role of shareholders' agreements in resolving shareholders' disputes in private companies which broadly confirmed the impression gained from the analysis of reported case law and the precedents of shareholders' agreements.

### ***1.3 Structure of the thesis:***

The thesis consists of eight chapters and proceeds in the following manner. After this introductory chapter, the second chapter discusses the methodology adopted which is socio-legal. The third chapter examines the nature and underlying causes of shareholders' disputes in private companies. The fourth chapter analyses the scope and potential of *ex ante* contractual arrangements - shareholders' agreements - to resolve shareholder disputes. The fifth chapter examines the nature and the evolution of the court-based dispute resolution mechanism under sections 459-461 of the CA 1985 and the criticisms of this mechanism advanced principally by the Law Commission. The sixth chapter analyses the impact of substantive law developments in the decade or so after the Law Commission Report. The seventh chapter analyses the impact of

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<sup>50</sup> See below chapters 5 and 6.

procedural law developments including ADR under the CPR on the effectiveness of the mechanism. The eighth chapter concludes.

## **Chapter 2**

### **Methodology**

#### **2.1 Introduction:**

This chapter discusses the nature of the socio-legal research in the thesis that involves combining traditional legal scholarship with empirical research. The discussion of legal scholarship focuses on the methods employed during the analysis of case law, legislation and precedents of shareholders' agreements. The discussion of the empirical phase of the research focuses upon the methods deployed in the empirical evaluation and the reasons behind the selection of those methods.

##### ***2.1.1 Aim of the research:***

The research has the following three related aims: (i) to evaluate scope and limits of contract-based dispute resolution through shareholders agreements; (ii) to evaluate the current effectiveness of section 459 in the light of post-1997 developments (iii) to re-evaluate the continuing validity of the Law Commission's critique in the light of (ii) above. In fact (iii) is a secondary aim which flows from the 'effectiveness' evaluation.<sup>1</sup>

#### **2.2 Legal scholarship:**

A study of the majority of section 459 reported cases, from 1980 when the provision was introduced, up to the present, was conducted to identify the reasons for bringing section 459 petitions in these cases.<sup>2</sup> Identification of those reasons assisted not only the understanding of the nature of shareholder disputes in private companies but also the underlying causes of these disputes. These reported cases were approached through library and learning resources of the Nottingham Law School, NTU. Along with the study of reported cases in hard copy available in the library, electronic databases such as Westlaw, Corporate Law Direct and Lawtel were also exploited to study the relevant case law. The study of unreported cases that might be helpful in this regard but could not

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<sup>1</sup> See above chapter 1 para 1.2 The research process.

<sup>2</sup> See below chapter 3 Characteristics of shareholder disputes in private companies.



be conducted owing to available resources operates as a limitation on this aspect of the research. The study is not and, by definition cannot be, wholly representative of the entire population of cases which have come before the courts whether reported or otherwise. However, the study of reported cases identified both causes and characteristics also identified in the legal literature and subsequently confirmed by the empirical research.

Secondly, an analysis of the available precedents was conducted to evaluate the potential and limitations of shareholders' agreements in resolving shareholder disputes.<sup>3</sup> Practically, it was difficult to capture the real nature of bespoke minority shareholders agreements in order to be able to analyse the potential and limitations of shareholders agreements. Since, as opposed to articles of association which are public documents after registration and are therefore accessible,<sup>4</sup> real bespoke shareholders' agreements are confidential as between the parties, it was impossible in practice to access and analyse those bespoke agreements customised by lawyers for use in specific contexts. The available precedents were not the actual bespoke agreements entered into by shareholders according to their particular needs in the real business environment. These precedents were sample or template agreements that resemble actual bespoke agreements and which could be altered if required, according to the needs of the shareholders in a particular business. The available precedents are also limited in number since law firms are not willing to share their proprietary information and to release in-house precedents in respect of which they may also assert intellectual property rights. However, the collection of precedents from different published sources was useful in providing a broad picture of the nature of shareholders' agreements and a useful insight into the contemporary professional practice of lawyers who seek to anticipate and prevent shareholder disputes. Furthermore, the use of published precedents was a "least worst" approach to the acquisition of data for the research purposes given the inherent difficulties associated with acquiring copies of actual shareholders' agreements entered into by "live" clients. During the research around 25

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<sup>3</sup> See below chapter 4 The scope of *ex ante* contracting as a means of protecting minority shareholders' interests.

<sup>4</sup> CA 2006, s 18(2).

precedents of shareholders' agreements were gathered from different sources that mainly include books and law firms. However, these are precedents and the execution of perfect minority protection shareholders' agreement depends upon various factors e.g., *inter alia* the bargaining position of shareholders.<sup>5</sup>

By bringing under consideration the nature of shareholder disputes in private companies through the analysis of the relevant reported case law<sup>6</sup> the scope of *ex ante* contracting as evident in available precedents in preventing those disputes was analysed. Precedents were analysed to evaluate the scope of shareholders' agreements in terms of their potential and limitations in preventing the identified complaints. Difference, if any, of approaches adopted in different precedents towards the same complaints was also noticed. The outcome of that analysis is found in chapter four below.

Thirdly, the legal analysis of the substantive and procedural law developments under the case law and the Civil Procedure Rules 1998, since the Law Commission review of shareholders' remedies, was conducted to evaluate the effectiveness of these developments to resolve shareholder disputes in private companies.

### **2.3 Empirical research:**

Empirical research was conducted to evaluate the current effectiveness of sections 459-461 of the CA 1985 as a mechanism for resolving shareholder disputes. In what follows, the chapter seeks to justify the selection of a qualitative empirical research strategy bearing in mind the limitations of and difficulties associated with a quantitative research strategy. The chapter will also touch upon the following matters: (i) methods; (ii) limitations associated with the present empirical inquiry; (iii) the validity and reliability of the present research; and (iv) ethical issues.

In the light of the available legal literature the impression was that in section 459 cases there might be an increasing tendency in favour of early settlement both pre-action and

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<sup>5</sup> In practice these factors that are discussed below in para 4.6, diminished the effectiveness of these agreements for the minority.

<sup>6</sup> See below chapter 3 para 3.1.

pre-trial following the House of Lords decision in *O'Neill v Phillips*,<sup>7</sup> which emphasized the desirability of early offers to settle and reinforced the CPR, which explicitly encourages ADR and requires the courts to manage cases proactively. Even in cases where the proceedings did not settle before trial, it was thought that trials would be more focused and would therefore involve less time and costs following these substantive and procedural developments. Hence, empirical research was carried out to explore the impact of these developments to update the understanding of how shareholder disputes are resolved in practice and the extent to which practitioners perceived the situation to have changed on the ground since the late-1990s.

### ***2.3.1 Justification for qualitative inquiry:***

In 1997 when the Law Commission produced its Report on review of shareholder remedies there were no detailed judicial statistics available from which frequencies could be generated on variables such as incidence, duration and cost of section 459 proceedings. The Law Commission's findings as to length, cost and complexity of what were then section 459 proceedings were mainly based on quantitative data that was acquired by the Law Commission for the purposes of the Report.<sup>8</sup> The Law Commission relied principally upon: (i) cases reported in Butterworth's Company Law Cases during the period 1988 to 1997; (ii) results of a statistical survey of petitions presented to the Companies Court at the Royal Courts of Justice between 1994 and 1996 seeking relief under section 459 of the CA 1985; (iii) the responses to its initial Consultation Paper. As is evident from the figures below, no detailed judicial statistics were available regarding petitions originated in the Companies Court from the years 1987 to 2005 from which anything meaningful in terms of critical variables can be inferred.<sup>9</sup> Interestingly, the statistics for 1987-1991 were more detailed than those published for 1992-2005 as they disaggregated the number of petitions commenced and orders made under sections 459-461. The number of petitions filed under section 459 declined in 1990 and 1991 but the number was also low in 1988 so nothing meaningful can be inferred by way of

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<sup>7</sup> [1999] 2 BCLC 1.

<sup>8</sup> See below chapter 5 para 5.6.1 for details regarding data acquired by the Law Commission and criticism of the Law Commission's methodology.

<sup>9</sup> See below Tables 2.1 and 2.2.

explanation for this decline since no obvious pattern was discernible. Furthermore, there is no publicly available data disaggregating petitions filed and relief granted after the introduction of the CPR and thus no meaningful comparison of the position before and after 1999 can be undertaken. Data available from 1992 to 2005 was extremely limited as judicial statistics only provide the aggregate of originating proceedings through petitions, applications and summonses in the Companies Court, Chancery Division of the High Court excluding winding up petitions. Such aggregate data from 1992-2005 did not provide separate numbers of section 459 petitions filed and relief granted under section 461 in the Companies Court and district registries and was therefore useless. Hence, owing to lack of disaggregated judicial statistics regarding 459 petitions in Companies Court of the Chancery Division and district registries before and after the CPR that might show any significant change in numbers it was not possible to draw any inferences regarding factors that might have contributed to any change.

**Table 2.1**

Number of originating proceedings through petitions, applications and summonses in the Companies Court, Chancery Division of the High Court except winding up petitions:<sup>10</sup>

Year	Number	Year	Number
2005	7,549	1998	6,492
2004	8,858	1997	7,182
2003	10,986	1996	6,971
2002	8,169	1995	6,419
2001	10,003	1994	5,557
2000	7,990	1993	5,805
1999	7,337	1992	6,050

**Table 2.2**

Number of originating proceedings through petitions, motions and summonses under the Companies Act 1985:<sup>11</sup>

Year	1991	1990	1989	1988	1987
Total number of originating proceedings	1668	1641	1665	1662	1159
Number of originating proceedings through petitions	217	228	312	301	268
Petitions for protection against unfair prejudice under sec 459	24	32	65	38	70
Relief granted under sec 459	1	3	2	1	7

Scientific collection of pre and post CPR quantitative data regarding section 459 petitions from the High court in London, district registries outside London and from county courts would have been required to carry out any meaningful enquiry into the relationship between legal and procedural change and the incidence of section 459 proceedings over time. Collection of that quantitative data could be time consuming and demands extensive resources. Moreover, by exploiting extensive resources and time if the required quantitative data would be available it could only inform us about changes in selected variables and then from that data we could infer the causal factors behind

<sup>10</sup> Data (1999-2005) has been obtained from judicial statistics of Department for Constitutional Affairs that can be now accessed at <http://www.judiciary.gov.uk/keyfacts/statistics/index.htm> and data (1992-1998) has been obtained from hard resources of library and learning resources of NTU.

<sup>11</sup> Data obtained (1991-1987) from judicial statistics of Department for Constitutional Affairs available in hard copy at library and learning resources of NTU.

those changes but quantitative data could not provide us the deep insight as to actual factors that possibly were behind those changes. For example by acquiring both pre and post CPR quantitative data as to the number of petitions filed; how long proceedings took from issue to final disposal; and how many orders had been made and then through exploring the difference if any, in figures the changes that may have resulted from changes in the law could be perceived. If the acquired data told us that the number of petitions that had been issued had decreased, it could not necessarily be inferred from that such decrease was due to substantive or procedural developments or some combination of the two.

The Law Commission asserted that the complexities associated with section 459 that cause lengthy and costly litigation arise in part from the generality of the wording of the section since it permits shareholders to put in issue anything that may be remotely relevant to their case.<sup>12</sup> In *O'Neill v Phillips*,<sup>13</sup> Lord Hoffmann took a number of positive steps to curb the width of the jurisdiction by holding that to prove unfair prejudicial conduct, minority shareholders must show (in effect) that there is some breach of express agreements or legal rules or the use of rules in a manner which equity would regard as contrary to good faith and sought to encourage the early settlement of disputes to avoid the expense of money and spirit inevitably involved in litigation and reinforced CPR.<sup>14</sup> Through quantitative data it was also hard to infer whether any change that has occurred in the trends of section 459 proceedings was owing to the CPR or the case law or both or to other variables such as general changes in practice that might have been happening independently of legal and procedural changes such as the availability of formal mediation processes provided by independent organizations like CEDR (Centre for Effective Dispute Resolution).

Also, quantitative data as to the level of pre-action settlements before and after the late 1990s is, by definition unavailable as such settlement is a private matter which does not involve the court. Similarly, there is no way of telling by quantitative means whether

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<sup>12</sup> *The Consultation Paper* [14.5]. See also below chapter 5.

<sup>13</sup> [1999] 2 BCLC 1.

<sup>14</sup> *O'Neill v Phillips* [1999] 2 BCLC 1, 9, 16, for details see below chapter 6.

cases settled in accordance with pre-action protocols were settled by traditional means of party and party negotiation or by other recognised method of ADR. In any event, even if quantitative data on variables of interest (incidence of proceedings; average time from issue to disposal; average cost) were available, they could not provide actual insights into the mechanisms that might be operating beyond observable changes in the number of petitions issued and so on. What litigants experienced about remedies available under section 459 and why; whether in practice litigants prefer negotiated settlement or court-based resolution and why they chose to do so; whether they prefer mediation over inter-lawyer negotiation to settle dispute, if so, then why; were the litigants are actually conscious of the time and costs involved in the litigation. Knowledge as to those actual factors could inform us about the actual preferences of litigants and could assist in future reforms. Hence, due to the limitations associated with the acquisition and utility of quantitative data and to obtain deep insights into the phenomena of legal change being researched a qualitative inquiry was considered both appropriate and desirable for the purposes of the present study.

The purpose of the qualitative research was to get the in depth perspective of frequent participants who had real world experience of and expertise in shareholder disputes and the mechanisms for their resolution. A qualitative approach was considered most suitable for conducting the research in order to generate insights about the effectiveness of dispute resolution processes from an insider perspective.<sup>15</sup> Accordingly, an interpretivist epistemology<sup>16</sup> was adopted. This requires the researcher to understand the subjective meanings attributed by participants to actions or activities in which they participate (specifically in my case the perceptions of experienced practitioners engaged in shareholder dispute resolution) in order to generate knowledge about the social world.<sup>17</sup>

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<sup>15</sup> See Punch, K. F., *Introduction to Social Research*. (2<sup>nd</sup> ed Sage, UK 2005) 238.

<sup>16</sup> Epistemology is a theory of knowledge and concerns what is (or should be) regarded as acceptable knowledge in a discipline. See Bryman A., *Social Research Methods* (2<sup>nd</sup> ed Oxford, UK 2004) 11 and Glossary.

<sup>17</sup> Interpretivists' epistemology is in contrast to a positivists' epistemology that places emphasis on causal explanations of human behaviour. See Bryman A., *Social Research Methods* (2<sup>nd</sup> ed Oxford, UK 2004) 13

### **2.3.2 Methods:**

Following a consideration of the nature of qualitative research and its philosophical underpinnings the following methods were employed in the empirical phase of the research.

#### *2.3.2.1 Semi-structured interviewing*

The research was conducted by means of semi-structured interviews with chancery barristers in order to obtain qualitative data directed to the research questions. An interview schedule was structured to explore the participants' experiences regarding the basic research questions explained above. In total fifteen semi-structured face to face interviews, including an initial pilot interview, were conducted with chancery barristers, the majority of whom were QC's, each having more than fifteen years of experience dealing with section 459 petitions both before and after the adoption of the CPR.<sup>18</sup>

Interviews were conducted with the help of an aide-memoire with appropriate exploitation of prompts during the course of interview.<sup>19</sup> The aide-memoire was divided into two main sections: the first was introductory and the second was comprised of open questions. These questions were based on the issues needed to be explored through the intended empirical investigation. After the interviewer's personal introduction, interviewees were informed about the general nature of the research project. Secondly, an ethical statement was read to them and they were informed briefly about confidentiality issues and their rights. Thirdly, their consent to digital recording was obtained formally and then they were requested to recount briefly the area of their practice. To explore the experiences of the interviewees they were asked questions about their experiences of the following: (i) changes in Chancery and section 459 practice resulting from the adoption of the CPR; (ii) changes in section 459 practice resulting from substantive law developments through case law; (iii) types of disputes and forms of relief they had encountered in section 459 context; (iv) the settlement process in shareholder disputes (v) specific aspects of the CPR and (vi) the role of shareholders'

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<sup>18</sup> See below Table 2.3.

<sup>19</sup> See Appendix 2.



agreements and the potential of default rules in model articles for private companies. Each interview lasted for approximately one and a half hours which allowed sufficient time to explore the views and experiences of the respondents regarding the research issues.

### 2.3.2.2 Sample:

**Table 2.3: Table of conducted interviews**

No.	Profession	Name/Code	Date interviewed	Location
1	QC	A	13-02-07	London
2	Junior Barrister	B	13-02-07	London
3	Junior Barrister	C	14-03-07	London
4	QC	D	15-03-07	London
5	QC	E	15-03-07	London
6	QC	F	26-03-07	London
7	QC	G	28-03-07	London
8	Junior Barrister	H	04-04-07	London
9	QC / Mediator	J	25-04-07	London
10	QC	K	26-04-07	London
11	Junior Barrister	M	01-05-07	London/ Birmingham
12	QC	P	17-05-07	London
13	Junior Barrister	R	18-05-07	London
14	QC	S	30-05-07	Bristol
15	Junior Barrister Practised as a solicitor before joining chambers	T	07-06-07	Leeds

The population of the research was comprised of Chancery barristers who routinely deal with section 459 cases to evaluate empirically the operation of the post-Woolf court process and the use and potential of ADR within that process, to resolve shareholder disputes in private companies effectively. Initially, it was planned to conduct interviews with solicitors as well as barristers. However, after commencing the research it was realized that it was hard to identify solicitors in law firms who were experienced in

section 459 work. The experience of the barristers interviewed was that they were generally instructed by solicitors at the very start of the case which showed that barristers are usually involved from the very beginning of the case and that there were not that many experienced solicitors in this area possibly because section 459 practice was not a repeat source of work for solicitors unlike, for example, work from insurance clients in the context of personal injury litigation. The barristers stated that in their practice they very rarely got instructions from same solicitors' firm twice. However, they did also indicate that there were some experienced litigators in the big law firms who were capable of resolving shareholder disputes pre-action and had good knowledge of the legal complexities involved in section 459 cases. But these solicitors would invariably resort to instructing specialist counsel in cases that could not be settled pre-action and where formal proceedings would need to be issued. A number of solicitors were identified by different research methods such as snowball sampling and internet searches. These solicitors were contacted by letter inviting them to participate in the research but did not respond.

In any event, as the barristers interviewed had all been involved in section 459 proceedings from inception to trial in contrast to solicitors, they had knowledge of all aspects of these proceedings and were therefore arguably better sources of data about the impact of specific aspects of the CPR and substantive law developments in practice. Whereas it appears that solicitors could only draw on limited experience of pre-action settlement, the barristers in my sample had much more extensive experience as befits specialist practitioners working in a niche area of Chancery practice. A common theme that emerged from the interviews is that most section 459 cases settle after proceedings are issued and there has been no felt decline in the volume of instructions since the introduction of the CPR. This implies that settlement after the commencement of proceedings has been stable over time. Furthermore, given the research questions, I was interested in finding out the circumstances in which section 459 petitions were issued and the way these petitions were dealt with by clients, by barristers and by the courts and barristers were in a better position to answer these queries. Unlike solicitors, barristers who took charge of the case later could also inform me why early settlement efforts had

failed. Furthermore, barristers also engage in efforts to settle disputes on behalf of clients and may also face the same complexities in achieving settlement that are faced by solicitors. Conducting interviews with actual litigants was not feasible because of access problems (client confidentiality and professional privilege which preclude lawyers from disclosing contact details) and, in any event, would only provide a narrow perspective based on experience of a single piece of litigation. Barristers could not only provide credible current data for research purposes but were be in a better position to explain the practical issues due to their experience and could assess the impact of legal developments upon the identified gaps in this area.

No separate list of barristers specialising in section 459 proceedings was available from which a sample could be selected. Therefore, the sampling frame of the population was created by compiling a list of names of barristers recorded as representing the parties in reported cases dealt with by the higher courts in the last twenty years. In order to employ the theoretical sampling technique also known as purposive sampling the respondents were identified carefully (i) using a metric-based analysis of the reported case law in the last twenty years to identify experienced counsel using appearance in reported cases over time as a proxy for “experience” and (ii) by employing snowball sampling techniques. Reported cases were identified on electronic databases such as Westlaw, Corporate Law Direct (Lexis Nexis) and Lawtel by entering relevant terms such as “unfair prejudice” in their search engines. A provisional list of prospective interviewees was drawn up in order of the number of times the barristers listed had appeared in reported cases. Two barristers had seven appearances in the list. Arber has asserted that theoretical sampling “is entirely governed by the selection of those respondents who will maximise theoretical development”.<sup>20</sup> However, from that sample frame of the population it was still hard to find all experienced barristers who were involved in section 459 cases since most of the names in the sample frame were not cited more than once and given the likelihood that most cases settle before trial, appearance in trial cases (as opposed to interim applications) is a far from perfect proxy. Indeed, the interviews eventually conducted revealed that barristers with only one or two appearances in the

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<sup>20</sup> See Arber S., ‘Designing Samples’ in N. Gilbert (ed), *Researching Social Life* (Sage, London 1993) 74.

reported cases were often vastly experienced. Conversely one barrister instructed in a leading case had only limited experience. This reinforced the necessity for employing snowball sampling techniques in the research. Hence, along with theoretical sampling, snowball sampling techniques were also employed (i) by asking the interviewees for names of other counsel experienced in handling section 459 cases more frequently and (ii) through exploiting existing contacts of the supervisory team and Nottingham Law School more generally. Interestingly the names cited by barristers in response to snowball sampling techniques were often names that were already on the original list. Thus, by a combination of sampling techniques, I arrived at a sample of highly specialised and experienced Chancery barristers.

Getting appointments from barristers did not seem to be an easy task in the beginning, owing to their extremely busy diaries, but their considerations for legal research that might assist in future legal reforms, made it possible. Altogether fifteen face to face interviews with barristers from eight different chambers were conducted during the empirical investigation. Theoretical and snowball sampling techniques suggested that there were not more than 25 experienced section 459 barristers and that they were concentrated in around ten chambers in London; Birmingham; Leeds and Bristol. London chambers were on the top of the list for having experienced barristers in shareholder disputes which was not surprising due to their proximity to the Companies Court which forms part of the Chancery Division of the High Court based in the Royal Courts of Justice in London. Data was collected until the research experienced theoretical or data saturation. This is where no further new data was expected to be generated by the research. Theoretical saturation “is reached when no new analytical insights are forthcoming from a given situation”.<sup>21</sup> As the research draws on the experience of a small, relatively homogenous population possessing “niche” legal expertise, theoretical saturation was achieved quickly in the research. Theoretical saturation was experienced after conducting around ten interviews. However, the interviewing process was continued to confirm the state of theoretical saturation.

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<sup>21</sup> See *ibid.*

Due to the lack of a complete list of experienced section 459 barristers it is not possible to assert scientifically the representative nature of the sample. Given the quantum of expertise and experience and the appearance in the sample of counsel, many of them silks from leading chambers in this area, the impression is that the sample was a representative one. In any event, unlike quantitative research, in qualitative research the sample need not be representative. This is because in qualitative research, “the researchers’ primary goal is an understanding of social processes rather than obtaining a representative sample”.<sup>22</sup>

#### 2.3.2.3 Analysis of Data:

The interviews were recorded using a digital recorder and fully transcribed later. By treating the interviewees’ responses as an external reality and owing to the narrative nature of the acquired qualitative data, a narrative approach has been applied to analyse the data gathered through the interviewing process.<sup>23</sup> Every effort was made to deal holistically with the available qualitative data.<sup>24</sup> The data was divided into sections and then coded in accordance with theoretical patterns that developed during the research process. Desk-based research that was conducted before the empirical investigation, proved very helpful in structuring the interview schedule.<sup>25</sup> As a result the interview schedule has proved relevant to theoretical patterns that develop in qualitative inquiry. Theory that emerged from the desk-based research was then tested and developed against the impressions that later emerged as a result of further qualitative inquiry. These impressions enabled me to arrive at some conclusions about the current ‘effectiveness’ of the remedy and will assist to answer the research questions and will also provide a clear frame of reference for future research in this field. However, effort has been made during analysis to be careful as far as possible about any preconceptions that I might have developed during legal scholarship.<sup>26</sup> Data was analyzed manually and my explanation of the data emerges from careful reading of the data acquired. Data obtained

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<sup>22</sup> See *ibid* 73.

<sup>23</sup> See Bryman A., *Social Research Methods* (2<sup>nd</sup> ed Oxford, UK 2004) 412-414.

<sup>24</sup> Punch, K. F., *Introduction to Social Research*. (2<sup>nd</sup> ed Sage, UK 2005) 217.

<sup>25</sup> See above para 2.3.2.1 Semi-structured interviewing, for categories of questions asked from interviewees.

<sup>26</sup> See also below para 2.3.4 Validity of present research.

was analyzed even during the collection process. Data collection stopped as the research reached theoretical saturation and then after further analysis theory was developed from the acquired data<sup>27</sup> in order to conclude the research.<sup>28</sup> Conclusions are derived from the impressionistic evidence obtained from interviewees' responses that have been collected during qualitative investigation.<sup>29</sup>

### ***2.3.3 Limitations of present research:***

While, a qualitative research strategy can be justified it inevitably has some limitations. Interviewee accounts of their "experience" may be biased by their professional interests in the generation of fee income. For example they may be inclined to comment unfavourably on the impact of the CPR if it has the impact of controlling the length and costs of proceedings (and vice versa). Similarly, interviewees that have strong mutual referral relationships with ADR providers may tend to speak in glowing terms about the effectiveness of ADR. Therefore to minimize the effects of any vested interest upon the interview data and to get the true picture, interviewees were asked to respond in detail only in the light of their experiences in conducting real cases on behalf of clients. This will not overcome the problems of subjectivity but the consistency of the responses at theoretical saturation will to some extent mitigate any concerns about vested interests of interviewees.

Secondly, owing to its qualitative nature the research did not provide any statistical information to compare the pre and post CPR number of early settlements after commencement of proceedings; mode of settlement and duration of proceedings in section 459 disputes. However, interviewees' own personal experience regarding section 459 practice, both pre and post CPR and exploitation of ADR in section 459 disputes was helpful to form a general impression as to settlements and duration of section 459 proceedings. Thirdly, the lack of solicitors' participation in the research might be a limitation since it was hard to identify solicitors in law firms who were experienced in

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<sup>27</sup> *Ibid* chapter 8.

<sup>28</sup> See below chapter 8 Conclusion.

<sup>29</sup> All interviewees are given alphabetical names to ensure anonymity and while presenting the findings interviewees are referred by their alphabetical names. See above Table 2.3.

section 459 litigation. But as stated above, barristers were in a good position to respond to my research questions as compared to solicitors.

#### ***2.3.4 Validity of present research:***

Validity here means, as Silverman has stated, the extent to which an account accurately represents the social phenomena to which it refers.<sup>30</sup> In this context the impartiality of the researcher, the reliability of the research and the generalization of findings are discussed here. During the research, questions were designed, interviews conducted and the acquired data analyzed in a manner that satisfies to some extent, the requirement regarding impartiality of the research. The questions were designed by considering the aims of the research and to explore the actual experiences of the interviewees. During the interview, interviewees were provided a complete opportunity to discuss their experiences in sufficient detail. Acquired data was analyzed and findings of qualitative interviewing were presented in the manner that sufficiently explains the respondents' views that they have expressed in the light of their personal experience. All the contradictory or inconsistent responses of the interviewees were properly considered at the time of analysis and discussed properly when findings were presented, to avoid oversimplifications of the research findings. While inevitably the researcher plays a significant role in the production and interpretation of the data, care has been taken to separate any personal opinions of the researcher from interviewees responses while analyzing the data and presenting the findings.<sup>31</sup> The research was not sponsored by any external body which also ensured the impartiality of this research and its findings. Furthermore, the research was conducted by me in my capacity as a student of law and a legal researcher and without any personal interest in any outcome of the research.

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<sup>30</sup> As quoted in glossary by Silverman, D., *Interpreting Qualitative Data* (3<sup>rd</sup> ed Sage, London 2006).

<sup>31</sup> Denscombe, M., *The Good Research Guide* (2<sup>nd</sup> ed Open University Press, Buckingham 2003) 268. Denscombe stated that researcher's identity, value and beliefs play a role in the production and analysis of qualitative data and cannot be entirely eliminated from the process of analysing qualitative data. On the other hand it was stated that self may give researcher a privileged insight into social issues so that the researcher's self should not be regarded as a limitation to the research but as a crucial resource. See Denscombe, M., *The Good Research Guide* (3<sup>rd</sup> ed Open University Press, England 2007) 300.

Reliability of the research relates to the methods of data collection and the concern that these methods should be consistent.<sup>32</sup> As indicated above, the role of the researcher is significant in the research. However, the way the research was conducted, including the sampling method, is sufficiently explained for other researchers to replicate my research.<sup>33</sup> To maintain the reliability of the research the same questions were asked of all the respondents. However, different prompts were exploited during the course of the interview in order to obtain elaboration and development of particular responses. In order to acquire valid data, every effort was made to develop an understanding and a relationship of trust with the interviewees it having been explained to them that the interview was exclusively for the purposes of academic research, that any verbatim extracts reported in the final thesis would be anonymised and that their contribution would be valuable to the assessment of the need for future reforms in this area of law. In order to become familiar with the interviewees and to make them comfortable they were informed during the course of interview, where necessary, that as a student of law and a legal researcher, the researcher was to some extent aware of the problems and therefore had some understanding of the complexities associated with the resolution of shareholder disputes and the concerns of the parties. Furthermore, to obtain valid data respondents were asked permission for interviews to be recorded after being given assurances that confidentiality and anonymity would be fully respected. This reduces the risk that the interviewees may not have been completely candid in providing accounts of their experiences. The interviews were conducted at a time which was convenient for the respondents in order to reduce the risk of distractions. The interviews were fully transcribed and analyzed manually by giving proper consideration to all prompts. The responses were compared with the assertions made in the literature as to the effectiveness of section 459 proceedings as a tool for resolving shareholder disputes.

As to the generalization of findings it is arguable that the data can be generalized to the population (lawyers experienced in section 459 cases) due to its representative nature discussed above. However – and to reiterate a point made earlier – the

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<sup>32</sup> Denscombe, M., *Ground Rules for Good Research* (Open University Press, Buckingham 2002) chapter 5, 100.

<sup>33</sup> See Denscombe, M., *The Good Research Guide* (3<sup>rd</sup> ed Open University Press, England 2007) 298.



representativeness of the data is not critical because the purpose is not to attain absolute knowledge but to achieve a better theoretical understanding of section 459 as a process from the impressionistic evidence acquired by qualitative investigation. As Bryman has asserted:

The findings of qualitative research are to generalize to theory rather than to populations. It is the cogency of the theoretical reasoning rather than statistical criteria that is decisive in considering the generalizability of the findings of qualitative research. In other words it is the quality of the theoretical inferences that are made out of qualitative data that is crucial to the assessment of generalizations".<sup>34</sup>

### **2.3.5 Ethical issues:**

All ethical issues that might arise in the research were considered carefully and respected and every possible effort was made to ensure that the interests of research participants were safeguarded.<sup>35</sup> Respondents were honestly informed about the aims and objectives of the research. While conducting the research the confidentiality and anonymity of the research participants was ensured in so far as possible. Respondents were fully informed regarding their participation and of their right to refuse to answer any question or to terminate the interview at any time if they chose to do so. Interviewees were not compelled to participate or to provide responses if they did not wish to do so. The data was collected by employing legal and fair means and was stored securely and anonymously. It was ensured that the acquired data was analyzed with complete honesty and no changes have been made to it for any personal interests of the researcher. The ethical codes of Nottingham Trent University and the Socio-Legal Studies Association were observed at all times.

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<sup>34</sup> See Bryman A., *Social Research Methods* (2<sup>nd</sup> ed Oxford, UK 2004) 285.

<sup>35</sup> See Henn, M., *A Short Introduction to Social Research* (Sage, London 2006); Diener E., and Crandall R., *Ethics in Social and Behavioral Research* (The University of Chicago Press, USA 1978); Homan, R., *The Ethics of Social Research* (Longman, UK 1991); Bryman A., *Social Research Methods* (2<sup>nd</sup> ed Oxford, UK 2004) Chapter 25; Bryman A., *Social Research Methods* (3<sup>rd</sup> ed Oxford, US 2008) Chapter 5.

## Chapter 3

### Characteristics of shareholder disputes in private companies

#### 3.1 Scope of the chapter:

This chapter discusses the characteristics of shareholder disputes in private companies in the light of the reported case law and findings of the empirical research. It makes a series of claims about the nature of these disputes generalizing from the available evidence. Private companies are often formed on the basis of mutual trust and personal relationships of shareholders. The breakdown of the relationship of shareholders causes disputes known as ‘exit disputes’. In this thesis the breakdown of shareholder relationships is termed ‘relational breakdown’. Relational breakdown occurs due to some underlying factors. These underlying factors are primary causes of shareholder disputes. Relational breakdown often precipitates opportunistic conduct by majority shareholders who may seek to enhance their control of the company by exploiting their majority power.<sup>1</sup> The opportunistic conduct of majority shareholders occurs by employment of different squeeze-out techniques. Understanding the characteristics of shareholder disputes will assist to prevent and resolve these disputes in an effective manner that is, with least time and costs.<sup>2</sup> The chapter proceeds as follows. After an introductory account which explores the relational nature of private companies the chapter firstly identifies the underlying causes of relational breakdown and then discusses the nature and kinds of shareholder disputes in private companies.

#### 3.2 Introduction:

The company has a separate legal personality of its own, distinct from its members.<sup>3</sup> Shareholders in private companies often start and run their businesses on the basis of

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<sup>1</sup> See Roberts, P., and Poole J., ‘Shareholders Remedies- Efficient Litigation and the Unfair Prejudice Remedy’ (1999) *Journal of Business Law* 38, 43.

<sup>2</sup> See above meaning of “effectiveness” in chapter 1 para 1.2 The research process.

<sup>3</sup> *Salomon v Salomon* [1897] AC 22.

mutual trust and confidence arising from their personal relationships. In *Ebrahimi v Westbourne Galleries Ltd*,<sup>4</sup> Lord Wilberforce stated that:

The words ['just and equitable'] are a recognition of the fact that a limited company is more than a mere judicial entity, with a personality in law of its own: that there is room in company law for recognition of the fact that behind it, or amongst it, there are individuals, with rights, expectations and obligations inter se which are not necessarily submerged in the company structure.

It was further stated that the company structure was defined by the Companies Act and by the articles of association of the company by which shareholders agreed to be bound. Due to the presence of the element of mutual trust, small private companies may fall into the category of quasi-partnership companies that enable the court to subject the exercise of legal rights to equitable considerations.<sup>5</sup> In *R & H Electric Ltd v Haden Bill Electrical Ltd*<sup>6</sup>, Walker J, relying on *Ebrahimi v Westbourne Galleries Ltd*<sup>7</sup> stated that a private company formed “on the basis of a personal relationship, involving mutual confidence [is] a typical if not essential ground on which it may be equitable to view a private company as a quasi-partnership”. The mutual trust element is often found where a pre-existing partnership has been converted into a limited company.<sup>8</sup>

In *Re a Company (No 005685 of 1988), ex parte Schwarcz (No 2)* it was asserted that:

No doubt in almost every case of a small or private company persons coming together to form a new company would not do so without placing trust and confidence in those who are to be the directors and managers of the company.<sup>9</sup>

The study of the relevant reported case law also shows that the private companies are commonly formed on the basis of mutual trust and the personal relationship of shareholders with all shareholders participating in the management of the company<sup>10</sup> and

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<sup>4</sup> [1972] 2 All ER 492, 500.

<sup>5</sup> See above chapter 1 para 1.1 for definition of quasi-partnership companies. See below chapter 5, for discussion regarding the presence and effects of equitable considerations in private companies.

<sup>6</sup> [1995] 2 BCLC 280, 285.

<sup>7</sup> [1972] 2 All ER 492, 500.

<sup>8</sup> See *Ebrahimi v Westbourne Galleries Ltd* [1972] 2 All ER 492, 500-501.

<sup>9</sup> *Re a Company (No 005685 of 1988), ex parte Schwarcz (No 2)* [1989] BCLC 427, 440.

<sup>10</sup> See above chapter 1 para 1.1. A significant proportion of small private companies who have fewer than five shareholders are companies in which all shareholders are directors and vice versa.

articles that restrict shareholder exit.<sup>11</sup> One American commentator has likened the close corporation to a partnership asserting that the analogy between partnership in the commercial sense and marriage applies with equal force to a close corporation.<sup>12</sup> In both, human relations are the major factor in the distribution of power between shareholders.<sup>13</sup> Disputes often arise among shareholders as a result of the breakdown of personal relations of shareholders in private companies – an occurrence that for convenience is referred to in this thesis as ‘relational breakdown’. It was commented that few disputes were as bitter and acrimonious as those between shareholders and resentment and fury seemed to be most intense when shareholders were from the same immediate or extended family.<sup>14</sup> In *Re a Company (No 005134 of 1986), ex parte Harries*<sup>15</sup> Gibson J stated that:

Proceedings of this kind have been linked to divorce proceedings, aptly so in that the whole history of the relationship between the parties is paraded before the court in minute detail with many an imputation alleged in respect of conduct the equivalent of infidelity and cruelty that has contributed to the irretrievable breakdown in relations.

Chiu has stated that:

Some shareholder disputes are not easily boiled down to specific matters, but may contain a bundle of grievances and allegations involving conduct of the majority. Such matters may be bound up with grievances over substantive management of the company or relational issues between shareholders.<sup>16</sup>

In fact, the appearance of conflicts between shareholders owing to relational breakdown should not be surprising due to the close relationship and close frequent contact of shareholders, in the day-to-day business and management of these companies.

A detailed study of the reported cases regarding shareholder disputes and empirical investigation has been conducted to ascertain the characteristics of shareholder disputes

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<sup>11</sup> See below para 3.3.1.1 *Richards v Lundy* [2000] 1 BCLC 376, See also *R A Noble and Sons* [1983] BCLC 273.

<sup>12</sup> Elson, A., ‘Shareholders’ Agreements, A Shield for Minority Shareholders of Close Corporations’ (1967) 22 *Bus Law* 449, 450.

<sup>13</sup> *Ibid* 450. See also Copp S., ‘Company Law and Alternative Dispute Resolution: An Economic Analysis’ (2002) 23(12) *Company lawyer* 361, 367.

<sup>14</sup> *Ibid* 450.

<sup>15</sup> [1989] BCLC 383, 385.

<sup>16</sup> Chiu, I.H., ‘Contextualising Shareholders’ Disputes – A Way to Reconceptualise Minority Shareholder Remedies’ (2006) *Journal of Business Law* 312, 330.

in private companies. There are three kinds of disputes that often arise once mutual trust has ended and the relationships which underpinned the formation of the company have broken down. In the first kind, relational breakdown precipitates squeeze-out behaviour that exacerbates the dispute. In the second kind, relational breakdown occurs as a consequence of negligent and inefficient management by the controlling shareholder. In the third kind, relational breakdown gives rise to exit disputes. These three kinds of disputes will be furthered referred to in the thesis as ‘type 1’, ‘type 2’ and ‘type 3’ disputes.

In type 1 disputes relational breakdown often generates a desire in the majority either to enhance their stake or to obtain the outright control of the company. That desire precipitates opportunistic conduct on the part of the majority. Opportunistic conduct or squeeze-out behaviour involves the employment of different techniques, known as squeeze-out techniques that exacerbate the dispute. Squeeze-out behaviour occurs when the majority shareholders misuse their powers available under majority rule<sup>17</sup> to gain an unfair advantage over minority shareholders by diminishing their role or stake in the company. The precipitating squeeze-out behaviour of majority shareholders in the event of relational breakdown exacerbates the dispute so that it is not possible for shareholders to work together in the same company.

In type 2 disputes relational breakdown of shareholders does not precipitate squeeze-out behaviour. Here the negligent or inefficient management of the company triggers relational breakdown to such an extent that it is hard for shareholders to continue the business together in the same harmony. Type 3 disputes, are ‘exit disputes’ that arise after relational breakdown once the parties have accepted that it is not feasible for them to stay united in the same company. Due to the closely held nature of these companies there are invariably restrictions on the transfer of shares in the articles. Therefore relational breakdown gives rise to further complaints regarding ‘illiquidity’ and ‘valuation’. The minority often desire to liquidate their investment at a value they consider is fair. However, the majority dispute the terms on which the minority are

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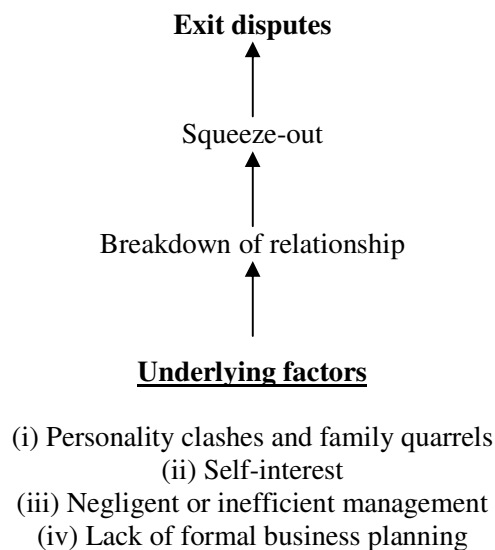
<sup>17</sup> See above chapter 1 para 1.1.

prepared to exit. The dispute then comes down essentially to money i.e. how much and on what terms one or other party walks away.

In fact the relational breakdown, that precipitates squeeze-outs and causes 'exit disputes', occurs owing to some underlying factors. These underlying factors are very often personality clashes and family quarrels, self-interest, negligent and inefficient management and lack of formal planning of shareholders before embarking on a business venture through the medium of private companies. These underlying factors lead to relational breakdown and can be described as primary causes of shareholder disputes. A probable model of the characteristics of minority shareholders disputes in private companies that can be inferred from the study of the reported case law and empirical research is set out below in figure 3.1 for convenience.<sup>18</sup>

*Figure: 3.1*

***Characteristics of Shareholder Disputes in Private Companies***



Unlike shareholders in listed companies, minority shareholders in private companies have no market to sell their shares. Moreover because of the closed nature of these

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<sup>18</sup> In fact figure 3.1 clearly explains the characteristics of type 1 and type 3 disputes. In type 2 disputes relational breakdown directly cause exit disputes skipping the deliberate squeeze-out behaviour of majority shareholders.

private companies there are often restrictions on transfer of shares to outsiders. Due to the lack of exit opportunities, minority shareholders in private companies arguably need recourse to the courts to resolve their disputes often by seeking exit. It is evident from the case law and the Law Commission Report that the resolution of these disputes and the provision of appropriate relief through the courts is a lengthy and expensive process.<sup>19</sup> Commentators<sup>20</sup> have suggested that this opportunistic behaviour through employment of squeeze-out techniques can be prevented and disputes arising from such opportunistic conduct can be resolved through *ex ante* contractual arrangements.<sup>21</sup> It has been asserted that *ex ante* contractual arrangements can avoid the need for recourse to the courts and so reduce the need for lengthy and cumbersome litigation.<sup>22</sup> Hence, to explore the scope and potential of *ex ante* contractual arrangements, it is necessary first to consider the characteristics of shareholder disputes in private companies. That includes the nature and causes of these disputes and for which *ex ante* contractual provision could be made. Identification of these characteristics also underpinned the study of the effective resolution of shareholder disputes: unless we could understand the nature and dynamics of these disputes we could not hope to understand how best to resolve them.

During the empirical research<sup>23</sup> the interviewees also discussed the factors underlying relational breakdowns and the characteristics of shareholder disputes drawing on their extensive practical experience. In the paragraphs below in the light of the study of the reported cases and interviewees' responses the chapter discusses the common factors underlying relational breakdown which I have described as primary causes of these disputes. I then go on to provide a more detailed account of the three types of disputes that I have identified.

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<sup>19</sup> See below chapter 5, for Law Commission's criticism on the court based dispute resolution mechanism under sections 459-461 of the CA 1985.

<sup>20</sup> See Boros, E., *Minority Shareholders Remedies* (Clarendon Press, Oxford 1995) and Cadman, J., *Shareholders' Agreements* (4<sup>th</sup> ed Sweet & Maxwell, London 2004).

<sup>21</sup> See below chapter 4 The scope of *ex ante* contracting as a means of protecting minority shareholders' interests.

<sup>22</sup> See below chapter 5 The evolution of the unfair prejudice remedy and the Law Commission's critique.

Chapter discusses in detail the problems associated with the proceeding under section 459 of the CA 1985.

<sup>23</sup> Methodology of empirical research is discussed above in chapter 2.

### **3.3 Causes of relational breakdown:**

As already indicated relational breakdown precipitates squeeze-out behaviour and cause 'exit disputes' in private companies. Relational breakdown occurs due to underlying factors that are in fact primary causes of shareholder disputes. Here the chapter identifies the underlying factors of relational breakdown as can be inferred from the relevant reported case law and the empirical data. The purpose of the discussion is to identify the patterns suggesting that relational breakdown is a critical characteristic of shareholder disputes in private companies. This is highly relevant to the evaluation of the effectiveness of *ex ante* contracting and section 459 as dispute resolution mechanisms.

#### ***3.3.1 Identification of the underlying factors of relational breakdown:***

There can be various possible underlying factors that end the mutual trust and lead to the break down of the relationship between shareholders in these companies which can be hard to identify. During the study of the reported case law and empirical investigation, an attempt was made to identify the main factors that tend to undermine shareholder relationships. The identification of these primary causes is very significant if we are to understand the nature of shareholder disputes in these types of companies with a view to preventing or resolving such disputes. O'Neal placed emphasis on the high desirability of a careful study of the underlying causes of squeeze-outs.<sup>24</sup> Clearly, effective resolution depends on a proper understanding of the disputes that are sought to be resolved within the legal system.

Due to the complex nature of these disputes it can be difficult to identify these underlying factors from the facts of the cases by reading the relevant law reports. It is often the case as in *Re Bhullar Bros Ltd*,<sup>25</sup> that the court will not look into the reasons behind the relational breakdown because it is not material for the purposes of the case.<sup>26</sup> Sometimes even the shareholders who are involved in these disputes fail to identify any specific cause of their dispute. Indeed one of the interviewees indicated that sometimes

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<sup>24</sup> See F.H. O'Neal and R. Thompson, *O'Neal's Oppression of Minority Shareholders*. (2<sup>nd</sup> ed Callaghan 1985) chapter 9 para 9:01.

<sup>25</sup> [2003] EWCA Civ 424; [2003] BCC 711; [2003] 2 BCLC 241.

<sup>26</sup> *Re Bhullar Bros Ltd* [2003] EWCA Civ 424 para 10. See also below para 3.4.1.2.1.



it is hard to identify any specific reason (either business or personal) that triggers relational breakdown [F].<sup>27</sup> Similarly in *Mckee v. O' Reilly*<sup>28</sup> the shareholders had a very close and successful business and personal relationship for some fourteen or fifteen years but for some reason which was hard to identify even by themselves their relationship deteriorated rapidly to the point that it was difficult for them to continue business successfully together. Both parties blamed the other for the breakdown.

The study of the reported case law and the empirical research show that the primary underlying causes of the shareholders disputes tend to be personality clashes and family quarrels, self-interest, negligent and inefficient management and lack of formal planning by shareholders before starting the business. It is these factors which tend to trigger relational breakdown. The interviewees' responses as a whole placed particular emphasis on personality clashes and family disputes, business conflicts and human vices such as greed or jealousy. Interviewee T expressed the view that the breakdown of personal or family relationships, and factors such as dishonesty and distrust are common causes of shareholder disputes. Interviewee K drew the analogy between shareholder and matrimonial disputes and reinforced the point that dishonesty is often an underlying cause. Interviewee C emphasized the role of self-interested behaviour in these disputes and noted, in particular, how greed on the part of the controlling shareholder was often a trigger for squeeze-out behaviour. Relational breakdown may be caused by one factor or a combination of factors though, as was the case in *Mckee v O'Reilly*, it is not always a straightforward matter to identify the pivotal factor or factors. Human vices such as greed and jealousy may operate independently or cumulatively with other factors such as conflicts regarding management of the business.<sup>29</sup> The underlying factors that lead to relational breakdown identified by the study of the reported case law and the empirical research are discussed below in detail.

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<sup>27</sup> Here alphabet in square brackets '[F]' refers to interviewee's name given to him in the thesis instead of using the original name of interviewee, for the purposes of ensuring anonymity. The same practice is observed in the whole thesis for all interviewees. See above chapter 2 para 2.3.2.3 Analysis of Data and Table 2.3.

<sup>28</sup> [2004] 2 BCLC 145.

<sup>29</sup> See below *Re London school of Electronics Ltd* [1985] BCLC 273 para 3.4.1.2.

### 3.3.1.1 Personality clashes and family quarrels:

One commentator has explained that, in practice clients who approach a lawyer with a view to incorporating their business tend to focus simply on the process of incorporation. The lawyer is not usually asked and perhaps he is not best qualified to answer, the important question, “are we a good fit?”<sup>30</sup> In *Re a Company (No 007623 of 1986)*, Lord Hoffmann (as he then was) asserted that in many cases it becomes impossible in practice for shareholders to work together in the same company without it obviously being the fault of one party or the other. They may have come together with a confident expectation of being able to co-operate but found later that owing to insurmountable differences in their personalities it is impossible.<sup>31</sup> He subsequently restated the view that relationships can break down without either side having done anything seriously wrong or unfair when he reached the House of Lords.<sup>32</sup> The interview evidence confirms that personality differences that are latent or clouded by over-optimism at the outset tend to cause relational breakdown subsequently once those differences are out in the open. O’ Neal has stated that dissension in a close corporation often results from personality clashes among shareholders and suggested that a prospective shareholder should consider the personalities of other shareholders before starting business with them.<sup>33</sup>

Interviewee D said that relational breakdown, like divorce, often occurs not because of external factors but because “people cannot stand each other any more”. Interviewee S also observed that shareholder disputes are often personal in nature:

People think they are contributing more to the business than their partners or they are not getting much recognition, somebody is taking too many holidays, somebody has got a better house or a better girlfriend. It is all personal. Alternatively they are suspicious of the other party or have become suspicious because even if they have not actually done something they just think they have. That suspicion gets worse and worse [S].

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<sup>30</sup> Elson, A., ‘Shareholders’ Agreements, A Shield for Minority Shareholders of Close Corporations’ (1967) 22 *Bus Law* 449, 450.

<sup>31</sup> *Re a Company (No 007623 of 1986)* [1986] BCLC 362, 366.

<sup>32</sup> See *O’Neill v Phillips* [1999] 2 BCLC 1, 14.

<sup>33</sup> See F.H. O’Neal and R. Thompson, *O’Neal’s Oppression of Minority Shareholders*. (2<sup>nd</sup> ed Callaghan 1985) chapter 2 para 2:02. See also below para 4.6.1 for scope of *ex ante* contracting to prevent personality clashes.

Interviewee J mentioned that people often started out in business but later discovered that one of them was more intelligent and hardworking and wanted to expand the business whereas the other was less ambitious and quite happy to maintain the *status quo*. Inevitably, this may lead to tension within the relationship [J]. In *Ex parte Kremer*<sup>34</sup> the petitioner complained that the respondent was patronising towards him, and had refused to accord him the status and responsibilities to which he felt he was entitled. The respondent denied these allegations and put a case in response to the effect that the petitioner was idle and frequently drunk. In *Allmark v Burnham*<sup>35</sup> both shareholders had been friends for many years before they had decided to go into business together. After a short time running the business their relationship became strained and ultimately broke down. The court found as a fact that the majority shareholder had not treated his erstwhile friend, the minority shareholder as a partner having equal status in the business. Indeed, the majority shareholder formed the view that the minority shareholder was not his intellectual equal and seems to have come to regard him with some disdain.

One interviewee went so far as to suggest that some people had personal characteristics that mean in truth “they should not be in business with someone else because they [are] not just made for it”. The same interviewee added that:

There were people who may be well-suited to running a business on their own but who either for convenience or genuinely because they think it would be a good idea, go into business with somebody else but it turns out that they find it difficult to work with others [J].

In *Irvine v Irvine* the majority shareholder was a dominant person who was dismissive of the need to involve his co-director and shareholder in decision making regarding the fixing of remuneration and dividends viewing himself as the generator of the bulk of the business profits.<sup>36</sup> It can be inferred that disputes may arise because the majority shareholder equates him/herself as being akin to a sole trader.

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<sup>34</sup> [1989] BCLC 365, 366.

<sup>35</sup> [2005] EWHC 2717; [2006] 2 BCLC 437 also known as *Re Distinct Services Ltd*.

<sup>36</sup> [2006] All ER (D) 153 para 357.

In *Woolwich v Twenty Twenty Productions Ltd*<sup>37</sup> the aggressive and bullying conduct of Mr. Woolwich who was a minority shareholder in the company towards junior members of staff lead to relational breakdown which, in turn, caused the other shareholders to exclude Woolwich from the company.<sup>38</sup> Woolwich's personal conduct was therefore at the root of the dispute. On one occasion, he shouted at members of staff who employed an archive researcher to work in the company. He said, "I am an executive producer and if I tell you he's (archive researcher) crap he is, and you do as I say". Moreover, "he denied he had acted inappropriately and insisted that he was entitled to reprimand staff". The court stated that the majority shareholders had been justified in concluding that Mr. Woolwich's continued involvement in the management of the company business placed the smooth running of the company's business in serious jeopardy and that his conduct was the cause of the breakdown of the original relationship of mutual confidence between him and his fellow shareholders.<sup>39</sup>

Interviewee H said that he had come across disputes which at root were highly personalized and had become so because of personal prejudices relating to matters such as race, gender or sexual orientation:

In one of my cases the majority had discriminated against the minority because the minority was homosexual. There are companies where people didn't want to work with women. They wake up one morning and decide OK, discriminate against homosexuals this week, very odd [H].

Interviewees also emphasized the role played by family quarrels in shareholder disputes. One pointed out that disputes in family-run companies often arise when the business is transferred to the next generation who may have been educated differently, have different personalities, face different cultural influences and may not have the same sense of cooperation as the previous generation who had founded the business [J]. Other interviewees added that often the founders of these family companies dealt with their differences very well but later disputes arose among their children because of their different personalities and goals in life [B, E].

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<sup>37</sup> [2003] All ER (D) 211 (Feb); [2003] EWHC 414 (Ch) 424.

<sup>38</sup> See below para 3.4.1.1.1 Disregard of minority shareholders' participation in the company.

<sup>39</sup> [2003] All ER (D) 211 (Feb); [2003] EWHC 414 (Ch) 432.

### 3.3.1.2 Self-interested behaviour:

In a great number of reported cases it can be inferred that self-interested behaviour - for example, the desire for power and wealth – has led to relational breakdown and caused one party to want to obtain outright control of the company. In these cases such behaviour precipitates the employment of squeeze-out techniques which elevate a personal dispute into a legal dispute.<sup>40</sup> These tendencies may only manifest themselves over time as the business and business relationship evolve. The interview evidence suggests strongly that behind many disputes the motivating factors were lust for power, jealousy, fear and greed. For example, one interviewee said this:

These businesses started in the spirit of good will like a marriage and 99 times out of 100 two human factors known as greed and jealousy are behind these disputes [G].

Interviewee F explained a variety of reasons behind the fact that people no longer like each other that cause disputes in private companies, but further stated that:

Disputes often arise when the company is worth something... and shareholders want to control the company or want to take the business in a different direction [F].

Sometimes the introduction of third parties such as wives, brothers or children may change the dynamic between the existing parties [B]. In *Richards v Lundy*<sup>41</sup> the minority shareholder was excluded from the management of the company by the majority on the basis of his alleged incompetence regarding the company's business. No such incompetence on the part of the minority had been established in the evidence and no such personality clashes existed that had made the minority shareholder's exclusion inevitable.<sup>42</sup> It appears in fact, that the majority shareholder was probably influenced by his son's return to the company, had considered the petitioner to be expendable and

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<sup>40</sup> In *A & BC Chewing Gum Ltd* [1975] 1 All ER 1017, *Re Cumana Ltd*, [1986] BCLC 430, *RA Noble and Sons (Clothing) Ltd*, [1983] BCLC 273 and *North Holdings Ltd v Southern Tropics Ltd* [1999] 2 BCLC 625 it can be inferred that self interested human nature led to the breakdown of the personal relationship of shareholders and caused disputes. It can also be inferred from cases like *Re a Company (No 005136 of 1986)* [1987] BCLC 82, *Re Kenyon Swansea Ltd* [1987] BCLC 514 and *Russell v Northern Bank Development Corporation Ltd* [1992] BCLC 1016 that the self-interested desire to increase power or wealth, led to the relational breakdown of shareholders and generates the desire to obtain outright control of the company by allotting shares and altering the articles to dilute the minority shareholders' investment or voting power in the company that cause dispute.

<sup>41</sup> [2000] 1 BCLC 376. See also *Ebrahimi v Westbourne Galleries Ltd* [1972] 2 All ER 492.

<sup>42</sup> See also below para 3.4.1.1.1 Disregard of minority shareholders' participation in the company.

decided to remove him from the company with a view to acquiring his shares so as to make the company entirely a family concern. This self-interested behaviour of the majority shareholder – the desire to assert outright family control over the business – appears to have precipitated the squeeze-out behaviour. Moreover, it appears that his actions were also motivated by the desire to minimise inheritance tax that might otherwise have been payable in respect of his interests in the company in the event of his death.

Interviewee H said that in one of his present cases his client who was a minority shareholder had been removed as a director of the company by a resolution of the board of directors. Even though the board of directors did not have the power to remove his client as a director, the resolution was passed to obtain outright control of the company. Furthermore, one of his client's shareholding was diluted by the company making a rights issue due to the personal financial interests of the majority. His client who was minority did not take up the rights issue because it was not worthwhile to his client to pay another £20,000 for the shares [H]. So self-interested behaviour is one major factor behind the relational breakdown in private companies.<sup>43</sup>

### *3.3.1.3 Lack of formal planning:*

Relational breakdown can also occur because of conflicts regarding management of the company's business. In *Jones v Jones*<sup>44</sup> the relationship between the two shareholders broke down. There were disagreements about business strategies. The first shareholder wanted to expand the enterprise by taking on more plant and equipment with a consequent increase in debt and risk. The other shareholder did not wish to do this and this led to a parting of the ways. This section discusses the situations in which these business conflicts can arise. A strong theme emerging from the desk-based and empirical research is that management conflicts often arise because the shareholders either give no or insufficient advance consideration to the nature and medium of the business venture upon which they are embarking.

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<sup>43</sup> These examples reflect fact patterns observable in reported cases: see cases cited and discussed in paras 3.4.1.1 and 3.4.1.2 below.

<sup>44</sup> *Jones v Jones* [2003] BCC 226 para 9.

(i) *Contradictory business interests:*

One interviewee stated that lack of shared vision and differing personal objectives commonly lead to relational breakdown:

People can have different business interests and their goals in life may diverge. Those who have children want long term planning and those who don't want profits [G].

In *Re Sam Weller and Sons Ltd*<sup>45</sup> the court held that a policy of paying minimal dividends over a long period of time could possibly be in the interests of the respondents through the enhancement of the capital value of their shares but was against the petitioner's interests in receiving immediate income in the form of larger dividend.<sup>46</sup> Therefore, the shareholders' contradictory business and investment objective resulted in diverging views over whether profits should be retained or distributed.

(ii) *Lack of understanding regarding the corporate medium:*

In the light of professional experience interviewee R said that shareholders' lack of understanding regarding the corporate medium may often cause disputes some time after the incorporation of the business. Shareholders may not necessarily grasp the intricacies of corporate law, the strength of the majority rule, the lack of an organized market in the shares and the fact that under private company articles of association there are often limited rights of exit:

People start companies and it is quite easy to do without really understanding exactly what these companies are. Then people find themselves in something that they have less control over than they thought and they find it hard to deal with. A lot of people don't appreciate just how restricted the rights of a minority shareholder are in a private company not only as a matter of law but also as a matter of economics [R].

Similarly, it appears that in *Quinlan v Essex Hinge Co Ltd*<sup>47</sup> due to disagreement over the company's policy and confidence of the majority upon their voting strength, the majority over reacted towards minority by employing squeeze-out techniques that caused dispute.<sup>48</sup>

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<sup>45</sup> *Re a Company (No 823 of 1987)* [1990] BCLC 80.

<sup>46</sup> See below para 3.4.1.2.1 Misappropriation of company's assets and proceeds.

<sup>47</sup> [1996] 2 BCLC 417.

<sup>48</sup> See below para 3.4.1.1.1 Disregard of minority shareholders' participation in the company.

*(iii) Unforeseen developments:*

A number of interviewees confirmed that small private companies are often formed on the basis of mutual trust and without any formal stipulations and planning at the time of starting business. Lack of advance planning regarding the business may cause conflicts anytime during the life of the company. Elson makes the colourful point that “when the rosy glow of anticipated profits which had blurred the natural good sense of the client had dissolved or had increased beyond expectation, the trouble began”.<sup>49</sup> Of course, the future direction of a business is not wholly predictable and unforeseen developments may frustrate shareholder expectations and overtake any plans that they may have been made. This point is borne out by the following interview extract:

The company is either much more profitable than the shareholders thought or it is much less profitable than their expectations and therefore the arrangements that they have made are not suitable for these new circumstances. Either somebody thinks they should be getting more money or somebody thinks that someone else should be receiving less [R].

*(iv) Disparity of contribution:*

Interviewee R also pointed out that conflicts can occur because of perceived disparities in contribution between shareholders:

One shareholder has a bright idea and the other shareholder is going to actually make it work. In this situation shareholders often fall out, because one person thinks he is contributing more than the other [R].

Similarly, in *Re Cumana Ltd*<sup>50</sup> the majority shareholder thought that the success of the business was largely due to his efforts and that the minority had contributed little. However, it was stated that:

Sometimes what parties call dishonesty in this context, is a question as to the parties’ belief as to the importance of their contribution to the business, as compared to their quasi-partners [M].

Interviewee M added that shareholders’ expectations from the company’s business were not always the same and they often did not share those expectations with one another at the start of the business, which caused dispute later.

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<sup>49</sup> Elson, A., ‘Shareholders’ Agreements, A Shield for Minority Shareholders of Close Corporations’ (1967) 22 Bus Law 449, 450.

<sup>50</sup> [1986] BCLC 430, 434.



(v) *Informality in the running of the company:*

Several interviewees explained that private companies are often formed on the basis of mutual trust so often the informal nature of governance and decision making in private companies can be a source of difficulty as well as flexibility.<sup>51</sup> The Company Law Review in setting out their ‘think small first’ objective also proposed that the law should be more simplified for small private companies; their approach was later implemented in the CA 2006.<sup>52</sup> Frequently directors do not have board meetings and sometimes they even do not have proper discussion of important business matters. In *Re a Company (No 00789 of 1987), ex parte Shooter*<sup>53</sup> the controlling shareholder did not hold annual general meetings and lay accounts before members, so that members were wholly deprived of any opportunity to know what was going on in the company.<sup>54</sup> Such informality also leads to minority shareholder’s unfair exclusion from management of the company.<sup>55</sup>

One interviewee added that shareholders generally do not complain about this informal decision making process but:

[Once their relationship breaks down] shareholders complain when previously they would never have complained about [decision making processes] by saying there has been failure to comply with section or article such and such [S].

The theme that emerges is that relational breakdown can occur as a result of a lack of advance formal planning by shareholders. This can encompass lack of preparation for the requirements of company law, failure to anticipate foreseeable developments and an absence of shared vision and business objectives as regards the management of the company. So it stresses the need for advance formal planning by shareholders which can be done by *ex ante* contractual arrangements.<sup>56</sup> As shareholders in these companies start business on the basis of their personal relationships, it seems that shareholders are

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<sup>51</sup> See *Fisher v Cadman* [2006] 1 BCLC 499.

<sup>52</sup> See Company Law Review ‘Modern Company Law for a Competitive Economy: Developing the Framework’ (URN 00/656, March 2000) Chapter 6. A number of respondents were in favour of a minimum regulation for small and closely-held companies [6.16].

<sup>53</sup> [1990] BCLC 384.

<sup>54</sup> See below para 3.4.1.1.1 Disregard of minority shareholders’ participation in the company.

<sup>55</sup> See below para 3.4.1.1 Exclusionary impact of squeeze-out.

<sup>56</sup> Below chapter 4 discusses in detail the scope and limitations of *ex ante* contracting in shareholders’ agreements.

optimistic about the prospects of their business relationship therefore do not feel any need for forward planning.<sup>57</sup>

### **3.4 Nature and kinds of minority shareholders' disputes:**

Relational breakdown causes disputes among shareholders who are often also directors of the company.<sup>58</sup> As stated in the introduction of the chapter above, in private companies, disputes that arise in the event of relational breakdown can be divided into three types. In type 1 disputes which are the major kind, relational breakdown precipitates squeeze-out behaviour by majority shareholders that exacerbates the dispute. Squeeze-out behaviour occurs when majority shareholders exploit their powers to gain an unfair advantage over minority shareholders or to reduce or eliminate the interests of minority shareholders in the company. In type 2 disputes relational breakdown occurs due to negligent or inefficient management of majority shareholders without any precipitating squeeze-out behaviour. Type 3 disputes revolve around the terms of exit of one or more minority shareholders from the company following relational breakdown. The courts do not intervene simply because relational breakdown has occurred, but only when it is triggered by negligent or inefficient management<sup>59</sup> or accompanied by squeeze-out behaviour.

#### ***3.4.1 The relational breakdown precipitating squeeze-out behaviour:***

It is evident from the desk-based and empirical research that relational breakdown in private companies often precipitates the opportunistic conduct of majority shareholders through the use of what I termed squeeze-out techniques. The employment of these techniques exacerbates the situation and causes shareholder disputes in these companies. In other words, what starts as a relational breakdown is escalated by squeeze-out behaviour to a full-blown legal dispute. Squeeze-out techniques invariably involve an abuse of majority rule. Misuse of majority rule may also involve conduct that breaches

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<sup>57</sup> See also below chapter 4 para 4.6.2 Optimism bias. However, behavioural analysis of shareholders' optimism drawing on psychology is beyond the scope of the thesis.

<sup>58</sup> See above chapter 1, Introduction, para 1.1. It is also evident from the cases below that in private companies shareholders are also directors of the company.

<sup>59</sup> See *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354; *Re Elgindata Ltd* [1991] BCLC 959. See also below para 3.4.2

of the terms upon which the company affairs should be run. In private companies these terms governing the conduct of the company's affairs can be based upon (i) mutual understanding of the shareholders giving rise to equitable considerations<sup>60</sup> or (ii) formal legal requirements and/or terms stipulated by shareholders in the articles of association or through private ordering in separate shareholders' agreements. The impact of the squeeze-out behaviour can be either exclusionary or expropriatory on some or all of the shareholders' rights regarding (i) participation in the management of the company and/or (ii) capital investment or returns.

This section discusses the exclusionary and expropriatory impacts of squeeze-out behaviour drawing upon my desk based and empirical research. It is useful to mention that the impact of squeeze-out behaviour upon minority shareholders can be both exclusionary and expropriatory simultaneously.

#### *3.4.1.1 Exclusionary impact of squeeze-out:*

The impact of squeeze-out behaviour is exclusionary when minority shareholders' rights to participate in the management of the company are disregarded by the majority. This disregard of participation includes instances where: (i) the minority is expressly excluded from the management of the company; (ii) the minority has not been provided access to information regarding the company's affairs; (iii) the minority has not been consulted in the decision making process of the company. These exclusionary impacts of squeeze-out behaviour are discussed further below.

##### *3.4.1.1.1 Disregard of minority shareholders' participation in the company:*

Lord Wilberforce observed in *Ebrahimi v. Westbourne Galleries Ltd*<sup>61</sup> that the company "structure is defined by the Companies Act and by the articles of association by which shareholders agree to be bound". Section 168(1) of the CA 2006 provides that a company may by ordinary resolution at a meeting remove a director before the expiration of his period of office, notwithstanding anything in any agreement between it

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<sup>60</sup> See *O'Neill v Phillips* [1999] 2 BCLC 1. For detail discussion of the case see below chapter 6 para 6.3 *O'Neill v Phillips*.

<sup>61</sup> [1973] AC 360, 379.

and him.<sup>62</sup> Minority shareholders in private companies often complain that they have been excluded from the management of the company, contrary to their expectations as a member of the company.<sup>63</sup> A survey conducted by the Law Commission in 1997 found that 67% of petitions presented by members of private companies in 1994 and 1995 to the Companies Court in London pursuant to section 459 of the CA 1985 for relief from unfair prejudice alleged exclusion from management.<sup>64</sup> All interviewees had encountered shareholder exclusion from management very often in practice. One interviewee stated in this context that:

In my experience getting rid of a shareholder as a director or employee, I mean exclusion from management of the company is the most common complaint [H].

In *Parkinson v Eurofinance Group Ltd*<sup>65</sup> the petitioner, Mr. Parkinson was excluded from management and control of the company. Moreover, the respondents sold the company to another company in which the respondents were together entitled to a majority of the votes. It was alleged *inter alia* that Mr. Parkinson had breached his duties as a director. Along with one alleged instance of dishonesty, it was alleged that he had failed to comply with the terms of a shareholders' agreement the existence of which he denied. Due to these allegations the respondents argued that Mr. Parkinson's exclusion was fair. The court disagreed. The trial judge, Pumfrey J, stated that:

There is no doubt that by the time that Mr. Parkinson was excluded from the management of the company the relationship of trust and confidence which had previously existed between the directors had come to an end.

It had also become clear to the judge during the trial that the parties' recollection of events had to a significant extent been overtaken by their mutual dislike. It was found as a fact that the relationship between the shareholders had foundered before the

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<sup>62</sup> This section does not contain an additional part of the previous provision under section 303 of the CA 1985 that a company may by ordinary resolution remove a director before the expiration of his period of office, notwithstanding *anything in its articles* or in any agreement between it and him. Nevertheless, it is thought that the operation of CA 2006, s 168 cannot be expressly excluded in the articles: see Davies P., *Gower and Davies' Principles of Modern Company Law* (8<sup>th</sup> ed Sweet and Maxwell, London 2008) 389 (n 102).

<sup>63</sup> See below *R & H Electric Ltd and another v Haden Bill Electrical Ltd* [1995] 2 BCLC 280; *Richards v Lundy* [2000] 1 BCLC 376; *Parkinson v Eurofinance Group Ltd* [2000] All ER (D) 826.

<sup>64</sup> See *the Law Commission Consultation Paper*, Appendix E – Statistics.

<sup>65</sup> [2000] All ER (D) 826.

petitioner's exclusion and that the main purpose of the exclusion was to prevent what was thought to be the risk of him launching a coup. Here, then, relational breakdown precipitated the desire on the respondents' part to obtain outright control by excluding Mr. Parkinson from the management of the company.

In *R & H Electric Ltd v Haden Bill Electrical Ltd*<sup>66</sup> a private company was planned, formed and set up in business in 1989 by four shareholders on the basis of their mutual trust.<sup>67</sup> The petitioner who was a minority shareholder was an experienced businessman, believed in hard work and stressed the need for economy and sacrifice until the business was really well established. The petitioner in evidence concerning his relationship with his fellow shareholders said that "they did, in the end rely just on trust".<sup>68</sup> Various draft shareholders' agreements were discussed but never executed.<sup>69</sup> In 1993 it appears that the majority shareholders formed the view that the petitioner was a "greedy old man" and in 1994 they allied together to exclude the petitioner from management even though he had made a significant contribution to the setting up of the company. One majority shareholder was considered by the court as a very ambitious man with much keener awareness of his talents than his limitations. Here again, relational breakdown precipitated the desire on the respondents' part to obtain outright control by excluding the petitioner from management.

In *Re Regional Airport Ltd*<sup>70</sup> a company was formed for the purposes of investing in and developing regional airports in the UK. The issued share capital was held 50 per cent by one shareholder and 10 per cent each by five other shareholders. Two of the minority shareholders complained regarding their removal as directors from management of the company by majority shareholders. The minority shareholders alleged that the company as a joint venture between the shareholders has always been a quasi-partnership company based upon a relationship of trust and confidence between the shareholders in

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<sup>66</sup> [1995] 2 BCLC 280.

<sup>67</sup> [1995] 2 BCLC 280, 294.

<sup>68</sup> [1995] 2 BCLC 280, 289.

<sup>69</sup> [1995] 2 BCLC 280, 295.

<sup>70</sup> [1999] 2 BCLC 30.

which all the shareholders were entitled to participate as directors of the company.<sup>71</sup> The court acknowledged the entitlement of the minority shareholders to participate in the management of company.<sup>72</sup>

In *Brownlow v G H Marshall Ltd*<sup>73</sup> a family run company was owned by a brother and two sisters who were equal shareholders in the company. The shares in the company were transferred to them by their late parents. The minority shareholder (Mrs. Brownlow) was dismissed and her service agreement was terminated with agreement of all other directors of the company at a board meeting without providing her any reasons for her dismissal. Nearly a year later she was formally removed from the office as a director. Mrs. Brownlow filed a petition under section 459 of the CA 1985 against her exclusion. The family company was formed on the personal relationship evolved over a long period of time. It was claimed by the respondents that there had been a breakdown in the necessary relationship of trust and confidence between Mrs. Brownlow on the one hand and the company and its other directors on the other. The company also faced unfair dismissal proceedings started by Mrs. Brownlow in the industrial tribunal. The majority resisted the claim by setting out the matters that have caused a breakdown in trust and confidence and which undermined the effective running of the company and cast doubt on the minority shareholder's integrity and influenced the decision to dismiss her. The majority shareholders also contended that the minority was excluded from management of company under the terms of the service agreement. The court stated that in a family company no agreement was reached between the shareholders as to what would happen to the shares of a person dismissed from employment under service agreements. In the absence of such agreement or some contrary understanding it does not seem that the terms of the service agreement override the equitable considerations

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<sup>71</sup> [1999] 2 BCLC 30, 34.

<sup>72</sup> Similarly, in *Richards v Lundy*, [2000] 1 BCLC 376, a pre-existing partnership was converted into a limited company. The association between the shareholders was based on a personal relationship which led them to set up a successful business together. Mr. Richard held 10 per cent of the issued share capital in the company. Self interested behaviour on the part of the majority led to relational breakdown and Mr. Richard was subsequently excluded from the management of the company in circumstances where there were also restrictions on the transfer of shares. The court also declare the exclusion of Mr. Richards from the management of the company as unfair. For discussion regarding underlying factors of the dispute see above para 3.3.1.

<sup>73</sup> [2000] 2 BCLC 655.

that had already arisen from the personal relationships within the company.<sup>74</sup> In the presence of such equitable considerations the minority shareholder should not have been removed from office without a reasonable offer being made for her shares. The court ordered buy-out relief sought by the minority shareholder, without discount for the minority nature of the holding. It can be inferred that the dispute arose in the next generation due to self interested behaviour of majority shareholders that caused relational breakdown precipitating a desire to obtain outright control of the company. A similar pattern can be observed in several other cases which tend to bear out the experience of the interviewee referred to above.<sup>75</sup>

Exclusion from participation in the affairs of the company can also occur in two other ways: (i) failure by the majority to consult the minority when making major decisions and (ii) failure by the majority to provide the minority with access to information regarding the company's affairs. Courts can also prefer for convenience to deal with

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<sup>74</sup> [2000] 2 BCLC 655, 674-675.

<sup>75</sup> Allegations of exclusion from management were also made or upheld in the following reported cases: In *Re Metropolis Motorcycles Ltd* [2006] All ER (D) 68 Mar, also known as *Hale v Waldock*, a minority shareholder who owned 42 per cent of the shares in the company alleged that he had right to return to work in the business and had been unfairly excluded from the management of the company. In *Quinlan v Essex Hinge Co Ltd* [1996] 2 BCLC 417, as a result of disagreement over the company's policy majority shareholders excluded a minority shareholder from the management of the company. In *Strahan v Wilcock* [2006] EWCA Civ 13, a minority shareholder also complained against his exclusion from management of a quasi-partnership company. In *Grace v Biagioli* [2006] 2 BCLC 70, the majority passed a resolution to remove the minority as a director without making any offer to purchase his shares. In *Hateley v Morris* [2004] 1 BCLC 582, a minority shareholder holding 25 per cent of the shares in the company complained that he had been excluded from management of the company. He claimed that exclusion was contrary to the arrangement between the shareholders and contrary to the nature of the company that was admitted as quasi-partnership. In *Jones v Jones* [2003] BCC 226; [2002] EWCA Civ 961, a 50 per cent shareholder of a quasi-partnership company complained against the resolution passed on the strength of a casting vote, to exclude him from management of the company. In *Woolwich v Twenty Twenty Productions Ltd* [2003] All ER (D) 211 (Feb); [2003] EWHC 414 (Ch), the company was owned by four shareholders. The majority shareholders at the general meeting of the company passed a resolution for removal of the minority shareholder from the board of the company. The minority shareholder who owned 24 per cent of the shares alleged in his petition *inter alia* that he had been excluded from management of the company by majority shareholders against his interests and contrary to the terms of the shareholders agreements which granted him right to be involved in the management of the company. In *Re a Company (No 005685 of 1988)*, *ex parte Schwarcz (No 2)* [1989] BCLC 427, minority shareholders complained against their wrongful exclusion from management of the company. In *A & BC Chewing Gum Ltd* [1975] 1 All ER 1017, minority shareholders complained that the majority had refused to recognise the removal of a current director and appointment of a new director in his place which infringed their rights under a shareholder agreement to participate in the management of the company. The court held that the majority's refusal was in breach of the shareholder agreement and contrary to the interests of minority shareholders and wound up the company on just and equitable grounds. *See also Re Kenyon Swansea Ltd* [1987] BCLC 514.

these complaints together where all these complaints regarding exclusion are present in one single case.<sup>76</sup> Cases of failure to consult and inform are not uncommon. Minority shareholders often complain that their participating role in the company has been diminished since they have not been properly consulted regarding important corporate decisions. For example in *RA Noble and Sons (Clothing) Ltd*<sup>77</sup> the petitioner alleged that he had not been adequately consulted and informed regarding certain key business transactions and that the respondent had improperly assumed control of the company and had excluded him from involvement in its affairs.<sup>78</sup>

A member cannot inspect the accounting and financial records of the company to get information about the company affairs at his own will. However, a shareholder can complain where he has a formal right to access information regarding company affairs and he has been denied that formal right. The Companies Act provides that every company must send a copy of its annual accounts and reports for each financial year to every member of the company and every member is entitled to be provided on demand and free of charge with a copy of the annual accounts and reports of the company.<sup>79</sup> In private companies, minority shareholders often complain that they have been inadequately informed about the company's affairs and thus excluded from effective participation in the company's affairs. . In *Allmark v Burnham*<sup>80</sup> it was expressly agreed between the shareholders that the minority shareholder's position as a director was not to be prejudiced or altered, and that he was to be kept updated on the progress of the business by weekly written reports. The majority ignored this agreement thus denying the minority what amounted to a contractual right to the provision of information. Complaints regarding denial to give access to company information, were made by

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<sup>76</sup> See *Allmark v Burnham* [2006] 2 BCLC 437, 460.

<sup>77</sup> [1983] BCLC 273.

<sup>78</sup> Similar allegations were made in *Re Cumana Ltd* [1986] BCLC 430 and in *Allmark v Burnham* [2006] 2 BCLC 437 also known as *Re Distinct Services Ltd*, where the company acquired and ran a newsagents, bookshop and greetings card business. The minority shareholder held 36 per cent and majority held 64 per cent of the shares in the company. The majority shareholder was not only running the company on a day-to-day basis which was his agreed primary role within the business, but also simply not involving or consulting the minority shareholder regarding the management of the company whether formally by not holding board meetings or informally.

<sup>79</sup> See ss 423(1) and 431(1) of the CA 2006. Previously ss 238(1) and 239(1) of the CA 1985.

<sup>80</sup> [2005] EWHC 2717; [2006] 2 BCLC 437 also known as *Re Distinct Services Ltd*.



minority shareholders in various reported cases.<sup>81</sup> It is also evident from the reported cases that complaint from exclusion from management can be accompanied by other self-serving behaviour of majority shareholders such as non-payment of dividend and wrongful diversion of company assets or business.<sup>82</sup>

#### *3.4.1.2 Expropriatory impact of squeeze-out:*

The impact of squeeze-out is expropriatory when the majority: (i) misappropriate the assets and proceeds of the company; and/or (ii) dilute the minority shareholders' investment or voting power in the company. Here the chapter discusses the expropriatory impact of squeeze-out in detail.

##### *3.4.1.2.1 Misappropriation of company's assets and proceeds:*

It is a fiduciary duty of directors to use the company assets for the benefit of the company as a whole and not for their own personal benefit.<sup>83</sup> Section 172(1) of the CA 2006 *inter alia* provides that:

A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.

In private companies minority shareholders often complain that majority shareholders who are also directors of the company have misappropriated the company's assets and proceeds for their own personal needs and to satisfy their personal interests.

During the empirical investigation an interviewee shared a recent experience of a case where the minority complained about abuse of power by majority shareholders:

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<sup>81</sup> See particularly the following: In *Re a Company (No 00789 of 1987), ex parte Shooter* [1990] BCLC 384, where the petitioner alleged that the controlling shareholder has not laid accounts before the members that was against their interests since they were not able to evaluate the true position of the company. In *Phoenix Office Supplies Ltd v Larvin* [2003] 1 BCLC 76, a minority shareholder of a quasi-partnership company complained that the majority shareholders had refused to give him access to its accounts and financial information on the ground that he was no longer director of the company. In *Mears v R Mears & Co (Holdings) Ltd* [2002] 2 BCLC 1 the petitioner complained that his forced departure from the board of the company and the company's refusal to provide relevant financial information to the potential purchaser of his shares was against his interests.

<sup>82</sup> See *Baker v Potter* [2004] EWHC 1422.

<sup>83</sup> See the general duties of the directors under ss 170-177 of CA 2006.

The majority did not want to take up a particular opportunity because they did not want the minority to get benefit from it and wanted to avail themselves of the opportunity through a different company without the knowledge of the minority [G].

In *Allmark v Burnham*<sup>84</sup> the majority shareholder established a business named 'Royal's Greetings' in competition with the company. Fixtures and fittings and stock belonging to the company were applied to the use of 'Royal's Greetings' business without keeping proper records and accounts of the inter-company trading. Some expenditure was met by the company for the benefit of 'Royal's Greetings'. Inevitably, a proportion of the majority shareholder's time and effort was taken up with the business of 'Royal's Greetings'. The court concluded that the majority shareholder, as a director and fiduciary, required the fully informed consent of the company to these arrangements and it was accepted in evidence that the minority had been neither informed nor consulted. In *Gerrard v Koby*<sup>85</sup> following relational breakdown the minority shareholders alleged that the majority had purchased property to the detriment of the company and with the expectation of making a secret profit that exacerbated the dispute to an extent that the best solution suggested was their separation.

In *Re Bhullar Bros Ltd*<sup>86</sup> a family company was owned by two brothers Mohan and Sohan. Later their children also became directors of the company. Each brother and his family owned 50 per cent shares in the company. The Mohan family alleged that the Sohan family had purchased a property for their personal benefit adjacent to the company's property without communicating the existence of investment opportunity to the company which is against their interests. At the time of the purchase the relationship between the shareholders had already broken down and a state of considerable acrimony prevailed. Subsequent negotiations to divide the company assets and business between the shareholders failed. The Court of Appeal held that the existence of the opportunity to buy the property was information that was relevant to the company which the Sohan

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<sup>84</sup> [2005] EWHC 2717; [2006] 2 BCLC 437 also known as *Re Distinct Services Ltd*. Underlying cause of the dispute was discussed below in para 3.4. See also *North Holdings Ltd v Southern Tropics Ltd* [1999] 2 BCLC 625 where the minority shareholder complained that majority has misused the assets of the company for their own benefit.

<sup>85</sup> [2004] All ER (D) 139 (Jul).

<sup>86</sup> [2003] EWCA Civ 424; [2003] BCC 711; [2003] 2 BCLC 241.

family were therefore under a duty to communicate to it.<sup>87</sup> Similar kinds of allegations of breach of fiduciary duties arising out of misappropriation of company's assets and proceeds were made in various other reported cases.<sup>88</sup>

Another aspect of expropriatory squeeze-out behaviour which can arise in cases where not all of the shareholders are directors is the application of company funds to pay directors' remuneration rather than by declaring dividends. As to the proper application of the company's funds in balancing the payment of remuneration to the directors and dividends to the shareholders, in *Re Halt Garage (1964) Ltd*<sup>89</sup> it was held that it was for the company management and not for the court to decide the amount to be awarded as reasonable remuneration. However, where directors' remuneration is considered excessive for their personal needs disputes may arise between the shareholders.<sup>90</sup> In *Bonham v Crow*<sup>91</sup> the minority shareholder alleged that the majority shareholders had paid themselves and the wife of one of the directors, excessive remuneration. The judge accepted that those grounds had caused unfair prejudice to the minority. Similar

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<sup>87</sup> [2003] EWCA Civ 424 para 41.

<sup>88</sup> In *Re London School of Electronics Ltd* [1985] BCLC 273 the minority shareholder complained that the City Tutorial College Limited, the majority shareholder in the company, had wrongfully diverted the students of the school to itself which was against his interests as a minority shareholder. It was concluded by court that while there was no doubt that during the academic year the minority shareholder proved himself to be difficult and unreliable in the discharge of his teaching and related duties, the majority shareholders had over reacted by diverting the company's business in their own interests thus depriving the minority of expected profits. It can be inferred that management conflict was due to self-interested behaviour of majority shareholders to enjoy the profits and success of business independent of the minority shareholder. These factors cause relational breakdown and resulted in squeeze-out behaviour which exacerbated the dispute. In *Re Cumana Ltd* [1986] BCLC 430, the majority shareholder diverted part of the business of the company into a company in which he held the majority shareholding. The court considered the move against the interests of the minority shareholder since there seemed to be no good commercial reason for such diversion. In *Ex parte Kremer* [1989] BCLC 365 at 366, petitioner alleged that the respondent had charged certain personal expenses to the company and allowed members of his family and friends to have holidays at the company's expense. In *Re a Company* [1986] 2 All ER 253, the minority shareholders alleged that the respondent had disposed of the company assets the purchase price of which had been paid into bank accounts abroad which was contrary to the interests of the minority. The petition was presented to require the respondent to account to the company for certain payments which had been made without authority. The Official Receiver was appointed, but had no success locating any of the assets of the company. The company's records were believed to be abroad and respondent was also living at an unknown address abroad. In *Brenfield Squash Racquets Club Ltd* [1996] 2 BCLC 184, the minority shareholder alleged that the majority had caused the company to grant bank security over the company's assets without there being any possible benefit to the company itself.

<sup>89</sup> [1982] 3 All ER 1016.

<sup>90</sup> *Re a Company, ex parte Burr* [1992] BCLC 724; *Lloyd v Casey* [2002] 1 BCLC 454.

<sup>91</sup> [2001] All ER (D) 409 (Dec).

allegations as to excessive remuneration of directors have been repeatedly made in the reported cases.<sup>92</sup>

Allegations of excessive remuneration of directors often accompany complaints as to little or no participation in the profits of the company. In reported case law minority shareholders repeatedly complain about the channeling of company resources towards the majority through unjustifiable directors' remuneration which might otherwise have provided minority shareholders with an income yield on their investment. The low dividend policy is linked with excessive remuneration because if the company profits are used to remunerate directors excessively there will not be enough profits left to distribute by way of dividend. In *Re a Company (No 00370 of 1987), ex parte Glossop*<sup>93</sup> Harman J stated that:

...in my judgment, right to say that directors have a duty to consider how much they can properly distribute to members. They have a duty, as I see it, to remember that the members are the owners of the company, that the profits belong to the members and that, subject to the proper needs of the company to ensure that it is not trading in a risky manner and that there are adequate reserves for commercial purposes, by and large, the trading profits ought to be distributed by way of dividends.

In *Re a Company (No 004415 of 1996)*<sup>94</sup> the companies were controlled both at board and at general meeting by the respondents. The petitioner's main ground of complaint was that over the years the companies had been declaring dividends at a lower level than

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<sup>92</sup> In *Allmark v Burnham* [2005] EWHC 2717; [2006] 2 BCLC 437 also known as *Re Distinct Services Ltd*, the minority shareholder alleged that majority shareholder remunerated himself excessively. The majority shareholder asserted that because the minority shareholder was no longer working, his responsibilities had doubled. The court considered the majority shareholder's justification for excessive remuneration as spurious. The majority shareholder was already supposed to be working full-time and a simple doubling of his salary was quite excessive and unjustifiable. In *Fisher v Cadman* [2006] 1 BCLC 499, a minority shareholder complained that the majority shareholders had failed to provide an explanation for the amount of remuneration, which she considered to be excessive that they had received. In *Irvine v Irvine* [2006] All ER (D) 153 (Mar), minority shareholders who were petitioners held together 49.96 per cent of the company's total issued share capital and the remaining 50.04 per cent shareholding in the company was held by the first respondent. The minority shareholders alleged that majority shareholders had procured excessive remuneration and declared inadequate dividends. The court after considering the breakdown of trust and confidence between the shareholders ordered the majority to buy-out the minority shareholder. In *Re a Company (No 002612 of 1984)* [1986] 2 BCC 99, the director had taken excessive remuneration by way of bonus and contribution to his pension fund that was regarded as unfairly prejudicial to the interests of the minority. In *R & H Electric Ltd and another v Haden Bill Electrical Ltd* [1995] 2 BCLC 280, one reason for the conflict was that the majority shareholders considered their remuneration as low in a business starting to thrive.

<sup>93</sup> [1988] BCLC 570, 577.

<sup>94</sup> [1997] 1 BCLC 479.

could be justified on any reasonable commercial grounds. Moreover at the same time the companies had been paying directors' fees to the respondents at a higher rate than could be justified by any normal commercial yardstick. The petitioners alleged that behind the oppressive conduct of respondents was a desire to build up profits within the company irrespective of its financial needs. Secondly it would be more advantageous for directors to get remuneration instead of declaring dividends which would also be beneficial for petitioners. Thirdly, there was respondents' personal antipathy towards one petitioner and a desire to damage his interests.<sup>95</sup> The court found an arguable case for the petitioners based on the respective levels of remuneration and the dividends declared by the companies.

In *Re Sam Weller and Sons Ltd*<sup>96</sup> the shareholders held or were beneficially interested in 42.5% of the issued share capital of a family company. It was asserted by the petitioners that the sole director was conducting the affairs of the company for the exclusive benefit of himself and his family. They alleged that even in the presence of accumulated profits and in absence of any remuneration from the company, the sole director had paid low dividends to the petitioners.<sup>97</sup> The sole director and his sons were taking an income from the company and causing the company to pay inadequate dividends to the shareholders. The court stated while dismissing the application to strike-out the petition, that in the absence of any increase in the dividend for so many years and because of the amount of accumulated profits and the amount of cash in hand it was against the interests of the shareholders like the petitioners, who did not receive directors' fees or remuneration from the company. It might be in the interests of the sole director and his sons that larger dividends should not be paid out to retain the profits in order to enhance the capital value of their holdings. Their interests were not necessarily identical with those of other shareholders in the company including the petitioners, who wanted a more immediate

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<sup>95</sup> *Ibid* 488-491.

<sup>96</sup> *Re a Company (No 823 of 1987)* [1990] BCLC 80.

<sup>97</sup> See also *Re Saul D. Harrison* [1995] 1 BCLC 14.

benefit to them in the form of larger dividends as their only income from the company was by way of dividend.<sup>98</sup>

*3.4.1.2.2 Dilution of minority shareholders' investment or voting power in the company:*

A dispute may arise among the shareholders where minority shareholders' investment or voting power is diluted through allotment of new shares either by altering the articles of association of the company, by breaching a shareholders' agreement or by breaching the provisions of the statute. The CA 2006 provides under section 561 that a company shall not allot new shares to a person unless it has offered those shares to existing shareholders on a pro rata basis. As evident from the case law minority shareholders' often complain against the conduct of majority shareholder where they have allotted the shares due to their self interest and against the interests of minority shareholders.

In *Re a Company (No 005134 of 1986) ex p Harries*<sup>99</sup> the petitioner complained that an allotment of shares was contrary to the pre-emptive provisions of the CA 1985. His claim was accepted that allotment of shares to the respondent without first offering them to the petitioner on pro rata basis was in breach of the legislative provision and therefore invalid.

In *Re Cumana Ltd*<sup>100</sup> the majority shareholder decided to make a rights issue for no good financial reasons and before capitalizing undistributed profits. The court inferred that the proposed rights issue was part of a scheme to reduce the minority shareholding in the company and might reduce it, if minority could not take up his proportion of the new share issue, from one-third to 0.33 per cent.

Similarly, an interviewee observed that a common complaint in his experience is that the rights issue has been made at a time when the majority shareholder is aware that the

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<sup>98</sup> *Re a Company (No 823 of 1987)* [1990] BCLC 80 at 88, see also *North Holdings Ltd v Southern Tropics Ltd* [1999] 2 BCLC 625 where the minority shareholder also complained that the majority shareholder adopted low dividend policy and awarded excessive remuneration against the interests of minority shareholders and failed to account for the profits made by the company.

<sup>99</sup> [1989] BCLC 383.

<sup>100</sup> [1986] BCLC 430, 435.

minority shareholder does not have sufficient personal funds or the scope to raise such funds and therefore knows that, in all likelihood, he will be unable to take up the rights and end up diluted as a result:

I did one petition in Hong Kong, the result of the rights issue was to dilute 40 percent shareholder down to 0.4 percent, a little extreme [K].

In *Parkinson v Eurofinance Group Ltd*<sup>101</sup> the petitioner shareholder alleged that sale of the company to another company where respondents were entitled to a majority of the votes was manifestly for the purpose of diluting the petitioner's shareholding and destroying the effectiveness of special rights attached to his shares. Therefore, it was alleged that this predominant motive was an exercise of the power for sale for an improper purpose which was unfair.<sup>102</sup> The court declared that dilution of petitioner's interests was not justified. In reported cases minority shareholders often alleged that the proposed issue of shares, diluted their investment in the company.<sup>103</sup>

Expropriatory squeeze-out behaviour may occur by passing a special resolution to change the articles with the purpose of directly or indirectly expropriating the minority. The majority shareholders' by special resolution can alter the articles of the company and it is considered as a normal incident to run the affairs of the company.<sup>104</sup> However, the alteration could be against the interests of minority shareholders.<sup>105</sup> In *Re Kenyon Swansea Ltd*<sup>106</sup> the respondent proposed that an extraordinary meeting of the company

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<sup>101</sup> [2000] All ER (D) 826.

<sup>102</sup> [2000] All ER (D) 826 para 88.

<sup>103</sup> In *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1 All ER 1126, the directors had allotted shares to change the balance of power. In *Re a Company (No 005136 of 1986)* [1987] BCLC 82, in a breach of directors fiduciary duties case, the petitioner alleged that the proposed issue of shares in a prescribed proportion (in proportion to their contribution to the service charge) was an effort to increase the voting power of a particular group of shareholders in the company for their future personal benefit. The court held that the directors had exercised their power to allot shares improperly. In *Russell v Northern Bank Development Corporation Ltd* [1992] BCLC 1016, a shareholder brought an action against other shareholders of company who were going to increase the share capital of the company contrary to the terms of a shareholders' agreement. The agreement provided that no further share capital in the company would be created or issued without the written consent of the parties to the agreement. The House of Lords declared that agreement was enforceable and the increase in share capital without the claimant's consent would be a breach of the shareholders' agreement.

<sup>104</sup> See s 21 of CA 2006 previously s 9 of the CA 1985.

<sup>105</sup> Hannigan B., 'Altering the Articles to Allow for Compulsory Transfer – Dragging Minority Shareholders to a Reluctant Exit' (2007) *Journal of Business Law* 471.

<sup>106</sup> [1987] BCLC 514.

be held to alter the company's articles of association with the purpose of modifying the pre-emption provisions so that he could transfer his shares to his wife without first having to offer them to the other shareholders in the company. The petitioner complained against the proposed alteration of the articles alleging that it was unfairly prejudicial to his interests and court held in favour of the petitioner.<sup>107</sup>

#### *3.4.1.3 Identification of squeeze-out techniques: empirical evidence:*

Squeeze-out behaviour occurs where the majority abuse majority rule and behave in a self-serving manner that is against the interests of minority shareholders and the impact of such behaviour can be exclusionary or expropriatory. The four most common squeeze-out techniques encountered by interviewees were: exclusion from management; non payment of dividend; excessive remuneration; dilution of share value through rights issues at time when the minority is not in a position to buy new shares. Other variants identified were: diversion of corporate assets; exploitation of corporate opportunities; serious breach of articles of association and the running of businesses that compete directly with the company.

In light of both the desk-based and empirical research I have adopted the following classification of squeeze-out techniques employed by majority shareholders while misusing their powers against the minority. Such classification provides a useful basis for exploring the extent to which such behaviour can be anticipated and regulated *ex ante* by contract, in private companies, a matter taken up in the next chapter.<sup>108</sup>

1. Exclusion of member from management of company.
2. Decisions taken without consultation.
3. Limited access to information about company affairs.
4. Misappropriation of company assets.
5. Complaints regarding remuneration of directors.

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<sup>107</sup> The majority's power to alter articles of association for expropriatory purposes has long been constrained by equity, see *Allen v. Gold Reefs of West Africa Ltd* [1900] 1 Ch 656. See also High Court of Australia's decision in *Gambotto v WCP Ltd* (1995) 182 C.L.R 432.

<sup>108</sup> See below chapter 4 para 4.5.1 *Ex ante* contracting to protect the minority from squeeze-out behaviour.



6. Little or no participation in profits or failure to pay dividends.
7. Allotment of shares to dilute minority shareholder investment or voting power in the company.

#### **3.4.2 Relational breakdown flowing from negligent management:**

The study of case law suggests that disputes often arise between shareholders where there is a conflict between shareholders regarding the management of the company. These management conflicts, can lead to relational breakdown and subsequent exit disputes without precipitating deliberate squeeze-out behaviour. These conflicts arise due to serious acts of mismanagement by majority shareholders. Mismanagement can be direct as is the case where the majority running the company are seriously incompetent<sup>109</sup> or indirect as is the case where the controlling shareholders fail to prevent continuous acts of mismanagement by the directors to the detriment of the shareholders.<sup>110</sup> Mismanagement generally involves the taking of decisions that are commercially disadvantageous and can cause the relationship between parties to break down in circumstances where the minority cannot readily exit the company and there is therefore no lever of governance through exit as there is in theory in the context of listed companies through the market for corporate control.

In *Re Macro (Ipswich) Ltd*<sup>111</sup> the proceedings concerned two companies. The mismanagement of the company's business in a negligent and inefficient manner led to relational breakdown and caused dispute. The petitioner alleged that the affairs of the companies had been mismanaged in a negligent and inefficient manner by the respondent, who was a majority shareholder and sole director of the company. It was alleged that firstly, employees of the respondent had taken commission from the builders employed by the companies without accounting to the companies for these sums. Secondly, due to the inadequate supervision of the respondent, persons left to grant lettings of the companies' properties had obtained secret payments in return for the grant of lettings. Thirdly, the respondent had failed to obtain competitive estimates for repair

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<sup>109</sup> *Re Elgindata Ltd* [1991] BCLC 959.

<sup>110</sup> *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354.

<sup>111</sup> [1994] 2 BCLC 354.

work and paid too much for repair and improvement work. Fourthly, the respondent had caused the companies to engage in costly litigation that was not for the companies' benefit. Fifthly, the respondent had failed to attend to the companies' affairs properly due to his absence from the business. The court also found that these were serious acts of mismanagement in the affairs of the company that were against the interests of minority shareholders.

The impact of negligent management can be exclusionary or expropriatory and may seriously damage the interests of minority shareholders like deliberate squeeze-out behaviour, discussed above. But the difference is that such mismanagement is not intended to squeeze-out the minority. In *Re Elgindata Ltd*<sup>112</sup> a minority shareholder alleged that (i) he had not been consulted with respect to policy decisions on which he expected to be consulted, (ii) the majority had managed the affairs of the company in an incompetent manner, (iii) the majority had misused the assets of the company for his own benefit and for the benefit of his friends and family. These conflicts regarding serious business mismanagement, without any deliberate squeeze-out behaviour by majority shareholders, cause relational breakdown, so minority sought an exit. The court did not find any squeeze-out behaviour on part of the majority shareholder but provided exit to minority shareholder because of the majority shareholder's propensity for using the company's assets for his personal benefit.

In *Re a Company (No 00789 of 1987), ex parte Shooter*<sup>113</sup> a minority shareholder alleged that the company's internal affairs had been mismanaged by the controlling shareholder by not holding the annual general meetings and laying accounts before members. So members were wholly deprived of any opportunity to consider the affairs of the company, to vote on the election or re-election of directors, or in any other way to know what was going on inevitably contrary to the interests of members. The court did not blame the controlling shareholder for bad faith but declared his conduct as irresponsible since he had conducted the affairs of the company in whatever way he thought fit and

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<sup>112</sup> [1991] BCLC 959.

<sup>113</sup> [1990] BCLC 384.

without any regard for formalities or legal obligations.<sup>114</sup> For conducting the affairs of the company properly in future the court ordered the controlling shareholder to divest himself of his shares in favour of the minority. It can be inferred that conflicts regarding management due to the negligent conduct of controlling shareholder breakdown the relationship of shareholders and cause dispute without precipitating any deliberate squeeze-out behaviour.

In *Fisher v Cadman*<sup>115</sup> a small family company was run on a very informal basis. A minority shareholder complained *inter alia* that majority shareholders had mismanaged the company business, by not holding the annual general meetings of the company in breach of articles of association and section 366 of the CA 1985.<sup>116</sup> The court asserted that ‘the background to the dispute was a sad breakdown in family relationships’<sup>117</sup> and considering such mismanagement to be against the interests of minority shareholder, ordered the exit of the minority through buy-out.

It is useful to mention here, that relational breakdown can also occur due to any underlying factor discussed above,<sup>118</sup> without any serious act of negligence or inefficient behaviour. These underlying factors include personal or business conflict due to personality clashes or management style.<sup>119</sup> It may not be convenient for shareholders to work together in the same company in the event of such relational breakdown. In such circumstances the court will not provide relief to the minority in the form of an exit on fair terms from the company. As the judge put it in one case:

...the requirement of prejudice means that the conduct must be shown to have done the members harm and I believe harm in a commercial sense, not in a merely emotional sense.<sup>120</sup>

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<sup>114</sup> *Ibid* 394.

<sup>115</sup> [2006] 1 BCLC 499.

<sup>116</sup> Now see s 336 of the CA 2006. Under the CA 2006 private companies are not required to hold annual general meetings except where they want to dismiss a director or an auditor before the expiration of his period of office. See s 168 of the CA 2006.

<sup>117</sup> [2006] 1 BCLC 499 para 3.

<sup>118</sup> See above para 3.3.1.

<sup>119</sup> See above para 3.3.1.

<sup>120</sup> See *Re Unisoft Group Ltd (No 3)* [1994] 1 BCLC 609, 611.

In the more recent authority of *Grace v Biagioli*<sup>121</sup> it was stated that there was no right of unilateral withdrawal for a shareholder when trust and confidence between shareholders no longer existed. It was, however, different if that breakdown in relations caused the minority prejudice in his capacity as a shareholder. To deal with this situation it may be convenient for shareholders to make provision for exit *ex ante* in a shareholders' agreement<sup>122</sup> or to settle the dispute out of court through negotiation.<sup>123</sup>

### **3.4.3 Exit disputes following relational breakdown:**

All the available evidence suggests that in the event of relational breakdown, the most practical outcome is for the minority shareholder to be bought out.<sup>124</sup> Where the dispute has escalated from a personal dispute into a legal dispute, as is the case where there is squeeze-out behaviour, the prospects of the parties remaining as co-participants in the same company will rarely be good.<sup>125</sup> The Law Commission findings suggest that among the inspected petitions presented to the Companies Court at the Royal Courts of Justice, between January 1994 and December 1996 seeking relief under section 459 of the CA 1985 in 69.5 per cent of petitions the relief sought was the purchase of petitioner's shares and in 23.6 per cent the relief sought was the sale of respondents' shares in the company.<sup>126</sup> In other words, in well over 90 per cent of those cases the purpose of the petition was to facilitate an exit by one party of the other. A good example is *Gerrard v Koby*<sup>127</sup> where the minority shareholder sought a buy-out order and the majority shareholder acknowledged in evidence that:

...the only practical outcome is that one or other side should end up with the company because after the present situation there is now no way [the parties] would be able to continue to work together.<sup>128</sup>

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<sup>121</sup> [2006] 2 BCLC 70, 92.

<sup>122</sup> See below chapter 4 para 4.5.3 *Ex ante* resolution of exit disputes.

<sup>123</sup> See below for settlement of shareholder disputes out of court, chapter 6 para 6.5.2.2 and chapter 7 para 7.4.1.

<sup>124</sup> Moreover, in circumstances, where the relational breakdown is owing to difference of opinion regarding the fundamental direction of business then there may be no alternative available even to the majority shareholder except to part with the minority.

<sup>125</sup> See above para 3.4.1.

<sup>126</sup> *The Law Commission Final Report*, Appendix J – Statistics relating to the filing of section 459 petitions.

<sup>127</sup> [2004] All ER (D) 139 (Jul).

<sup>128</sup> [2004] All ER (D) 139 (Jul) para 19.

On the basis that the parties' personal relationships will often be irreparably damaged with the consequence that future conflict disruptive to the running of the business is inevitable, there appears to be a strong judicial preference for buy-outs (whether by negotiation in the case of simple relational breakdown or by court order under section 461 of the CA 1985).<sup>129</sup>

Therefore, relational breakdown in private companies often gives rise to further complaints regarding 'illiquidity' and 'valuation' of the shares of the party who is to be bought out. In private companies shareholders have no organized market for selling their shares as available to shareholders in listed companies. Shareholders in listed companies and partners in partnerships do not face the same degree of illiquidity problems. In listed companies shareholders have a market in which to sell their shares and in partnerships partners can dissolve the partnership to realise their share by giving notice to the other partners.<sup>130</sup> Though in practice to avoid cessation of business and to ensure continuity the partners may regulate exit through a properly drafted partnership agreement providing for continuation of the business and valuing of the exiting partner shares. In private companies even if shareholders find a buyer for their shares they might not be able to sell their shares due to restrictions on the transfer of shares in the articles of association.<sup>131</sup>

As stated above owing to the non-existence of an organised market for selling their shares and the presence of pre-emptive provisions or other restrictions on transfer of shares to outsiders in the articles,<sup>132</sup> it is often hard for minority shareholders in private

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<sup>129</sup> See *R & H Electric Ltd and another v Haden Bill Electrical Ltd* [1995] 2 BCLC 280; *O'Neill v Phillips* [1999] 2 BCLC 1; *Grace v Biagioli* [2006] 2 BCLC 70; [2005] EWCA Civ 1222. For detailed discussion of how the courts deal with illiquidity and valuation problems and of appropriate relief in shareholder disputes see below chapter 5.

<sup>130</sup> It is a default rule only and this right can be limited by means of a properly drafted partnership agreement. See section 32 of the Partnership Act 1890 which provides that subject to any agreement between the partners, a partnership is dissolved *inter alia* if entered into for an undefined time, by any partner giving notice to the other or others of his intention to dissolve the partnership.

<sup>131</sup> See *Richards v Lundy* [2000] 1 BCLC 376.

<sup>132</sup> Private companies are often run on the basis of mutual trust and confidence by limited numbers of shareholders who often do not welcome a new shareholder from outside into a company's management.

companies to liquidate their investment.<sup>133</sup> Therefore minority shareholders may have to face a state of illiquidity as a result of relational breakdown. Minority shareholders in listed companies do not face anything like the same degree of illiquidity and therefore minority shareholders in private companies are more likely to become embroiled in disputes than their equivalents in listed companies.<sup>134</sup> Generally, in exit disputes the issues faced by the court will include such matters as which party will sell out and which remain<sup>135</sup> and the basis upon which a valuation of the shares will be determined.<sup>136</sup>

In the event of relational breakdown shareholders may well be comfortable with the idea of buy-out as the only practical resolution but this will leave the issue of ensuring that the exiting shareholder gets a fair value for their shares.<sup>137</sup> In *Re a Company (No 004377 of 1986)* Hoffmann J (as he then was) commented that section 459 petitions often bear some resemblance to divorce petitions.<sup>138</sup> Voluminous evidence was served which tracked the breakdown of a business relationship commenced in the hope and expectation of profitable collaboration:

Each party blamed the other but often it was impossible to say more than the petitioner said in this case that there was a clear conflict in personalities and management style. It was almost always clear from the outset that one party would have to buy the other's shares and it was usually equally clear who that party would be. The only real issue was the price [to be paid for] the shares.<sup>139</sup>

In *Re (No 006834 of 1988), ex parte Kremer*<sup>140</sup> it was stated that:

This is an ordinary case of breakdown of confidence between the parties. In such circumstances, fairness requires that the minority shareholder should not have to maintain his investment in a company managed by the majority with whom he has fallen out. But the unfairness disappears if the minority shareholder is offered a fair price for his shares.

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<sup>133</sup> See above Chapter 1, para 1.1 Background.

<sup>134</sup> The problem is known as a 'close corporation problem', see above chapter 1, para 1.1 Background. See also Davies P., *Introduction to Company Law* (Oxford University Press, New York. 2002) 216.

<sup>135</sup> See *Re Regional Airports Ltd* [1999] 2 BCLC 30, 81.

<sup>136</sup> See *Profinance Trust SA v Gladstone* [2002] 1 BCLC 141; *Re Cumana Ltd* [1986] BCLC 430; *Re Regional Airports Ltd* [1999] 2 BCLC 30, 83.

<sup>137</sup> For discussion regarding fair valuation of shares see below chapter 5 para 5.5.2.1 Valuation of shares.

<sup>138</sup> In *Re a Company (No 004415 of 1996)* [1997] 1 BCLC 479, 493 Sir Richard Scott V-C stated that "there has been a tendency in some past s 459 cases for the litigation to become a Chancery version of a bitterly contested divorce...".

<sup>139</sup> *Re a Company (No 004377 of 1986)* [1987] BCLC 94, 101.

<sup>140</sup> [1989] BCLC 365, 368.

In *O'Neill v Phillips*,<sup>141</sup> Lord Hoffmann stated that:

The unfairness does not lie in the exclusion alone but in exclusion without a reasonable offer. If the respondent to a petition has plainly made a reasonable offer, then the exclusion as such will not be unfairly prejudicial and he will be entitled to have the petition struck out. It is therefore very important that participants in such companies should be able to know what counts as a reasonable offer.

Disputes regarding valuation of shares are often very complicated and therefore time consuming for both the shareholders and courts. The question what is fair depends upon the facts of the each individual case. The courts also follow the principle that the valuation of minority shareholding should be fair.<sup>142</sup> In *Re a Company (No 005134 of 1986)*, *ex parte Harries*<sup>143</sup> it was stated that there was no hard and fast rule to be applied and that in valuing shares the court must be guided by what was fair in particular circumstances. At exit, disputes regarding fair valuation of shares are about the following issues.

(i) Timing of valuation.<sup>144</sup>

(ii) Any adjustments required to be made to share valuation owing to unfairly prejudicial conduct such as excessive remuneration.<sup>145</sup>

(iii) Discounts, if any, applicable due to a minority holding. In quasi-partnership companies at the time of buy-out of minority shareholder in pursuance of an order under section 461(2) of the CA 1985, where the petitioner is not at fault, his shares are valued on a pro rata basis according to the value of the company as a whole and without any discount.<sup>146</sup> However, minority shareholders often complain at the time of buy-out that their shares are valued at a discount due to the fact of disposing of a minority holding in the company. In practice, even if there are no restrictions on transfer of shares to a willing buyer the value of a minority shareholding may be discounted to reflect lack of control in management of the company.

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<sup>141</sup> [1999] 2 BCLC 1, 16.

<sup>142</sup> *Re Bird Precision Bellows Ltd* [1985] BCLC 493, [1984] Ch 419.

<sup>143</sup> [1989] BCLC 383, 398.

<sup>144</sup> See *Profinance Trust SA v Gladstone* [2002] 1 BCLC 141.

<sup>145</sup> In *Irvine v Irvine* [2006] All ER (D) 153 (Mar) para 358, the court ordered the purchase of the minority shares that was sought by minority shareholders and for valuation to be fair at a price, which took into account the excess remuneration drawn by the first respondent.

<sup>146</sup> See *Profinance Trust SA v Gladstone* [2002] 1 BCLC 141, 149; *Re Bird Precision Bellows Ltd* [1985] BCLC 493, 504, the petition was presented under section 75 of the Companies Act 1980. See also *O'Neill v Phillips* [1999] 2 BCLC 1, 16-17.

(iv) Issues about to what extent any valuation mechanism in the articles or a shareholders' agreements could be overridden by courts. In *Fisher v Cadman*<sup>147</sup> a company was based on quasi-partnership relationship giving rise to equitable constraints.<sup>148</sup> The court, for fair valuation of minority's shares, did not strictly adhere to the articles of association of the company that provided for the discounted price of shares due to minority holding at the time of buy-out.

### **3.5 Conclusion:**

Private companies are often formed on the basis of mutual trust deriving from personal relationships between shareholders. Relational breakdown due to underlying factors such as personal or business conflicts cause disputes in these companies. The prevalence of relational breakdown as a trigger for legal disputes is perhaps not surprising given that shareholders are commonly in close proximity in the day-to-day management of private companies. It is evident from the study of the case law and findings of empirical research that shareholder disputes follow discernible patterns. They often start as personal disputes that may then escalate into legal disputes where the majority engages in squeeze-out behaviour. Alternatively, the disputes may arise as a result of damaging incompetence, promoting the need for the minority to find a means of exiting the company, or they may relate purely to exit where, following relational breakdown, the parties often accept the need for a parting of the ways, but are in disputes over the terms, most notably the price of the share.

The resolution of these disputes by courts is said to be a lengthy and therefore expensive process. Commentators have suggested that shareholder disputes in private companies can be prevented and resolved through *ex ante* contractual arrangements. Interviewees also added that relational breakdown occurs due to lack of advance formal planning of shareholders regarding the conduct of the business. It can also be argued that to prevent the relational breakdown due to personality clashes shareholders should also consider in advance carefully the personality of other shareholders with whom they are going to

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<sup>147</sup> [2006] 1 BCLC 499.

<sup>148</sup> [2006] 1 BCLC 499, 528.



start business. However, it is not completely clear that advance thought to these underlying factors will necessarily prevent relational breakdown or subsequent exit disputes or provide a viable mechanism for anticipating and controlling self-interested behaviour arising from human vices such as greed or jealousy. The next chapter considers the scope and potential of forward planning through the use of shareholders' agreements as a tool for anticipating and resolving shareholder disputes.

## Chapter 4

### The scope of *ex ante* contracting as a means of protecting minority shareholders' interests

#### 4.1 Scope of the chapter:

This chapter discusses the scope, potential and limitations of *ex ante* contracting as a mechanism for protecting minority shareholders' interests and anticipating the types of shareholder disputes identified as recurring instances in the previous chapter. Minority shareholders' interests in the event of relational breakdown can be protected by controlling the use of majority rule and by providing minority shareholders with an exit from the company on fair terms. After discussing the legal significance of shareholders' agreements, the chapter discusses their utility, potential and limitations as a means by which minority shareholders might protect their interests in private companies. The discussion is made in the light of a study of the available practitioner precedents and the interviewees' responses. Owing to associated limitations it is not wholly possible to protect the interests of minority shareholders in the event of relational breakdown by *ex ante* contracting. Therefore, shareholders need recourse to the courts to protect their interests in that event. The chapter proceeds as follows. After an introduction the chapter discusses: (i) the significance of shareholders' agreements as an appropriate medium of *ex ante* contracting in private companies; (ii) the potential of these agreements, as a mechanism for forestalling use of squeeze-out techniques<sup>1</sup> or resolving exit disputes; (iii) the limitations associated with *ex ante* contracting in the present context.

#### 4.2 Introduction:

It is evident from the discussion in the previous chapter, that the breakdown of the personal relationship of shareholders where this is the basis on which the company was formed is commonly the backdrop to shareholders disputes. The relational breakdown in these companies give rises to three kinds of disputes. To reiterate: in the first kind relational breakdown precipitates squeeze-out behaviour which exacerbates the dispute;

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<sup>1</sup> These squeeze-out techniques are identified above in the chapter 3 para 3.4.1.3 Identification of squeeze-out techniques: empirical evidence.

in the second kind, negligent management causes relational breakdown, without precipitating squeeze-out behaviour, to such an extent that the minority shareholder wishes to exit; in the third kind, relational breakdown is accompanied by disputes regarding terms of exit.<sup>2</sup>

It is asserted in this chapter that, theoretically, *ex ante* contracting can prevent squeeze out behaviour and can provide for clarity as regards exit rights. *Ex ante* contracting cannot prevent the parties from falling out but only seek to anticipate some of the possible consequences. The squeeze-out techniques can be prevented by providing in advance for how the business is to be conducted in ways that expressly limit the powers of majority shareholders that flow from majority rule. Type 2 disputes due to negligent or inefficient management can to some extent be dealt with by providing in advance how the business will be conducted and by putting restrictions on powers of majority shareholders.<sup>3</sup> Type 3 disputes - exit disputes - can be addressed through detailed exit provisions giving rise to a contractual right to exit on fair terms in defined events.<sup>4</sup> However, *ex ante* contracting cannot prevent the relational breakdowns that drive shareholders to seek separation but can only minimize the repercussions of relational breakdown.<sup>5</sup>

The protection of minority shareholders through *ex ante* contracting has received considerable attention in the legal literature.<sup>6</sup> Chiu has stated that there is a room for

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<sup>2</sup> At the event of relational breakdown the minority seeks to leave the company because it is not possible for the minority to work with the majority anymore, in the same company. Restrictions on transfer of shares in private companies cause exit dispute. See above chapter 3 para 3.4.3 Exit disputes following relational breakdown.

<sup>3</sup> See nature of type 2 disputes above in chapter 3 para 3.4.2 Relational breakdown flowing from negligent management.

<sup>4</sup> See nature of type 3 disputes above in chapter 3 para 3.4.3 Exit disputes following relational breakdown.

<sup>5</sup> See above chapter 3 para 3.4.1 The relational breakdown precipitating squeeze-out behaviour.

<sup>6</sup> See Stecher, M. W (ed) *Protection of minority shareholders* (Kluwer Law International Ltd, London 1997) General Report at 1; Cadman, J., *Shareholders' Agreements* (4<sup>th</sup> ed Sweet & Maxwell, London 2004) chapters 1-4; Boros, E., *Minority Shareholders Remedies* (Clarendon Press, Oxford 1995) chapter 4 and Introduction to Thomas R., and Ryan C., *The Law and Practice of shareholders' agreements*. (Butterworths, London. 1999). Copp S., 'Company Law and Alternative Dispute Resolution: An Economic Analysis' (2002) 23(12) *Company lawyer* 361.

private contractual ordering in shareholder relations and contractual methods of dispute resolution between shareholders.<sup>7</sup> Copp stated that:

In conclusion, it is clear that many company disputes could be avoided if the parties made express contractual provision for the issues or were subjected to a more extensive default regime in Table A.<sup>8</sup>

An interviewee while discussing the nature of shareholder disputes and their resolution asserted that:

The moral of the story is that these businessmen are to blame. These businessmen cannot expect the court to come to their rescue under [statutory provision...] what they ought to do is to anticipate it and to have shareholders' agreements or articles of association in advance. [G]

With the help of professional advice the best shareholders can do is to contemplate and agree in advance how the business will be conducted and conflicts will be resolved in future, and seek to anticipate and address likely problems insofar as these can be foreseen. The following paragraphs discuss the appropriate medium of *ex ante* contracting in private companies. These paragraphs consider the legal significance of minority protection shareholders' agreements as an additional source of legal rights and liabilities alongside the articles of association of the company.

#### **4.3 *Ex ante* contracting:**

Minority shareholders can seek to protect themselves against misuses of majority rule by bargaining for express protections in the articles of association or in separate shareholders' agreements.<sup>9</sup> Section 18(1) of the CA 2006 provides that 'A company must have articles of association prescribing regulations for the company'.<sup>10</sup> Traditionally, the articles of association of the company after registration are the main medium of regulating the internal affairs of the company.<sup>11</sup> In the absence of registered

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<sup>7</sup> See Chiu, I.H., 'Contextualising Shareholders' Disputes – A Way to Reconceptualise Minority Shareholder Remedies' (2006) *Journal of Business Law* 312, 313.

<sup>8</sup> See also Copp S., 'Company Law and Alternative Dispute Resolution: An Economic Analysis' (2002) 23(12) *Company Lawyer* 361, 368. In the absence of registered articles of association Table A regulates the internal affairs of the company so far as applicable, see below discussion in 4.3 *Ex ante* contracting.

<sup>9</sup> See also Copp S., 'Company Law and Alternative Dispute Resolution: An Economic Analysis' (2002) 23(12) *Company Lawyer* 361, 370.

<sup>10</sup> Previously, s 7(1) of CA 1985.

<sup>11</sup> See s 18(2) of CA 2006 for registration of the company articles.

articles of association default model articles for private companies regulate the internal affairs of the company so far as applicable.<sup>12</sup> The articles of association have a contractual effect. Section 33 of CA 2006 provides that ‘The provisions of a company’s constitution bind the company and its members to the same extent as if there were covenants on the part of the company and of each member to observe those provisions.’<sup>13</sup>

The nature of this contract is very different from the ordinary commercial contract.<sup>14</sup> In *Bratton Seymour Service Co Ltd v Oxborough*, Steyn LJ (as he then was) mentioned that by virtue of section 14 of the CA 1985 [now section 33 of the CA 2006] the articles of association become, upon registration, a contract between a company and members. It is, however a statutory contract of a special nature with its own distinctive features. Steyn LJ further mentioned the following distinctive features. Firstly, this statutory contract derives its binding force not from a bargain struck between parties but from the terms of the statute. Secondly, unlike an ordinary contract, it is not defeasible on the grounds of misrepresentation, common law mistake, mistake in equity, undue influence or duress. Thirdly, it cannot be rectified on the grounds of mistake. Fourthly, it can be altered by a special resolution without the consent of all the contracting parties. Fifthly, it is binding only insofar as it affects the rights and obligations between the company and the members acting in their capacity as members. If it contains provisions conferring rights and obligations on outsiders, then those provisions do not bite as part of the contract between the company and the members, even if the outsider is coincidentally a member. Similarly, if the provisions are not truly referable to the rights and obligations of members as such it does not operate as a contract.<sup>15</sup>

Shareholders in private companies can protect their interests by declaring in the articles of association the manner by which the company affairs will be conducted in future. However, the articles of association are not the most attractive means of protecting minority shareholders’ interests due to the limitations associated with them. Section

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<sup>12</sup> See s 20(1) of CA 2006. Previously known as ‘Table A’ under CA 1985.

<sup>13</sup> S 33 of CA 2006 provides the effect of company’s constitution of which the articles of association are significant part. Previously, see s 14 of CA 1985.

<sup>14</sup> See *Bratton Seymour Service Co Ltd v Oxborough* [1992] BCLC 693.

<sup>15</sup> See *ibid* 698.

21(1) of the CA 2006 provides that a company may by special resolution alter its articles. The articles can be altered by special resolution without the consent of all the members. This contrasts with the position in the general law of contract where variations of contract terms are only lawful if the parties to the contract all consent. Secondly, as discussed above, the articles of association can only be enforced by and against the members in their capacity as members and not in any other 'outsider' capacity such as director or solicitor of the company.<sup>16</sup>

Hence, to overcome these problems of variability and enforceability and to protect themselves effectively minority shareholders can supplement their rights under the articles by entering into separate shareholders' agreements. Shareholders' agreements can provide that parties to the agreement shall not vote in favour of any resolution to alter the articles of the company without the prior written consent of all the shareholders or of the minority shareholder or of his nominated director of the company, regarding that alteration. Care must be ensured here that the company should not be a party to such an agreement since any stipulation among the parties fettering the statutory power of the company to alter its articles is not enforceable under law.<sup>17</sup> In *Russell v Northern Bank Development Corp Ltd*,<sup>18</sup> clause 3 of the shareholders' agreement provided that "no further share capital shall be created or issued in the company... without the written consent of each of the parties hereto".<sup>19</sup> The issue was whether clause 3 was an invalid fetter on the statutory power of the company to increase its share capital or whether it was no more than an agreement between the shareholders prescribing their manner of voting in a given situation. Lord Jauncey of Tullichettle confirmed that a company cannot be a party to a contract that fetters its statutory powers. He applied the ruling of the House of Lords in *Welton v Saffery*<sup>20</sup> and commented that "shareholders may lawfully agree *inter se* to exercise their voting rights in a manner which, if it were

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<sup>16</sup> See also *Hickman v Kent* [1915] 1 Ch 881, *Re Tavarone Mining Co* (1873) 8 Ch App 956, *Beattie v E & F Beattie Ltd* [1938] Ch 708.

<sup>17</sup> *Russell v Northern Bank Development Corp Ltd* [1992] 1 W.L.R 588; [1992] 3 All ER 161.

<sup>18</sup> [1992] 1 W.L.R 588; [1992] 3 All ER 161.

<sup>19</sup> *Russell v Northern Bank Development Corp Ltd* [1992] 1 W.L.R 588, 591.

<sup>20</sup> [1897] A.C. 299, 331.

dictated by the articles, and were thereby binding on the company would be unlawful”.<sup>21</sup> This reflects the “long standing principle of English law that a company cannot by contract deprive itself of the right to exercise its statutory powers”.<sup>22</sup> The Law Commission also regarded this principle as being axiomatic. Notwithstanding the principle, however, the same effect can be achieved as between the parties to a shareholder agreement, by the terms of such an agreement.<sup>23</sup> The alteration of the articles can also be prevented by stipulating among the shareholders that a particular matter is a class right which cannot be altered without the consent of the holders of that class of shares.

The most significant benefit of shareholders’ agreements for minority shareholders is that unlike articles, shareholders’ agreements cannot be altered by the majority unilaterally (e.g., by special resolution). To alter the terms of shareholders’ agreements the consent of all the parties to the agreement is necessary as is the case, as a matter of default principle, with any contract. Secondly, through shareholders’ agreements as opposed to articles of association, outsider rights and members’ rights other than in their capacity as members can be declared and enforced by the parties. Therefore, while enforcing shareholders’ agreements shareholders do not have to face the obstacles such as the legal requirement that conduct complained of must be regarding protection of members’ interests as members and regarding company’s affairs.<sup>24</sup> To ensure the smooth and easy running of the business there should be a balance of powers among the different constituencies. These constituencies include the minority shareholders, the majority shareholders and the company, if the company is a party to the agreement for enforcing minority protection rights against the company. However, in the light of *Russell v Northern Bank Development Corp Ltd*<sup>25</sup> it is generally thought for reasons set out above that the company should not be made a party to a shareholders’ agreement and

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<sup>21</sup> *Russell v Northern Bank Development Corp Ltd* [1992] 1 W.L.R 588, 594.

<sup>22</sup> Cadman, J., *Shareholders’ Agreements* (4<sup>th</sup> ed Sweet & Maxwell, London 2004) 8.

<sup>23</sup> See *the Consultation Paper*, part 3 [3.17].

<sup>24</sup> See *Re J E Cade and Son Limited* [1992] BCLC 213 and *Re Unisoft Group Ltd (No 3)* [1994] 1 BCLC 609.

<sup>25</sup> [1992] BCLC 1016.

that any terms that it is desired should have contractual effect between the company and the shareholders are better hived off into a separate agreement.

The articles of association and shareholders' agreements are completely different documents.<sup>26</sup> The articles of association are created and regulated by company law<sup>27</sup> whereas shareholders' agreements are created and regulated by the principles of the law of contract. By shareholders' agreements here I mean agreements to which all shareholders are parties rather than agreements between some of the shareholders. Agreements of the later type may be made between shareholders who collectively control the majority of the voting power and, to the extent that they regulate the exercise of that power, may conceivably have adverse effects on minority shareholders who are not parties to them.

Due to their contractual rather than statutory basis shareholders' agreements have some other advantages over articles of association.

- (i) They can be enforced through the traditional contractual remedies as well as through section 459 of the CA 1985.
- (ii) Shareholders' agreements preserve confidentiality of the parties' relationships since they are private documents and are not open to the public inspection, in contrast to articles of association.
- (iii) The articles deal only with matters arising after the incorporation of company<sup>28</sup> because the company's constitution only has contractual effect on incorporation. The shareholders' agreements can make provision regarding events prior to and leading up to incorporation.<sup>29</sup>
- (iv) Shareholders' agreements can be entered into by some or all of the shareholders and therefore have the merits of flexibility.

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<sup>26</sup> Cadman, J., *Shareholders' Agreements* (4<sup>th</sup> ed Sweet & Maxwell, London 2004) 2.

<sup>27</sup> See ss 18 and 33 of the CA 2006.

<sup>28</sup> S 15(1) of the CA 2006 requires that on registration of a company the registrar of companies shall give a certificate that the company is incorporated.

<sup>29</sup> See *the Consultation Paper* [3.7].



- (v) Shareholders' agreements can be drawn in accordance with the particular requirements of the shareholders even to create rights, which are not immediately connected with the company's business.
- (vi) Shareholders' agreements can be made between the shareholders and the company to oblige the company to act in a prescribed way regarding a particular issue such as directors' remuneration. However, these stipulations should not be in conflict with the provisions and underlying policy of the statute by depriving the company of its statutory powers.<sup>30</sup>

However, there is a disadvantage associated with shareholders' agreements compared to articles of association. Unlike the articles of association every new member of the company as a result of transfer or subscription of new shares is not automatically bound by the existing shareholders' agreements but has to enter specifically into the shareholders' agreement at the time of obtaining membership. In contrast, a new registered member of a company pursuant to section 112(2) of CA 2006 is automatically bound by the existing articles of association of the company pursuant to section 33 of the CA 2006. In the following paragraphs the chapter discusses the utility and potential of the shareholders' agreements as a tool of protecting minority shareholders' interests in private companies.

#### **4.4 The utility of shareholders' agreements as a tool of prevention:**

Due to the above-mentioned obstacles associated with the articles of association it can be advisable for minority shareholders in private companies to seek to protect themselves from the oppression of majority shareholders by supplementing the articles with shareholders' agreements. In practice, minority protection shareholders' agreements are stipulations between the shareholders having contractual effect governing *inter alia* the arrangements for managing and financing the company, the relationships between the shareholders and the terms upon which shareholders can exit the company by transferring some or all of their shares. These agreements seek to anticipate and make provision *ex ante* to deal with anticipated problems of the various

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<sup>30</sup> See *Russell v Northern Bank Development Corp Ltd* [1992] BCLC 1016.

types identified in the previous chapter<sup>31</sup> that may arise in the future with the aim of minimising disruption to the company's business.<sup>32</sup>

Within the boundaries set by the general law the shareholders are free to agree whatever terms they wish in their agreements. It is asserted in the legal literature that disputes in these companies can be avoided by providing in advance the ways the business will be conducted in future.<sup>33</sup> The drafting of provisions by *ex ante* contracting provides an opportunity for the shareholders at the very start of their business relationship, to consider the nature and direction of their future relations in that particular business. Detailed drafting of the articles of association or shareholders agreements can serve this purpose. Nowadays practising lawyers often emphasise and recommend *ex ante* contracting to shareholders in private companies through shareholders' agreements, which can be in order to promote their own interests in generating fee earning work.<sup>34</sup> A comparative study of different jurisdictions has shown that the use of shareholders' agreements is widespread and in some jurisdictions shareholders' agreements are more frequently used to protect minority rights than the articles of association.<sup>35</sup> In private companies that have the character of a quasi-partnership, at practical level shareholders are commonly advised to document their relationships *inter se* wherever possible in the form of a shareholders' agreement giving them additional, contractual rights.<sup>36</sup> Elson claims that:

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<sup>31</sup> See above, chapter 3 para 3.4.1.3 Identification of squeeze-out techniques: empirical evidence.

<sup>32</sup> See Stecher, M. W (ed) *Protection of Minority Shareholders* (Kluwer Law International Ltd, London 1997) 251; for shareholders' agreements see Cadman, J., *Shareholders' Agreements* (4<sup>th</sup> ed Sweet & Maxwell, London 2004) chapters 1, 4; Boros, E., *Minority Shareholders Remedies* (Clarendon Press, Oxford 1995) chapter 4.3 and Introduction to Thomas R., and Ryan C., *The Law and Practice of Shareholders' Agreements*. (Butterworths, London. 1999).

<sup>33</sup> Boros, E., *Minority Shareholders Remedies* (Clarendon Press, Oxford 1995) Cadman, J., *Shareholders' Agreements* (4<sup>th</sup> ed Sweet & Maxwell, London 2004); F.H. O'Neal and R. Thompson, *O'Neal's Oppression of Minority Shareholders* (2<sup>nd</sup> ed Callaghan 1985).

<sup>34</sup> Law firms recommendations are evident from their websites see such as [www.andrewjackson.co.uk/legal-resources/legal-fact-file/shareholders-agreements/](http://www.andrewjackson.co.uk/legal-resources/legal-fact-file/shareholders-agreements/); [www.Businesslawfirm.co.uk/Articles/company/shareholders-agreements.aspx](http://www.Businesslawfirm.co.uk/Articles/company/shareholders-agreements.aspx); [www.macdonaldhenderson.co.uk/articles/companyandcommercial2.html](http://www.macdonaldhenderson.co.uk/articles/companyandcommercial2.html); [www.ukincorp.co.uk/s-43-uk-company-shareholders-agreements.html](http://www.ukincorp.co.uk/s-43-uk-company-shareholders-agreements.html).

<sup>35</sup> Stecher, M. W (ed) *Protection of Minority Shareholders* (Kluwer Law International Ltd, London 1997) 12.

<sup>36</sup> *Ibid* 20.

The best protection that can be extended a client about to enter into a corporate venture is a well-drawn agreement between shareholders designed to safeguard their interests on a mutually fair basis.<sup>37</sup>

During the empirical investigation interviewee H acknowledged the importance of shareholders' agreements by stating that these agreements made a lot of difference such as by stating clearly whether it was a quasi-partnership or not. In the absence of a shareholders' agreement, proof of unfair prejudice based on breach of some implied or informal agreement might require the petitioner to establish first that there was a quasi-partnership, a requirement that could prolong the proceedings:

If you have a shareholders' agreement where the parties' expectations are spelt out in words there is much less scope for arguments. Shareholders' agreements really sort matters and make life a lot easier [H].

The point was reinforced by another interviewee:

The moral of all this is do not leave it to the court to sort the dispute out: provide for it in advance [G].

Interviewee M while expressing the merits of shareholders' agreements stated:

In large companies the parties' rights and obligations are expressly drafted through sophisticated documentation which generally allows their disputes to be resolved much more quickly [M].

Similarly, courts also prefer to enforce the already stipulated agreements of shareholders in the event of dispute.<sup>38</sup> The Law Commission found that shareholders frequently make agreements with other members to give them rights in addition to those conferred by the memorandum and articles of association to secure greater protection for themselves.<sup>39</sup> As regards the attitude of the courts to shareholders' agreements one interviewee stated that:

Courts do like shareholders agreements because all the rights and obligations are set out in the agreement and it means that that is what the parties set down, thought about and agreed [T].

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<sup>37</sup> Elson, A., 'Shareholders' Agreements, A Shield for Minority Shareholders of Close Corporations' (1967) 22 *Bus Law* 449, 451.

<sup>38</sup> See *Rayfield v Hands* [1960] Ch 1.

<sup>39</sup> See *the Consultation Paper* [3.3] [3.4] and [3.17].

In the next section, the potential of shareholders' agreements to prevent shareholder disputes in private companies is discussed, by linking the discussion back to the discussion in the previous chapter about the nature of shareholder disputes.

#### **4.5 Potential of shareholders' agreements to protect minority shareholders following relational breakdown:**

It is evident from the study of the precedent shareholders' agreements,<sup>40</sup> that these agreements can theoretically be used to prevent squeeze-out behaviour.<sup>41</sup> Furthermore *ex ante* contracting can be used to address negligent behaviour and provide an exit mechanism to shareholders in defined circumstances. As one interviewee put it:

I think a lot of these disputes could be avoided in small private companies if the parties had actually thought at an early stage how the business was going to be run and how the possibility that one party might wish to exit would be handled [M].

Interviewee H acknowledged that shareholders' agreements would be to an extent exhaustive of shareholders' rights and expectations so that shareholders know where they stand regarding their rights should a dispute arise [H]. Shareholder' rights can be reinforced by contractually enhancing the voice of the minority in corporate decision making processes thus limiting the power of the majority under the constitution and as a matter of general corporate law. The voice of minority shareholders can be enhanced by giving them either extra voting rights or a veto in relation to certain decisions with the result that no such decision could be made without their consent. By enhancing the voice of minority shareholders in this way squeeze-out behaviour may be averted but instead a deadlock may ensue. Interviewee E was particularly enthusiastic about the potential of shareholders' agreements:

Good agreements can prevent disputes from arising in the first place since you have already agreed the way the company should be run. Shareholders' agreements are not so much about speedy and cost effective resolution but to prevent disputes from arising in the first place [E].

In fact, shareholders' agreements after declaring the rights of the shareholders mainly enhance the voice of the minority shareholders through voting power in anticipated

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<sup>40</sup> See above chapter 2 Methodology para 2.2 Legal scholarship.

<sup>41</sup> See Copp S., 'Company Law and Alternative Dispute Resolution: An Economic Analysis' (2002) 23(12) Company lawyer 361, 370.

conflicting situations. This eliminates the strength of majority rule in the company and tries to incorporate the benefits of a partnership or joint venture structure into the governance of the company. As in partnerships all the partners are entitled to participate in the management of the partnership and decisions are usually made with the consent of all the partners. It is evident from the study of the available precedents of shareholders' agreements that contractual provisions governing the ways in which the business will be conducted are of two kinds.

*(i) Declaration of rights:*

Shareholders' agreements may declare after negotiation the rights and obligations of shareholders in anticipated conflicting situations, in an effort to avoid squeeze-out behaviour.<sup>42</sup> Agreements may declare the express rights for minority shareholders to participate in the management of the company accompanied by express provisions on consultation and access to information regarding the company affairs. Agreements may also declare the policy regarding the dividend and remuneration of directors and provision to manage the business in the best interests of the company. Advance declaration of these rights may assist to protect the interests of minority shareholders from misuse of powers of majority shareholders, since there will be no ambiguity left behind regarding the positions of shareholders in the company.

*(ii) Enhanced voice:*

These rights can be reinforced by enhancing the voice of minority shareholders in the corporate decision making process and limiting the powers of the majority and so protect the minority against the opportunistic conduct of majority shareholders. The voice can be enhanced by giving the minority either extra voting rights or veto powers namely a provision of right to consent upon all important matters of the company, including decisions regarding management of company's business and assets, altering the articles of company and allotment of new shares to obtain finance. To enhance shareholders' voice agreements may declare that 'the shareholders shall not exercise their voting rights

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<sup>42</sup> Squeeze-out techniques are discussed above in chapter 3 paras 3.4.1 The relational breakdown precipitating squeeze-out behaviour and 3.4.1.3 Identification of squeeze-out techniques: empirical evidence.

and other powers of control available to them in relation to the company without the prior written approval or consent of each shareholder'. The enhanced voice of minority shareholders by veto power in shareholders agreements may prevent the squeeze-out but can create the deadlock.<sup>43</sup>

There can be overlap between these two types of stipulations to protect the minority shareholders. Minority shareholders' voice can be enhanced regarding the rights that have already been granted to them by reinforcing in agreements that no change can be made to these rights without the consent of minority shareholders'. For instance, directors' remuneration can be declared in shareholders' agreements and it can be provided further in the agreement, 'no change can be made to such remuneration figure, without the consent of the minority shareholder of the company'.<sup>44</sup>

Below the chapter analyses the nature, scope and potential of shareholders' stipulations having contractual effect in the light of available precedents.<sup>45</sup> By considering the nature of available precedents, the chapter discusses the way the rights of minority shareholders' can be declared and their voice can be enhanced. The actual prevention of disputes depends upon the strict adherence to these agreements. Moreover, *ex ante* contracting in shareholders' agreements cannot prevent the actual relational breakdown that precipitates squeeze-out behaviour or precedes exit disputes in these companies. Below the chapter considers the potential of shareholders' agreements (i) to prevent squeeze-out behaviour,<sup>46</sup> (ii) to prevent negligent and efficient management<sup>47</sup> and (iii) to resolve exit disputes following relational breakdown.<sup>48</sup>

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<sup>43</sup> See below para 4.5.1.1 Deadlock as a consequence of the enhanced voice of minority shareholders.

<sup>44</sup> See below, Complaints regarding excessive remuneration of directors.

<sup>45</sup> The precedents referred to here are easily accessible though for the convenience of the reader a number of precedent clauses are reproduced in Appendix 1.

<sup>46</sup> See below para 4.5.1 *Ex ante* contracting to protect the minority from squeeze-out behaviour.

<sup>47</sup> See below para 4.5.2 *Ex ante* contracting to address negligent mismanagement.

<sup>48</sup> See below para 4.5.3 *Ex ante* resolution of exit disputes.

#### ***4.5.1 Ex ante contracting to protect the minority from squeeze-out behaviour:***<sup>49</sup>

The nature and characteristics of squeeze-out behaviour were discussed extensively in the previous chapter. *Ex ante* contracting may assist in protecting the interests of minority shareholders from squeeze-out behaviour by reducing the scope for ambiguity as regards the legal relationship between the company's participants. These stipulations declare the rights and enhance the voice of minority in decision making process that control the powers of majority, in anticipation of pre-defined squeeze-outs techniques and can theoretically prevent squeeze-out behaviour of majority. The scope and potential of *ex ante* contracting regarding each of the squeeze-out techniques identified in the classification at the end of the previous chapter is evaluated separately.

##### *(i) Exclusion of member from management of company:*

Minority shareholders can be excluded from the management of a company by the majority either completely or partially.<sup>50</sup> Complete exclusion occurs when the majority tells the minority that he can no longer participate in the management of the company. Partial exclusion occurs where the majority fails to consult when making key decisions or fails to provide information regarding the company's affairs. Shareholder complaints as to exclusion from management of the company of private companies can be prevented by expressly declaring in the shareholders' agreement that all shareholders have an equal right to participate in the management of the company as directors of the company. Such clause in shareholders' agreement may provide that: 'company's business shall be managed by all of the shareholders of the company and every member has a right to fully participate in the management of the company as a director of the company. All major and minor decisions regarding the management and the business affairs of the company shall be made with the mutual consent of all the shareholders of the company'.<sup>51</sup> Such declaration will provide the minority shareholder with an express contractual right to participate fully in the management of the company.

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<sup>49</sup> Nature of this kind of disputes is discussed above in chapter 3 para 3.4.1.

<sup>50</sup> See above chapter 3 para 3.4.1.1.1 Disregard of minority shareholders' participation in the company.

<sup>51</sup> See precedents' clauses discussed and referred below.

Furthermore, to entrench the participation of a minority shareholder in the management of the company, a right to participate in management can be attached to a separate class of shares allotted to the minority shareholder. The usual technique is to provide that the minority shareholder is entitled to appoint at least one director to represent his particular class of shares. Agreements may provide that, 'each shareholder has a right in accordance with the articles to appoint a director and remove such director and appoint another person to be director in his place'.<sup>52</sup> The right to participate in the management can be further reinforced by enhancing the voice of minority shareholders in shareholders' agreements. Such stipulations in agreements may provide that no decision can be made in a shareholders' meeting in respect of certain identified matters without the presence and unanimous consent of all the members of the company.<sup>53</sup> In effect, this gives the minority shareholders a veto in respect of defined matters.

The complaints against minority shareholders' partial exclusion from the management of the company can be addressed *ex ante* by making express provision that decisions on certain identified matters can only be taken with the consent of minority shareholders.<sup>54</sup> Shareholders' agreements by declaring that unanimous approval of all the shareholders of the company will be required to make decisions regarding the company affairs can entrench the right of the minority to participate in the management of the company. The majority will then not be legally capable of making decisions regarding the company affairs on his own.

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<sup>52</sup> LexisNexis Butterworths, Butterworths Corporate Law Services - Encyclopaedia of Forms and Precedents (hereinafter 'Butterworths') see 291 Shareholders' agreement for minority protection clause 4.1 can be accessed at [www.lexisnexis.com/uk](http://www.lexisnexis.com/uk). and Joffe V.H., *Minority Shareholders: Law Practice and Procedure* (2<sup>nd</sup> ed LexisNexis Butterworths, London 2004) (hereinafter, 'Joffe's') appendix 1, Precedent 24, clauses 3.1, 3.2. See also below appendix 1 para 1 Appointment of directors.

<sup>53</sup> See 'Butterworths' 291 Shareholders' agreement for minority protection clause 3 and Cadman, J., *Shareholders' Agreements* (4<sup>th</sup> ed Sweet & Maxwell, London 2004) (hereinafter 'Cadman') Precedent A, Minority Protection Agreement, clause 12. See below appendix 1 para 2 Matters requiring consent of both parties.

<sup>54</sup> In *Re Cumana Ltd* [1986] BCLC 430, pursuant to the agreement the minority was entitled to be consulted on all major matters concerning the affairs of the company. See above chapter 3 para 3.4.1.1.1.



A shareholder cannot inspect the accounting and financial records of the company to get information about the company affairs at his own will.<sup>55</sup> A shareholder has the right to be adequately informed regarding the affairs of the company to evaluate the true position of the company.<sup>56</sup> Minority shareholders' complaints about limited access to information about the company affairs may be forestalled by providing expressly for greater information rights than they might otherwise enjoy under the Companies Act or the articles of association. Such clause may provide that 'shareholders shall have full and free access to all trading records, accounts, books, bank statements and other financial records of the company for investigating and verifying the affairs of the company and its assets, liabilities and financial position.'<sup>57</sup> In the presence of these extra information rights majority will be legally bound to keep minority shareholders fully informed regarding the affairs of the company.

*(ii) Complaints regarding excessive remuneration of directors:*<sup>58</sup>

Minority shareholders' complaints as to excessive remuneration of directors can be prevented by making provision for how directors' remuneration is to be determined. Furthermore, this squeeze-out behaviour – which potentially reduces or eliminates the dividends that might otherwise be payable to minority shareholders who are not also directors – can be prevented by providing that directors' remuneration shall not exceed a prescribed amount, without the consent of minority shareholders or without the unanimous consent of all or any particular group or class of shareholders of the company. Such clause may provide that 'the company will not without the prior approval of all shareholders pay any remuneration to any person other than as proper remuneration for work done or services provided in connection with its business'.<sup>59</sup> This will prevent majority shareholders as directors of the company from taking excessive remuneration against the interests of minority shareholders.

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<sup>55</sup> See above chapter 3 para 3.2.1.

<sup>56</sup> See ss 423(1) and 431(1) of the CA 2006.

<sup>57</sup> See 'Butterworths' 291 Shareholders' agreement for minority protection clause 4.2. See below appendix 1 para 3 Access to information.

<sup>58</sup> See above chapter 3 para 3.4.1.2.1 Misappropriation of company's assets and proceeds.

<sup>59</sup> See Cadman's, Precedent A, Minority Protection Agreement, clause 12(1)(h). See below appendix 1 para 5 Matters requiring directors' approval.

*(iii) Little or no participation in profits or failure to pay dividends:*<sup>60</sup>

Minority shareholders' complaints about non-payment or derisory payment of dividends can be addressed by providing for an express dividend policy *ex ante* in shareholders' agreements.<sup>61</sup> Such clause regarding dividend may provide that 'the company shall distribute by way of dividend in respect of each financial year, certain profits of the company'.<sup>62</sup> This clarity as regards participation in distributable profits can be further reinforced by providing further that no change can be made to the defined dividend policy without the consent of the minority shareholders or the unanimous consent of all the shareholders of the company. An express dividend policy will prevent shareholders from accumulating profits in the company and minority shareholders will be able to exert greater control over their distribution.

*(iv) Misappropriation of company's assets:*<sup>63</sup>

Majority shareholders might be discouraged from misappropriating the company assets by stipulating in shareholders' agreements that assets of the company must be used for the benefit of the company as a whole and not for majority shareholders' personal benefit. Agreements may provide that 'majority shareholders as directors of company shall not involve themselves in a situation that will conflict with the interests of the company'. This is also just a reiteration of directors' obligation which they are supposed to observe under the general law.<sup>64</sup> A range of provisions can be made in shareholders' agreements to control the conduct of majority shareholders to avoid misappropriation of company assets.<sup>65</sup> It can be stipulated that 'assets can only be disposed of for the best price obtainable in particular circumstances'.<sup>66</sup> Shareholders' agreements may provide that 'the company shall not incur any borrowing in excess of a certain amount'.<sup>67</sup> Furthermore, minority shareholders voice can be enhanced by providing in shareholders'

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<sup>60</sup> See above chapter 3 para 3.4.1.2.1 Misappropriation of company's assets and proceeds.

<sup>61</sup> see Cadman's, Precedent A, Minority Protection Agreement, clause 9.

<sup>62</sup> See 'Butterworths' Precedent 8, clause 8.3. See below appendix 1 para 7 Dividend policy.

<sup>63</sup> See above chapter 3 para 3.4.1.2.1 Misappropriation of company's assets and proceeds.

<sup>64</sup> See s 175 of CA 2006.

<sup>65</sup> See Cadman's, Precedent A, Minority Protection Agreement, clause 12.

<sup>66</sup> See Cadman's, Precedent A, Minority Protection Agreement, clause 12(1)(o). See below appendix 1 para 5 Matters requiring directors' approval.

<sup>67</sup> See Cadman's, Precedent A, Minority Protection Agreement, clause 12(1)(l)(m)(n). See below appendix 1 para 5 Matters requiring directors' approval.

agreements that ‘certain defined assets or assets having a monetary value above a defined threshold cannot be bought or disposed of in the name of the company without the unanimous consent of all the shareholders’ of the company’. In this manner the majority shall be bound not to transact regarding the assets of the company without the consent of minority shareholders. This serves to reinforce further the provisions of CA 2006, which regulate substantial property transactions.<sup>68</sup>

*(v) Allotment of shares to dilute minority shareholder investment or voting power in the company:*<sup>69</sup>

Allotment of shares to dilute minority shareholder investment or voting power in the company can be prevented through *ex ante* contracting firstly, by giving the shareholders a veto under shareholders’ agreements over any issuance of new shares. Such clause may provide that ‘the shareholders undertake to each other, that no alteration, increase or reduction can be made to issued share capital of the company without the prior approval of all the shareholders of the company’.<sup>70</sup> Secondly, shareholders can be granted pre-emption rights regarding new share issues which may be more extensive than their statutory pre-emption rights. Pre-emption clause may provide that ‘the company shall be financed by the shareholders in proportion to their existing cash subscription for the shares in the company’.<sup>71</sup> In this way the majority will not be able to issue shares without the consent of minority shareholders. Moreover, on issue the minority will have a right to subscribe for a new shares issue in proportion to their existing shareholding that will not dilute their investment in the company. However, it should be noted that the granting of enhanced pre-emption rights in the articles or in a shareholders’ agreements will not necessarily protect minority shareholders from the more subtle forms of squeeze-out behaviour – such as timing the allotment when minority

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<sup>68</sup> See s 190 of CA 2006.

<sup>69</sup> See above chapter 3 para 3.4.1.2.2 Dilution of minority shareholders’ investment or voting power in the company.

<sup>70</sup> See Cadman’s, Precedent A, Minority Protection Agreement, clause 12(2)(a). See below appendix 1 para 6 Matters requiring Shareholders’ approval.

<sup>71</sup> See ‘Butterworths’ 291 Shareholders’ agreement for minority protection clause 8.2. See below appendix 1 para 8 Pre-emption rights. See also Cadman’s, Precedent B, Minority Protection Articles, clause 5 (version B).

shareholders have no or insufficient access to finance – discussed earlier.<sup>72</sup> If the pre-emption rights are included in the articles of association then any alteration of such article may be protected in ways also discussed above.<sup>73</sup>

#### *4.5.1.1 Deadlock as a consequence of the enhanced voice of minority shareholders:*

The enhanced voice of minority shareholders through the conferral of veto power in shareholders' agreements can create deadlock among the shareholders. A deadlock is a situation, in which a disagreement cannot be settled and neither side has sufficient voting power to carry resolutions either at board level or in general meeting. In private companies deadlock occurs in two ways. Firstly, decisions requiring unanimous consent of all the shareholders of the company cannot be taken if one shareholder dissents and blocks the decision. Secondly, where the company is deliberately structured to give two shareholders or two blocks of shareholders equal shareholdings 50/50 in a company it will not be possible for one shareholder (or one shareholding block) to take a decision if it is opposed by the other shareholder (or shareholding block). Deadlock situations when they arise may precipitate a winding up of the company on just and equitable grounds.<sup>74</sup> However to avoid these drastic consequences it can be inferred from the available precedent shareholders' agreements that provision for resolution of the deadlock will commonly be made through mechanisms designed to create breathing space for negotiations or by means of a referral to an independent third party. Hence, minority shareholders' can use a deadlock as leverage for their voice to be heard by majority shareholders. In the next section the chapter discusses in the light of available precedents, the methods shareholders employ to resolve deadlock through *ex ante* contractual arrangements.

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<sup>72</sup> See *A Company* [1985] BCLC 80; *Re Cumana Ltd* [1986] BCLC 430.

<sup>73</sup> For alteration of articles to modify pre-emption provision see above *Re Kenyon Swansea Ltd* [1987] BCLC 514, chapter 3 para 3.4.1.2.2. For discussion as to stipulations in shareholders' agreements to prevent alteration of articles, see above para 4.3 Ex ante contracting and *Russell v Northern Bank Development Corp Ltd* [1992] 1 W.L.R 588.

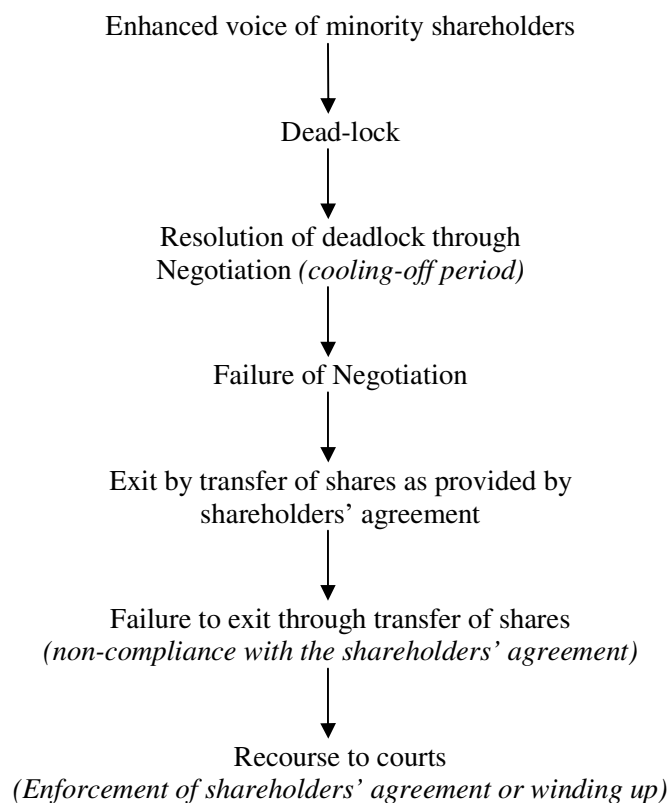
<sup>74</sup> See below para 4.5.1.2.3 Winding-up.

#### 4.5.1.2 *Ex ante contracting to resolve deadlock:*

Shareholders' agreements often provide mechanisms to resolve the deadlocks deliberately created through the conferral of enhanced contractual rights on minority shareholders that give them greater power than they would enjoy ordinarily by virtue of a minority shareholding. In the light of available precedents figure 4.1 below depicts a standard pattern of provisions that are often included in shareholders' agreements as a means of resolving deadlock.

Figure: 4.1

#### ***Ex ante contracting mechanisms to resolve deadlock***



#### 4.5.1.2.1 *Negotiation:*

Shareholders' agreements may provide that shareholders will use all reasonable endeavours to resolve the matter in dispute within a prescribed time period. That period can be described as a cooling-off period. In this period shareholders explain in writing their own stance and consider the stance of other shareholders regarding the particular

issue in good faith.<sup>75</sup> Shareholders' may resort to negotiation in the cooling off period to resolve deadlock. A mechanism that triggers the possibility of negotiation may prove helpful in creating space for shareholders to consider each others' viewpoints with a view to resolve their differences amicably with or without outside assistance.

At the time of deadlock when parties are not immediately willing to cooperate with one another these negotiations might be made more effective and successful, if conducted with the assistance of a third party such as a trained mediator.<sup>76</sup> Recourse (by prior agreement) to a mediated negotiating process as a mechanism for breaking a deadlock may save time and costs and avert the risk of court proceedings which, in the context of shareholder disputes, may prove time consuming, costly and cumbersome.<sup>77</sup> Judging by the available precedents, it is common to provide for a method to resolve disputes or deadlock situations either by referring the matter to a third party or by some pre-agreed process of dialogue between shareholders.<sup>78</sup>

If the negotiation to resolve the dead lock fails shareholders may use exit mechanism by transferring their shares in accordance with the terms of the agreement.<sup>79</sup> Depending on the circumstances negotiations could also be attractive for shareholders to resolve possible obstacles associated with the transfer of shares e.g., valuation of shares.<sup>80</sup> It is possible that effective negotiation may preserve or repair the relationship of the parties and lead to the amicable resolution of the dispute without the need for any shareholders having to exit, especially when mutual trust and relationship of the parties still exists and there are possibilities for them to continue working together in harmony.

Shareholders' agreements may provide that effort to resolve the deadlock shall be made by referring the dispute to third party arbitration with the arbitrator having adjudicative

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<sup>75</sup> See 'Butterworths' Precedent 1, clause 13.2, accessed on September 2006. See below appendix 1 para 9 Negotiation.

<sup>76</sup> See below chapter 7 for possible role of mediator to resolve shareholder disputes.

<sup>77</sup> See below chapter 5, Resolution of disputes, for problems associated with statutory minority protection remedy available under s 459 of CA 1985.

<sup>78</sup> See 'Butterworths' Precedent 8, clause 13.2.1.

<sup>79</sup> See below 4.5.1.2.2 Exit by transfer of shares.

<sup>80</sup> See above 3.4.3 Exit disputes following relational breakdown.

powers – that is ability to make determinations binding on the parties.<sup>81</sup> A referral to arbitration differs from a referral to a mediator for the purposes of assisting the parties in negotiating a resolution.<sup>82</sup> It appears from the available precedents that the use of arbitration clauses is not common in the context of minority protection shareholders' agreements.

#### *4.5.1.2.2 Exit by transfer of shares:*

In the event that negotiations fail, shareholders' agreements commonly provide for an exit mechanism as a means of resolving deadlock situations.<sup>83</sup> As a result of deadlock where all the efforts to resolve the deadlock by referral to a third party or by the shareholders themselves in a cooling-off period fails, shareholders' agreements may trigger share transfer provisions as a practical means of resolution. The classic pattern is a mechanism that enables a shareholder to exit by first offering his or her shares to the other shareholders at a valuation to be determined in accordance with the agreement.<sup>84</sup> If a smooth exit in accordance with the transfer provisions cannot be negotiated then shareholders' agreements may include provision for the company, to be wound up, effectively as a "nuclear option" to concentrate the parties' minds.

#### *4.5.1.2.3 Winding-up:*

Shareholders' agreements may provide that where shareholders cannot agree on fair terms of exit of minority shareholder, to resolve the deadlock the parties shall procure as a last resort that the company should be immediately wound up under section 122(1)(g) of Insolvency Act 1986.<sup>85</sup> Winding-up is a 'nuclear option' exercised when there is no other option available to minority shareholders to protect their interests. Winding-up results in the cessation of the business and therefore will inevitably destroy value, but can be used by minority shareholder as leverage to resolve the deadlock or to exit from the company.

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<sup>81</sup> See Arbitration Act 1996. For scope of arbitration to resolve shareholder disputes see discussion in Chiu, I.H., 'Contextualising Shareholders' Disputes – A Way to Reconceptualise Minority Shareholder Remedies' (2006) *Journal of Business Law* 312.

<sup>82</sup> See below chapter 7 para 7.4.2.3.4 Mediation.

<sup>83</sup> See Cadman's, Precedent E, clause 13.

<sup>84</sup> See Cadman's, Precedent E, clause 13 and Joffe's appendix 1, Precedent 24, clause 5.

<sup>85</sup> See Butterworths, Precedent 8, clauses 13 and 15. See also below para 4.5.3 *Ex ante* resolution of exit disputes.

#### **4.5.2 *Ex ante contracting to address negligent mismanagement:***<sup>86</sup>

As regards the type 2 disputes provision can be made in shareholders' agreements to the effect that the majority will run the company's business: (i) in an appropriate manner and in the best interests of the company as a whole in accordance with good business practices<sup>87</sup> and (ii) in a proper and an efficient manner and will not behave negligently towards the business.<sup>88</sup> However, relational breakdown due to negligent and inefficient behaviour cannot be prevented only by declaring the way the company's business will be conducted. These clauses in shareholders' agreement serve no purpose beyond reiterating the statutory provisions of the Companies Act 2006.<sup>89</sup> However higher standard of duty of care and skill than statutory duties, may be imposed by these agreements. Negligent and inefficient management might be discouraged by putting restrictions on shareholders' business activities and by enhancing the voice of minority shareholders in shareholders' agreements, by considering the nature of particular business. As discussed above enhanced voice of minority shareholders may create the deadlock.<sup>90</sup> Negligent behaviour of majority shareholders can also be prevented to some extent by conducting regular board meetings to discuss and evaluate the company's progress and nature of available opportunities that company can avail. Shareholders may agree *ex ante* that complete record of company accounts and business transactions shall be kept and regular shareholders' meetings shall be conducted, to fully inform shareholders as to company's affairs and to avoid negligent behaviour.<sup>91</sup>

#### **4.5.3 *Ex ante resolution of exit disputes:***<sup>92</sup>

Shareholders may seek to anticipate exit disputes by providing *ex ante* an exit strategy for minority shareholders, similar to exit strategy provided at dead-lock.<sup>93</sup> The Law Commission came out in favour of exit rights at will for shareholders stating that:

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<sup>86</sup> See above chapter 3 para 3.4.2 for nature of this kind of disputes.

<sup>87</sup> See Cadman's, Precedent A, Minority Protection Agreement, clause 10(1)(a)(b) and Butterworths, precedent 5, clause 9.1. See below appendix 1 para 4 The Company's business.

<sup>88</sup> See Cadman's, Precedent A, Minority Protection Agreement, clause 10(1)(a)(g)(h). See below appendix 1 para 4 The Company's business.

<sup>89</sup> See the general duties of directors in the CA 2006, ss 171-177.

<sup>90</sup> See above para 4.5.1.1.

<sup>91</sup> See Cadman's, Precedent A, Minority Protection Agreement, clause 10(1)(i)(m). See below appendix 1 para 4 The Company's business.

<sup>92</sup> See above chapter 3 para 3.4.3 for nature of these exit disputes.



It is hoped that by encouraging the parties to make provisions for a future breakdown in their relations...allow parties to manage the break down in such a way as to cause the minimum disruption to the business itself.<sup>94</sup>

Shareholders agreements may provide that minority has a right to exit in the event of relational breakdown after a fair valuation of his shares. These agreements further provide the manner in which the value will be determined; the person who will determine the value and the pre-emption rights of the remaining shareholders in relation to the exiting shareholder's shares. In *ex parte Kremer*<sup>95</sup> article 7 of the company's articles provided that:

A member desiring to transfer shares otherwise than to a person who is already a member of the company shall give notice in writing of such intention to the directors of the company, giving particulars of the shares in question. The directors as agents for the member giving such notice may dispose of such shares or any of them to members of the company at a price to be agreed between the transferor and the directors or failing agreement at a price fixed by the auditors of the company as the fair value thereof.

Even though, as pointed out earlier, relational breakdown of itself will not ground a petition under section 459,<sup>96</sup> it is open to shareholders to make provision for exit in circumstances where relationships have broken down without fault (in any legal sense) on either side. As one interviewee pointed out:

O'Neill v Phillips has not permitted 'no fault divorce' but parties can agree in advance as to 'no fault divorce' and this can be helpful ... [G].

Interviewee S acknowledged that *ex ante* provision of a right to exit at will was entirely possible in principle but expressed concern about the mechanics of such a right in practice:

I think someone has to make if you like the political decision or the company decision as to whether there should in effect be 'no fault divorce'. Because if you want to have a mechanism for buy-out or fair valuation you have to decide whether that should be... if you like... in any event without having to prove that somebody has done anything wrong... so should it be there as a no fault divorce mechanism [S].

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<sup>93</sup> See above paras 4.5.1.2 *Ex ante* contracting to resolve deadlock and 4.5.1.2.2 Exit by transfer of shares.

<sup>94</sup> See *The Law Commission Report* [5.8].

<sup>95</sup> *Re a Company (No 006834 of 1988) ex parte Kremer* [1989] BCLC 365, 367.

<sup>96</sup> See above chapter 3 para 3.4 Nature and kinds of minority shareholders' disputes and below chapter 5.

Shareholders' agreements firstly, may provide the procedure that will be adopted at the time of transfer<sup>97</sup> and secondly, the circumstances that will trigger the transfer of shares. Provision can also be made by way of a "nuclear option" for the company to be wound up if there is non-compliance with the exit provisions where triggering circumstances have arisen.<sup>98</sup> In the light of available precedents the main circumstances that are often included as triggers for the transfer of shares are as follows.

(i) *Material breach of any provision of the agreement:*

Shareholders' agreements may provide that as a result of any material breach of the agreement the defaulting shareholder is deemed to serve a notice to transfer his shares to other shareholders in the company.<sup>99</sup>

(ii) *Termination of shareholders' agreement:*

Shareholders agreements may provide that a shareholder may serve a notice to terminate the agreement due to the occurrence of a specified event that will then trigger the operation of the exit provisions.<sup>100</sup> Agreements may provide for the company to be wound up if the shareholders fail to transfer their shares at such notice. These terminating events can be the same triggering circumstances that can cause the transfer of shares discussed here.

(iii) *Ceases to be an employee/director of the company:*

Shareholders' agreements may provide for a shareholder who ceases to be an employee or director of the company or who is no longer providing services to the company to transfer his shares.<sup>101</sup>

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<sup>97</sup> See above para 4.5.1.2.2 Exit by transfer of shares.

<sup>98</sup> See above para 4.5.1.2.3 Winding-up.

<sup>99</sup> See Cadman's, Precedent E, clause 15. See also below appendix 1 para 10 Termination.

<sup>100</sup> Butterworths, precedent 5, clauses 14.1 and 14.2 and 15. See also below appendix 1 para 10 Termination.

<sup>101</sup> See Butterworths, precedent 5, clause 14.2.4 and clause 15.

(iv) *Death/ ill-health of a shareholder:*

As a result of death or ill-health of a shareholder, a shareholders' agreement may provide for compulsory transfer of shares of a deceased shareholder or of shareholder who cannot perform his duties due to his ill-health.<sup>102</sup>

Moreover shareholders' agreements may provide that a shareholder may transfer his whole legal and beneficial title to his shares to other shareholders' in the company or to a third party during the continuance of the agreement without providing any triggering circumstances for such transfer<sup>103</sup> or subject to certain conditions or restrictions.<sup>104</sup> Shareholders' agreements may prohibit transfer of shares to particular types of persons such as bankrupts or persons of unsound mind.

On exit the biggest concern of a minority shareholder who has invested time, money and effort in that particular business, is to ensure there is a fair valuation of his shareholding. The reflection of minority shareholders' investment of financial as well as human capital at the time the valuation is carried out can be more satisfying and fair for minority shareholders. Shareholders' agreements may provide the process to value the shares at exit of minority shareholder.<sup>105</sup> However, application of this *ex ante* valuation process may not be entirely satisfactory for minority shareholders at exit.<sup>106</sup> This raises legal questions about the extent to which provisions made for exit in advance in articles and shareholders' agreements can be overridden by the courts.

#### **4.6 Limitations of shareholders' agreements:**

Advance declaration of rights by the parties regarding conflicting situations through *ex ante* contracting in a clear way can minimise the scope for squeeze-out behaviour and can put the minority shareholders in a significantly stronger position when squeeze-outs arise. Furthermore, *ex ante* contracting may, in theory, lead to swifter and more cost-

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<sup>102</sup> See Butterworths, precedent 5, clause 14.2.3 and clause 15.

<sup>103</sup> See above reference to *Re a Company (No 006834 of 1988) ex parte Kremer* [1989] BCLC 365, 367.

See also Joffe's appendix 1, Precedent 24, clause 4.

<sup>104</sup> See Cadman's, Precedent A, Minority Protection Agreement, clause 13(1).

<sup>105</sup> See above para 4.5.1.2.2 Exit by transfer of shares.

<sup>106</sup> See below para 4.6.6 Enforcement of shareholders' agreements.

effective resolution by means of speedy exit because the means of addressing foreseeable problems have been defined in advance.<sup>107</sup> However, the study of the precedents and interviewees' responses suggests that, while there is considerable enthusiasm for shareholders' agreements among lawyers, that might be because they are a means of generating fees from clients; they cannot prevent relational breakdown *per se*. Moreover, there are a range of other limitations associated with *ex ante* contracting which may be thought of as standard limitations with any attempt to regulate commercial relationships by contract. This part of the chapter considers these limitations and argues that they are such that shareholders' agreements are at best an imperfect mechanism for protecting minority shareholder interests.

While as indicated above, interviewees were generally in favour of shareholders' agreements and considered them to be a useful mechanism for anticipating, preventing, and responding to disputes, they also pointed out a number of limitations associated with shareholders' agreements. One interviewee said:

I am in favour of shareholders' agreements but it depends how good these agreements are. It further depends upon how sophisticated the businessmen are, and whether they are prepared to abide by the agreement. If the people are prepared to abide by articles and do the decent things, the fact they have made an agreement is not going to make any difference. Bad behaviour is bad behaviour [J].<sup>108</sup>

It can be asserted from the interviewees' responses as a whole that a majority of interviewees recommended the use of shareholders' agreements but recognized their limitations in practice. These limitations are as follows:

- (i) The potential of *ex ante* contracting to eliminate factors which contribute to relational breakdown
- (ii) Optimism bias
- (iii) Transaction costs
- (iv) Concerns as to over-protection of minority shareholders
- (v) Unequal bargaining position of shareholders

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<sup>107</sup> Boros, E., *Minority Shareholders Remedies* (Clarendon Press, Oxford 1995) 105.

<sup>108</sup> See also below para 4.6.6 Enforcement of shareholders' agreements.

- (vi) Enforcement of shareholders' agreements

Each of these limitations is discussed further below.

***4.6.1 The potential of ex ante contracting to eliminate factors which contribute to relational breakdown:***

In the previous chapter it was seen that shareholder disputes in private companies often follow relational breakdown which, in turn, can arise for a variety of underlying reasons. O'Neal has emphasised the importance of comprehensive planning to eliminate as many of the factors that contribute to shareholder dispute if such disputes are to be prevented or resolved.<sup>109</sup> It is open to doubt whether *ex ante* contracting can address the underlying factors which contribute to relational breakdown that were identified in the previous chapter. *Ex ante* contracting in shareholders' agreements can theoretically protect minority shareholders from squeeze-out behaviour and can resolve exit disputes by making detailed provision for how exit is to be triggered and on what terms but it is difficult to contend that the break down of personal relationships *per se* could be effectively prevented by contractual means. There are a number of reasons why not.

Several interviewees suggested that relational breakdown arise as a result of personal and business conflicts.<sup>110</sup> Business conflicts may arise due to different approaches among shareholders towards the management and direction of the business. Interviewees stated that business disagreements arise owing to lack of advance formal consideration of shareholders regarding the medium and nature of business they are going to enter. Shareholders generally do not consider in advance how the majority rule will work in a private company and what type of decisions will be required when the business will develop or decline in future.<sup>111</sup> It can be asserted that (i) *ex ante* contracting can control the use of majority rule by enhancing the voice of the minority<sup>112</sup> and (ii) make some provision for foreseeable future conflicting situations. However, *ex ante* contracting

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<sup>109</sup> See F.H. O'Neal and R. Thompson, *O'Neal's Oppression of Minority Shareholders*. (2<sup>nd</sup> ed Callaghan 1985) chapter 9 para 9:01.

<sup>110</sup> See chapter 3 above para 3.3.1 Identification of the underlying factors of relational breakdown.

<sup>111</sup> See above chapter 3 para 3.3.1.3 Lack of formal planning.

<sup>112</sup> See above para 4.5.1 *Ex ante* contracting to protect the minority from squeeze-out behaviour.

cannot provide in advance for every eventuality that may contribute to relational breakdown. Shareholders' approach towards the future direction of the business is often hard to foresee and may depend upon the future success or decline of the business. The economic policies of the country and future business or market trends may also influence the decisions of businessmen and have a role in shaping the direction of the business. Shareholders' objectives in business and lives may change with time and age. All of these variables, which are impossible to foresee in advance may be factors underlying relational breakdown.

Shareholders who start business with great enthusiasm may turn out to be negligent or inefficient regarding the affairs of the company. As stated above, effects of negligent attitude can be mitigated by keeping regular eye on shareholders' business activities.<sup>113</sup> However, no *ex ante* contracting is possible to stop shareholder from being negligent, inefficient or lazy in ways that may cause relational breakdown.

Personal conflicts mainly arise due to shareholders' different personalities and different personal objectives in life. These personal conflicts cause relational breakdown owing to lack of shareholders' understanding regarding the personalities and objectives of other shareholder with whom they are going to start the business.<sup>114</sup> Shareholders personal conflicts might be avoided if shareholders consider the personalities and objectives of other shareholders before going into business with them e.g., whether the prospective shareholder is comfortable with the idea of team work in a company. In fact, the scope of *ex ante* contracting is very limited to avoid such personal conflict. *Ex ante* contracting cannot prevent personal conflicts since often these personality differences are latent and hard to foresee at the start of the business. The obvious analogy is matrimonial disputes where differences in personalities, latent at the time of a marriage may become a source of conflict subsequently. Therefore *ex ante* contracting cannot be expected to be particularly successful as a method of preventing the kind of personal conflicts that cause relational breakdowns. Moreover, it is not practical to respond *ex ante* to all

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<sup>113</sup> See above para 4.5.2 *Ex ante* contracting to address negligent mismanagement.

<sup>114</sup> See above chapter 3 para 3.3.1.1 Personality clashes and family quarrels.

foreseeable personal and business conflicts that may cause relational breakdown. One interviewee stated that:

Shareholders' agreements could not cover every situation, since shareholders could not legislate for every conceivable eventuality [C].

The case law and interviewees experiences suggest that most of these private companies are family companies and the large amount of relational breakdown occur in the next generation of the founders of company. Shareholders do not get the opportunity to choose their business partners as they receive their interests in these companies by inheritance.<sup>115</sup> Therefore often it is not possible for shareholders to choose their business partners and to make effective provision for possible anticipated areas of disputes.

Shareholders in private companies commonly start business on the basis of mutual trust and personal relationship. The threat regarding relational breakdown is inherent in any kind of close personal relationship including family relationship. The analogy – which has sometimes been drawn by members of the judiciary<sup>116</sup> – is again with marriage.<sup>117</sup>

The self-interested behaviour of shareholders generates greed and jealousy and can contribute to relational breakdown.<sup>118</sup> It is not possible to stop shareholders from thinking in a self-interested manner or from seeking to enhance their control of the company. The self-interested behaviour of shareholders can also affect the personalities and business choices of shareholders at any time during the life of the company. Moreover, self-interest of shareholders can breakdown the relationship of shareholders, independent of any personal or business conflict. Owing to a range of limitations that are discussed below, *ex ante* contracting is not always possible for shareholders to deal with the factors that cause relational breakdowns. Hence, owing to above reasons it does not seem practical to deal with these underlying factors by *ex ante* contracting in a way that

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<sup>115</sup> See also F.H. O'Neal and R. Thompson, *O'Neal's Oppression of Minority Shareholders*. (2<sup>nd</sup> ed Callaghan 1985) chapter 2 para 2:02.

<sup>116</sup> See *Re a Company (No 004377 of 1986)* [1987] BCLC 94 above in chapter 3 para 3.4.3 Exit disputes at relational breakdown and *Re a Company (No 005134 of 1986)*, *ex parte Harries* [1989] BCLC 383 above in chapter 3 para 3.2 Introduction.

<sup>117</sup> See also Copp S., 'Company Law and Alternative Dispute Resolution: An Economic Analysis' (2002) 23(12) *Company lawyer* 361, 367.

<sup>118</sup> See above chapter 3 para 3.3.1.2 Self-interested behaviour.

will prevent the relational breakdown among shareholders. Like pre-nuptial arrangements that can only respond to the consequences of marriage breakdown rather than its causes, *ex ante* contracting in shareholders agreements can generally only mitigate the effects of relational breakdown by controlling the powers of majority and providing an exit on fair terms .

#### **4.6.2 Optimism bias:**

As private companies are often founded on the basis of mutual trust and confidence, shareholders may well be over-optimistic and over-confident about their prospects and so dismiss the need for shareholders' agreements. One interviewee said:

These agreements are like pre-nuptial agreements to whom people say no at the time of the marriage because they think why do we need a pre-nuptial agreement... we are never going to fall out and corporate divorce is similar [M].

Due to factors such as personal good faith regarding business, initial trust in fellow shareholders and excitement regarding the new business shareholders may not anticipate future conflicts. Later on when shareholders try to pursue their own interests and business objectives, relational disputes arise. Shareholders are also confident upon their personal relationships to sort their differences out in future. In this spirit of optimism and confidence the parties neither wish to think about problems that could arise nor anticipate that such problems could happen to them.

Interviewee R acknowledged shareholders' optimism in the context of private companies and emphasised differences in the character of disputes in large private companies and commercial joint ventures – where there is a greater likelihood that the parties will have received legal advice and put in place comprehensive articles and shareholders' agreements to regulate their relationship – when compared with small private companies. The more dependent the company is on close relationships between the participants for its smooth running, the more difficult it is to foresee the problems that can arise [R]. Interviewee T stated:

Generally you do not get shareholders agreements in quasi-partnerships because they are more about informality [T].



Conversely, the more concerned the parties are to try and foresee problems in advance and document every conceivable aspect of their business relationship, the more one may doubt the wisdom of them venturing into business together. That itself indicates the lack of mutual trust and possibility of future conflicts in the company. In this situation it is suggested not to enter into such business based on personal relationships but to treat it as a purely commercial enterprise and stipulate minority protection agreements accordingly, if possible. Recounting the experience of a prominent Wisconsin lawyer, O'Neal writes:

...when clients who come to him to form a closely held enterprise are so concerned about possible future disagreements that they want binding agreements in advance to resolve such difficulties, he may advise them not to go into business together.<sup>119</sup>

#### **4.6.3 Transaction costs:**

One interviewee suggested, for better protection of minority, agreements needed to be very comprehensive so there should be no scope for any dispute left behind [S]. Drafting shareholders' agreements can be a complex and lengthy process. Negotiations are conducted under the supervision of experienced lawyers and efforts may be made when drafting these agreements to cover all possible contingencies in a particular business. Drafting shareholders' agreements will inevitably increase transaction costs for the parties. The more comprehensive and complex the agreement, the greater those transaction costs are likely to be. Parties who incorporate their business may well be deterred from putting in place a shareholders' agreement by concerns over likely legal costs. The point was acknowledged by two interviewees:

Disputes in private companies can be avoided by ex ante contracting but sometimes people don't have money to pay lawyers to negotiate these agreements [M].

Shareholders' agreements are expensive and it can cost thousands of pounds in negotiating the agreement. However there are precedents available in books [G].

Perhaps not surprisingly, many of the interviewees took the view that a properly drafted agreement which might involve the parties incurring considerable expense is better than

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<sup>119</sup> Professor J. A. C. Hetherington, Special Characteristics, Problems, and Needs of the Close Corporation, 1969 U Ill LF 1, 17, n 65 as quoted by F.H. O'Neal and R. Thompson, *O'Neal's Oppression of Minority Shareholders*. (2<sup>nd</sup> ed Callaghan 1985) chapter 9 para 9:01, n 3.

no agreement or a cheaper, badly drafted agreement. Not paying for specialist counsel was thought to be a false economy. Interviewee J said:

There is no real excuse for not thinking about what your articles say. The trouble is of course, if you want an off the shelf general trading company you will get it very cheap... it won't cost you much more than £100 but it won't be tailor-made. If you want something tailor-made settled by an experienced lawyer it will cost significantly more but you will get something worthwhile [J].

It has been suggested that problems regarding both optimism and transaction costs can be dealt with to some extent by providing default rules in model articles of association.<sup>120</sup>

#### *4.6.3.1 The significance of default rules:*

During the empirical research while discussing transactions costs, interviewees were also asked to consider the significance of the inclusion of default rules in model articles. Interviewees acknowledged the utility of default rules providing an exit for the minority, but were not hopeful regarding their potential to deal with shareholders disputes. Interviewees indicated that the problem was as to the nature of these provisions, what these provisions should state on standard basis in model articles.<sup>121</sup> Interviewee S acknowledged that as a principle, provision for 'exit at will' either in shareholders' agreements or in model articles, was a very good idea but the devil would be in the detail of any such provisions. Interviewee A expressed the view that there would be difficulties arriving at any consensus around whether there should be 'exit at will' or defined circumstances triggering a right to exit and, if the later option was favoured, what defined circumstances might be included. Interviewee E thought that default rules would be useful backstop but was not ultimately persuaded that they could meet the circumstances of every case that may arise in future.

As is the case with bespoke shareholders agreements there is an inherent limitation that if the default rules try to meet every eventuality they are almost certain to be unsuccessful given that circumstances change over time. At the same time, if they were

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<sup>120</sup> See *The Law Commission's Report* Part 5 paras 5.4-5.32.

<sup>121</sup> Under the CA 2006 now the table A is replaced by the model articles for private limited companies.

drafted in a flexible, open-ended way they may not deal effectively with the immediate problem at hand. One interviewee made the point in the following way:

On the one hand certainty equals fairness but on the other hand certainty as it turns out may not be fair because it may not deal with the particular situation. The more flexible it is the more able it is to cover different circumstances but the more uncertain it is because you don't know the answer. So you have that tension constantly between the desire for certainty and the desire for flexibility [A].

Interviewees also indicated:

Default rules cannot cover every situation such as complexities as to basis of valuation and discounts. Moreover, legal questions could arise around the fair application of default rules that could be difficult to resolve [C].

It is also important to obtain a balance between the rights of minority and majority shareholders and that balance is very hard to achieve in the context of default rules [G].

Interviewee F supported the adoption of default rules and considered it helpful as a means for providing a clear legal justification for exit via a buy-out bearing in mind that Lord Hoffmann had rejected the idea of 'exit at will' or 'no fault divorce' in *O'Neill v Phillips*,<sup>122</sup> but did not anticipate such provision being implemented in the near future.

The Law Commission in its final report<sup>123</sup> recommended the inclusion of default rules such as a shareholders' exit article for smaller private companies in Table A, but it was not included in the model articles for private companies under the CA 2006.<sup>124</sup> The Law Commission mentioned the view of respondents to their original Consultation Paper to the effect that exit routes too readily available might be economically damaging, leading to the break up of small businesses at the first sign of disagreement.<sup>125</sup>

Similarly the Company Law Steering Group also expressed concern about the proposed exit article that:

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<sup>122</sup> [1999] 2 BCLC 1. See below chapter 6.

<sup>123</sup> *The Law Commission's Report* Part 5 paras 5.4-5.32 and appendix C.

<sup>124</sup> See Draft Model Articles for Private Companies Limited by Shares in French D (editor) *Blackstone's Statutes on Company Law* (2007-2008) (11<sup>th</sup> ed. Oxford University Press, New York 2007) 725.

<sup>125</sup> *The Law Commission's Report* [5.7].

The clear conclusion was that the article would not be used in practice because on commercial grounds it would not be incorporated in company constitutions by well informed founders and was inherently undesirable on grounds of lack of flexibility – it was impossible to prescribe in advance, and for the full diversity of companies, what would be a fair exit regime. For ill-informed founders it would be a trap.<sup>126</sup>

One interviewee also expressed concern:

I am a bit worried about default provisions in Table A. I think that people ought to think about what they are doing. It is up to people to have a structure that reflects their own business and not for the state to provide an easy get out [J].

Lack of any clear enthusiasm for default rules among experienced counsel<sup>127</sup> may in part explains why the idea was not adopted in the model articles for private companies under the CA 2006.

#### ***4.6.4 Concerns as to over-protection of minority shareholders:***

Majority shareholders may be concerned that shareholders' agreements – especially those that confer veto rights and rights to exit at will – may “over-protect” the minority and therefore operate against their interests. Of course, the issue of “over-protection” or “under protection” will come down to the relative bargaining positions of the parties in negotiations. Needless to say the lawyers who draft and negotiate such agreements will be influenced by the interests of their clients. As one interviewee put it:

You have to look whether you are drafting for majority or for minority. It is very difficult to strike a balance between majority and minority. I don't know the perfect shareholder agreement [G].

In company law application of majority rule is common to run the affairs of the company in an efficient manner. The veto power enhanced the voice of minority shareholders and decisions cannot be made unless there is a unanimous consent of all shareholders, which can slow the decision making process of the company and can create deadlock. The slow decision making process can be against the interests of the both the shareholders and the company. Moreover, minority shareholders might exercise their veto power in bad faith to block decisions that may not be against their interests but

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<sup>126</sup> *Modern Company Law for a Competitive Economy: Developing the Framework* (URN 00/656, March 2000) [4.103] can be accessed at [http:// www.berr.gov.uk/](http://www.berr.gov.uk/).

<sup>127</sup> Lack of enthusiasm can be due to fear of loss of fee income generated from clients for drafting shareholders' agreements.

will be beneficial for majority shareholders and the company. Therefore the possibility is that majority shareholders in these companies might avoid the advance stipulations to enhance the voice of minority shareholders and would prefer to run the affairs of company by applying the majority rule.

Secondly, majority shareholders may hesitate to accept minority's right to exit at will to avoid over-protection of minority shareholders. Exit at will can provide a useful means of resolving disputes without the need for costly litigation but may not be suitable for majority shareholders where they are relying upon the minority not withdrawing capital from the business and in circumstances where they may find it difficult to finance a buy-out. This might result in the drastic consequence of a winding-up. Again, the majority may be concerned that the minority may exploit the right to 'exit at will' for his personal interests and to threaten majority to invest somewhere else more profitable or to leave majority in distress. In *Phoenix Office Supplies Ltd v Larvin*,<sup>128</sup> Auld LJ made the point that:

[In a small company with a few shareholders] each holding a significant proportion of the company's issued capital, a sudden demand from one of them, for essentially personal reasons, to seek to withdraw his investment could be very damaging, even potentially ruinous, to [the other shareholders] and the company.

The Law Commission mentioned the views of respondents to its Consultation Paper that:

Serving an exit notice might enable shareholders to exert pressure improperly, knowing that the other party could not afford to pay for his shares.<sup>129</sup>

One interviewee was particularly sympathetic to majority shareholders' concerns about a 'no fault' entitlement to buy-out:

Any shareholder may suddenly insists that he wants his shares bought out after an independent valuation. That may be unfair on shareholders left behind in the company. These shareholders could complain that (i) the minority shareholder is leaving a sinking ship (ii) the majority shareholders do not have finances, to be able to buy him out [S].

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<sup>128</sup> [2003] 1 BCLC 76 para 30.

<sup>129</sup> *The Law Commission's Report* [5.7].

Interviewee G added that:

Like pre-nuptial agreements in marriage, shareholders don't know what is going to happen in future. Therefore, majority shareholders are concerned that minority may use exit option in his own interest e.g., when the share price seems in his favour [G].

#### **4.6.5 Unequal bargaining position of shareholders:**

Concerns about “over protection” or “under-protection” of minority shareholders will to some considerable extent be driven by the relative bargaining position of the parties. Minority shareholders’ cannot respond effectively to majority shareholders’ concerns regarding over protection of minority shareholders owing to their weak bargaining position. Minority shareholders in private companies may not have the bargaining strength to regulate their business affairs with majority shareholders on an equal footing. Minority shareholders with low bargaining power owing to their minority holdings in the company may not be able to stipulate agreements with majority shareholders, to protect their interests in future. Conversely, majority shareholders who are strongly placed are unlikely to want to introduce qualifications to majority rule.

In fact courts also do not improve the bargaining position of minority shareholders by granting them what they might have stipulated in advance on the assumption of equal bargaining power. Courts only come to the rescue of the minority where there is a breach of some legal right or the exercise by the company of legal rights in a manner that is contrary to equity.<sup>130</sup> Interviewee G stressed that shareholders should regulate the affairs of business in advance and acknowledged that in most cases the minority shareholder does not have the bargaining position required to stipulate minority protection agreements. The same interviewee further elaborated that:

If shareholders did not have bargaining strength in the beginning then the court should not improve their bargaining position *ex post*... This was the real world of business and if shareholders did not plan then why should the court come to their rescue [G].

It can be asserted that unequal bargaining positions of shareholders can be a limitation to drafting minority protection shareholders’ agreements in private companies.

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<sup>130</sup> See *O'Neill v Phillips* [1999] 2 BCLC 1.

#### ***4.6.6 Enforcement of shareholders' agreements:***

Shareholders' agreements demand strict enforcement to be effective. Shareholders' agreements can be helpful on their own but may not be enough for protecting minority shareholders. Even declaring in the statute that a director must in good faith would promote the success of the company for the benefit of its members as a whole and must avoid a situation in which his direct or indirect interest conflicts with the interests of the company cannot guarantee the protection of minority shareholders' interests without effective means of enforcement.<sup>131</sup> Majority shareholders respect *ex ante* contractual rights when there is a strict enforcement of those rights. Like any agreement on breach of these agreements shareholders need to have recourse to the courts for enforcement of their rights available under these agreements. Such as where minority has a right to participate in the management of the company and has been excluded from the management, agreement is ultimately needed to be enforced by the courts. In *Rayfield v Hands*<sup>132</sup> to deal with the problem of illiquidity, article 11 of the articles of association of a private company provided that "every member who intends to transfer shares shall inform the directors who will take the said shares equally between them at a fair value". At the time of transfer of shares the directors refused to buy the claimant's shares. On the claimant's application, the court held in his favour that article 11 constituted an enforceable contract between the directors who were bound to purchase his shares at a fair value. If the rights of the parties are clear under shareholders' agreements regarding a particular conflict and the dispute is merely regarding the breach of shareholders' agreement then shareholders can enforce those rights through contractual remedies under ordinary principles of contract law. Shareholders' can also enforce shareholders' agreements through statutory minority protection remedy under section 459 of CA 1985 when breach of the agreement is unfairly prejudicial to their interests.<sup>133</sup>

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<sup>131</sup> See CA 2006 ss 172(1) and 175(1).

<sup>132</sup> [1960] Ch 1.

<sup>133</sup> See *O'Neill v Phillips* [1999] 2 BCLC 1. Lord Hoffmann supported the contractual relationship of the parties by stating that, to prove unfair prejudicial conduct under section 459 of the CA 1985, minority shareholders have to show that there is some breach of their formal (legally binding) or informal (binding under equity) agreement.

Unfortunately there are problems associated with enforcement of shareholders' agreements by courts such as complications regarding the fairness and interpretation of contractual terms needed to be enforced in particular situations. In *Re Abbey Leisure Ltd*, it was held that:

There was nothing unreasonable in the petitioner refusing to accept the risk that an accountant's valuation of his interest in the company under the machinery in the articles might apply a discount for his minority shareholding.<sup>134</sup>

Interviewee S stated that there were often disputes around whether the defined circumstances that triggered a right to exit and buy-out had actually been triggered on the facts. An interviewee referred an example, that if relational breakdown due to breach of agreement or unfair prejudicial conduct was a trigger for buy-out of minority then to enforce the agreement minority needed first to prove the breach or unfairly prejudicial conduct. The allegation alone could not be enough to justify exit. Proving such triggering circumstances may prolong the court proceedings and can result in lengthy and expensive litigation [C].

Interviewees said that in practice shareholders' agreements often just give something else to argue about. A particular problem that one interviewee identified surrounded possible defects at the point of contract formation:

A well drafted shareholder agreement can help, but the trouble is when you have small disputes you will simply get collateral factual disputes, because one would say well, I know I signed the shareholder's agreement, but Fred said to me we didn't really need to worry about it, it was just a piece of paper. The solicitor said to me, I had to sign it but not to worry because I would always have a right to be a director. Then you just get arguments about whether, that was in fact said. Unfortunately, sometimes it adds to the problem rather than taking it away [R].

Interviewee D added that a party might argue that it was unfair for the agreement to work in these circumstances or that the valuation was wrong.

If a shareholders' agreement provides the exit route for a dissatisfied shareholder to resolve a dispute, courts always prefer to enforce that already stipulated agreement, to

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<sup>134</sup> *Re Abbey Leisure Ltd* [1990] BCC 60 (CA).



avoid the cost and delay in proceedings.<sup>135</sup> However, shareholders may claim that it is unfair to apply the agreement to the particular situation. Courts can ignore shareholders' agreements where in particular circumstances it is fair to do so and that may diminish the attractiveness of entering these agreements in advance. In *Exeter City AFC Ltd v The Football Conference Ltd*<sup>136</sup> the petitioner presented a petition under section 459 of CA 1985. The respondent applied to stay the petition under section 9 of the Arbitration Act 1996 by stating that there was an arbitration clause and the dispute should not go down section 459 route but should be arbitrated. The court did not grant a stay by stating that section 9 of the Arbitration Act did not apply and the court was an appropriate tribunal to decide these issues.

One interviewee said that it was very difficult in practice to get a court to shift from the written shareholder agreement but it was possible. He further added that shareholders may have mandatory exit provisions in shareholders agreements or in the articles of association but the courts can ignore them if the courts consider that these agreements or any of their provisions operate unfairly. So, for example, if the shareholders' agreement does not set out a right for the exiting shareholder to make representations to the valuer the judge may think that this is unfair and not a proper basis for arriving at a valuation. In support of his view the same interviewee mentioned that:

In *Re Abbey Leisure Ltd*<sup>137</sup> and *Re Benfield Greig Group plc*<sup>138</sup> shareholders' agreements say that if you want to exit the company this is the way we are going to value your shares. The courts said that you can still have 459 because the valuation process is somehow unfair or the value fixed by the auditor is unfair [T].

In *Re a Company (No 004377 of 1986)* Hoffmann J held that:

[Unless] there has been bad faith or plain impropriety in the conduct of the respondents or about cases in which, the articles provide for some arbitrary or artificial method of valuation... [I] do not consider that in the normal case of the breakdown of a corporate quasi-partnership there should ordinarily be any legitimate expectation that a member wishing to have his shares purchased should be entitled to have them valued by the court rather than the auditors pursuant to the articles.<sup>139</sup>

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<sup>135</sup> See *Rayfield v Hands* [1960] Ch 1; *Russell v Northern Bank Development Corp Ltd* [1992] BCLC 1016.

<sup>136</sup> [2005]1 BCLC 238.

<sup>137</sup> [1990] BCLC 342.

<sup>138</sup> [2002]1 BCLC 65.

<sup>139</sup> *Re a Company (No 004377 of 1986)* [1987] BCLC 94, 102.

Interviewee B had recently been involved in a case where the court had held that it was not fair on the petitioner to require that he comply with detailed share sale provisions in the articles.

As to the valuation process in shareholders' agreements, one interviewee expressed concerns that defining a valuation process in an agreement was not enough since there were cases for instance, where the shareholders agreed to a valuation by the company's auditor, but the auditor had previously valued the shares for tax reasons at a very low value or the auditor was looking for the next job from the company so the exiting shareholder could not trust auditor. Moreover, a minority shareholder may prefer to delay his exit if the valuation would subsequently be improved by foreseeable increases in turnover or profits in the near future [F]. Shareholders may complain that the valuation process prescribed in shareholders' agreements is not fair because it has not considered the reduction in the value of company's shares owing to squeeze-out behaviour. That may raise the question whether there is any squeeze-out behaviour or not and how much loss the minority may have suffered due to squeeze-out behaviour that may take the question into courts and prolong the dispute. In *Guinness Peat Group plc v British Land Co plc*,<sup>140</sup> it was held that the value of minority shareholding in the company is a disputed question of fact. Factual disputes are normally resolved in an adversarial system by a trial after pleadings, discovery and oral evidence tested by cross examination therefore the question of valuation merits a full hearing. The ability of courts to override articles or shareholders' agreements introduces uncertainties as regards their enforceability in the terms drafted.

Shareholders agreements can cause problems regarding enforcement of informal rights of minority shareholders under equity. As *O'Neill v Phillips*<sup>141</sup> stated that to prove the unfair prejudicial conduct there must be a breach of some legal or equitable rights of

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<sup>140</sup> [1999] 2 BCLC 243, 253-254.

<sup>141</sup> [1999] 2 BCLC 1.

shareholders. It is very hard to enforce any right that may otherwise be binding in equity if you have shareholders' agreements.<sup>142</sup> Interviewee T said:

Generally speaking it is very difficult to argue a quasi-partnership if you have shareholders' agreements [T].

Interviewee G suggested that from the minority shareholder perspective it may therefore sometimes be better not to enter into formal agreements with the majority:

If you cannot have proper *ex ante* contracting it is often better not even to try it. At least you can say to the court, we did not bargain in advance so now it is right for you to impose a solution [G].

Hence, if the comprehensive negotiations and minority protection stipulations are not possible to deal with conflicting situations exhaustively, it may be advisable for shareholders' in some circumstances not to enter formal agreements and rely instead upon section 459.<sup>143</sup>

#### **4.7 Conclusion:**

In private companies *ex ante* contracting through shareholders' agreements, can theoretically prevent squeeze-out behaviour and provide mechanisms to resolve exit disputes but it cannot prevent actual relational breakdown. Relational breakdown occurs due to underlying factors such as personal and business conflicts. In fact *ex ante* contracting in shareholders agreements cannot eliminate the underlying factors that cause relational breakdown but can only mitigate the effects of relational breakdown by qualifying the powers of the majority and providing an exit to the minority on fair terms. Shareholders' agreements can declare the rights and enhance the voice of minority shareholders to control the powers of majority shareholders to prevent squeeze-out behaviour. This enhanced voice of minority shareholders can create deadlock. Thus, shareholders' agreements often provide mechanisms to resolve deadlock by negotiation, transfer of shares or winding up the company. Similarly, *ex ante* contracting cannot prevent the company from being negligently mismanaged. However, *ex ante* contracting

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<sup>142</sup> See below chapter 5 for detailed discussion regarding the impact of decision in *O'Neill v Phillips* [1999] 2 BCLC 1.

<sup>143</sup> In this context, majority shareholder may prefer to enter into shareholders' agreements to avoid circumstances that may give rise to equitable considerations.

can provide provisions to lessen the opportunities for shareholders to behave in a negligent manner and to mitigate the repercussions of negligent behaviour. Finally, shareholder agreements can be useful in resolving exit disputes.

However, there are limitations associated with *ex ante* contracting in shareholders' agreements. Majority shareholders' are always concerned with over-protection of minority shareholders. Minority shareholders are not always able to fully protect themselves because of inequality in their bargaining position. Shareholder optimism and transaction costs may deter parties from regulating their relationship through a comprehensively drafted shareholders' agreement. Finally, shareholders' agreements still have to be interpreted and enforced and it is not necessarily easy to predict when the courts might intervene in any event through section 459 to override their terms on the grounds that such terms themselves operate unfairly.

Therefore, due to a range of limitations associated with *ex ante* contracting in shareholders' agreements, shareholders need recourse to a legal mechanism other than contract to resolve their disputes. The principal mechanism that company law provides for this purpose are the provisions in sections 459-461 of the CA 1985 which enable a court to relieve conduct in the affairs of the company that is unfairly prejudicial to membership interests. The next chapter considers the evolution of these provisions up to the date of the Law Commission's Report on shareholder remedies.

## **Chapter 5**

### **The evolution of the unfair prejudice remedy and the Law Commission's critique**

#### **5.1 Scope of the chapter:**

The chapter discusses the principle of majority rule in company law and legal protections available to minority shareholders against the misapplication of majority rule. The chapter mainly focuses upon the evolution of the statutory unfair prejudice remedy under sections 459-461 of the CA 1985 through case law, to resolve shareholder disputes by providing an appropriate relief to minority shareholders, after the promulgation of the provision until the Law Commission review of shareholders' remedies in the late nineties. Problems were identified by the courts and the Law Commission with the application of section 459 of CA 1985, such as length, cost and complexity of proceedings under the section, which diminished the effectiveness of this remedy. Hence, the chapter provides a necessary background to the analysis conducted in the remaining chapters, of subsequent substantive law and procedural changes, introduced to improve the effectiveness of the remedy.

#### **5.2 Introduction:**

The chapter discusses here the application of the principle of majority rule in private companies and legal protections available to minority shareholders against the misapplication of majority rule. The discussion as to available protections covers law of shareholder remedies that includes, the derivative action on behalf of the company, shareholders' personal actions, just and equitable winding up of the company and the statutory unfair prejudice remedy. The statutory unfair prejudice remedy under section 459 of the CA 1985 has proved the most attractive remedy for minority shareholders in this context.<sup>1</sup> The discussion of majority rule and the law of shareholder remedies generally provides necessary context for understanding how section 459 evolved.

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<sup>1</sup> See Payne J., 'Sections 459-461 Companies Act 1985 in Flux: The Future of Shareholder Protection' (2005) 64(3) Cambridge Law Journal 647, 647.

### ***5.2.1 The principle of majority rule:***

Company law provides the governance mechanism by the application of the principle of majority rule namely that: decisions regarding a company's affairs will be made according to the wishes of the majority of the shareholders of the company. Majority rule is exercised by shareholders by passing ordinary (by simple majority)<sup>2</sup> and special resolutions (by a majority of not less than 75%).<sup>3</sup> The principle provides a sensible and logical approach to corporate decision making.<sup>4</sup> Lord Wilberforce has stated that "those who take interests in companies limited by shares have to accept majority rule".<sup>5</sup> The strict application of majority rule in these companies can be against the interests of minority shareholders, when majorities use the voting power attached to their shares for their personal interests and by ignoring the adverse effects of their decision making power, upon minorities.<sup>6</sup> Therefore to protect their interests minority shareholders may have to monitor majority shareholders and this may result in agency costs.<sup>7</sup> Law can play a significant role in reducing the agency costs.

In the context of minority shareholders' protection, the United States Supreme Court ruled in one case that the "majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority".<sup>8</sup> The decision making power of majority shareholders is accepted but "the limitation is only that in pursuing the best interests of the corporation according to their business judgment, those in control may not breach their fiduciary duty to the minority".<sup>9</sup> A fiduciary relationship arises "when

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<sup>2</sup> See s 282 of CA 2006.

<sup>3</sup> See s 283 of CA 2006.

<sup>4</sup> Hollington, R., *Minority Shareholders' Rights*. (Sweet and Maxwell, London 1990) 3.

<sup>5</sup> *Re Kong Thai Sawmill (Miri) Sdn Bhd* [1978] 2 MLJ 227, 229 as quoted by Stephen M., *Mayson French and Ryan on Company Law* (22<sup>nd</sup> ed Oxford University Press, Oxford 2005) para 18.3.3.2.

<sup>6</sup> See above chapter 3 para 3.4 Nature and kinds of shareholder disputes. In *North-West Transportation Co Ltd v Beatty* (1887) L.R. 12 App. Cas. 589 at 593, the Privy Council stated that every shareholder had a perfect right to vote upon any question with which the company was legally competent to deal, although he might have a personal interest in the subject-matter opposed to, or different from the general or particular interests of the company.

<sup>7</sup> See above chapter 1 para 1.1 for 'agency cost theory'. See also Kraakman R. and Hansmann H., *The Anatomy of Corporate Law* (Oxford University Press, New York 2004) 21.

<sup>8</sup> *S. Pac. Co. v. Bogert*, 250 U.S. 483, 487-88 (1919) as quoted by Art R.C., 'Shareholders Rights and Remedies in Close Corporations: Oppression, Fiduciary Duties, and Reasonable Expectations' (2003) 28 *The Journal of Corporation Law* 37, 389 fn 114.

<sup>9</sup> See Art R.C., 'Shareholders Rights and Remedies in Close Corporations: Oppression, Fiduciary Duties, and Reasonable Expectations' (2003) 28 *The Journal of Corporation Law* 371, 389.

one person places trust in the faithful integrity of another who as a result gains superiority or influence over the first”.<sup>10</sup> That ensures that majority shareholders cannot use their voting power attached to their shares only for their personal interests and beyond any limitations.<sup>11</sup> It has been asserted that “controlling shareholders owe a fiduciary duty to the minority that is comparable to the directors’ duty to the corporation”.<sup>12</sup> A leading case from the Oregon Court of Appeals in 1989 stated that the majority shareholder of a close corporation owes the minority fiduciary duties of loyalty, good faith, fair dealing and full disclosure.<sup>13</sup>

By contrast, in the UK, while directors owe fiduciary duties to the company, majority shareholders do not generally owe fiduciary duties directly to individual minority shareholders and such duties would only be imposed on majority shareholders in exceptional circumstances.<sup>14</sup> Shares are property of the shareholder who holds them and a right to vote is usually attached to ordinary shares. Due to the proprietary nature of shares, a shareholder can exercise the voting power attached to his shares for his own personal benefit.<sup>15</sup> In *Northern Countries Securities Ltd v Jackson and Steeple Ltd*, it was held that “when a shareholder is voting for or against a particular resolution he is voting as a person owing no fiduciary duty to the company and who is exercising his own right of property to vote as he thinks fit”.<sup>16</sup> It was stated further in the same case that:

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<sup>10</sup> Black’s Law Dictionary, 8th ed (West Group, 2004)

<sup>11</sup> In UK it was stated that “a successful fiduciary plea, however, affords the possibility of a gain -based remedy rather than a loss-based remedy”, that is advantageous to the aggrieved party in a few ways. See Loke, A.F.H, ‘Fiduciary Duties and Implied Duties of Good Faith in Contractual Joint Ventures’ (1999) *Journal of Business Law* 538, 539.

<sup>12</sup> See Art R.C., ‘Shareholders Rights and Remedies in Close Corporations: Oppression, Fiduciary Duties, and Reasonable Expectations’ (2003) 28 *The Journal of Corporation Law* 371, 386.

<sup>13</sup> *Chiles v Robertson*, 767 P.2d 903, 911-12 (Or. Ct. App. 1989) as quoted by *ibid* n 89.

<sup>14</sup> See *Peskin v Anderson* [2001] 1 BCLC 372 where the principle was confirmed by the Court of Appeal. See also Hirt H-C., ‘In What Circumstances should Breaches of Directors’ Duties give rise to a Remedy under ss 459-461 of the Companies Act 1985’ (2003) 24(4) *Company Lawyer* 100.

<sup>15</sup> See Hirt H-C., ‘In What Circumstances should Breaches of Directors’ Duties give rise to a Remedy under ss 459-461 of the Companies Act 1985’ (2003) 24(4) *Company Lawyer* 100, 106.

<sup>16</sup> *Northern Countries Securities Ltd v Jackson and Steeple Ltd* [1974] 1 W.L.R. 1133, 1144.

A director is an agent, who casts his vote to decide in what manner his principal shall act through the collective agency of the board of directors; a shareholder who casts his vote in general meeting is not casting it as an agent of the company in any shape or form.<sup>17</sup>

Now the CA 2006 provides under section 170(1) that “the general duties specified in sections 171 to 177 [of the Act] are owed by a director of a company to the company”.

In the leading section 459 case of *Re Saul D Harrison and Sons plc*<sup>18</sup> it was stated:

... that the powers which the shareholders have entrusted to the board are fiduciary powers, which must be exercised for the benefit of the company as a whole. If the board act for some ulterior purpose, they step outside the terms of the bargain between the shareholders and the company.

However, the effect of breach of directors’ fiduciary duties may be unfairly prejudicial to the interests of minority shareholders of the company.<sup>19</sup> In private companies, shareholders are often also directors of the company.<sup>20</sup> Minority shareholders in the company may expect that majority shareholders will use their voting power in good faith and exercise their powers qua directors for the benefit of the company as a whole. Historically, in *Allen v. Gold Reefs of West Africa, Ltd*<sup>21</sup> it was held that a power to alter the articles must like all other powers, be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities. It must be exercised not only in the manner required by law but also *bona fide* for the benefit of the company as a whole.<sup>22</sup> The ‘interests of the company as a whole’ is a formula which is employed to achieve the underlying purpose of protecting the minority from unconscionable conduct by the majority.<sup>23</sup> Now section 172(1) of the CA 2006 provides that ‘a director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole’.

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<sup>17</sup> [1974] 1 W.L.R. 1133, 1144

<sup>18</sup> [1995] 1 BCLC 14, 18.

<sup>19</sup> See *Re Saul D Harrison* [1995] 1 BCLC 14; *Re a Company (No 005134 of 1986) ex parte Harries* [1989] BCLC 383. See also below para 5.5.1.3.1 Meaning of unfairness (ii) Breach of fiduciary duties.

<sup>20</sup> See above chapter 1.

<sup>21</sup> [1900] 1 Ch. 656, 670.

<sup>22</sup> See also *Shuttleworth v Cox Bros. Ltd* [1927] 2 K.B. 9.

<sup>23</sup> *Peter’s American Delicacy Co v Heath* (1939) 61 CLR 457 H Ct Aust as quoted by E. Ferran, *Company Law and Corporate Finance* (Oxford University Press, Oxford 1999) 149 n 191.



### 5.2.2 *Derivative action:*

The principle of majority rule developed in company law, “as a result of the courts’ historical reluctance to become involved in disputes over the internal management of business ventures”.<sup>24</sup> The Law Commission in its final Report on shareholders’ remedies stated that the guiding principle of company law was that “an individual member should not be able to pursue proceedings on behalf of a company about matters of internal management, that is, matters which the majority are entitled to regulate by ordinary resolution”.<sup>25</sup> However, under the common law a minority shareholder could bring an action on behalf of the company known as a ‘derivative action’ where the act of the majority, who was in control of the company and might pass the resolution to block action on behalf of the company against the wrongdoers, amounted to a so-called fraud on the minority. The ‘fraud on the minority’ where the ‘wrongdoer is in control’ is an exception to famous rule in *Foss v Harbottle*.<sup>26</sup> The rule provides that the proper claimant in an action in respect of a wrong alleged to be done to a company is prima facie the company.<sup>27</sup> In *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* it was stated that it is “[an] elementary principle that A cannot, as a general rule, bring an action against B to recover damages or secure other relief on behalf of C for an injury done by B to C”.<sup>28</sup> The exception to the rule provides a minority shareholder with a right to bring a derivative claim on behalf of the company. In *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*, it was stated that if the act amounted to fraud and the wrongdoers were themselves in control of the company then the aggrieved minority shareholder was allowed, to bring a minority shareholders’ action on behalf of themselves and all others.<sup>29</sup> Moreover ‘fraud’ in this sense has a wider meaning. In *Daniels v Daniels*, it was stated that if minority shareholders could sue for fraud there is

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<sup>24</sup> *The Consultation Paper* [4.2].

<sup>25</sup> *The Law Commission’s Report* [1.9].

<sup>26</sup> *Foss v Harbottle* (1843) 2 Hare 461. In *Foss v Harbottle* two shareholders brought this action against the company’s directors and promoters alleging, *inter alia* that they had sold land to the company at an exorbitant price. They brought this action on behalf of themselves and all other shareholders except the defendants. It was held that the conduct complained of was a wrong done to the company and that only the company could sue, see Hicks A. and Goo S.H., *Cases and Material on Company Law*. (5<sup>th</sup> ed Oxford University Press, New York 2004) 380-382.

<sup>27</sup> See *Edwards v Halliwell* [1950] 2 All ER 1064.

<sup>28</sup> [1982] Ch 204, 210.

<sup>29</sup> [1982] Ch 204, 210-211.

no reason why they could not sue where the action of the majority and the directors though without fraud, confers some benefit on those directors and majority shareholders themselves. A minority shareholder who had no other remedy might sue where directors use their powers intentionally or unintentionally, fraudulently or negligently in a manner which benefits themselves at the expense of the company.<sup>30</sup> In *Estmanco (Kilner House) Ltd v Greater London Council*<sup>31</sup> it was stated that apart from the benefit to themselves at the company's expense, the essence of the matter seems to be an abuse or misuse of power. Now the common law derivative claims are replaced by the statutory derivative claims under section 260-264 of the CA 2006.<sup>32</sup> Under section 260(3) of the CA 2006:

A derivative claim under this Chapter may be brought only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company.

### **5.2.3 Personal action:**

A minority shareholder on his own behalf may bring proceedings to enforce his rights available in the articles of association of company.<sup>33</sup> Furthermore a member may also bring a personal action to enforce the rights available under separate shareholders agreements<sup>34</sup> or to enforce the statutory rights granted by the CA 2006 e.g., section 431(1) of the CA 2006 provides that every member of the company is entitled to be provided on demand and free of charge with a copy of annual accounts and reports of the company.<sup>35</sup>

### **5.2.4 Just and equitable winding-up:**

Ever since the Companies Act 1862, successive Companies Acts have made provision for companies to be wound up on just and equitable ground.<sup>36</sup> The nature and scope of the just and equitable ground under the section (section 222(f) of the Companies Act

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<sup>30</sup> *Daniels v Daniels* [1978] Ch 406, 414.

<sup>31</sup> [1982] 1 WLR 2, 12.

<sup>32</sup> See *Franbar Holdings Ltd v Katan, Johan and Medicentres* [2008] EWHC 1534 (Ch).

<sup>33</sup> See s 33(1) of CA 2006. See also above chapter 4 para 4.3 *Ex ante* contracting.

<sup>34</sup> See above chapter 4 for scope of *ex ante* contracting in separate shareholders' agreements.

<sup>35</sup> Previously s 238 of CA 1985.

<sup>36</sup> See Joffe V.H., *Minority Shareholders: Law Practice and Procedure* (3<sup>rd</sup> ed Oxford University Press, Oxford 2008) chapter 4 para 4.01.

1948 - as it then was) was reviewed in *Ebrahimi v Westbourne Galleries Ltd.*<sup>37</sup> In 1982 the Cork Committee<sup>38</sup> recommendations were implemented in the Insolvency Law 1985. Subsequently these provisions along with material contained in the Companies Act 1985 were consolidated in the Insolvency Act 1986.<sup>39</sup>

Now under Insolvency Act 1986 a minority shareholder may also apply to court for the company be wound up on the just and equitable ground. Section 122(1)(g) of the Insolvency Act 1986 provides that ‘a company may be wound up by the court if the court is of the opinion that it is just and equitable that the company should be wound up’. The House of Lords in *Ebrahimi v Westbourne Galleries Ltd*<sup>40</sup> stated a general approach towards just and equitable winding up. In *Ebrahimi*, the petitioner applied for an order under section 210 of the Companies Act 1948 for purchase of his shares in the company and in the alternative for an order under section 222(f) of the 1948 Act that the company be wound up on the ground that was just and equitable to do so. Lord Wilberforce ruled that:

[the ‘just and equitable’ provision] does as equity always does, enables the court to subject the exercise of legal rights to equitable considerations; considerations, that is, of personal character arising between one individual and another, which may make it unjust, or inequitable, to insist on legal rights, or to exercise them in a particular way.<sup>41</sup>

The decision has a significant impact upon the evolution of unfair prejudice remedy, discussed below. The court further held that if the shareholder could prove breach of some basic obligation of his fellow shareholders in good faith, the conclusion must be by applying such equitable considerations that the association should be dissolved.<sup>42</sup>

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<sup>37</sup> [1972] 2 All ER 492.

<sup>38</sup> ‘Report of the Review Committee on Insolvency Law and Practice’ (Cmnd 8558, HMSO, London 1982).

<sup>39</sup> Hannigan B., *Company Law* (Lexis Nexis, UK 2003) 791.

<sup>40</sup> [1972] 2 All ER 492.

<sup>41</sup> [1972] 2 All ER 492, 500.

<sup>42</sup> [1972] 2 All ER 492, 501.

### **5.3 Evolution of the unfair prejudice remedy up to the time of the Law Commission Report:**

More than half a century ago a special remedy was introduced by the legislature to protect minority shareholders from oppressive conduct of majority shareholders under section 9 of the Companies Act 1947, which became section 210 of the Companies Act 1948, by giving the ‘courts more flexibility and as an alternative to winding up a company on just and equitable grounds’.<sup>43</sup> The section was the result of the Report presented by the Committee on Company Law Amendment in 1945.<sup>44</sup> After carefully examining the proposals intended to strengthen the minority shareholders of a private company in resisting oppression by the majority, the Cohen Report concluded that it was impossible to frame a recommendation to cover every case of oppression. In many cases the winding up of the company would not benefit the minority shareholders, since the break up value of the assets might be small, or the only available purchaser might be that very majority whose oppression had driven the minority to seek redress. Therefore, it was suggested that the court should also have the power to impose upon the parties to a dispute whatever settlement the court considered just and equitable. The discretion must be unfettered, for it was impossible to lay down a general guide to the solution of what were essentially individual cases. The Cohen Report did not expect the court in every case to find and impose a solution but proposed to give the court a jurisdiction which the court lacked at that time, and thereby at least empower the court to impose a solution in those cases where one might be found.<sup>45</sup>

It can be seen that prior to the introduction of statutory relief for unfairly prejudicial conduct, the application of majority rule in company law left minority shareholders with limited powers of bringing action to remedy the unfair conduct of majority shareholders. These powers included, as discussed above, the derivative action on behalf of the company, a personal action<sup>46</sup> and an application to court to wind up the company on just

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<sup>43</sup> *The Consultation Paper* [7.4] [7.8].

<sup>44</sup> ‘Report of the Committee on Company Law Amendment’ (Cmnd 6659 HMSO, London 1945) hereinafter, *The Cohen Report*.

<sup>45</sup> See *The Cohen Report* [60].

<sup>46</sup> Shareholders may bring personal action to protect their rights provided by the articles of association under s 33 of CA 2006.

and equitable ground. The Cohen Report proposed a wider ‘oppression’ remedy which the legislature introduced in section 210 of the Companies Act 1948. Section 210 is the statutory predecessor of the present unfair prejudice remedy (formerly section 459 of the Companies Act 1985; now section 994 of the Companies Act 2006). Section 210 of the Companies Act 1948 provided that a member of a company might complain that the affairs of the company were being conducted in a manner oppressive to some part of the members (including himself)... Sub-section 2 further provided that the court might make such order as it thought fit and if on any such petition the court was of the opinion that (a) the company’s affairs were being conducted in an oppressive manner and (b) to wind up the company would unfairly prejudice that part of the members, but otherwise the facts would justify the making of a winding up order on the ground that it was just and equitable that the company should be wound up.

The section did not prove useful for protecting minority shareholders’ interests owing to its restrictive scope. Firstly, the section was construed restrictively by the courts as the phrase ‘in a manner oppressive’ was interpreted by courts as behaviour that is burdensome, harsh and wrongful.<sup>47</sup> In *Re Jermyn Street Turkish Baths Ltd* it was stated that oppression occurred when shareholders, having a dominant power in a company exercise that power to conduct the company's affairs in a manner that was unfair or as stated above ‘burdensome, harsh and wrongful’ to the other members of the company or some of them, and lacked that degree of probity which they were entitled to expect in the conduct of the company's affairs.<sup>48</sup> In *Re Five Minute Car Wash Service Ltd*, relying on the observation of Lord Keith in *Elder v Elder & Watson Ltd*,<sup>49</sup> Buckley, J stated that “... oppression involves, I think, at least an element of lack of probity or fair dealing to a member in the matter of his proprietary rights as a shareholder.” Buckley J further stated that it was necessary to establish that oppressive conduct was designed to achieve some unfair advantage over those claiming to be oppressed.<sup>50</sup> For conduct to be oppressive under the section it had to be wrongful. That restricted the scope of the section to acts of

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<sup>47</sup> *SCWS v Meyer* [1959] A.C. 324, 342.

<sup>48</sup> See *Re Jermyn Street Turkish Baths Ltd* [1971] 1 WLR 1042, 1059.

<sup>49</sup> [1952] SC 49, 55.

<sup>50</sup> [1966] 1 All ER 242, 247-248.

majority shareholders which were illegal: “so that only behaviour which was unlawful independently of this section could be protected”.<sup>51</sup> Therefore exclusion of minority shareholder from management of company was not regarded as oppressive under the section 210 if the majority shareholders were legally authorised to act in this way under the statute.<sup>52</sup>

The Jenkins Committee reported in 1962 that:

It is also suggested that ‘oppressive’ is too strong a word to be appropriate in all the cases in which applicants ought to be held entitled to relief under the section.<sup>53</sup>

The Report expressed concern regarding the ambiguity that:

Whether the element of wrongfulness in oppressive conduct means actual illegality or invasion of legal rights or was it satisfied by the conduct which without being actually illegal could nevertheless be justly described as reprehensible?<sup>54</sup>

The Report mentioned the statement of Lord Cooper in *Elder v Elder & Watson Ltd*<sup>55</sup> with reference to the meaning of oppression in section 210 that:

... the essence of the matter seems to be that the conduct complained of should at the lowest involve a visible departure from the standards of fair dealing, and a violation of the conditions of fair play on which every shareholder who entrusts his money to a company is entitled to rely.

The Committee stated that this statement accorded with their view as to the intention underlying section 210 as originally framed. The section was meant to cover complaints not only to the effect that the affairs of the company were being conducted in a manner oppressive (in a narrower sense) to the members concerned but also to the effect that those affairs were being conducted in a manner unfairly prejudicial to the interests of those members. The Committee recommended that the section should be amended to make this clear.<sup>56</sup>

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<sup>51</sup> Payne J., ‘Sections 459-461 Companies Act 1985 in Flux: The Future of Shareholder Protection’ (2005) 64(3) Cambridge Law Journal 647, fn 6

<sup>52</sup> The majority can use their voting power to remove a director from office under s 168 of CA 2006, formerly s 303 of CA 1985. See Clark B., ‘Unfairly Prejudicial Conduct: A Pathway through the Maze’ (2001) 22(6) Company Lawyer 170, 170-171.

<sup>53</sup> ‘Report of the Company Law Committee’ (Cmnd 1749, HMSO, London 1962) hereinafter ‘*The Jenkins Committee*’ [202].

<sup>54</sup> *Ibid* [203].

<sup>55</sup> [1952] S.C. 49, 55.

<sup>56</sup> *The Jenkins Committee* [204].

Secondly, the scope of section 210 was restrictive because to invoke the section the petitioner had to establish that it was just and equitable to wind-up the company but that a winding up order would be detrimental to the petitioner's interests. The restrictive way in which the section was construed made it virtually useless in practice.<sup>57</sup>

#### **5.4 Section 459 of the Companies Act 1985:**

Therefore, to fill this gap and to strengthen the position of minority shareholders the Jenkins Committee<sup>58</sup> proposed the introduction of statutory relief for 'unfairly prejudicial' conduct. This was originally enacted in section 75 of the Companies Act 1980 and later re-enacted as section 459 of the Companies Act 1985.<sup>59</sup> Under the present law in England and Wales, the unfair prejudice remedy in sections 459-461 of the Companies Act 1985 is the most attractive and widely used<sup>60</sup> remedy available to minority shareholders in private companies. Lord Hoffmann stated that "... section 75 [as section 459 then was] was a valuable and overdue reform of the law which conferred on the court a wide and useful discretion".<sup>61</sup>

The Law Commission stated that the remedy for unfairly prejudicial conduct contained in sections 459-461 of the CA 1985 was the most widely used by minority shareholders to obtain some personal remedy in the event of unsatisfactory conduct of a company's business.<sup>62</sup> The remedy was often used where there is a breakdown in relations between the owner-managers of small private companies.<sup>63</sup> The wide scope of the provisions and a vast discretion of courts to award relief had significantly increased the attractiveness of the section and lessened the use of other available remedies<sup>64</sup> by the time the Law Commission conducted its review.<sup>65</sup> There are three main reasons for the attractiveness of this court based dispute resolution mechanism under sections 459-461 of the CA

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<sup>57</sup> See discussion in, *Instone R.*, 'Unfair Prejudice: An Interim Report' [1988] *Journal of Business Law* 20.

<sup>58</sup> 'Report of the Company Law Committee' (Cmnd 1749, HMSO, London 1962).

<sup>59</sup> Now see ss 994-996 of the CA 2006. See also above chapter 1 para 1.2 The research process.

<sup>60</sup> See *The Consultation Paper* [1.7].

<sup>61</sup> *Re a Company (No 007623 of 1986)* [1986] BCLC 362, 367.

<sup>62</sup> *The Law Commission's Report* [1.5].

<sup>63</sup> *The Law Commission's Report* [1.5].

<sup>64</sup> See above paras 5.2.2, 5.2.3, 5.2.4 for discussion of these remedies.

<sup>65</sup> Interviewees confirmed that in practice to obtain personal relief shareholders always prefer to file petition under s 459 of the CA 1985.

1985. First, section 459 is wide in scope and therefore has the potential to deal with a variety of minority shareholders' complaints concerning the conduct of majority shareholders even conduct which may fall short of actual illegality.<sup>66</sup> Secondly, by using section 459, shareholders can avoid many of the legal and practical complexities associated with the other remedies such as the personal action for breach of the company's constitution and the derivative action.<sup>67</sup> Thirdly, the section provides a sensible, practical alternative to winding up under section 122(1) (g) of the Insolvency Act 1986 on the just and equitable ground.

The potency of the provision was highlighted in *Re Saul D Harrison and Sons plc*,<sup>68</sup> where it was said, *per* Hoffmann LJ (as he then was) that:

The fact that the board are protected by the principle of majority rule does not necessarily prevent their conduct from being unfair within the meaning of section 459. Enabling the court in an appropriate case to outflank the rule in *Foss v Harbottle* was one of the purposes of the section.<sup>69</sup>

Shareholders may bring a derivative action on behalf of a company. However, by bringing a successful derivative action shareholders obtain a relief for the company whereas, by a successful petition under section 459 shareholders obtain a personal relief that is more attractive for a shareholder.

The rights available under the provisions of the articles of association that bind the company and its members<sup>70</sup> can also be enforced under section 459 of the CA 1985.<sup>71</sup>

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<sup>66</sup> *The Law Commission's Report* [2.2] and '*the Jenkins Committee*' [203]. See also below para 5.5.1.3 Unfair prejudice to membership interests.

<sup>67</sup> As the Law Commission commented the procedure for derivative actions was lengthy and costly, involving a preliminary stage which in one case took 18 days of court time to resolve. See *The Law Commission's Report* [1.4]. However, now new statutory derivative action is introduced under ss 260-264 of CA 2006.

<sup>68</sup> [1995] 1 BCLC 14, 18.

<sup>69</sup> Recently in *Clark v Cutland* [2003] 2 BCLC 393 a minority shareholder was allowed, to obtain a remedy for the company under section 459 of CA 1985 and outflank the rule in *Foss v Harbottle*. See Payne J., 'Sections 459-461 Companies Act 1985 in flux: the future of shareholder protection' (2005) 64(3) Cambridge Law Journal 647. Furthermore, it is open to petitioner to seek an order against the company for payment of any costs incurred by him, in obtaining that remedy for the company. It was mentioned that the trial judge acceded to the submission that there was a wide jurisdiction under section 461 to give relief against third parties which could have been granted in a derivative action, [2003] 2 BCLC 393 para 8.

<sup>70</sup> See s 33 of CA 2006 (previously s 14 of CA 1985).

<sup>71</sup> See below para 5.5.1.3.1 Meaning of unfairness (i) Breach of legal rights.



Along with the articles of association rights under other contractual arrangements can also be enforced by a petition under section 459 of the CA 1985. In *Re BSB Holdings Ltd (No 2)*,<sup>72</sup> Arden J stated that in *Re Saul D Harrison*, the reference to the articles applied equally to any other contractual arrangement which governed the relationship between the shareholders. The Law Commission stated that when the court examined whether the conduct of which complaint was made was wrongful, the court had to consider the parties' rights under the articles and other agreements which governed the relationship between shareholders.<sup>73</sup>

Section 125(2) of the Insolvency Act 1986 provides that the court will not make a winding-up order if the court is "of the opinion both that some other remedy is available to the petitioners and that they are acting unreasonably in seeking to have the company wound up instead of pursuing that other remedy."<sup>74</sup> Section 459 provides an alternative to winding up in this context, which is useful because it avoids the drastic option of winding up in favour of a more practical solution. Moreover, the winding up jurisdiction is not wider than the section 459 jurisdiction and where shareholders fail to prove unfair prejudice they cannot apply for winding up of the company.<sup>75</sup>

On the other hand the wide scope of the statutory unfair prejudice remedy has increased the length and consequently costs of the proceeding under section 459 and so it can be argued – as have the Law Commission – that the very breadth of the discretion has been a factor that has diminished the effectiveness of the remedy as a tool for resolving shareholder disputes.<sup>76</sup>

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<sup>72</sup> [1996] 1 BCLC 155, 238.

<sup>73</sup> *The Consultation Paper* [9.15].

<sup>74</sup> See *In the matter of Woven Rugs Ltd* (Chancery Division – Companies Ct) accessed at Lawtel on 5/9/08, it was stated that the registrar had rightly concluded that in presence of an alternative remedy in the form of the unfair prejudice provisions of s. 459 of CA 1985 there was no reasonable prospect of obtaining a winding up petition. See also *Re Abbey Leisure Ltd* (1989) 5 BCC 183 (Judgment by Hoffmann J) and *Re Abbey Leisure Ltd* [1990] BCC 60 (CA).

<sup>75</sup> Recently, in *Re Guidezone Ltd*, [2000] 2 BCLC 321, 357 it was stated that the conduct of the majority that was not unfairly prejudicial to the interests of the member under section 459 of the Companies Act 1985 could not found a case for a winding-up order on 'just and equitable' ground because winding-up jurisdiction was, at the very least, no wider than section 459 jurisdiction.

<sup>76</sup> See *The Law Commission's Report* [1.9 (vi)] and below para 5.6 Effective resolution of shareholder disputes.

At the event of dispute in private companies minority shareholders need to have recourse to the courts by filing a petition under the statutory unfair prejudice remedy (i) to enforce shareholders' agreements<sup>77</sup> or (ii) where no shareholders' agreement exists between the shareholders due to limitations associated with shareholders' agreements or (iii) where, if one exists, it is silent regarding the particular issue alleged to be unfairly prejudicial to minority shareholders' interests.<sup>78</sup> Courts are called in to adjudicate firstly, regarding the existence of unfairly prejudicial conduct and secondly, to provide the appropriate relief as a result of that unfairly prejudicial conduct *inter alia* by deciding the terms of separation such as fair valuation of shares. The chapter analyses the nature of this court based dispute resolution mechanism to resolve shareholder disputes in private companies. The resolution of shareholder disputes is comprised of two ingredients. The first is the provision of appropriate relief to minority shareholders as a result of unfairly prejudicial conduct and the second is the provision of that relief in a minimum time and costs.<sup>79</sup> In fact the first ingredient is related to substance and the second ingredient is related to process. Both of the ingredients are discussed below in detail.

### **5.5 Resolution of disputes by providing an appropriate relief to minority shareholders:**

The first ingredient of resolution of shareholder disputes in private companies is the provision of appropriate relief to minority shareholders as a result of unfairly prejudicial conduct. Regarding this first ingredient two questions arise: (i) what substantive law rights do minority shareholders in private companies have in English Law and what forms of behaviour will ground a cause of action; (ii) what relief is available if these rights are infringed and a cause of action is successfully established. The jurisdiction of the court based dispute resolution mechanism under sections 459-461 of the CA 1985

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<sup>77</sup> See above para 4.6.6 Enforcement of shareholders' agreements.

<sup>78</sup> In this context in *Re Metropolis Motorcycles Ltd* [2006] EWHC 364 (Ch) para 90, it was stated that where an agreement between members of a company did not cover a change in circumstances which arose in relation to the management of the company's business, the conduct of the affairs of the company could be unfairly prejudicial within the meaning of section 459 of the CA 1985, notwithstanding the absence of prior arrangements, and the court could thus intervene.

<sup>79</sup> See *The Law Commission's Report* [1.9 (vi)] and below para 5.6 Effective resolution of shareholder disputes.

can be divided into two parts. This division helps to answer the first ingredient of the resolution of shareholder disputes. First is the jurisdiction of court to decide issue regarding establishment of the cause of action under section 459 of the CA 1985. Second is the jurisdiction of court to provide appropriate relief to minority shareholders under section 461 of the CA 1985 in the event of dispute and where shareholders established the cause of action under section 459 of CA 1985. Below the chapter will analyse the jurisdiction of the courts under sections 459-461 to provide an appropriate relief to minority shareholders, and how the jurisdiction evolved through case law after the promulgation of the section until the Law Commission review of shareholders' remedies in the late nineties which criticised the effectiveness of the remedy<sup>80</sup> and prior to the land mark decision in *O'Neill v Phillips*.<sup>81</sup> The aim is therefore to provide an account of the state of the law at the time it was reviewed by the Law Commission.

#### ***5.5.1 Jurisdiction of the court under section 459 of the CA 1985 to decide unfairly prejudicial conduct:***

Here the chapter discusses the evolution of the courts' jurisdiction to determine whether conduct was unfairly prejudicial under section 459 of the CA 1985 up to the time of the Law Commission review of shareholders remedies in the late nineties. As to the first question, section 459(1) of the CA 1985 provides that:

a member of a company may apply to the court by petition for an order under this part on the ground that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

##### ***5.5.1.1 Member of a company:***

The conduct complained of under the section must be a conduct which is unfairly prejudicial to the interests of a member or shareholder in his capacity as a shareholder and not in any other capacity that he might also possess such as a creditor or customer of

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<sup>80</sup> See below para 5.6.2 The Law Commission's critique of section 459 of the CA 1985.

<sup>81</sup> *O'Neill v Phillips* [1999] 2 BCLC 1.

a company.<sup>82</sup> In *Re Unisoft Group Ltd* Harman J, relying upon the judgment of Lord Grantchester QC in *Re a Company*,<sup>83</sup> ruled that the complaints made in that case were about the relationship of landlord and tenant and the relationship of service provider and service user and not as a member of the company. He further stated that the allegations showed a course of conduct which might be objectionable but it was not activities in the conduct of the company's business which had caused prejudice to the member qua member.<sup>84</sup> In *Re Blackwood Hodge plc*<sup>85</sup> it was stated that the petitioners must establish not merely that the directors breached their duties but also that those breaches caused the petitioners to suffer unfair prejudice in their capacity as shareholders. A member of the company is defined under section 112 of the CA 2006.<sup>86</sup> Section 112 provides that members of the company include (i) the subscribers of a company's memorandum and (ii) and every other person who agrees to become a member and his name is entered in company's register of members. Section 459(2) provides that for the purpose of this section reference to a member in this section also includes a person to whom shares in the company have been transferred or transmitted by operation of law.

#### 5.5.1.2 Affairs of the company:

The conduct complained of under section 459 must be a conduct regarding the affairs of the company and not regarding the conduct of a shareholder behaving in his personal capacity. As Harman J stated in *Re Unisoft Group Ltd* that:

Shareholders disputes concerning dealing with their shares are not the same as unfair conduct of the company's business. Shareholders must be kept distinct from the company so far as their private position as shareholders is concerned... the vital distinction between acts or conduct of the company and the acts or conduct of the shareholder in his private capacity must be kept clear. The first type of act will found a petition under s 459; the second type of act will not.<sup>87</sup>

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<sup>82</sup> However in *Gamlestaden Fastigheter AB v Baltic Partners Ltd* [2007] UKPC 26; [2008] 1 BCLC 468, Privy Council held that an investor in a joint venture company who had, in pursuance of the joint venture agreement, invested not only in subscribing for shares but also in advancing loan capital, ought not to be precluded from the grant of relief s 461(1) of the 1985 Act on the ground that the relief would benefit the investor only as loan creditor and not as member. The purpose of s 459 of the 1985 Act was to provide a means of relief to persons unfairly prejudiced by the management of the company in which they held shares.

<sup>83</sup> [1983] BCLC 126, 135-136.

<sup>84</sup> *Re Unisoft Group Ltd* [1994] 1 BCLC 609, 626.

<sup>85</sup> [1997] 2 BCLC 650, 673.

<sup>86</sup> Previously s 22 of CA 1985.

<sup>87</sup> *Re Unisoft Group Ltd* [1994] 1 BCLC 609, 623.

### 5.5.1.3 Unfair prejudice to membership interests:

The conduct complained of to obtain relief under section 459 must be unfairly prejudicial to the interests of the members of the company.<sup>88</sup> The concept of unfair prejudice in section 459 can be described as a general standard to guide the court about the kind or degree of misbehaviour or mismanagement that should justify the intervention of court.<sup>89</sup> In *Re Macro (Ipswich) Ltd*<sup>90</sup> it was stated that “the jurisdiction under s 459 has an elastic quality which enables the courts to mould the concepts of unfair prejudice according to the circumstances of the case”. In *Re a Company [No. 004475 of 1982]*<sup>91</sup> Lord Grantchester QC cited *Gore-Browne on Companies*<sup>92</sup> to the effect that:

"Clearly a 'dictionary definition' of 'unfairly prejudicial' conduct of the affairs of the company will require a more liberal approach to the problems of minority shareholders in small companies. If 'prejudicial' may be defined, in dictionary terms, as 'causing prejudice, detrimental to rights, interests etc.', and 'unfair' as that which is *not* 'just, unbiased, equitable, legitimate,' then clearly the new standard will be less demanding of the petitioning shareholder in respect of the burden of proof and of the kind of conduct of which he is entitled to complain. Seemingly, what he must show is that the value of his shareholding in the company has been seriously impaired as a consequence of the conduct of those who control the company in a way that is 'unfair'.

It follows from this that ‘prejudice’ is not particularly difficult to establish. A shareholder may prove prejudicial conduct under the section by establishing for example that the value of his shareholding has been diminished. As in *Bovey Hotel Ventures Limited*<sup>93</sup> Slade J stated that:

without prejudice to the wording of the section, which may cover many other situations, a member of a company will be able to bring himself within the section [section 75 of CA 1980] if he can show that the value of his shareholding in the company has been seriously diminished or at least seriously jeopardised by reason of a course of conduct on the part of those persons who have had de facto control of the company, which has been unfair to the member concerned.<sup>94</sup>

Equally, however, while it may be sufficient to establish that the relevant conduct diminished the value of the petitioner’s shares, it appears that it is not a necessary pre-

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<sup>88</sup> Here members of the company refer to shareholders of the company.

<sup>89</sup> Boyle, A.J., *Minority Shareholders’ Remedies* (Cambridge University Press, Cambridge 2002) 94.

<sup>90</sup> [1994] 2 BCLC 354, 404.

<sup>91</sup> [1983] Ch. 178, 188-189.

<sup>92</sup> Boyle, A.J., (ed) *Gore-Browne on Companies* (43rd ed Jordan, London 1977) paras 28-13 as quoted by *Re A Company (No. 004475 of 1982)* [1983] Ch. 178, 188-189.

<sup>93</sup> 31 July 1981, unreported

<sup>94</sup> As quoted by *Re RA Noble and Sons (Clothing) Ltd* [1983] BCLC 273, 290.

condition in all cases. Thus, in *Re R A Noble and Sons (Clothing) Ltd*,<sup>95</sup> Nourse J stated that exclusion from participation in all major decisions affecting the company's affairs, could in other circumstances be unfairly prejudicial even though, the value of the shareholding in the company might not have been seriously diminished or jeopardised. In fact the purpose of the unfair prejudice remedy under section 459 is to protect the interests of minority shareholders. These interests are the common understandings between the shareholders regarding the affairs of the company which form the basis of their association either in the form of (i) legal rights or express agreements or (ii) arising out of legitimate expectations (now 'equitable considerations').<sup>96</sup>

Under the law as it evolved prior to 1997 unfairness occurred when these common understandings between the shareholders were infringed upon or disregarded by majority shareholders. Minority shareholders could establish a cause of action under the section when the unfairness was prejudicial to their interests qua shareholders of the company.<sup>97</sup> In *Re Sam Weller and Sons*<sup>98</sup> it was stated that the word 'interests' was wider than a term such as 'rights', and its presence as part of the test of s 459(1) suggested that the Parliament had recognised that members might have different interests, even if their rights as members were the same. Further, the adverb 'unfairly' introduced the wide concept of fairness in relation to the prejudice to the interests of some part of the members that must be established. That reinforces the notion that it was possible that even if all the members were prejudiced by the conduct complained of, the interests of only some may have been unfairly prejudiced. The Law Commission stated that it was also important to any consideration of the meaning of the term 'interests' to recognise that it was impossible to separate the concept of 'unfairness' from that of 'interests'.<sup>99</sup>

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<sup>95</sup> *Re RA Noble and Sons (Clothing) Ltd* [1983] BCLC 273, 291.

<sup>96</sup> See *Re Saul D Harrison* [1995] 1 BCLC 14, 19.

<sup>97</sup> See above para 5.5.1 Jurisdiction of court under section 459 of the CA 1985 to decide unfairly prejudicial conduct.

<sup>98</sup> [1990] BCLC 80, 85.

<sup>99</sup> See *The Consultation Paper* [9.17].

In *Re Saul D Harrison and Sons plc*,<sup>100</sup> Neill LJ stated, the words ‘unfairly prejudicial’ were general words and should be applied flexibly to meet the circumstances of the particular case.<sup>101</sup> To prove the cause of action under the section a shareholder was required to show that the conduct complained of was both unfair and prejudicial to his interests. Neill LJ quoted Peter Gibson J in *Re a Company (No 005685 of 1988)*, *ex parte Schwarcz (No 2)*<sup>102</sup> who stated that:

the conduct must be both prejudicial (in the sense of causing prejudice or harm to the relevant interest) and also 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.

#### 5.5.1.3.1 Meaning of unfairness:

It was stated that “the element of unfairness is at the heart of the unfair prejudice remedy”.<sup>103</sup> In *Re R A Noble and Sons (Clothing) Ltd*,<sup>104</sup> Nourse J quoted Slade J in *Bovey Hotel Ventures Limited*<sup>105</sup> that the test of unfairness must be an objective not a subjective one: it was not necessary for the petitioner to show that the persons who had de facto control of the company had acted in the conscious knowledge that this was unfair to the petitioner or they were acting in bad faith. It was stated that the test was “whether a reasonable bystander observing the consequences of their conduct, would regard it as having unfairly prejudiced the petitioner’s interests”.<sup>106</sup> The test was finally reformulated in *Re Saul D Harrison*<sup>107</sup>, the leading authority on the meaning of unfair prejudice to membership interests prior to the Law Commission’s Report. Hoffmann LJ (as he then was) stated three instances when unfairness justified the application of section 459, (i) breach of terms agreed between shareholders of a company (breach of legal rights), (ii) breach of fiduciary duties of directors, (iii) breach of some sort of fundamental understanding between the shareholders of a company (breach of legitimate expectations). Section 459 of the CA 1985 due to its expansive jurisdiction, can deal with a variety of squeeze-out techniques that are unfairly prejudicial to the interests of

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<sup>100</sup> [1995] 1 BCLC 14, 27.

<sup>101</sup> *Re Saul D Harrison and Sons plc* [1995] 1 BCLC 14, 27.

<sup>102</sup> [1989] BCLC 427, 437.

<sup>103</sup> Hollington R., *Shareholders’ Rights* (4<sup>th</sup> ed Sweet and Maxwell, London 2004) paras 7-53.

<sup>104</sup> *Re RA Noble and Sons (Clothing) Ltd* [1983] BCLC 273.

<sup>105</sup> 31 July 1981, unreported.

<sup>106</sup> See *Re RA Noble and Sons (Clothing) Ltd* [1983] BCLC 273, 290-291.

<sup>107</sup> [1995] 1 BCLC 14, [1994] BCC 475.

minority shareholders in private companies. Here the chapter discusses the scope of the term 'unfairness' under the section as described by the Court of Appeal in *Re Saul D Harrison*<sup>108</sup> to deal with squeeze-out behaviour of majority shareholders.<sup>109</sup> However, to prove the cause of action under the section other elements of the section discussed above, must also be satisfied.<sup>110</sup>

(i) Breach of legal rights:

Breach of contractual terms either under articles of association or separate shareholders' agreements can be unfair to the interests of minority shareholders of the company under section 459 of the CA 1985. In *Re A & BC Chewing Gum Ltd*,<sup>111</sup> the petitioners complained that the respondents had repudiated the petitioners' right to participate in the management of the company that was established by the company's articles and the terms of a shareholders' agreement.<sup>112</sup> The petitioners applied for an order that the company be wound up under section 222(f) of the Companies Act 1948 (now section 122(1)(g) of the Insolvency Act 1986) on the ground that it was just and equitable to do so. The repudiation was considered so fundamental that it rendered it just and equitable that the company should be wound up. Furthermore, the breach of the statutory provisions of the Companies Act to which the company is bound to follow may also be considered as unfair under the section, for example, a breach of the statutory pre-emption rights of existing shareholders on a new allotment of shares for cash.<sup>113</sup> In *Re a Company (No 005134 of 1986) ex parte Harries*<sup>114</sup>, the court held that there was no doubt there was a substantial contravention of section 17 of the then Companies Act 1980 that provided that a company was prohibited from allotting new shares unless it had offered those shares to existing shareholders in proportion to their existing holdings in the company. Therefore, the allotment constituted unfairly prejudicial conduct.

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<sup>108</sup> [1995] 1 BCLC 14.

<sup>109</sup> These squeeze-out techniques are identified in above in chapter 3 para 3.4.1 The relational breakdown precipitating squeeze-out behaviour.

<sup>110</sup> Latest developments are introduced to control the width of the section in *O'Neill v Phillips* [1999] 2 BCLC 1, these developments are discussed in detail below in chapter 6.

<sup>111</sup> [1975] 1 All ER 1017.

<sup>112</sup> [1975] 1 All ER 1017, 1027.

<sup>113</sup> Now s 561(1) of CA 2006; formerly s 89 of CA 1985.

<sup>114</sup> [1989] BCLC 383, 396.



Hoffmann LJ held in *Re Saul D Harrison* that:

In deciding what is fair or unfair for the purposes of section 459, it is important to have in mind that fairness is being used in the context of a commercial relationship. The articles of association ... govern the relationships of the shareholders with the company and each other... a member of the company is taken to have agreed to them. Since keeping promises and honouring agreements is probably the most important element of commercial fairness, the starting point in any case under s 459 will be to ask whether the conduct of which the shareholder complains was in accordance with the articles of association.<sup>115</sup>

(ii) Breach of fiduciary duties:

Directors owe fiduciary duties to the company in the past under common law and now under section 172(1) of the CA 2006 that provides that a director must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.<sup>116</sup> One practitioner commentator has stated that the starting point when considering a possible claim for unfair prejudice is to ask whether the directors had acted in breach of their fiduciary duties?<sup>117</sup> An academic commentator has written that:

The courts have drawn upon the jurisprudence relating to fiduciary duties in interpreting the scope of section 459 but it is clear that the oppression remedy creates a standard which differs from both the common law of fiduciary duties and the list of fiduciary duties breach of which will found a derivative action, being narrower than the former and wider than the latter.<sup>118</sup>

In *Re Jermyn Street Turkish Baths Ltd*<sup>119</sup> Buckley L.J. emphasised that a director's breach of duty would not of itself amount to oppression (now unfair prejudice) unless the director used his majority voting powers to stifle proceedings by the company or other shareholders in relation to his breach.<sup>120</sup>

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<sup>115</sup> [1995] 1 BCLC 14, 17-18; [1994] BCC 475, 488.

<sup>116</sup> See also ss 171-177 of CA 2006.

<sup>117</sup> Hollington R., *Shareholders' Rights* (4<sup>th</sup> ed Sweet and Maxwell, London 2004) paras 7-154, 7-143.

<sup>118</sup> Payne J., 'Sections 459-461 Companies Act 1985 in Flux: The Future of Shareholder Protection' (2005) 64(3) Cambridge Law Journal 647, 663.

<sup>119</sup> [1971] 1 W.L.R 1042 (CA).

<sup>120</sup> As quoted by Hirt H-C., 'In What Circumstances should Breaches of Directors' Duties give rise to a Remedy under ss 459-461 of the Companies Act 1985' (2003) 24(4) Company Lawyer 100, 106.

Hoffmann LJ observed in *Re Saul D Harrison* that:

In deciding what is fair or unfair for the purposes of s 459... The answer to this question often turns on the fact that the powers which the shareholders have entrusted to the board are fiduciary powers, which must be exercised for the benefit of the company as a whole. If the board act for some ulterior purpose, they step outside the terms of the bargain between the shareholders and the company... As a matter of ordinary company law, this may or may not entitle the individual shareholder to a remedy. It depends upon whether he can bring himself within one of the exceptions to the rule in *Foss v Harbottle* (1843) 2 Hare 461. But the fact that the board are protected by the principle of majority rule does not necessarily prevent their conduct from being unfair within the meaning of s 459.<sup>121</sup>

Neill LJ stated in *Re Saul D Harrison*<sup>122</sup> that a shareholder could legitimately complain if the directors exceeded the powers vested in them or exercised their powers for some illegitimate or ulterior purpose.

In a number of cases before 1997 courts have considered breach of fiduciary duties as unfair to minority shareholders. Misappropriation of the company's assets for personal interests of directors was considered by courts as breach of directors' fiduciary duties to the company and therefore can be unfairly prejudicial to the interests of the minority shareholders. In *Re London School of Electronics Ltd*<sup>123</sup> the minority shareholder complained that the City Tutorial College Limited, the majority shareholder in the company, had wrongfully diverted the students of the school to itself which was against his interests as a minority shareholder. The court held that the majority shareholders had diverted the company's business in their own interests thus depriving the minority of expected profits.<sup>124</sup>

The amount of directors' remuneration and the level of dividend to be declared are commercial decisions for the company to make but these decisions must be made in good faith in the best interests of the company as a whole. In *Re a Company (No. 00370 of 1987) ex parte Glossop*, Harman J stated that "directors have a duty to consider how

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<sup>121</sup> [1995] 1 BCLC 14, 17-18; [1994] BCC 475, 488-489.

<sup>122</sup> [1995] 1 BCLC 14, 31.

<sup>123</sup> [1985] BCLC 273.

<sup>124</sup> See also above chapter 3 para 3.4.1.2.1 Misappropriation of company's assets and proceeds. See also *Re Bhullar Bros Ltd* [2003] EWCA Civ 424, the petitioner in 459 petition alleged breach of fiduciary duty to the company. The court found breach of fiduciary duty to the company in acquiring the property in the name of another company and ordered the respondents to procure a transfer of the property to the company at the price which was paid for it.

much they can properly distribute to members”.<sup>125</sup> In companies where the directors’ remuneration and dividend policy has not been declared in advance it is breach of fiduciary duty if the remuneration is beyond reasonable commercial standards and the company has not declared the dividend despite there being profits available for distribution therefore the breach can be unfairly prejudicial to the interests of minority shareholders.<sup>126</sup> In *Re a Company (No 4415 of 1996)* it was held that:

The petitioner’s case in this regard must be assessed by objective criteria. If the remuneration and dividend levels cannot be justified by objective commercial criteria it is easy to conclude the companies have been managed in a way unfairly prejudicial to the non-directors shareholders...<sup>127</sup>

Minority shareholders may express their concerns as to right issue that it is breach of fiduciary duties because it is for the benefit of majority shareholders and to dilute their investment in the company or the majority shareholders are aware that minority cannot afford to take up new shares in the company .<sup>128</sup> In *Re a Company (No 005134 of 1986) ex parte Harries*<sup>129</sup> the petitioner complained that allotment of shares was contrary to the pre-emptive provisions of the Companies Act 1985. The court stated that it seemed clear beyond argument that the allotment was invalid as being for an improper purpose, namely to increase the respondent’s holding and to reduce the petitioner’s holding and with an improper motive to reward the respondent. The court held that a director, a fiduciary, who unilaterally benefited himself from allotment of shares to the detriment of another shareholder could not consider it to be for a proper purpose<sup>130</sup> therefore the allotment was unfairly prejudicial to the petitioner. However, minority shareholders cannot complain a rights issue that is unfairly prejudicial where they cannot take up their rights due to personal financial difficulties or they are not interested to invest more in a

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<sup>125</sup> [1988] 1 W.L.R 1068, 1076.

<sup>126</sup> See above chapter 3 para 3.4.1.2.1 Misappropriation of company’s assets and proceeds.

<sup>127</sup> [1997] 1 BCLC 479.

<sup>128</sup> In *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] 1 All ER 1126, 1136 where proceedings were commenced to set aside the issue of shares, giving the Privy Council’s judgment, Lord Wilberforce held that it must be unconstitutional for directors to use their fiduciary powers over the shares in the company purely for the purpose of destroying an existing majority, or creating a new majority which did not previously exist. In *Re Cumana Ltd* [1986] BCLC 430, 435 it was held that the proposed rights issue (in breach of fiduciary duties) was part of a scheme to reduce petitioner’s shareholding in the company and was therefore clearly unfairly prejudicial to petitioner’s interests. See also above chapter 3 para 3.4.1.2.2 Dilution of minority shareholders’ investment or voting power in the company.

<sup>129</sup> [1989] BCLC 383, 396.

<sup>130</sup> See also *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821, 831.

company where they are in minority and the rights issue is for genuine business purposes.<sup>131</sup> Consistent with *Re Saul D Harrison* abuse of fiduciary powers in above manners amounted to unfairly prejudicial conduct before *O'Neill v Phillips*.<sup>132</sup>

Directors also owe duty to a company to exercise reasonable care, skill and diligence to a company.<sup>133</sup> Serious mismanagement of company business can be breach of fiduciary duties, and therefore be unfairly prejudicial to the interests of minority shareholders of the company under section 459.<sup>134</sup>

(iii) Legitimate expectations of shareholders:

In *Re Fildes Bros. Ltd*,<sup>135</sup> the starting point in determining the rights *inter se* of the members was said to be the articles of association. However, in that case, Megarry J went on to say that:

One must have regard not merely to what the articles say, but also to what the parties are shown to have agreed in any other manner. It cannot be just and equitable to allow one party to come to the court and require the court to make an order which disregards his contractual obligations. The same, I think, must apply to a settled and accepted course of conduct between the parties, whether or not cast into the mould of a contract.<sup>136</sup>

In *Ebrahimi v Westbourne Galleries Ltd*, Lord Wilberforce further developed this view of the just and equitable provision. He held that a member could rely on the provision if he could prove, that the members had some special underlying obligation *inter se* arising in good faith, or confidence, to the effect that so long as the business continued he should be entitled to participate in management, an obligation so basic that if broken, the conclusion must be that the association must be dissolved. The principles on which he

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<sup>131</sup> In *Re a Company* [1986] BCLC 362, it was relied on that the proposed rights issue was an unfair conduct and the company had no need of additional capital and the purpose of the issue was merely to dilute the petitioner's interests in the company (therefore breach of fiduciary duties). But it was found that the board genuinely believed that the company required additional capital that would not only in itself provided additional funds but also made it easier to obtain credit from a bank.

<sup>132</sup> *O'Neill v Phillips* [1999] 2 BCLC 1. Now s 561(1)(a) of the CA 2006 protects the minority shareholders at the event of issuance of new shares by providing existing shareholder right of pre-emption and states that the allotment must be in good faith and for the benefits of the company as a whole.

<sup>133</sup> See s 174 of CA 2006.

<sup>134</sup> *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354; *Re Elgindata Ltd* [1991] BCLC 959. See also above chapter 3 para 3.4.2 Relational breakdown following from negligent management.

<sup>135</sup> [1970] 1 WLR 592.

<sup>136</sup> *In Re Fildes Bros. Ltd* [1970] 1 WLR 592, 596.

might do so were those worked out by the courts in partnership cases where there had been exclusion from management even where under the partnership agreement there was a power of expulsion.<sup>137</sup>

In *Re a Company (No 00477 of 1986)*<sup>138</sup> Hoffmann J (as he then was) clearly stated that the interests of a member are not necessarily limited to his strict legal rights under the constitution of the company. The use of the word 'unfairly' in section 459, like the use of the words 'just and equitable' in section 517(1)(g) (of the CA 1985),<sup>139</sup> enables the court to have regard to wider equitable considerations. As Lord Wilberforce said of the latter words in *Ebrahimi v Westbourne Galleries*<sup>140</sup> they were recognition of the fact that in a limited company rights, expectations and obligations of shareholders' inter se were not necessarily submerged in the company structure. As under the Companies Act, shareholders may by a simple majority remove a director before the expiration of his period of office.<sup>141</sup> However, it can be unfairly prejudicial to the interests of minority shareholder who is also a director of a company. Hoffmann J further stated in *Re a Company (No 00477 of 1986)*<sup>142</sup> that "the member's interests as a member who has ventured his capital in the company's business may include a legitimate expectation that he will continue to be employed as a director and his dismissal from that office and exclusion from the management of the company may therefore be unfairly prejudicial to his interests as a member". In most companies and in most contexts, whether the company was large or small, the member's rights under the articles of association and the Companies Act could be treated as an exhaustive statement of his interests as a member. By referring to Hoffmann J in *Re a Company (No 00477 of 1986)* above, Vinelott J in *Re Blue Arrow plc* also stated that "the interests of a member are not limited to his strict legal rights under the constitution of the company. There are wider equitable considerations which the court must bear in mind in considering whether a case falls within s 459 in particular in deciding, what are the legitimate expectations of a

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<sup>137</sup> [1972] 2 All ER 492, 501.

<sup>138</sup> [1986] BCLC 376, 378-379.

<sup>139</sup> Now section 122(1)(g) of the Insolvency Act 1986.

<sup>140</sup> [1972] 2 All ER 492, 500.

<sup>141</sup> See s 168(1) of CA 2006. See also above chapter 3 para 3.4.1.1.1 Disregard of minority shareholders' participation in the company.

<sup>142</sup> [1986] BCLC 376, 379.

member”.<sup>143</sup> This use of the phrase legitimate expectations coupled with the breadth of the judicial discretion conferred by section 459 marked an important milestone in the evolution of section 459.

In *Re a Company*<sup>144</sup> Hoffmann J stated that “the jurisdiction to remedy conduct 'unfairly prejudicial' to the interests of members enables the court to protect not only the rights of members under the constitution of the company but also the 'rights, expectations and obligations' of the individual shareholders inter se... In the typical case of the corporate quasi-partnership, these will include the expectations that the member will be able to participate in the management of the company and share in its profits through salaried employment”. In *Re Posgate & Denby (Agencies) Ltd*<sup>145</sup> Hoffmann J (as he then was) reiterated that:

...the concept of unfair prejudice which forms the basis of the jurisdiction under s 459 enables the court to take into account not only the rights of members under the company's constitution, but also their legitimate expectations arising from the agreements or understandings of the members inter se. There is an analogy in Lord Wilberforce's analysis of the concept of what is 'just and equitable' in *Ebrahimi v Westbourne Galleries Ltd*<sup>146</sup>. The common case of such expectations being superimposed on a member's rights under the articles is the corporate quasi-partnership, in which members frequently have expectations of participating in the management and profits of the company, which arise from the understandings on which the company was formed and which it may be unfair for the other members to ignore...

... in *Ebrahimi v Westbourne Galleries Ltd*, Lord Wilberforce said that in most cases the basis of the association would be 'adequately and exhaustively' laid down in the articles. The 'superimposition of equitable considerations' requires, he said, something more. This was said in the context of the 'just and equitable' ground for winding up, but in my judgment it is equally necessary for a shareholder who claims that it is 'unfair' within the meaning of s 459 for the board to exercise powers conferred by the articles to demonstrate some special circumstances which create a legitimate expectation that the board would not do so. Section 459 enables the court to give full effect to the terms and understandings on which the members of the company became associated but not to rewrite them”.<sup>147</sup>

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<sup>143</sup> *Re Blue Arrow plc* [1987] BCLC 585, 590.

<sup>144</sup> [1986] BCLC 391, 396.

<sup>145</sup> [1987] BCLC 8.

<sup>146</sup> [1972] 2 All ER 492, [1973] AC 360.

<sup>147</sup> [1987] BCLC 8, 14.

However, while deciding the question of imposition of equitable considerations in *Re a Company (004377 of 1986)*<sup>148</sup> Hoffmann J stated that:

... having regard to the articles, the petitioner could have had no legitimate expectation that in the event of a breakdown of relations between [petitioner] and [respondents] they would not be relied on to require him to sell his shares at fair value. To hold the contrary would not be to 'superimpose equitable considerations' on his rights under the articles but to relieve him from the bargain he made.

In *Re a Company (No 004377 of 1986)*,<sup>149</sup> the petitioner claimed that the company was a quasi-partnership and therefore the petitioner had a legitimate expectation that unless the petitioner did something which plainly justified his exclusion, he would enjoy continued employment and participation in the management. Hoffmann J stated that, it could not be accepted that if there was an irretrievable breakdown in relations between members of a corporate quasi-partnership, the exclusion of one shareholder from management and employment was *ipso facto* unfairly prejudicial conduct, which entitled the excluded shareholder to petition under section 459. It must depend upon whether, if there was to be a parting, it was reasonable that he should leave rather than the other member or members and upon the terms he was offered for his shares.<sup>150</sup>

In *Re Elgindata Ltd*<sup>151</sup> it was stated that in general members of a company had no legitimate expectations going beyond the legal rights conferred on them by the constitution of the company. Nonetheless, legitimate expectations superimposed on a member's legal rights might arise from agreements or understandings between the members. Where, however, the acquisition of shares in a company was one of the results of a complex set of formal written agreements it was a question of construction of those agreements whether any such superimposed legitimate expectations could arise.

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<sup>148</sup> [1987] BCLC 94, 103.

<sup>149</sup> [1987] BCLC 94, 100-101.

<sup>150</sup> See also below para 5.5.2 Jurisdiction of court under section 461 of the CA 1985 to provide appropriate relief, for discussion regarding the unfairness in exclusion from management cases, where fair offer was made by majority shareholders. Later on Lord Hoffmann stated in *O'Neill v Phillips* [1999] 2 BCLC 1 that unfairness lies in the exclusion of the minority without a reasonable offer, See below chapter 6 para 6.5.2.2 Early fair offers to buy-out.

<sup>151</sup> [1991] BCLC 959, 985.

Hoffmann LJ held in *Re Saul D Harrison* that:

Not only may conduct be technically unlawful without being unfair: it can also be unfair without being unlawful... there are cases in which the letter of the articles does not fully reflect the understandings upon which the shareholders are associated. Lord Wilberforce drew attention to such cases... in *Ebrahimi v Westbourne Galleries Ltd*...<sup>152</sup> [It was stated that] the personal relationship between a shareholder and those who control the company may entitle him to say that it would in certain circumstances be unfair for them to exercise a power conferred by the articles upon the board or the company in general meeting.<sup>153</sup>

Hoffmann LJ used the term 'legitimate expectation' to describe the correlative right in the shareholder to which such a relationship might give rise. He stated that:

It often arose out of a fundamental understanding between the shareholders which formed the basis of their association but was not put into contractual form.<sup>154</sup>

Furthermore, to prove unfairness under section 459 in *Re Saul D Harrison and Sons plc*,<sup>155</sup> Neill LJ stated that:

It will be necessary to take account not only of the legal rights of the petitioner, but also consider whether there are any equitable considerations such as the petitioner's legitimate expectations to be weighed in the balance.

Neill LJ added that:

Though in general members of a company have no legitimate expectations going beyond the legal rights conferred on them by the constitution of the company, additional legitimate expectations may be superimposed in certain circumstances. These may arise from the agreements or understandings between the members or between the members and the directors.

Neill L J derived further support from Lord Wilberforce's speech in *Ebrahimi v Westbourne Galleries Ltd*<sup>156</sup> that the just and equitable provision in s 222(f) of the Companies Act 1948:

[E]nable the court to subject the exercise of legal rights to equitable consideration; considerations, that is, of a personal character arising between one individual and another, which may make it unjust, or inequitable, to insist on legal rights, or to exercise them in a particular way.<sup>157</sup>

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<sup>152</sup> [1972] 2 All ER 492, 500.

<sup>153</sup> [1994] BCC 475, 488-490.

<sup>154</sup> [1994] BCC 475, 490.

<sup>155</sup> [1995] 1 BCLC 14, 27.

<sup>156</sup> [1972] 2 All ER 492.

<sup>157</sup> See *Ebrahimi v Westbourne Galleries Ltd* [1972] 2 All ER 492, 500.



In *Re Estate Acquisition and Development Ltd*<sup>158</sup> it was held that:

There may, of course, be special circumstances which have the result that, if removal takes place under the statutory provisions, there will be grounds for complaint under s 459. Circumstances of the kind which existed in *Ebrahimi v Westbourne Galleries Ltd*<sup>159</sup> constitute a typical example.

In *Re BSB Holdings Ltd (No 2)*<sup>160</sup> it was stated that section 459 had to be viewed as a field of law which provided extensive minority protection in specific areas. The words 'unfairly prejudicial' were wide and general and the circumstances in which they applied could not therefore be exhaustively categorised. Except where the circumstances were governed by the judgments in *Re Saul D Harrison & Sons plc*<sup>161</sup>, the categories of unfair prejudice were not closed. The standards of corporate behaviour recognised through section 459 might in an appropriate case thus not be limited to those imposed by enactment or existing case law.

It is evident from the discussion that in private companies, section 459 grants the courts a wide jurisdiction, to protect minority shareholders' interests against unfairly prejudicial conduct of majority shareholders. In the context of public companies, legitimate expectations do not arise since in public companies rights of the parties are adequately and exhaustively laid down in the articles. Therefore no legitimate expectations beyond articles of association, fiduciary obligations and the Companies Act arise in such circumstances.<sup>162</sup> As to application of the legitimate expectations in public listed companies in *Re Astec (BSR) plc* it was stated that:

The concept of legitimate expectation as explained and developed in *Re Westbourne Galleries* and *Re Saul D Harrison* cannot apply in the context of public listed companies.<sup>163</sup>

However, the concept of 'legitimate expectations' had clearly become a potent one by the time the Law Commission carried out its review of this area of law.<sup>164</sup>

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<sup>158</sup> [1995] BCC 338, 349-350.

<sup>159</sup> [1972] 2 All ER 492.

<sup>160</sup> [1996] 1 BCLC 155, 234, 237, 243.

<sup>161</sup> [1995] 1 BCLC 14.

<sup>162</sup> See *Ebrahimi v Westbourne Galleries Ltd* [1972] 2 All ER 492, 500. See also *Re Saul D Harrison* [1994] BCC 475, 490.

<sup>163</sup> [1999] BCC 59, 88.

<sup>164</sup> See below 5.6.2 The Law Commission's critique of section 459 of the CA 1985.

### ***5.5.2 Jurisdiction of courts under section 461 of the CA 1985 to provide appropriate relief:***

Here the chapter discusses the evolution of courts' jurisdiction through case law to provide appropriate relief under section 461 of the CA 1985, up to the point of the Law Commission review of shareholders' remedies in late nineties. As to the second question,<sup>165</sup> section 461(1) of CA 1985 provides that if the court is satisfied that a petition under this part is well founded, it may make such order as it thinks fit for giving relief in respect of the matters complained of by the petitioner.<sup>166</sup>

Under section 461(2) the court may order the following to provide relief to minority shareholder.

(a) The court may make orders regulating the conduct of the company's affairs in the future. In *R & H Electric Ltd v Haden Bill Electrical Ltd* the court ordered that the loans to the company should be repaid to the company controlled by the petitioner as soon as reasonably possible.<sup>167</sup>

(b) The court may require the company to refrain from doing or continuing an act complained of by the petitioner or to do an act which the petitioner has complained it has omitted to do. In *McGuinness v Bremner plc* the petitioners sought and were granted an order requiring the respondent to convene an extraordinary general meeting of the company.<sup>168</sup>

(c) The court may authorise civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct. Under this provision permission can be granted to minority shareholder to commence a derivative action on behalf of the company.

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<sup>165</sup> See above para 5.5 Resolution of disputes by providing an appropriate relief to minority shareholders.

<sup>166</sup> These matters complained of can be the squeeze-out techniques employed by majority against minority at relational breakdown. See above chapter 3 for common squeeze-out techniques.

<sup>167</sup> [1995] 2 BCLC 280, 295.

<sup>168</sup> *McGuinness v Bremner plc* [1988] BCLC 673.

(d) The court may provide for the purchase of the shares of any members of the company by other members or by the company itself.

Orders under section 461(2) of CA 1985 are subject to wide discretionary powers of courts under section 461(1) of CA 1985 where the court may make such order as it thinks fit to provide relief to the petitioner. In *Re Bird Precision Bellows*<sup>169</sup> it was ruled that:

The whole framework of the section, and of such of the authorities as we have seen, which seem to me to support this, is to confer on the court a very wide discretion to do what is considered fair and equitable in all the circumstances of the cases, in order to put right and cure for the future the unfair prejudice which the petitioner has suffered at the hands of the other shareholders of the company.

In *Re a Company (No 00789 of 1987), ex parte Shooter*<sup>170</sup> Harman J stated that:

The words of section 461(1) are extremely wide and are not cut down by any of the authorities shown to me. In my view there is a power here to make such orders as I consider will enable the company, for the future, to be properly run, and for its affairs to be under the conduct of somebody in whom shareholders generally can have confidence that the company will be properly conducted.

Even though the court has wide discretionary powers under section 461(1) and 461(2) to provide appropriate relief to a minority shareholder, the most usual order sought by the petitioner and made by the court in this context is buy-out of shareholdings under section 461(2)(d). As is evident from the reported case law<sup>171</sup> and the Law Commission data in the overwhelming majority of section 459 cases the remedy sought by shareholders and awarded by court was buy-out.<sup>172</sup> In other words, the relief sought involved a cessation of the underlying business relationship and exit of one or more parties from the company.<sup>173</sup>

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<sup>169</sup> [1986] Ch. 658, 669.

<sup>170</sup> [1990] BCLC 384, 394-395.

<sup>171</sup> See *R & H Electric Ltd and another v Haden Bill Electrical Ltd* [1995] 2 BCLC 280; *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354; *Re Elgindata Ltd* [1991] BCLC 959; *Re London School of Electronics Ltd* [1985] BCLC 273; *Re Cumana Ltd* [1986] BCLC 430; *Re a Company (No 005134 of 1986) ex parte Harries* [1989] BCLC 383. The latest cases where buy-out is ordered were *Grace v Biagioli* [2006] 2 BCLC 70; *Irvine v Irvine* [2006] All ER (D) 153 (Mar); *Blackmore v Richardson* [2005] EWCA Civ 1356; *Allmark v Burnham* [2005] All ER (D) 410 (Nov); *Brownlow G H Marshall Ltd* [2000] 2 BCLC 655.

<sup>172</sup> See the Law Commission's findings above in chapter 3 para 3.4.3 Exit disputes following relational breakdown.

<sup>173</sup> See above chapter 3.

It is not hard to see why buy-out is often sought and awarded. If, as was discussed in chapter 3, shareholder disputes in private companies are more often than not the function of relational breakdown, possibly further exacerbated by squeeze-out behaviour, then a parting of the ways would seem to be the only practical solution. In these situations, if the parties try to stay together then the danger always exists that disputes may arise in future. A buy-out of one party or the other therefore seems to be the best course. It resolves the disputes in a practical fashion while also allowing the company to continue and avoiding the more drastic possibility of a just and equitable winding up. In private companies, owing to restrictions on transfer of shares, minority shareholders have to face a state of 'illiquidity'.<sup>174</sup> A court-ordered buy-out (or the prospects of such) provides a means of addressing this illiquidity by mandating an exit based on a fair valuation of the outgoing shareholder's shares.

In *Re a Company*<sup>175</sup> Hoffmann J stated that in companies formed on the basis of personal relationships, the only solution where those relationships broke down was for the shareholders to part a company.<sup>176</sup> If one shareholder was excluded from management it could not automatically be regarded as unfairly prejudicial to the interests of the excluded shareholder. It must depend upon whether it was reasonable that one should leave rather than the other. In *Re a Company (No 004377 of 1986)* Hoffmann J stated that, "the parties no doubt went into the venture expecting to get on with each other. But if a cautious advisor had said to them, "what is to happen if you fall out?" I have no doubt that they would have said, "then we shall have to part. One of us will have to buy the shares of the other, or the company will have to be wound up" ".<sup>177</sup> Hoffmann J further stated in these disputes it was almost always clear that one party would have to leave and who that party would be.<sup>178</sup>

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<sup>174</sup> See above chapter 3 para 3.4.3 Exit disputes following relational breakdown.

<sup>175</sup> [1986] BCLC 362, 366.

<sup>176</sup> See also above characteristics of shareholder disputes in chapter 3.

<sup>177</sup> [1987] BCLC 94, 100.

<sup>178</sup> [1987] BCLC 94, 101. See also above chapter 3 para 3.4.3 Exit disputes following relational breakdown.

Generally in making an order under section 459(2)(d) the court orders the respondent to buy the petitioner's shares. However, depending on the circumstances, the court may order the respondent to sell his shares to the petitioner. Thus, in *Re a Company (No 00789 of 1987) ex parte Shooter*,<sup>179</sup> having ruled that affairs of the company had been conducted by the controlling shareholder in a manner unfairly prejudicial to the interests of the members of the company, the court ordered him to divest himself of his shares in the petitioner's favour on the ground that his behaviour had been such that he was unfit to control the company.<sup>180</sup>

Minority shareholders cannot invoke section 459 to obtain relief where majority shareholders have made a fair offer to buy their shares. In *Re a Company (No 006834 of 1988), ex parte Kremer*, Hoffmann J stated that the unfairness disappeared if the minority shareholder was offered a fair price for his shares at exit. In such a case, section 459 was not intended to enable the court to preside over a protracted and expensive contest of virtue between the shareholders and to award the company to the winner.<sup>181</sup> The position taken by Lord Hoffmann in *O'Neill v Phillips*<sup>182</sup> represents continuity with this earlier approach rather than a new significant legal change.

#### 5.5.2.1 Valuation of shares:

If a buy-out is ordered or agreed in principle a separate 'exit dispute' may arise over the terms of the exit and, in particular, the valuation of the shares.<sup>183</sup> In *Re a Company (No 004377 of 1986)* Hoffmann J stated that in these disputes the only real issue to resolve was the price of the shares<sup>184</sup> in order to encourage early consideration of the issue of fair valuation he developed the principle that the failure to make a fair offer may of itself

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<sup>179</sup> [1990] BCLC 384.

<sup>180</sup> *Re a Company (No 00789 of 1987), ex parte Shooter* [1990] BCLC 384, 395.

<sup>181</sup> *Re a Company (No 006834 of 1988), ex parte Kremer* [1989] BCLC 365, 368. See also above chapter 3 para 3.4.3 Exit disputes following relational breakdown.

<sup>182</sup> [1999] 2 BCLC 1. See also below chapter 6 para 6.5.2.2 Early fair offers to buy-out.

<sup>183</sup> See above chapter 3 para 3.4.3 Exit disputes following relational breakdown.

<sup>184</sup> [1987] BCLC 94, 101.

amount to unfair prejudice where it is clear that the relationship between the parties has irretrievably broken down.<sup>185</sup>

Shareholders in private companies are thought to be more committed to the companies due to their substantive investment of time and money in the company as compared to shareholders in listed companies. Shareholders in listed companies are rarely involved in the management of the company and can diversify the possible risk by investing in different companies.<sup>186</sup>

Generally, in private companies disputes as to valuation of shares where the minority shareholder is exiting have revolved around three issues: (i) whether a discount is applicable due to the fact that shares are minority holding; (ii) whether and to what extent the valuation should be adjusted to reflect the impact of any conduct found or agreed to have been unfairly prejudicial; (iii) date of valuation. The evolution of the law on these issues until the Law Commission review of shareholders' remedies in the late nineties, is discussed below.

*(i) Discounts:*

At the time of buy-out, minority shareholders often complain as to valuation of their shares when their shares are valued at discount due to the fact that they are disposing of a minority holding in the company.<sup>187</sup> In private companies if there are no restrictions on transfer of shares to a willing buyer the value of a minority shareholding may be discounted to reflect lack of control in management of the company unless it is a quasi-partnership company.<sup>188</sup> In *Re Bird Precision Bellows Ltd*,<sup>189</sup> Nourse J stated that the share price fixed by the court should be fair and, although general guidelines could be given as to what constituted a fair price in cases of common occurrence the issue could

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<sup>185</sup> See *Re a Company* [1986] BCLC 362, 366 and *Re a Company (No 006834 of 1988)*, *ex parte Kremer* [1989] BCLC 365.

<sup>186</sup> Therefore, while valuing shares in private companies, for the purpose of fair valuation the fact as to the substantive investment of shareholders' personal commitment as well as financial capital in the company should be considered and reflected in the price of their shareholdings.

<sup>187</sup> See *Re Elgindata Ltd* [1991] BCLC 959. See also *Re Abbey Leisure Ltd* [1990] BCC 60 (CA).

<sup>188</sup> *Re a Company (No 005134 of 1986)* *ex parte Harries* [1989] BCLC 383; *Re Bird Precision Bellows Ltd* [1984] BCLC 195.

<sup>189</sup> [1984] BCLC 195.

not be conclusively determined until the facts in a particular case had been examined.<sup>190</sup> There was no rule of universal application either that the price of a minority shareholding in a small private company should be fixed on a *pro rata* basis according to the value of the shares as a whole or, alternatively, that the price should be discounted to reflect the fact that the shares were a minority holding. In a majority of cases where purchase orders were made under section 75 (now section 459) in relation to quasi-partnerships the vendor shareholder was unwilling in the sense that the sale had been forced upon him. Usually the vendor was a minority shareholder whose interests were unfairly prejudiced by the manner in which the affairs of the company had been conducted by the majority.

Nourse J further stated that on the assumption that the unfair prejudice had made it no longer tolerable for the shareholder to retain his interest in the company, a sale of his shares would invariably be his only practical way out short of a winding-up. In that kind of case it would not merely be fair, but most unfair, that he should be bought out on any basis which involved a discounted price. Therefore, the correct course in the circumstances would be to fix the price *pro rata* according to the value of the shares as a whole and without any discount, as being the only fair method of compensating an unwilling vendor of the equivalent of a partnership share.<sup>191</sup>

However, as to discounted price it was stated that in the exceptional case where a shareholder had so acted as to deserve his exclusion, the price could be appropriately discounted since he could be treated as if he had elected to sell his shares, and such a sale would be at a discount.<sup>192</sup> Secondly, a shareholder who acquired shares from another at a price which was discounted because they were a minority holding there could not be any universal or even a general rule that he should be bought out under the section on a more favourable basis, even in a case where his predecessor had been a quasi-partner in a quasi-partnership. He might himself have acquired the shares purely for investment and played no part in the affairs of the company. In that event it might

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<sup>190</sup> [1984] BCLC 195, 201.

<sup>191</sup> [1984] BCLC 195, 201-202.

<sup>192</sup> [1984] BCLC 195, 202.

well be fair that the shareholder should be bought out on the same basis as he himself had bought, even though his interest had been unfairly prejudiced in the meantime. A fortiori, there could be no universal or even a general rule in a case where the company had never been a quasi-partnership in the first place.<sup>193</sup>

The Court of Appeal stated in *Re Bird Precision Bellows Ltd*<sup>194</sup> that the trial judge had correctly exercised his discretion vested in him by the section that in a quasi-partnership company shares should be valued on a *pro rata* basis without any discount for the fact that shares represent a minority shareholding.<sup>195</sup> So while there is a broad discretion in the court there seem to be well settled principles: (i) whether the valuation should be discounted or *pro rata* is to be determined having regard to all the circumstances of the particular case; (ii) in quasi-partnership cases where one quasi-partner has been excluded from management, there is virtually a presumption that a *pro rata* valuation will apply; (iii) in other cases, a discount will usually apply but this is subject always to point (i) above.

*(ii) Impact of unfairly prejudicial conduct on value of shares:*

Issues regarding the presence of unfairly prejudicial conduct of majority shareholders may have a considerable significance in deciding the question of valuation of shares.<sup>196</sup> In *SCWS v Meyer*<sup>197</sup> it was stated that the correct principle of approaching the matter is:

By considering what would have been the value of the shares at the commencement of the proceedings had it not been for the effect of the oppressive conduct of which complaint was made.

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<sup>193</sup> [1984] BCLC 195, 202.

<sup>194</sup> [1985] BCLC 493, 504.

<sup>195</sup> In *R & H Electric Ltd v Haden Bill Electrical Ltd* [1995] 2 BCLC 280, the court also ordered the buy-out of the minority shareholding by the majority without any discount for its being a minority holding.

<sup>196</sup> See also below chapter 6 para 6.5.2.3.1 Strike-out application on the basis of fair offer, where problems associated with making fair offers to strike out petitions were discussed.

<sup>197</sup> [1959] A.C. 324, 364. This is an old case under section 210 of CA 1948. Old cases are still regarded as authoritative because statutory provision on relief (as distinct from the nature of the conduct) has not substantially changed since 1948.



Lord Denning further stated that:

One of the most useful orders mentioned in the section - which will enable the court to do justice to the injured shareholders - is to order the oppressor to buy their shares at a fair price: and a fair price would be, I think, the value which the shares would have had at the date of the petition, if there had been no oppression... It is, no doubt, true that an order of this kind gives to the oppressed shareholders what is in effect money compensation for the injury done to them: but I see no objection to this. The section gives a large discretion to the court and it is well exercised in making an oppressor make compensation to those who have suffered at his hands.<sup>198</sup>

In *Re Jermyn Street Turkish Baths Ltd*<sup>199</sup> it was stated that:

Section 210 gives the court an unlimited judicial discretion to make such order as it thinks fit... in prescribing the basis on which the price on such a sale is to be calculated, the court can in effect provide compensation for whatever injury has been inflicted by the oppressors.

Generally there will need to be an adjustment to reflect the diminishing effect of the majority's conduct. But even if the court finds in favour of the petitioner, the petitioner's own conduct may be taken into account in determining the valuation. In *Re London School of Electronics*<sup>200</sup> it was held that the valuation ought to be made on the footing that the students which the petitioner removed to the college run by the petitioner, had remained with the company.

(iii) *Date of valuation:*

Regarding the date of valuation Nourse J in *Re London School of Electronics Ltd*<sup>201</sup> explained in his judgment that:

If there were to be such a thing as a general rule, I myself would think that the date of the order or the actual valuation would be more appropriate than the date of the presentation of the petition or the unfair prejudice. Prima facie an interest in a going concern ought to be valued at the date on which it is ordered to be purchased. But whatever the general rule might be it seems very probable that the overriding requirement that the valuation should be fair on the facts of the particular case would, by exceptions, reduce it to no rule at all.

In *Re Cumana Ltd*<sup>202</sup> the Court of Appeal stated that the trial judge had chosen the date of the petition for valuation of shares. There was evidence that the shares had gone down in value between the date of the petition and the date of the judgment. They might have

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<sup>198</sup> *SCWS v Meyer* [1959] A.C. 324, 369.

<sup>199</sup> [1970] 3 All ER 57, 67.

<sup>200</sup> [1985] BCLC 273, 282. See also above chapter 3 para 3.4.1.2.1 Misappropriation of company's assets and proceeds.

<sup>201</sup> [1985] BCLC 273, 281.

<sup>202</sup> [1986] BCLC 430, 435-436.

gone up. The Court of Appeal upheld the reason the trial judge gave for choosing the date of the petition as a sound one, namely:

The date of the petition is the date on which the petitioner elects to treat the unfair conduct of the majority as in effect destroying the basis on which he agreed to continue to be a shareholder, and to look to his shares for his proper reward for participation in a joint undertaking.

The Court of Appeal stated that the choice of a date of valuation in these cases was in the discretion of the trial judge. If there was evidence before the court that the majority shareholder deliberately took steps to depreciate the value of the shares in anticipation of a petition being presented, it would be permissible to value the shares at a date before such action was taken. Hence, prior to *O'Neill v Phillips*<sup>203</sup> the general principle seems to be that it is discretion of the court to choose the valuation date that results in fair valuation of shares in any particular case.

### **5.6 Effective resolution of shareholder disputes:**

As stated above, the second ingredient of resolution of shareholder disputes is related to process namely, the provision of appropriate relief to minority shareholder with minimum time and costs. This – the question of effectiveness – is the central concern of the thesis.<sup>204</sup> Lengthy proceedings increase the costs of litigation. The Law Commission stated that “all shareholders’ remedies should be made as efficient and cost effective as can be achieved in the circumstances”.<sup>205</sup> The question arises whether the resolution of shareholder disputes through courts is currently effective in this context. As it is evident from the above discussion, the section due to its wide scope, deals with almost all aspects of unfairly prejudicial conduct of majority shareholders against minority in private companies.<sup>206</sup> The problems have been identified by the courts and the Law Commission regarding the court based dispute resolution mechanism under sections 459-461 of the CA 1985 such as length, cost and complexity of proceedings due to wide

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<sup>203</sup> [1999] 2 BCLC 1.

<sup>204</sup> The effectiveness resolution of shareholder disputes means resolution in minimum time and cost to shareholders, companies and the administration of justice by the courts. See also above meaning of ‘effectiveness’ in chapter 1 para 1.2.

<sup>205</sup> See *The Law Commission’s Report* [1.9 (vi)], see also *The Consultation Paper* [14.13].

<sup>206</sup> See above para 5.5.1 Jurisdiction of the court under section 459 of the CA 1985 to decide unfairly prejudicial conduct.

scope of the section. The efforts have been made on both the substantive<sup>207</sup> and procedural level<sup>208</sup> to streamline the effectiveness of this court based dispute resolution mechanism under sections 459-461 of the CA 1985.<sup>209</sup>

The two ingredients of resolution of shareholder disputes are interrelated. In fact establishing the cause of action under section 459 of CA 1985 due to its wide scope can prolong the proceedings and therefore increase costs.<sup>210</sup> On the other hand, efforts to reduce the length of the proceedings to avoid costs by reducing the width of the section may affect the process by which the cause of action can be proved by the petitioner and thus limit its scope.

I now turn to discuss the Law Commission's review of shareholders remedies and, in particular, its criticism of the effectiveness of section 459. The review – which was carried out during 1996 – was directed primarily at answering the question: “when can shareholders bring proceedings to enforce their or the company's rights”?<sup>211</sup> In the course of its deliberations, *inter alia* the Law Commission focused attention on the effectiveness of the remedy for unfairly prejudicial conduct under sections 459-461 of CA 1985. It confirmed that the provisions were the most widely used by minority shareholders to obtain some personal remedy in the event of breaches of directors' duties, or other misconduct in relation to the company's business.<sup>212</sup> The Law Commission asserted that proceedings for relief from unfair prejudice often entail *complex factual investigations* and result in *costly and cumbersome litigation*.<sup>213</sup> The vast majority of those who responded to its consultation agreed with this assessment.<sup>214</sup> By considering the Law Commission's criticism of the remedy for unfairly prejudicial

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<sup>207</sup> See below chapter 6 Substantive law developments since the Law Commission's review.

<sup>208</sup> See below chapter 7 Procedural law developments.

<sup>209</sup> As Cheung stated in the context of unfair prejudice remedy that in the United Kingdom, the principle concern of the Law reform bodies was not directed towards the substantive remedy itself, but to the length, complexity and costs of the litigation of typical unfair prejudice actions and the destructive effect such proceedings had on small private companies. See Cheung R., ‘The Statutory Unfair Prejudice Remedy in Hong Kong: Part 3’ (2008) 29(11) *Company Lawyer* 346, 350.

<sup>210</sup> See above para 5.4 Section 459 of the Companies Act 1985.

<sup>211</sup> See *The Consultation Paper* [1.1]

<sup>212</sup> See *The Consultation Paper* [1.7]

<sup>213</sup> See *The Consultation Paper* [1.7]

<sup>214</sup> *The Law Commission's Report* [2.1] [1.6] and [1.6 n 14]; *The Consultation Paper* [11.1].

conduct, the subsequent chapters will evaluate the impact of the later substantive and procedural developments and the extent to which they have improved the effectiveness of the remedy, since the Law Commission reported.<sup>215</sup>

### ***5.6.1 The Law Commission's methodology:***

The Law Commission's review was based on (i) a survey of petitions presented to the Companies Court at the Royal Courts of Justice between January 1994 and December 1996 and (ii) an analysis of the unfair prejudice cases reported in Butterworth's Company Law Cases (BCLC) between the years 1988-1997. Through the survey the Law Commission sought to establish the nature and characteristics of section 459 petitions: what types of company were involved; the nature and extent of the pleaded allegations; the relief sought; the outcome; and the length of the proceedings. As to the cost of section 459 petitions the Law Commission conceded that there was little publicly available information.<sup>216</sup> Instead they relied on anecdotal evidence derived from a handful of cases that had gone to trial where the costs were substantial<sup>217</sup> and also relied more generally on research done on costs in civil litigation in connection with Lord Woolf's inquiry into Access to Justice.

#### ***5.6.1.1 Criticism of the Law Commission's methodology:***

The Law Commission's assertions as to the length; cost and complexity of proceedings associated with section 459 petitions were in part based on quantitative data. However, that quantitative data was not acquired scientifically. As to the length and cost of section 459 petitions the Law Commission mainly relied on (i) cases reported in BCLC between 1988 and 1987; (ii) the results of a statistical survey of petitions under section 459 at the High Court in London that found that the average time for disposal of petitions

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<sup>215</sup> See above chapter 1 para 1.2 for the meaning of the effectiveness of the remedy.

<sup>216</sup> *The Law Commission's Report* [1.6 n 14].

<sup>217</sup> See below para 5.6.2.2 Length and costs of proceedings. In *Re Elgindata Ltd* [1991] BCLC 959 the hearing lasted 43 days, costs totalled £320,000 and the shares, originally purchased for £40,000, were finally valued at only £24,600. In *Re Macro (Ipswich) Ltd* [1994] 2 BCLC 354 the hearing of s 459 proceedings and a related action lasted 27 days at first instance alone. The parties subsequently claimed that they were entitled to recover total costs of £725,000 under orders of the court; see *Re Macro (Ipswich) Ltd* [1996] 1 WLR 145, 148. This did not include the costs of the subsequent appeal hearing: *Re Macro (Ipswich) Ltd* 22 May 1996 (unreported, CA). As mentioned by the Law Commission in its Consultation Paper *The Consultation Paper* [1.7 n 16].

(assuming no appeal in those cases that reached trial) was 4.71 months; and (iii) responses to their own Consultation Paper. The Law Commission received 109 responses to the Consultation Paper. The Law Commission did not consider unreported cases (although it did draw anecdotally on one unreported case as evidence of the length and costliness of section 459 proceedings)<sup>218</sup> nor did it survey petitions presented in Chancery District Registries outside London or in the county courts. The Law Commission focused on authorities rather than the average cases. Moreover, the Law Commission reported only about the length of the trial and the data do not inform how the process was working in the pre-action and pre-trial phases, which is crucial to understand why the disputes end up in courts and do not settle. There was no focus on settlement of section 459 disputes. Unfortunately, at the time of the Law Commission review of shareholders remedies and, even now, there are no detailed judicial statistics available regarding section 459 petitions.<sup>219</sup>

#### ***5.6.2 The Law Commission's critique of section 459 of the CA 1985:***

Firstly, commenting on *Saul D Harrison* the Law Commission stated that:

The courts have held in number of cases that the petitioner had a legitimate expectation of being able to participate in the management of the company and that exclusion from management could be unfairly prejudicial to his interests qua member.<sup>220</sup>

The Law Commission in its Consultation Paper mentioned the view of the Jenkins Committee that expressly stated:

... if the section is to afford effective protection it must extend to cases in which the acts complained of fall short of actual illegality.<sup>221</sup>

The Law Commission stated that on this basis, conduct could be unfairly prejudicial without there being a breach of the rights belonging to the shareholder or the company.

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<sup>218</sup> *Re Freudiana Music Co Ltd* (24 March 1993- unreported). See below para 5.6.2.2 Length and costs of proceedings.

<sup>219</sup> See above Judicial statistics in chapter 2 para 2.3.1 Justification for qualitative inquiry.

<sup>220</sup> *The Consultation Paper* [9.34].

<sup>221</sup> *The Law Commission's Report* [2.2]; *The Jenkins Committee* [203]. *The Jenkins Committee* was, of course, concerned about the narrow scope of the former oppression remedy. See also above para 5.3 Evolution of the unfair prejudice remedy up to the time of the Law Commission Report.

Although the Court of Appeal in *Saul D Harrison*<sup>222</sup> can be regarded as having laid down ‘guidelines’ for the application of the section, no reference was made to the possibility of unfairly prejudicial conduct which does not involve the invasion of a legal right, except where the shareholder has a ‘legitimate expectation’ over and above the legal rights conferred by the company’s constitution and arising out of a relationship between shareholders which fell within the categories or analogous situations set out in *Ebrahimi v Westbourne Galleries Ltd.*<sup>223</sup> The Law Commission stated that therefore where there was no invasion of legal rights or no legitimate expectation existed conduct which would appear to be deserving of a remedy might be left unremedied, contrary to the expectation of the Jenkins Committee.<sup>224</sup> The Law Commission stated in its Report that the courts would find that new situations not mentioned in *Saul D Harrison*<sup>225</sup> were in appropriate cases capable of constituting unfairly prejudicial conduct.<sup>226</sup> However on the contrary the Law Commission proposed that such proceedings should be dealt with primarily by active case management by the courts<sup>227</sup> and did not suggest any amendment to the section.<sup>228</sup> Secondly, the Law Commission stated that litigants may seek to establish a “legitimate expectation” when that was not the real substance of their complaint, and this might lead to a proliferation of issues in section 459 proceedings.<sup>229</sup>

Secondly, some judges had been critical of the length and costs of section 459 proceedings in the course of deciding cases that had come before them.<sup>230</sup> The Law Commission echoed these criticisms and linked the problem directly to the wide scope of section 459. Below the section discusses the main points emerging from the Law Commission’s Report.

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<sup>222</sup> [1995] 1 BCLC 14.

<sup>223</sup> *Ebrahimi v Westbourne Galleries Ltd* [1972] 2 All ER 492. See *The Consultation Paper* [20.17].

<sup>224</sup> See *The Consultation Paper* [20.18].

<sup>225</sup> [1995] 1 BCLC 14.

<sup>226</sup> *The Law Commission’s Report* [4.12].

<sup>227</sup> See below chapter 7 para 7.2.2 The Law Commission’s proposals.

<sup>228</sup> *The Law Commission’s Report* [4.12].

<sup>229</sup> See *The Consultation Paper* [20.18].

<sup>230</sup> See the discussion below in para 5.6.2.2 Length and costs of proceedings.

### 5.6.2.1 *Wide scope of the section:*

Due to its wide scope the unfair prejudice remedy under section 459 had proved to be the most attractive remedy for protection of minority shareholders' interests as compared to other available remedies in English Law. The Law Commission stated that the wording of section 459 was extremely wide and allowed conduct going back over many years to be raised by the parties.<sup>231</sup> The main problem in respect of the unfair prejudice remedy arose out of the generality of the wording, as this permits applicants to put in issue anything that may be remotely relevant.<sup>232</sup> That results in complex, often historical, factual investigations and, therefore, in costly, cumbersome litigation.<sup>233</sup>

The courts' wide jurisdiction under the section to promote fairness demands detailed examination of company affairs. In *Re Unisoft Group Ltd (No 3)*<sup>234</sup> Harman J stated that:

[In petitions under section 459 of CA 1985] it befits the court, in my view, to be extremely careful to ensure that oppression is not caused to parties, ... by allowing the parties to trawl through facts which have given rise to grievances but which are not relevant conduct within even the very wide words of the section.

Due to the wide scope of the section, shareholders may bring any issue to the court that they think is unfairly prejudicial to their interests. The Law Commission in its final Report stated that weak allegations are often made by the parties to lend ballast to what are essentially their main grievances.<sup>235</sup> It is not surprising because the court will look at conduct cumulatively in making its assessment about unfairly prejudicial conduct therefore, the petitioners (or their lawyers) would look to raise as many allegations as they possibly could, without necessarily discriminating the strong ones from the weak.<sup>236</sup>

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<sup>231</sup> *The Law Commission's Report* [2.1].

<sup>232</sup> *The Consultation Paper* [14.5].

<sup>233</sup> *The Consultation Paper* [14.5].

<sup>234</sup> [1994] 1 BCLC 609, 611.

<sup>235</sup> *The Law Commission's Report* [2.1].

<sup>236</sup> Cheung stated that unfair prejudice petitions are notorious for their potentially burdensome nature, the protracted and costly legal proceedings, the breadth of the factual inquiry that may be involved where petitioners rely on numerous grounds of allegations and the potentially wide scope for expert evidence on issues such as share valuation. See Cheung R., 'The Statutory Unfair Prejudice Remedy in Hong Kong: Part 3' (2008) 29(11) *Company Lawyer* 346, 350.

In *Re Unisoft Group Ltd (No 3)*<sup>237</sup> Harman J stated that the words of the section “on the face of them are, extraordinarily wide and general”. That as a result has enhanced the jurisdiction of courts to consider any relevant matter in any particular case that shareholders’ may consider as unfairly prejudicial to their interests as a member of the company. Harman J<sup>238</sup> further stated that:

[the words of the section] allow on the face of them, every sort and kind of conduct which has taken place over an almost unlimited – certainly upwards of 20 years – period of time in the management of the company business to be dug up and gone over.

The Law Commission in its Consultation Paper mentioned that in *Re Macro (Ipswich) Ltd*<sup>239</sup> the proceedings involved an examination of events spanning some 40 years and in *Re Sam Weller and Sons Ltd*<sup>240</sup> events spanning some 38 years. In *Rotadata Ltd*<sup>241</sup> the petition ran “to over 30 closely typed pages with 121 paragraphs and a total of 21 separate allegations against the respondents”.

Two other problems were identified with the scope of the provision. The first was the impact on courts in terms of the potential for burgeoning case loads, due to wide scope of the section and broad discretion of courts under the section.<sup>242</sup> Copp has argued that provisions regarding unfairly prejudicial conduct were to some extent the victims of their own success, since due to their width, they gave rise to a considerable volume of litigation; therefore it was required to limit the scope of the section.<sup>243</sup> But the limited scope of the provisions might also lead to the sterility of these provisions.<sup>244</sup> Riley argued that the availability and sheer width of the unfair prejudice remedy has also

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<sup>237</sup> [1994] 1 BCLC 609, 611.

<sup>238</sup> *In Re Unisoft Group Ltd (No 3)* [1994] 1 BCLC 609, 611.

<sup>239</sup> [1994] 2 BCLC 354.

<sup>240</sup> [1990] Ch 682.

<sup>241</sup> See *Rotadata Ltd* [2000] 1 BCLC 122, 127f.

<sup>242</sup> One main reason for introduction of this remedy by legislature after a long time apart from emphasis upon internal management principle (see the Law Commission Final Report para 1.9 (ii)) might be the awareness of the legislature as to the case load of shareholder disputes that might have upon the courts as a result of provision of the remedy.

<sup>243</sup> Copp S., ‘Company Law: Individual Shareholder Rights’ (2000) 11(1) *International Company and Commercial Law Review* N6-8, N8.

<sup>244</sup> *Ibid* N7-N8.



increased the case load on the courts within a small period of its promulgation.<sup>245</sup>

The second was the ever present danger that minority shareholders could use it to harass the majority and involve the company in unnecessary litigation contrary to the guiding principle of company law that those who manage the company should be free to run it without unnecessary shareholder interference.<sup>246</sup> As Lord Hoffmann has stated:

The very width of the jurisdiction means that, unless carefully controlled, it can become a means of oppression.<sup>247</sup>

In *Re Ring Tower (No. 2)*<sup>248</sup> it was warned that “the jurisdiction should be carefully controlled to prevent it from becoming an instrument of oppression”.

#### 5.6.2.2 Length and costs of proceedings:

The Law Commission stated that the generality of the statutory wording has also increased uncertainty so that those who are not experts in company law may find it difficult to predict whether or not a court is likely to find unfairly prejudicial conduct, and a shareholder may not have access to the advice of an expert in company law.<sup>249</sup> Moreover, uncertainty may also increase the length and costs of proceedings. The width of the discretion tends to generate complex and highly fact-sensitive cases requiring historical investigation, lengthy discovery and detailed evidence all of which adds to legal costs.<sup>250</sup>

As to the length and costs of unfair prejudice cases under section 459 of CA 1985, the Law Commission in its final Report mentioned, that these cases that go to trial often last

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<sup>245</sup> See Riley, C.A., ‘Contracting Out of Company Law: Section 459 of the Companies Act 1985 and the Role of the Courts’ (1992) 55 *Modern Law Review* 782, 792.

<sup>246</sup> See *The Law Commission’s Report* [1.9 (v)].

<sup>247</sup> *Re a Company* (No 007623 of 1984) [1986] BCLC 362, 367.

<sup>248</sup> [1989] BCLC 427, 437, [1989] 5 BCC 82, 90D as quoted by *Rock Ltd v RCO Holdings Ltd* [2004] BCC 466, 477.

<sup>249</sup> *The Consultation Paper* [14.6].

<sup>250</sup> See *The Law Commission’s Report* [2.1]. Clark stated that litigation in this area was expensive because any accusations of prejudicial conduct within the company inevitably entailed a great deal of historical investigation and evidential discovery, see Clark B., ‘Unfairly Prejudicial Conduct’ (1999) 38 *Scots Law Times* 321, 322. *Inter alia* expenses include mainly the lawyers’ fees due to their long hours of involvement in such cases.

weeks rather than days.<sup>251</sup> The Law Commission “has examined the cases reported in Butterworths Company Law Cases for the last ten years (1988-1997). Fourteen cases were shown to have gone to a full trial and the average length of the hearing was just over three weeks (16 days)”.<sup>252</sup> The Law Commission in its final Report has provided some information as to costs of petitions under section 459 of the Companies Act 1985 by stating that in *Re Elgindata Ltd*<sup>253</sup> the hearing lasted 43 days, costs totalled £320,000 and the shares originally purchased for £40,000, were finally valued at only £24,600. In *Re Macro (Ipswich) Ltd*<sup>254</sup> the hearing of section 459 proceedings and a related action lasted 27 days at the first instance alone. The parties subsequently claimed that they were entitled to recover total costs of £725,000 under orders of the court.<sup>255</sup> The Law Commission in its Consultation Paper drew attention to the extreme example of *Re Freudiana Music Co Ltd*<sup>256</sup> where the hearing lasted for a year and extended over some 165 days in court. The judgment stretched to some 499 pages in length and the costs awarded in favour of the respondent alone were £2 million.<sup>257</sup> In *Rotadata Ltd*<sup>258</sup> parties indicated estimated time for the hearing of the petition between five and eight days. In *Re Unisoft Group Ltd (No 3)*<sup>259</sup> Harman J stated that:

Petitions under s 459 have become notorious to the judges of this court – and I think also to the Bar – for their length, their unpredictability of management, and the enormous and appalling costs which are incurred upon them particularly by reason of the volume of documents liable to be produced. By way of example on this petition there are before me upwards of 30 lever-arch files of documents.

### 5.6.2.3 Courts’ respect for majority rule:

The wide scope of the section intended by the Parliament also provides the courts a wide discretion to decide the notion of fairness in any particular case and an equally broad discretion to grant relief under section 461 of the Companies Act 1985. The Cohen Committee recommended that the court should be given unfettered discretion to impose

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<sup>251</sup> *The Law Commission’s Report* [1.6].

<sup>252</sup> *The Law Commission’s Report* [1.6 fn 13].

<sup>253</sup> [1991] BCLC 959.

<sup>254</sup> [1994] 2 BCLC 354.

<sup>255</sup> *The Law Commission’s Report* [1.6 fn 14].

<sup>256</sup> 24 March 1993- unreported.

<sup>257</sup> See *The Consultation Paper* [11.1]; *The Law Commission’s Report* [1.6 fn 13].

<sup>258</sup> See *Rotadata Ltd* [2000] 1 BCLC 122, 127f.

<sup>259</sup> [1994] 1 BCLC 609, 611.

upon the parties to a dispute whatever settlement it considered just and equitable.<sup>260</sup> By accepting the utility of such discretion Hoffmann J in *Re Company (No 007623 of 1984)*<sup>261</sup> stated that section 75 [now section 459] was a “valuable and over due reform of the law which conferred on the court a wide and useful discretion”.

However, due to the principle of judicial respect for commercial decisions the courts have showed themselves unwilling to intervene in company’s internal matters. In *Shuttleworth v Cox Bros and Co*<sup>262</sup> court stated that “it is not the business of the Court to manage the affairs of the company. That is for the shareholders and directors”. In *Carlen v Drury*<sup>263</sup>, Lord Eldon LC stated that “the court could not undertake the management of every brewhouse and playhouse in the kingdom”. In *Howard Smith Ltd v Ampol Petroleum Ltd*,<sup>264</sup> Lord Wilberforce stated that “there is no appeal on merits from management decisions to courts of law: nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at”. The Law Commission in its final Report also mentioned the guiding principle of company law that “the court should continue to have regard to the decisions of the directors on commercial matters if the decision was made in good faith, on proper information and in the light of relevant considerations, and appears to be a reasonable decision for the directors to have taken”.<sup>265</sup> Therefore, the wide discretion of the courts under section 459, which is intended by the Parliament to assist and protect shareholders,<sup>266</sup> enhances the traditional tension that exists between the legislature and courts in the commercial sphere. The legislature has sought to increase “the courts policing of the way in which companies are run” and yet courts are traditionally reluctant to interfere in the affairs of a company and “think it right to leave those who own or run companies to get on with it”.<sup>267</sup> It was stated that “the quest for a regime

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<sup>260</sup> *The Cohen Report* [60].

<sup>261</sup> [1986] BCLC 362.

<sup>262</sup> [1927] 2 KB 9, 23 per Scrutton LJ.

<sup>263</sup> [1812] 1 Ves & B 154.

<sup>264</sup> [1974] A.C. 821, 832.

<sup>265</sup> *The Law Commission’s Report* [1.9].

<sup>266</sup> Prentice, DD., ‘Protecting Minority Shareholders Interests’ in Feldman and Meisel (eds) *Corporate and Commercial Law: Modern Developments* (Lloyd’s of London Press Limited, London 1996) 103.

<sup>267</sup> Neuberger D., ‘Company Law Reform: The Role of the Courts’ in John de Lacy (ed) *The Reform of United Kingdom Company Law* (Cavendish Publishing Limited, UK 2002) 59.

which provides effective minority shareholder protection continues to clash with the sanctity accorded to the principle of majority rule. Finding the optimum balance between these two opposing notions has proved elusive”.<sup>268</sup> The petition involves the courts in an investigation of how a company’s affairs have been managed to consider the impact of decision-making on shareholders’ interests.<sup>269</sup> Accordingly, the courts do not seem to be minded to intervene in shareholder disputes because of (i) their respect for majority rule and historic unwillingness to intervene in company’s internal matters; (ii) the potential impact of protracted shareholder disputes on the courts’ case burden and time.

### **5.7 Conclusion:**

The chapter provides account of the law at the time of the Law Commission’s review of shareholders’ remedies in the late nineties and the Law Commission’s criticism of section 459 of CA 1985. The unfair prejudice remedy under section 459 of the CA 1985 is the most attractive and widely used remedy available to minority shareholders, against the misapplication of the majority rule in private companies. Unfairness is an important element to prove cause of action under the section. Prior to *O’Neill v Phillips*<sup>270</sup> and until the Law Commission’s review, unfairness arises in three instances: (i) breach of agreed terms between shareholders, (ii) breach of fiduciary duties of directors, (iii) breach of some sort of fundamental understanding between the shareholders giving rise to legitimate expectations. Buy-out is the most common relief sought and awarded in shareholders disputes. Section 459 cannot be invoked by minority where majority have made a fair offer to buy-out. The real issue to resolve in these disputes is regarding terms of exit or price of shares at the event of buy-out.

The Law Commission and the courts identified the problems of length, costs and complexity of section 459 proceedings due to the wide scope of the section. Furthermore, along with complex, lengthy and expensive litigation, burgeoning case load, dangers of misuse of the remedy by minority shareholders and tension between

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<sup>268</sup> Lowry, J., ‘The Pursuit of Effective Minority Shareholder Protection: s. 459 of the Companies Act 1985’ (1996) 17(3) *Company Lawyer* 67, 67.

<sup>269</sup> See Roberts, P., and Poole J., ‘Shareholders Remedies- Efficient Litigation and the Unfair Prejudice Remedy’ (1999) *Journal of Business Law* 38, 48.

<sup>270</sup> [1999] 2 *BCLC* 1.

courts' wide jurisdiction and discretion under the section and the traditional reluctance of courts to interfere in the affairs of the company are all factors that lessen the effectiveness of this remedy, for minority shareholders.

To streamline the effectiveness of section 459 to resolve the disputes with minimum cost and delay measures have been proposed at both the substantive and the procedural level.<sup>271</sup> The next chapter discusses substantive law developments after the Law Commission Report in 1997 – focusing particular attention on the House of Lords decision in *O'Neill v Phillips* – and the impact of those substantive law developments, upon the effective resolution of shareholder disputes under sections 459-461 of the CA 1985. In chapter 7 procedural law developments after the Law Commission Report are discussed and the chapter also seek to evaluate their impact on the effectiveness of section 459 proceedings.

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<sup>271</sup> On a procedural level case management has been implemented under the Civil Procedure Rules 1998, SI 1998/3132. See below chapter 7.

## Chapter 6

### Substantive law developments since the Law Commission's review

#### 6.1 Scope of the chapter:

The chapter discusses substantive law developments that have impacted on the effectiveness of sections 459-461 as a tool for resolving shareholder disputes since the Law Commission Report. The leading developments in this context were brought about by the House of Lords in *O'Neill v Phillips*.<sup>1</sup> The chapter explores in the light of the analysis of the case law and interviewees' responses the impact of *O'Neill v Phillips* as well as other case law developments in this area of legal practice and evaluates the extent to which these developments have enhanced the effectiveness of the dispute resolution mechanism in resolving disputes in minimum time and cost.

#### 6.2 Introduction:

It was stated that after the introduction of section 459 of CA 1985, protection of minority shareholders "formerly one of the most stagnant areas of company law, has now arguably become one of the most active".<sup>2</sup> The Law Commission criticized the fact that the proceedings under section 459-461 were complex, lengthy and therefore expensive due to the wide scope of the section.<sup>3</sup> The Company Law Review in one of its consultation documents<sup>4</sup> stated that minority rights and remedies were principally of concern to private companies, as it was believed clarity, accessibility and cost-effectiveness were of prime importance, particularly in relation to smaller companies as their members and directors might have limited financial resources or access to expert advice. This influenced the approach to personal rights, unfair prejudice, the *O'Neill* ruling and the conditions for derivative actions in that particular consultation.<sup>5</sup> In fact, as

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<sup>1</sup> *O'Neill v Phillips* [1999] 1 WLR 1092; [1999] 2 BCLC 1; [1999] 2 All E.R. 96; [1999] BCC 600.

<sup>2</sup> See Clark B., 'Unfairly Prejudicial Conduct' (1999) 38 Scots Law Times 321, 321.

<sup>3</sup> See above chapter 5.

<sup>4</sup> See Company Law Review 'Modern company law for a competitive economy: completing the structure' (Company Law Review Steering Group, URN 00/1335, Nov 2000). A consultation document from the Company Law Review Steering Group.

<sup>5</sup> Company Law Review 'Modern company law for a competitive economy: completing the structure' (Company Law Review Steering Group, URN 00/1335, Nov 2000) Chapter 5 Corporate Governance: Shares and Shareholders, [5.60].

is evident below from the discussion of *O'Neill v Phillips*, the clarity of the section is linked to the cost-effectiveness of the remedy.<sup>6</sup>

On a substantive level, to improve the effectiveness of shareholders remedies, the Law Commission in its final Report proposed *inter alia*: (i) legislative provision for presumptions in proceedings under section 459-461<sup>7</sup> (ii) some reforms relating to proceedings under sections 459-461, to limit the difficulties caused by the wide ranging nature of the remedy and to address potential or perceived lacunae in the remedy<sup>8</sup> but rejected any amendments to the wording of the section<sup>9</sup> (iii) shareholders' exit article<sup>10</sup> (iv) a new derivative action.<sup>11</sup> Among these proposals, only the proposal for the statutory derivative action was implemented under the CA 2006.<sup>12</sup> After the Law Commission Report, the substantive law developments were mainly made by case law that had an impact upon the proceedings under section 459-461 of CA 1985. Along with focusing upon the nature of the substantive law developments, the chapter explores the effectiveness of these developments in providing minority shareholders an appropriate relief in minimum time and cost, in the light of the analysis of the case law and interviewees' responses.

As to the scope of the section, one commentator has questioned whether, the section should be seen as providing merely protection from harms which were unlawful independent of it and if not, how and where should the courts draw the line of 'what constituted unfair prejudice' under the section.<sup>13</sup> In fact, balance is required between the scope of the section and its usefulness in practice. If the section is construed too

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<sup>6</sup> See below para 6.4.1 The reasoning behind the judicial shift in emphasis from 'legitimate expectations' to 'equitable considerations'.

<sup>7</sup> *The Law Commission's Report* [3.27]-[3.30].

<sup>8</sup> *The Law Commission's Report* part 4.

<sup>9</sup> See *The Law Commission's Report* part 4 [4.3]-[4.13].

<sup>10</sup> See *The Law Commission's Report* part 5 [5.32] and Appendix C to the Report. See above chapter 4 para 4.6.3.1 The significance of default rules, for potential of exit article as proposed by the Law Commission.

<sup>11</sup> See *The Law Commission's Report* part 6 [6.15].

<sup>12</sup> See Company Law Review 'Modern Company Law for a Competitive Economy: Developing the Framework' (URN 00/656, March 2000) chapter 4 [4.100]-[4.111]. For the statutory derivative action see ss 260-264 of CA 2006.

<sup>13</sup> See Payne J., 'Sections 459-461 Companies Act 1985 in Flux: The Future of Shareholder Protection' (2005) 64(3) Cambridge Law Journal 647, 648.

narrowly it runs the risk of limiting shareholders to just and equitable winding up (as was the case with section 210 of CA 1948); if it is construed too widely it may increase uncertainty so add to the length and costs of proceedings. The House of Lords in *O'Neill v Phillips* by restating the scope of the concept of 'unfairness' under section 459, provided an answer to these questions. As well as establishing the parameters of 'unfairness' on the substantive level, *O'Neill v Phillips* has also impacted on the procedural level by emphasizing the importance of early buy-out offers at fair value as a means of resolving disputes.<sup>14</sup> By considering the significance of the judgment of *O'Neill v Phillips* regarding its impact upon the section 459 practice, the chapter will discuss the facts of the case and judgments delivered in the case at first instance, in the Court of Appeal and the House of Lords. Later in the chapter, the reasoning, developments and the impact of the judgment is considered with the impact of the other developments introduced by case law.

### **6.3 O'Neill v Phillips:**<sup>15</sup>

#### ***6.3.1 Facts of the case:***

A private company was operating in the construction industry. Mr. O'Neill (the petitioner) was employed as a manual worker in the company. Mr. Phillips (the respondent) was impressed by Mr. O'Neill's energy and ability and gave Mr. O'Neill 25 per cent shares and appointed him a director. In an informal discussion, Mr. Phillips expressed the hope that Mr. O'Neill would be able to take over fully the day-to-day running of the company and indicated that on that basis he would allow him to draw 50% of the company's profits despite only having 25% of the shares, thus waiving one third of his own dividend entitlement. Mr. O'Neill did take over the running of the business and Mr. Phillips retired from the board, leaving Mr. O'Neill as sole director. Mr. O'Neill was credited with half the profits.

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<sup>14</sup> See below para 6.4.3 A fair offer to buy-out.

<sup>15</sup> [1999]1 WLR 1092; [1999] 2 BCLC 1; [1999] 2 All E.R. 96; [1999] BCC 600.



There were discussions with a view to Mr. O'Neill obtaining a 50% shareholding. Solicitors, counsel and the company's accountants were consulted and draft documents were prepared. Negotiations reached a point at which Mr. Phillips indicated that in principle he was willing to increase Mr. O'Neill's shareholding to 50% when the company's net asset value reached £500,000 and his voting rights to 50% when it reached £1,000,000. These figures were referred to as 'the targets'. It was contemplated that a formal agreement would be drafted to embody these terms and any others found desirable. However this did not happen and at that point, negotiations stopped. The judge found at trial that no formal agreement for the allocation of more shares to Mr. O'Neill (whether conditionally or unconditionally) had ever been concluded.

The construction industry went into recession and the company began to struggle. Mr. Phillips became alarmed about the company's financial position and concerned about Mr. O'Neill's management. He decided as controlling shareholder, to resume personal command. He gave Mr. O'Neill the option of managing under him, the UK or the German branches of the business. Mr. O'Neill chose to go to Germany. Mr. Phillips resumed the position of managing director and Mr. O'Neill remained on the board as an ordinary director. Mr. Phillips was not as impressed with Mr. O'Neill's energy and commitment as he had been, when times were good. He strongly criticised Mr. O'Neill and told him at a meeting that he was no longer to act as managing director and would no longer receive 50% of the profits. He would be paid only his salary and any dividends payable upon his 25% shareholding.

Mr. O'Neill prepared to sever his links with the company and made arrangements to set up a competing business in Germany. Mr. O'Neill wrote a letter to Mr. Phillips that was in effect a letter before action and said that Mr. Phillips had broken his promises to pay Mr. O'Neill 50% of the profits and to allot him (subject to reaching the targets) 50% of the shares. He had thereby reduced his position to that of an employee. In 1992, without further correspondence, Mr. O'Neill issued a petition under section 459 of CA 1985 seeking relief for unfairly prejudicial conduct under section 461 of CA 1985 or alternatively an order under section 122(1)(g) of the IA 1986 for the winding up of the

company. The allegations of unfairly prejudicial conduct came down to two complaints. The first was Mr. Phillips's termination of equal profit-sharing and the second was his repudiation of the alleged agreement for the allotment of more shares.

### **6.3.2 *The judgment at first instance:***

The trial judge rejected these allegations and dismissed the petition on two grounds.<sup>16</sup> The first ground was that it failed on the facts. Mr. Phillips had not committed himself permanently and unconditionally to an equal sharing of profits and Mr. O'Neill's expectation was to receive 50 per cent profits while he acted as managing director.<sup>17</sup> If circumstances changed, Mr. Phillips was entitled as controlling shareholder to redraw his responsibilities and remuneration.<sup>18</sup> He had made no commitment which made it unfair for him to exercise this power, likewise in the case of the additional shares.<sup>19</sup> The matter had never gone beyond negotiation and Mr. Phillips had made no legally binding promises. It was therefore not unfair for him to retain and conduct the business on the basis of his majority holding.<sup>20</sup>

Secondly the judge dismissed the petition since the alleged prejudice to Mr. O'Neill's interests was not suffered in his capacity as a member of the company. The profit-share was his remuneration for acting as managing director and the additional shares, likewise a reward and incentive for working for the company. They did not derive from his previously having a 25% shareholding which also had been a reward for his services as an employee. Mr. O'Neill's membership of the company was therefore irrelevant to the expectations which he claimed it would be unfair to deny. They would have been exactly the same if he had not previously held any shares at all.<sup>21</sup> Mr. O'Neill appealed from the

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<sup>16</sup> See *Re a Company (No 00709 of 1992)* [1997] 2 BCLC 739, per J Paul Baker QC sitting as a judge of the High Court. The facts were also stated in the judgment of the House of Lords in *O'Neill v Phillips* [1999] 2 BCLC 1.

<sup>17</sup> See *Re a Company (No 00709 of 1992)* [1997] 2 BCLC 739, 758.

<sup>18</sup> See *Re a Company (No 00709 of 1992)* [1997] 2 BCLC 739, 758.

<sup>19</sup> See *Re a Company (No 00709 of 1992)* [1997] 2 BCLC 739, 748.

<sup>20</sup> See *O'Neill v Phillips* [1999] 2 BCLC 1, 6.

<sup>21</sup> See *Re a Company (No 00709 of 1992)* [1997] 2 BCLC 739, 758-759. See also *O'Neill v Phillips* [1999] 2 BCLC 1, 6.

order of the trial judge and sought an order for the purchase of his shares in the company by Mr. Phillips on the basis of his unfairly prejudicial conduct.

### ***6.3.3 The Court of Appeal:***

The Court of Appeal allowed the appeal and ordered Mr. Phillips to buy Mr. O'Neill's shares.<sup>22</sup> Nourse LJ delivering the judgment for the court held that although there was no concluded agreement about giving him more shares, Mr. O'Neill had a 'legitimate expectation' that he would receive them when the targets were reached. If this expectation had been fulfilled his entitlement at the first stage to 50 per cent of the shares would have replaced his entitlement to 50 per cent of the profits, to whose receipt he had a legitimate expectation in the meantime.<sup>23</sup> The Court of Appeal held that Mr. Phillips "was not justified: first, in determining Mr. O'Neill's entitlement to the additional 25 per cent of the profits and with it his expectation of receiving further shares in the company".<sup>24</sup> The denial of Mr. O'Neill's expectations without an offer to buy his shares at a fair value was therefore unfairly prejudicial to the interests of O'Neill as a member of the company.<sup>25</sup> Furthermore due to denial of his legitimate expectations, Mr. O'Neill had been in effect forced out of the company. He could no longer be expected to remain with the company and was bound to engage himself elsewhere due to a kind of constructive expulsion.<sup>26</sup> The court did not consider he had been wrong to set up a competing business in Germany since Mr. O'Neill had not entered into any covenant with the company not to compete after he left its employment.<sup>27</sup> The court rejected the argument that O'Neill had acted unreasonably by refusing an offer for shares, since the offer did not include his costs.<sup>28</sup> Mr. Phillips appealed to the House of Lords against the decision of the Court of Appeal that his conduct was unfairly prejudicial to the interests of Mr. O'Neill. Below the judgment of the House of Lords is considered. It is argued that the House of Lords decision has clarified the boundaries of the legal concept of 'unfair prejudice' and enhanced legal certainty.

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<sup>22</sup> *Re Pectel Ltd* [1998] BCC 405.

<sup>23</sup> *Re Pectel Ltd* [1998] BCC 405, 412.

<sup>24</sup> *Re Pectel Ltd* [1998] BCC 405, 415.

<sup>25</sup> *Re Pectel Ltd* [1998] BCC 405, 413-415.

<sup>26</sup> See *O'Neill v Phillips* [1999] 2 BCLC 1, 7.

<sup>27</sup> *Re Pectel Ltd* [1998] BCC 405, 415.

<sup>28</sup> *Re Pectel Ltd* [1998] BCC 405, 416.

### ***6.3.4 The judgment of the House of Lords:***

Section 459 of the CA 1985 was considered for the first time by the House of Lords in *O'Neill v Phillips*.<sup>29</sup> The House of Lords unanimously allowed the appeal of Mr. Phillips. In a speech unanimously endorsed by his fellow Law Lords, Lord Hoffmann<sup>30</sup> agreed with the Court of Appeal that the company had the characteristics identified by Lord Wilberforce in *Ebrahimi v Westbourne Galleries Ltd*,<sup>31</sup> as commonly giving rise to equitable restraints upon the exercise of powers under the articles. It followed that it would have been unfair of Mr. Phillips to use his voting powers under the articles to remove Mr. O'Neill from participation in the conduct of the business without giving him the opportunity to sell his interest in the company at a fair price. Mr. O'Neill first received the shares as a gift and as an incentive. In making that gift Mr. Phillips did not surrender his right to dismiss Mr. O'Neill from the management without making him an offer for the shares. Mr. O'Neill was simply an employee who happened to have been given some shares but over the following years the relationship changed. Mr. O'Neill invested his own profits in the company and worked to build up the company's business. Lord Hoffmann stated that *Re H R Harmer Ltd*,<sup>32</sup> showed that shareholders who receive their shares as a gift but afterwards work in the business might become entitled to enforce equitable restraints upon the conduct of the majority shareholder.<sup>33</sup>

Lord Hoffmann further stated that the difficulty for Mr. O'Neill was that Mr. Phillips did not exclude him from participation in the management of the business. After the meeting he remained a director and continued to earn his salary as a manager of the business in Germany. The Court of Appeal held that he had been constructively removed by the behaviour of Mr. Phillips in the matter of equality of profits and shareholdings. So the question then was, whether Mr. Phillips acted unfairly in respect of these matters. The Court of Appeal said that Mr. O'Neill had a legitimate expectation of being allotted more

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<sup>29</sup> [1999] 2 BCLC 1.

<sup>30</sup> Lord Hoffmann throughout his judicial career has played a leading role in the development of unfair prejudice remedy. See Goddard R., 'Taming the Unfair Prejudice Remedy: Section 459-461 of the Companies Act 1985 in the House of Lords' (1999) 58(3) Cambridge Law Journal 487, 487.

<sup>31</sup> [1972] 2 All ER 492, 500. See also above chapter 5 para 5.5.1.3.1 Meaning of unfairness, (iii) Legitimate expectations of shareholders.

<sup>32</sup> [1958] 3 All ER 689.

<sup>33</sup> [1999] 2 BCLC 1, 12.

shares when the targets were met. No doubt it was legitimate or reasonable, in the sense that it reasonably appeared likely to happen. Mr. Phillips had agreed in principle, subject to the execution of a suitable document. Lord Hoffmann stated that here the Court of Appeal might have been misled by the expression 'legitimate expectation'. The real question was whether in fairness or equity Mr. O'Neill had a right to receive the additional shares. Lord Hoffmann stated that Mr. Phillips had never formally agreed to allot them and had made no legally binding promise on the point. It seemed to follow that there was no basis consistent with established principles of equity, for a court to hold that Mr. Phillips was behaving unfairly in withdrawing from the negotiation. This would not be restraining the exercise of legal rights but would be imposing upon Mr. Phillips an obligation to which he never formally agreed. On the facts the parties had entered into negotiations with a view to a transfer of shares on professional advice and subject to a condition that they were not to be bound until a formal document had been executed. It was not possible to say that an obligation had arisen in fairness or equity at an earlier stage.<sup>34</sup>

Lord Hoffmann held that the same reasoning applied to the sharing of profits. Mr. Phillips had said informally that he would share the profits equally while Mr. O'Neill managed the company and he himself was not involved in day-to-day business. He deliberately retained control of the company and with it the right to redraw Mr. O'Neill's responsibilities. The consequence was that he came back to run the business and Mr. O'Neill ceased to be managing director. Mr. Phillips had made no promise to share the profits equally in such circumstances and it was therefore not inequitable or unfair for him to refuse to carry on doing so. The Court of Appeal seemed to have contemplated that Mr. Phillips might have been entitled to do what he did if he had given Mr. O'Neill notice of his intentions and treated him more politely at the meeting. These matters could not affect the question of whether a change in the profit-sharing arrangements was a breach of good faith. It followed that there was no basis for the Court of Appeal's finding that Mr. O'Neill had been driven out of the company. Mr. O'Neill might have decided that he had lost confidence in Mr. Phillips and that he could no longer work with

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<sup>34</sup> [1999] 2 BCLC 1, 12-13.

him but his decision was not the result of anything wrong or unfair which Mr. Phillips had done.<sup>35</sup>

#### *6.3.4.1 Capacity in which prejudice is suffered:*

As to the capacity in which prejudice is suffered, Lord Hoffmann stated that assuming there had been a contractual obligation, once Mr. O'Neill had invested his own money and effort in the company, his position might have changed from employee to shareholder. A promise to give Mr. O'Neill more shares or a larger share in the profits might well have been based not merely upon his position as an employee but on the fact that he already had a stake in the company. Lord Hoffmann referred to cases like *R & H Electric Ltd v Haden Bill Electrical Ltd*<sup>36</sup> which showed, the requirement that prejudice must be suffered as a member should not be too narrowly or technically construed.<sup>37</sup> But the point did not arise because no promise was made. Below the chapter considers the developments made by *O'Neill v Phillips* and other case law.

### **6.4 Developments introduced by *O'Neill v Phillips*:**

Lord Hoffmann's speech in *O'Neill v Phillips* developed the law in relation to the unfair prejudice remedy in a number of important ways. I turn now to discuss these developments.

#### ***6.4.1 The reasoning behind the judicial shift in emphasis from 'legitimate expectations' to 'equitable considerations':***<sup>38</sup>

Lord Hoffmann's speech shifted the focus from the term 'legitimate expectations' to 'equitable considerations' as a touchstone for establishing unfairness in section 459 cases. In certain circumstances the exercise of a company's strict legal rights may be subject to and qualified by equitable considerations. Emphasis upon equitable considerations flows from *Ebrahimi* and had been imported into section 459 jurisdiction

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<sup>35</sup> [1999] 2 BCLC 1, 13.

<sup>36</sup> [1995] 2 BCLC 280.

<sup>37</sup> See also above para 6.3.2 The judgment at first instance. Lord Hoffmann agreed with the trial judge as to the outcome but did not support all of his reasoning.

<sup>38</sup> See also above chapter 5 para 5.5.1.3.1 Meaning of unfairness, (iii) Legitimate expectations of shareholders.

in the 1980s as is clear from the previous chapter.<sup>39</sup> Lord Hoffmann stated that Parliament had chosen fairness as the criterion by which the court must decide whether it had jurisdiction to grant relief under section 459. Parliament chose this concept to confer a wide power to do what appeared just and equitable and to free the court from technical considerations of legal rights. Equally, however, it did not mean that the court can do whatever the individual judge thought to be fair. The concept of fairness must be applied judicially and the content it was given by the courts must be based upon rational principles of law and equity.

Lord Hoffmann stated that in *Re Saul D Harrison & Sons plc*<sup>40</sup> the term 'legitimate expectation', was used by him as a label for the 'correlative right' to which a relationship between company members might give rise in a case where, on equitable principles, it would be regarded as unfair for a majority to exercise a power conferred upon them by the articles (or the general company law) to the prejudice of another member. Lord Hoffmann amplified the point as follows:

I gave as an example the standard case in which shareholders have entered into association upon the understanding that each of them who has ventured his capital will also participate in the management of the company. In such a case it will usually be considered unjust, inequitable or unfair for a majority to use their voting power to exclude a member from participation in the management without giving him the opportunity to remove his capital upon reasonable terms. The aggrieved member could be said to have had a 'legitimate expectation' that he would be able to participate in the management or withdraw from the company.

Lord Hoffmann then stated that it had probably been a mistake on his part to coin the term 'legitimate expectations'. In saying that it was 'correlative' to the equitable restraint, it was meant that it could exist only when equitable principles of the kind that had been described would make it unfair for a party to exercise rights under the articles: "it is a consequence, not a cause, of the equitable restraint".<sup>41</sup> Endorsing the view of Warner J<sup>42</sup> that "The court ... has a very wide discretion, but it does not sit under a palm tree", Lord Hoffmann stressed that:

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<sup>39</sup> See above chapter 5 para 5.5.1.3.1 Meaning of unfairness, (iii) Legitimate expectations of shareholders.

<sup>40</sup> [1995] 1 BCLC 14, 19.

<sup>41</sup> See also Prentice D. and Payne J., 'Section 459 of the Companies Act 1985 – the House of Lords' View' (1999) 115 Law Quarterly Review 587.

<sup>42</sup> *Re J E Cade & Son Ltd* [1992] BCLC 213, 227.

The concept of a legitimate expectation should not be allowed to lead a life of its own, capable of giving rise to equitable restraints in circumstances to which the traditional equitable principles have no application.<sup>43</sup>

He considered that this is exactly what seemed to have happened in the Court of Appeal *O'Neill v Phillips*. Fairness was a notion which could be applied to all kinds of activities and its content would depend upon the context in which it was being used. Conduct which was perfectly fair between competing businessmen might not be fair between members of a family. The context and background were very important.<sup>44</sup>

Lord Hoffmann discussed two features behind the formation of the company. A company was an association of persons for an economic purpose. The manner in which the affairs of the company might be conducted was closely regulated by rules to which the shareholders had agreed.<sup>45</sup> Secondly, company law had developed seamlessly from the law of partnership, which was treated by equity, like the Roman *societas*, as a contract of good faith. One of the traditional roles of equity, as a separate jurisdiction, was to restrain the exercise of strict legal rights in certain relationships in which it considered that this would be contrary to good faith. These principles had, with appropriate modification, been carried over into company law.<sup>46</sup>

Effectively recasting the test for 'unfair prejudice' that had been put forward in *Re Saul D Harrison*,<sup>47</sup> Lord Hoffmann developed the analysis as follows:

The first of these two features leads to the conclusion that a member of a company will not ordinarily be entitled to complain of unfairness unless there has been some breach of the terms on which he agreed that the affairs of the company should be conducted. But the second leads to the conclusion that there will be cases in which equitable considerations make it unfair for those conducting the affairs of the company to rely upon their strict legal powers. Thus unfairness may consist in a breach of the rules or in using the rules in a manner which equity would regard as contrary to good faith.<sup>48</sup>

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<sup>43</sup> [1999] 2 BCLC 1, 11.

<sup>44</sup> See *O'Neill v Phillips* [1999] 2 BCLC 1, 7.

<sup>45</sup> Such as rights provided under articles of association, shareholders' agreements and statutes.

<sup>46</sup> [1999] 2 BCLC 1, 7.

<sup>47</sup> See above chapter 5 paras 5.5.1.3 Unfair prejudice to membership interests and 5.5.1.3.1 Meaning of unfairness.

<sup>48</sup> [1999] 2 BCLC 1, 8. Such as a right to participate in the management of the company in quasi-partnership companies.



Lord Hoffmann applied the same reasoning to the concept of unfairness under section 459 as was applied by Lord Wilberforce in *Ebrahimi v Westbourne Galleries Ltd*<sup>49</sup> for winding up a company. Lord Hoffmann quoted Lord Wilberforce in *Ebrahimi v Westbourne Galleries Ltd*<sup>50</sup> who after referring to cases on the equitable jurisdiction to require partners to exercise their powers in good faith said that:

The 'just and equitable' provision does not entitle one party to disregard the obligation he assumes by entering a company, nor the court to dispense him from it. It does, as equity always does, enable the court to subject the exercise of legal rights to equitable considerations; considerations, that is, of a personal character arising between one individual and another, which may make it unjust, or inequitable, to insist on legal rights, or to exercise them in a particular way.

Most importantly Lord Hoffmann stated that "a balance has to be struck between the breadth of the discretion given to the court and the principle of legal certainty".<sup>51</sup> Petitions under section 459 were often lengthy and expensive. Therefore, certainty was highly desirable to identify some principles, in the light of which lawyers should be able to advise their clients whether or not a petition was likely to succeed. Lord Hoffmann stated "the way in which such equitable principles operate is tolerably well settled and it would be wrong to abandon them in favour of some wholly indefinite notion of fairness".<sup>52</sup> Lord Hoffmann referred to an example of such equitable principles in action in *Blisset v Daniel*<sup>53</sup> a case to which Lord Wilberforce had referred in *Ebrahimi v Westbourne Galleries Ltd*<sup>54</sup> where it was held that "upon the true construction of the articles, two-thirds of the partners could expel a partner by serving a notice upon him without holding any meeting or giving any reason" but "the power must be exercised in good faith".<sup>55</sup> Lord Hoffmann cited some references to contrast the 'the literal construction of the articles' with good faith and 'the plain meaning of the deed' and 'what the parties can fairly have had in contemplation'. Nineteenth century English law, with its division between law and equity, traditionally took the view that while literal

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<sup>49</sup> [1972] 2 All ER 492, 500.

<sup>50</sup> [1972] 2 All ER 492, 500.

<sup>51</sup> [1999] 2 BCLC 1 at 8. See also Hanlon J., 'The Protection of Minority Interests in Company Law' (2001) 35(1) Law Teach 83.

<sup>52</sup> [1999] 2 BCLC 1, 8-9.

<sup>53</sup> (1853) 10 Hare 493.

<sup>54</sup> [1972] 2 All ER 492, 501.

<sup>55</sup> [1999] 2 BCLC 1, 9.

meanings might prevail in a court of law, equity could give effect to what it considered to have been the true intentions of the parties by preventing or restraining the exercise of legal rights.<sup>56</sup>

In *O'Neill v Phillips*, Lord Hoffmann agreed with Jonathan Parker J in *Re Astec (BSR) plc*<sup>57</sup> that:

... in order to give rise to an equitable constraint based on “legitimate expectation” what is required is a personal relationship or personal dealings of some kind between the party seeking to exercise the legal right and the party seeking to restrain such exercise, such as will affect the conscience of the former.

Lord Hoffmann stated that one useful cross-check in a case like this was to ask whether the exercise of the power in question would be contrary to what the parties, by words or conduct, have actually agreed. In *Blisset v Daniel* the limits were found in the ‘general meaning’ of the partnership articles themselves. In a quasi-partnership company, these limits would usually be found in the understandings between the members at the time they entered into association. Moreover, there might be later promises, by words or conduct, which it would be unfair to allow a member to ignore. A promise might be binding as a matter of justice and equity although would not be enforceable in law.<sup>58</sup>

Lord Hoffmann added that exercising rights in breach of some promise or undertaking was not the only form of conduct which would be regarded as unfair for the purposes of section 459. There might be some event which puts an end to the basis upon which the parties entered into association with each other, making it unfair that one shareholder should insist upon the continuance of the association. The unfairness might arise not from what the parties had positively agreed but from a majority using its legal powers to maintain the association in circumstances to which the minority could reasonably say it did not agree. Lord Hoffmann stated that this form of unfairness was also based upon established equitable principles but had not arisen on the facts in *O'Neill v Phillips*.<sup>59</sup>

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<sup>56</sup> [1999] 2 BCLC 1, 10.

<sup>57</sup> [1998] 2 BCLC 556, 588.

<sup>58</sup> [1999] 2 BCLC 1, 10-11.

<sup>59</sup> [1999] 2 BCLC 1, 11.

Lord Hoffmann also discussed two other interesting and significant issues namely, the possibility of ‘exit at will’ also known as ‘no-fault divorce’ in private companies and the scope of early offers to buy-out in shareholder disputes along with the provision of guidelines as to making fair offers. These developments have important implications for section 459 practice and therefore are discussed below.

#### **6.4.2 No right of unilateral withdrawal or ‘exit at will’:**

Lord Hoffmann stated that Mr. O'Neill claimed that the trust and confidence between the parties had broken down and that was accepted by Mr. Phillips. It was obvious that there ought to be a parting of the ways on the facts. Even if Mr. Phillips had not done anything unfair that caused the relational breakdown it would be unfair to leave Mr. O'Neill locked into the company as a minority shareholder. It was submitted on Mr. O'Neill's behalf that, in a quasi-partnership company where the relationship between the quasi-partners has broken down, one partner ought to be entitled at will to require the other partner or partners to buy his shares at a fair value. In the present case trust and confidence broke down *inter alia* because Mr. Phillips failed to do certain things which, on the judge's findings, he had never promised to do. Lord Hoffmann stated there was no support in the authorities for such a stark right of unilateral withdrawal.<sup>60</sup> He referred to his own judgment in *Re a Company (No 006834 of 1988), ex p Kremer*<sup>61</sup> and stated that if a breakdown in relations had caused the majority to remove a shareholder from participation in the management it was not fair to the excluded member, who usually lost his employment, to keep his investment locked in the company. It did not mean that a member who had not been dismissed or excluded could demand buy-out simply because he felt that he had lost trust and confidence in the others.

In fact, Lord Hoffmann supported the Law Commission's view that ‘exit at will’ should not be permitted.<sup>62</sup> Lord Hoffmann stated that the Law Commission had not recommended the introduction of a statutory remedy in situations where there is no fault,

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<sup>60</sup> [1999] 2 BCLC 1, 13.

<sup>61</sup> [1989] BCLC 365.

<sup>62</sup> [1999] 2 BCLC 1, 14 and *The Law Commission's Report* [3.66].

so that members of a quasi-partnership could exit at will. The Law Commission stated that:

In our view there are strong economic arguments against allowing shareholders to exit at will. Also, as a matter of principle, such a right would fundamentally contravene the sanctity of the contract binding the members and the company which we considered should guide our approach to shareholder remedies.<sup>63</sup>

Lord Hoffmann agreed with the Law Commission view where they plainly did not consider that section 459 already provided a right to exit at will.<sup>64</sup>

Lord Hoffmann in *O'Neill v Phillips* does not recognise a right of unilateral withdrawal on the basis that the minority has lost trust and confidence in the majority. However, Lord Hoffmann stated that if the exclusion from management occurred due to a breakdown of the parties' personal relationship then it is usually a waste of time to try to investigate who caused the breakdown. Such breakdowns often occur without either side having done anything seriously wrong or unfair.<sup>65</sup> Lord Hoffmann acknowledged the right to exit at breakdown of the personal relationship of shareholders that caused exclusion from management. In the later case of *Grace v Biagioli*<sup>66</sup> the Court of Appeal clearly stated that from Lord Hoffmann's speech it could be deduced that it was not enough merely to show that the relationship between the parties has irretrievably broken down. There was no right of unilateral withdrawal for a shareholder when trust and confidence between shareholders no longer exist. However, it was different if that breakdown in relations then causes the majority to exclude the petitioner from the management of the company or otherwise to cause him prejudice in his capacity as a shareholder (in other words, engages in some form of squeeze-out behaviour).

#### **6.4.3 A fair offer to buy-out:**

It was submitted on behalf of Mr. Phillips that even if (which was denied) his conduct was unfairly prejudicial, the petition should have been dismissed because he had made an offer to buy the shares at a fair price and this was the whole of the relief to which Mr.

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<sup>63</sup> *The Law Commission's Report* [3.66].

<sup>64</sup> [1999] 2 BCLC 1, 14.

<sup>65</sup> *O'Neill v Phillips* [1999] 2 BCLC 1, 12-13.

<sup>66</sup> [2005] EWCA Civ 1222; [2006] 2 BCLC 70; [2006] BCC 85, para 61.

O'Neill would have been entitled. Lord Hoffmann stated that in the absence of unfair prejudice this point did not need to be decided, in other words the relationship had broken down but O'Neill had not been excluded from management. But Lord Hoffmann considered the effect of an offer to buy the shares as an answer to a petition under section 459, due to its great practical importance.

In fact the points of defence contained no offer to buy but later Mr. Phillips made an offer to buy Mr. O'Neill's shares at a price to be agreed or in default of agreement to be fixed by a chartered accountant as valuer on the basis that the value was one-quarter of the fair value of the entire issued share capital (*pro rata* valuation). The offer was rejected *inter alia* on the basis that it made no provision for Mr. O'Neill's litigation costs since presentation of the petition. Therefore the petition went to a full hearing. The trial judge dismissed the petition and did not find it necessary to deal with the offer. The Court of Appeal accepted the argument that rejection of offer was justified because it did not provide for Mr. O'Neill's costs.

The House of Lords also agreed that the offer was inadequate. Lord Hoffmann stated that if the petitioner was offered everything to which he had been held entitled, the respondent might as in the case of a *Calderbank* letter<sup>67</sup> be entitled to say that the costs after the date of the offer should be borne by the successful petitioner, who ought to have accepted the offer and brought the litigation to an end. On the other hand, a petition that was contested for nearly three years by a petitioner who had a *prima facie* case would not obtain everything to which he was entitled unless there was an offer of costs.<sup>68</sup>

Lord Hoffmann stated that Mr. Phillips had fought the petition to the end and he was justified in doing so. But where personal relationships have broken down "parties ought to be encouraged, where at all possible, to avoid the expense of money and spirit

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<sup>67</sup> *Calderbank v Calderbank* [1975] 3 All ER 333.

<sup>68</sup> [1999] 2 BCLC 1, 15-16.

inevitably involved in such litigation by making an offer to purchase at an early stage”<sup>69</sup> which supports early settlement of these disputes.<sup>70</sup> Lord Hoffmann stated that this was a somewhat unusual case in that Mr. Phillips, despite his revised views about Mr. O'Neill's competence, was willing to go on working with him. So the court did not accept that Mr. O'Neill was excluded by Mr. Phillips from the company. Lord Hoffmann further stated that the majority shareholder was entitled to take this position, even if only because he might consider it less unattractive than having to raise the capital to buy out the minority. Usually in these types of cases, the majority shareholder would want to put an end to the association. In such a case, it would almost always be unfair for the minority shareholder to be excluded without an offer to buy his shares.<sup>71</sup> Therefore if the majority is willing to work with the minority, the minority shareholder cannot exit at will but if the majority is not willing to continue the association then it is unfair if the minority is excluded from the company without a fair offer to buy-out.

Lord Hoffmann referred to the Law Commission's recommendation<sup>72</sup> that in a private company limited by shares in which substantially all the members were directors, there should be a statutory presumption that the removal of a shareholder as a director, was unfairly prejudicial conduct. This did not seem to him to be very different in practice from the present law. In *O'Neill v Phillips*, Lord Hoffmann stated that if the breakdown in the relationship has caused the majority shareholders to exclude the minority from participation in the management of the company, it is unfair to the excluded member who will usually have lost his employment, to keep his assets locked in the company. Therefore in this situation his shareholding should be purchased by the majority shareholders. Lord Hoffmann stated that “unfairness does not lie in the exclusion from management alone but in exclusion without a reasonable offer. If the respondent to a

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<sup>69</sup> [1999] 2 BCLC 1, 16.

<sup>70</sup> *O'Neill v Phillips* [1999] 2 BCLC 1, 12-13, 15-16.

<sup>71</sup> [1999] 2 BCLC 1, 16.

<sup>72</sup> *The Law Commission's Report* paras 3.26 to 3.56 as quoted in *O'Neill v Phillips* [1999] 2 BCLC 1, 16.

petition has plainly made a reasonable offer, then the exclusion as such will not be unfairly prejudicial and he will be entitled to have the petition struck out”.<sup>73</sup>

### **6.5 Evaluation of the impact of case law developments:**

As discussed above, the leading case in this area was *O’Neill v Phillips*. The impact of the judgment in *O’Neill v Phillips* is twofold. First it discontinues the previous concept of ‘legitimate expectations’ in section 459 cases by wholly absorbing it within the scope of ‘equitable considerations’. Second the judgment articulates, endorses and reinforces a number of existing tendencies within section 459 law and practice namely, that (i) exit at will is not permitted to minority shareholders in private companies and (ii) early fair offers to buy-out the minority are perceived as an appropriate way of settling shareholder disputes with the consequence that the court may strike out the petition if it considers that a fair offer (including costs) has been made to purchase the petitioner’s shares. In addition, Lord Hoffmann also set out guidelines regarding the early fair offers to buy-out, to settle the shareholder dispute. Therefore, *O’Neill* deals with both substance (meaning of ‘unfairness’) and process (encouragement of early offers) of section 459 proceedings. Along with substance this chapter discusses the impact of *O’Neill* upon the process; however the wider discussion regarding the procedural change is reserved for the next chapter. A couple of other cases also have an impact upon section 459 proceedings which are discussed below.

Interviewees acknowledged the presence of the problems identified by the courts and the Law Commission i.e., length, costs and complexity of the section 459 proceedings along with burgeoning case load upon courts.<sup>74</sup> Their general view was that the legal developments discussed in this chapter had had an impact upon section 459 practice and affected the way in which they and the courts dealt with section 459 cases. The strong consensus was that *O’Neill v Phillips*<sup>75</sup> and *Grace v Biagioli*<sup>76</sup> were particularly

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<sup>73</sup> *O’Neill v Phillips* [1999] 2 BCLC 1, 16. See below paras 6.5.2.2 Early fair offers to buy-out and 6.5.2.3 Fair valuation of shares at offer to buy-out, for problems associated with making a fair offer and what constitutes a fair offer.

<sup>74</sup> See above chapter 5 para 5.6.2 The Law Commission’s critique of section 459 of the CA 1985.

<sup>75</sup> *O’Neill v Phillips* [1999] 2 BCLC 1.

<sup>76</sup> *Grace v Biagioli* [2006] 2 BCLC 70.

significant developments in terms of their practical implications because they had enhanced legal certainty regarding the application of statutory minority protection remedy and by declaring buy-out after fair valuation as the most appropriate form of relief in shareholder disputes.

*O'Neill v Phillips* was probably the leading case which had the most impact in the area [M].

Interviewees as a whole stated that *O'Neill v Phillips* played the role (i) by controlling the conduct of section 459 proceedings, it restricted the scope of the section and concluded that to prove unfairly prejudicial conduct there must be some breach of agreed terms, that enhanced the certainty of the provision and (ii) by reinforcing the already prevailing practices in the area it encouraged offers to buy-out at an early stage to avoid time and expense involved in the litigation [B, C, H, J].

Interviewees considered that the substantive law developments – especially *O'Neill v Phillips* – had had a greater impact than the procedural developments discussed in the next chapter. Interviewee E stated that:

The CPR was less significant for section 459 proceedings and *O'Neill v Phillips* had done more [E].

Below the chapter discusses the nature and especially the impact of the case law developments in this area of legal practice. Discussion includes the impact of the discontinuation of the concept of legitimate expectations and continuation of the prevailing practices in the light of the analysis of the case law and the interviewees' responses.

### ***6.5.1 Impact of discontinuation of the concept of legitimate expectations:***

Lord Hoffmann, who has played an important role in developing the remedy into its present state,<sup>77</sup> while delivering the significant judgment in *O'Neill v Phillips*, he clarified the meaning of unfairness in the context of section 459 cases.<sup>78</sup> Indeed in

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<sup>77</sup> See cases like *Re a Company* [1986] BCLC 376, in the Court of Appeal see *Re Saul D Harrison* [1995] 1 BCLC 14 and later in the House of Lords in *O'Neill v Phillips* [1999] 2 BCLC 1, discussed here.

<sup>78</sup> See above chapter 5 para 5.5.1.3.1 Meaning of unfairness.



*O'Neill v Phillips* Lord Hoffmann has taken some positive steps to curb the width of the jurisdiction by narrowing and recasting the concept of 'legitimate expectations' regarding the affairs of the company.<sup>79</sup> Lord Hoffmann repudiated the way that the Court of Appeal had broadly exploited the term 'legitimate expectations' and stated that the 'equitable considerations' must be the basis of the 'legitimate expectations' of shareholders. Clark stated that the Court of Appeal's approach had widened the scope of 'legitimate expectations' in a way that threatened to shift the balance too far in favour of minority shareholders and beyond that which the legislature had intended.<sup>80</sup> Tilting the balance towards minority shareholders leads to the risk that the unfair prejudice remedy will become an instrument of oppression in their hands which, in turn, may subsequently demand a more restrictive approach towards the availability of the remedy.<sup>81</sup> It was mentioned that there was a "risk that section 459 might be abused by shareholders using the threat of litigation as an unfair bargaining tool".<sup>82</sup> Furthermore, as Clark stated that the House of Lords' repudiation of the liberal stance of the Court of Appeal might allay the fears that such stance might open the floodgates for section 459 petitions.<sup>83</sup>

Section 459 could be invoked where the bargain was reached by the shareholders by informal and non-legally enforceable understandings between the shareholders rather than in the company's formal constitution.<sup>84</sup> In fact, Lord Hoffmann in *O'Neill v Phillips* by supporting the contractual relationship<sup>85</sup> of the parties stated that, to prove unfair prejudicial conduct, minority shareholders have to show that there is some breach of their formal (legally binding) or informal (binding under equity) rights.<sup>86</sup> In *Grace v*

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<sup>79</sup> The concept of 'legitimate expectations' was used by Lord Hoffmann himself in *Re Saul D Harrison & Sons plc* [1995] 1 BCLC 14, 19 and which he considered a mistake in *O'Neill v Phillips* [1999] 2 BCLC 1, 12. See above para 6.4.1.

<sup>80</sup> See Clark B., 'Unfairly Prejudicial Conduct' (1999) 38 Scots Law Times 321, 323.

<sup>81</sup> As in *Rock Ltd v RCO Holdings Ltd* [2004] BCC 466, 477 it was stated that "it is difficult to see how this petition can be described as anything other than an instrument of oppression". See above para 5.6.2.1 Wide scope of the section.

<sup>82</sup> Roberts, P., and Poole J., 'Shareholders Remedies- Efficient Litigation and the Unfair Prejudice Remedy' (1999) *Journal of Business Law* 38, 47.

<sup>83</sup> See Clark B., 'Unfairly Prejudicial Conduct' (1999) 38 Scots Law Times 321, 323.

<sup>84</sup> Payne J., 'Sections 459-461 Companies Act 1985 in Flux: The Future of Shareholder Protection' (2005) 64(3) *Cambridge Law Journal* 647, 649.

<sup>85</sup> See chapter 4 above for discussion regarding contractual relationship of shareholders to prevent and resolve minority shareholders disputes in private companies.

<sup>86</sup> *O'Neill v Phillips* [1999] 2 BCLC 1, 9.

*Biagioli*<sup>87</sup> the Court of Appeal by referring to *O'Neill v Phillips* stated, members' rights and obligations in the articles of association and any collateral agreements were subject to established equitable principles which might moderate the exercise of strict legal rights when insistence on the enforcement of such rights would be unconscionable.

*O'Neill v Phillips* was also applied in *Re Guidezone Ltd*<sup>88</sup> where Parker J held that 'unfairness' for the purposes of section 459 was not to be judged by reference to subjective notions of fairness, but rather by testing whether, applying established equitable principles, the majority had acted, or was proposing to act, in a manner which equity would regard as contrary to good faith. In the case of the quasi partnership company, exclusion of the minority from participation in the management of the company contrary to the agreement or understanding on the basis of which the company was formed was a clear example of conduct by the majority which equity regards as contrary to good faith.<sup>89</sup> Furthermore it was stated that applying traditional equitable principles, equity would not hold the majority to an agreement, promise or understanding which was not enforceable at law unless and until the minority had acted relying on it.<sup>90</sup>

As discussed in the previous chapter, section 459 of CA 1985 confers on the judiciary extensive discretion, in determining both the scope of the section and the relief to be ordered under section 461 if the petition is successful.<sup>91</sup> Lord Hoffmann referred to the concern expressed by the Law Commission in its report<sup>92</sup> and emphasized that balance is required between the discretion of the court and the principle of legal certainty".<sup>93</sup> From a wider practical perspective, Cheung considered it a step in the right direction to the

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<sup>87</sup> [2006] 2 BCLC 70; [2005] EWCA Civ 1222, [2006] BCC 85, para 61

<sup>88</sup> [2000] 2 BCLC 321.

<sup>89</sup> [2000] 2 BCLC 321, 355-356.

<sup>90</sup> [2000] 2 BCLC 321, 356.

<sup>91</sup> See Roberts, P., and Poole J., 'Shareholders Remedies- Efficient Litigation and the Unfair Prejudice Remedy' (1999) *Journal of Business Law* 38, 40.

<sup>92</sup> See above chapter 5, para 5.6.2 The Law Commission's critique of section 459 of the CA 1985 and the Law Commission Report para 4.11.

<sup>93</sup> [1999] 2 BCLC 1, 8. See also Hanlon J., 'The Protection of Minority Interests in Company Law' (2001) 35(1) *Law Teach* 83.

future development of the remedy in light of the burgeoning case law on sections.<sup>94</sup> It has been questioned whether in seeking to balance certainty and discretion, Lord Hoffmann in *O'Neill v Phillips* placed too much emphasis upon legal certainty<sup>95</sup> and, more generally, whether that balance has been appropriately struck.<sup>96</sup> The emphasis on contract and traditional equitable principles combined with the restriction of the concept of legitimate expectations would no doubt give rise to greater certainty as to the application of provisions under section 459-461 of CA 1985. In fact, the wide scope of the section leads to uncertainty and move towards greater certainty runs risk that section 459 ends up not doing the job that the Jenkins Committee envisaged.<sup>97</sup>

In 2000 the Company Law Review (CLR)<sup>98</sup> explained that in the view of its members the effect of the decision was that to sustain an action for unfair prejudice in reliance on some claim other than a breach of the articles or some other breach of duty, a member must show breach of some sort of agreement, based on words or conduct, which made it inequitable to confine him to his strict rights under the articles. It was mentioned that most respondents to the CLR's consultation favoured removing this constraint and allowing any case to be brought which raised an argument that the claimant had been prejudiced unfairly on its particular facts, whether or not an agreement of some kind had been breached.<sup>99</sup>

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<sup>94</sup> Cheung R., 'The Statutory Unfair Prejudice Remedy in Hong Kong: Part 3' (2008) 29(11) *Company Lawyer* 346, 347.

<sup>95</sup> Goddard R., 'Taming the Unfair Prejudice Remedy: Section 459-461 of the Companies Act 1985 in the House of Lords' (1999) 58(3) *Cambridge Law Journal* 487, 490.

<sup>96</sup> Copp S., 'Company Law: Individual Shareholder Rights' (2000) 11(1) *International Company and Commercial Law Review* N6-8, N7-N8.

<sup>97</sup> See above chapter 5 para 5.6.2.1 Wide scope of the section.

<sup>98</sup> See Company Law Review 'Modern company law for a competitive economy: completing the structure' (Company Law Review Steering Group, URN 00/1335, Nov 2000) A consultation document from the Company Law Review Steering Group. Chapter 5, Corporate Governance: Shares and Shareholders.

<sup>99</sup> See *ibid* [5.77].

Notwithstanding these responses, the CLR concluded that the *O’Neill* ruling ought not to be reversed:

The effect of the unfair prejudice claim being unlimited is to lead to all manner of factual allegations being potentially admissible, which encourages the widest possible range of evidence being adduced to assemble a case of unfairness. This makes proceedings lengthy and undisciplined and means that there is little guidance for those operating companies as to what is and is not acceptable conduct.<sup>100</sup>

It was stated that this could also lead to enormously lengthy and expensive proceedings, which were unsustainable for small companies, producing potentially unjust results at wholly disproportionate expense.<sup>101</sup>

CLR agreed with the House of Lords that the best basis for focusing such an allegation was the notion of departure from an agreement, broadly defined, between those concerned, to be identified from their words or conduct. It was believed that in clear cases of unfairness, where the conduct of the respondent was evidently outside the scope of the prior mutual contemplation of the parties, the courts would have no difficulty in identifying the conduct as beyond the scope of the agreement between them, as so broadly defined.<sup>102</sup> Furthermore it was stated that:

...where broader protection is of importance to members of a particular class it is for them to contract for it... We are not persuaded that the commercial uncertainty within company structures which would arise from providing a broad unfairness remedy for interference with economic interests would be justifiable... Here again section 459, as focused by the *O’Neill* decision, will continue to apply.<sup>103</sup>

The House of Lords in *O’Neill* had skillfully navigated between the competing positions – danger of being ‘over broad’ and danger of it being too narrow – to arrive at the middle ground. It can be inferred that *O’Neill v Phillips* has enhanced the legal certainty that may have cut down the number of unrealistic or weak petitions but proving unfairly prejudicial conduct can still be a lengthy process. This is because petitioners still have to show that there is some breach of their formal or informal rights that is unfairly prejudicial to their interests and that may prolong the proceedings.

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<sup>100</sup> See *ibid* [5.78].

<sup>101</sup> See *ibid* [5.78]. See also above chapter 5 para 5.6.2.1 Wide scope of the section.

<sup>102</sup> See *ibid* [5.79].

<sup>103</sup> See *ibid* [5.81].

During empirical investigation interviewees stated that *O'Neill v Phillips* had controlled the conduct of section 459 proceedings by discontinuing the wide use of the concept of 'legitimate expectations' and refocusing emphasis on 'equitable considerations'. The interviewees all thought that the House of Lords in *O'Neill v Phillips* had restricted the scope of the section that thus changed the approach of shareholders, practitioners and courts in practice. The more restrictive interpretation was thought to have increased the certainty of the provision and therefore reduced the scope for petitions. Two interviewees expressed concerns as to narrow interpretation of the provision that was a wide remedy. All these responses are discussed below in detail.

*O'Neill v Phillips* controlled the conduct of section 459 proceedings by discontinuing the concept of legitimate expectations since the section was excessively exploited by shareholders in the past due to its attractiveness:

When the section was introduced, everybody saw it as a great new remedy. So there were an awful lot of [petitions], a lot which were very hopeless. The courts then had to step in and said, no hang on a minute, we need to cut back on it [R].

*O'Neill v Phillips* has narrowed the scope of section 459 and therefore affected the practitioners' approach towards the cases [F].

In the past the scope of the section was interpreted widely by courts and practitioners.

Interviewee H gave the example:

We were in a pub and he said 'look John, you can become a shareholder and a director of the company and you have got the job for life'. That might become the basis of petition [for unfairly prejudicial conduct], but now it is different [H].

After *O'Neill* the shareholders' and courts' approach towards section 459 petitions had changed. Interviewees stated that:

The way section 459 is litigated has changed. I think shareholders are more reluctant to undertake 459 petitions now than they used to be. You cannot use 459 in all the ways that you could in the past... now it is more restricted. *O'Neill v Phillips* re-emphasised that section 459 petitions could not be used simply because somebody had grievances about the way the company was being run or indeed simply had fallen out with another person in the company. That was not enough now. Shareholders had to go further than that to prove that some agreed term had actually been infringed or breached [R].

Now courts are perhaps a little bit more rigorous than may be they were in past... they will look at allegations more carefully than before to ensure that petitions are not allowed to proceed which really are not going anywhere [M].

However, *O'Neill v Phillips* increased the certainty of legal principles regarding the application of section 459 to resolve shareholder disputes in private companies. It had tightened up the section 459 so one big difference was that in quasi-partnership cases in particular, the 'equitable consideration' relied upon need to be fully particularized:

I think the first big change is that in the mid eighties and in late eighties you could draft your section 459 petition quite loosely. The idea of 'legitimate expectation'... that phrase... you could run a case basically on the basis of "my dad said to me one day, 'son all this would be yours', all the company would be yours". You could actually run a case on that as a 'legitimate expectation'. Now you cannot... I think now it's much tighter and narrower actually. The court has made it more difficult to run a section 459 petition for a quasi-partnership anyway. They require much more detail and much more evidence [T].

Two interviewees stated that in practice, the more restrictive interpretation of the section may possibly have had the effect of cutting down on the number of petitions that might otherwise have been brought by shareholders in these companies and possibly therefore decreased the burden on the courts. Interviewees stated that due to increased legal certainty as to what unfairness meant, there was less scope for minority to misuse the remedy as a mean of oppression to threaten the majority shareholders. Enhanced certainty as to the scope of the section assisted shareholders to evaluate the strength of the cases and prospects in a court and was a helpful factor in encouraging a compromise during negotiation [R, T].

Accordingly it can be argued that enhanced certainty due to narrow interpretation of the provision cut down the number of petitions that otherwise might have been brought therefore reduced the case load upon courts<sup>104</sup> and the discretion of courts to which the courts were traditionally reluctant to exploit.<sup>105</sup> Shareholders are reluctant to bring weak petitions and there is less scope for minority to misuse the remedy to threaten the majority shareholders for increasing his bargaining position in the company.<sup>106</sup>

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<sup>104</sup> See above chapter 5 para 5.6.2.1 Wide scope of the section.

<sup>105</sup> See above chapter 5 para 5.6.2.3 Courts' respect for majority rule.

<sup>106</sup> See above chapter 5 para 5.6.2.1 Wide scope of the section.

The majority of the interviewees welcomed the development and regarded it as contributing to greater legal certainty. However, one interviewee was rather more guarded and did express concern about Lord Hoffmann's approach. Interviewee H criticised *O'Neill* as equating 'unfairness' to the breach of some sort of obligation despite its wider connotations:

The statute says "unfair prejudice" but Lord Hoffmann in particular has put a gloss on that restricting its effect... The unfair prejudice remedy was intended to be a very broad brush section and gradually the judges decided, no that was too wide and cut it down. I suspect the reason is that judges don't like section 459 trials, because they are very fact sensitive and involve a lot of hard work on the facts rather than law. So what better way to get rid of them than to construe the section restrictively [H]?

The motive might be to lessen the scope of litigation but this is not an established canon of construction. It is a motive, but it is not a rule of construction. You cannot think Oh God I don't want these cases in court, and use that as the basis for construing the section restrictively. You don't construe an Act of Parliament by reference to the volume of litigation that it generates. They did a similar thing with directors' disqualifications. These used to be heard by judges, but the judges hate them so they changed the rules so that a registrar can hear them [H].

Interviewee H further stated that *O'Neill* restricted the scope of the section. Enhanced legal certainty reduced the discretion of courts to which the courts were traditionally reluctant to exploit<sup>107</sup> but proving unfairly prejudicial conduct in a court could still be a lengthy and cumbersome process and therefore expensive. The decision in *Saul D Harrison* was considered by interviewee 'a bit harsh'. It was stated that within next few years somebody was going to spot this and said that it was no longer an effective remedy: "there would be a new Lord Greene who would give a report and Parliament would widen the scope". In this interviewee's view, the section should be construed as widely as possible. The wide scope of the section might increase the case load on courts but it would be relatively easy to get relief and lead to more cases settling earlier [H].

It can be asserted that after *O'Neill*, due to enhanced legal certainty there are less number of petitions launched in courts now, but to prove cause of action court proceedings can still be lengthy and expensive. Enhanced legal certainty assists shareholders to evaluate the strength of the cases and may help shareholders to achieve a compromise during negotiation.

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<sup>107</sup> See above chapter 5 para 5.6.2.3 Courts' respect for majority rule.

### ***6.5.2 Impact of continuation or reinforcement of prevailing practices:***

Developments under *O'Neill v Phillips* namely rejection of no-fault divorce and emphasis upon early fair offers to buy-out to settle the dispute were described as an articulation of prevailing practices in the area. It was stated that *O'Neill* was not necessarily new. But it had reinforced and clarified the practice of early offers to buy-out and had given a clear roadmap for parties wishing to make offers and to strike out the petitions. It was quite helpful because it gave a very clear framework to how these offers should be made [M]. Below the impact of case law developments that reinforced the prevailing practices in the area is discussed.

#### *6.5.2.1 No exit at will:*

By supporting the Law Commission's view, *O'Neill v Phillips* has not permitted minority shareholder's 'exit at will'. Lord Wilberforce observed in *Ebrahimi v Westbourne Galleries Ltd*<sup>108</sup> that the quasi-partnership analogy should not be pressed too far: 'A company, however small, however domestic, is a company not a partnership or even a quasi-partnership ...'.<sup>109</sup> It appears that Lord Hoffmann in *O'Neill v Phillips* attempted to create a balance between equitable considerations that arise in the context shareholders' rights and the fact that the company is after all a commercial enterprise.

*O'Neill* held that to establish the cause of action under the section and to obtain the buy-out order minority shareholders have to prove the breakdown of the personal relationship of shareholders and conduct that is unfairly prejudicial to minority shareholders' interests e.g., exclusion from management of a company. On the other hand majority shareholders may claim there is no unfairly prejudicial conduct and the minority is trying to seek a 'no-fault divorce' that may prolong the court proceedings which necessarily involve the expenditure of time and money of both the parties and courts. After the prohibition of exit of minority shareholders at simple relational breakdown in *O'Neill v Phillips*, minority shareholders may turn to seek help from the

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<sup>108</sup> [1972] 2 All ER 492, 500.

<sup>109</sup> [1999] 2 BCLC 1, 13-14.



court's jurisdiction under 'just and equitable winding up' as a means of leveraging their investment out of the company.

In *Re Guidezone Ltd*<sup>110</sup> in seeking a winding up order, the petitioners relied on *Re R A Noble and Sons (Clothing) Ltd*<sup>111</sup> where Nourse J held that, although the petitioner had not established that its interests had been unfairly prejudiced, nevertheless in the circumstances, it was just and equitable that the company be wound up. Therefore, it was submitted that it was not necessary to establish 'unfairness' for the court to make a winding up order on the just and equitable ground – in other words the jurisdiction to make a winding up order under section 122(1)(g) was wider than the jurisdiction to grant relief under section 459. By discussing the relationship between the jurisdiction under section 459 and the jurisdiction to order a winding up on the 'just and equitable' ground under section 122(1)(g) it was held that it was plainly implicit in Lord Hoffmann's reasoning in *O'Neill v Phillips* that the winding up jurisdiction was at the very least, no wider than the section 459 jurisdiction.<sup>112</sup> The two parallel jurisdictions, in accordance with Nourse J's decision in *Re R A Noble and Sons (Clothing) Ltd*<sup>113</sup> that conduct which was not unfair for the purposes of section 459 should nevertheless be capable of founding a case for a winding up order on the 'just and equitable' ground was inconsistent with *O'Neill v Phillips*.<sup>114</sup> The case further reinforces the point that English Law does not allow 'exit at will'.

Interviewees considered that *O'Neill v Phillips* had not authorised 'exit at will' or 'no fault divorce' and stated that:

The Law Commission had also decided the same before *O'Neill v Phillips*. It was a policy decision and the court had set a policy decision in *O'Neill*, and there was no change to section 459 in the new Companies Act 2006. Therefore, now shareholders had to obtain the right to exit at will by contractual arrangements [G].

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<sup>110</sup> [2000] 2 BCLC 321, 356-357.

<sup>111</sup> [1983] BCLC 273.

<sup>112</sup> See also discussion in Boyle, A.J., *Minority Shareholders' Remedies* (Cambridge University Press, Cambridge 2002) 98-100.

<sup>113</sup> [1983] BCLC 273.

<sup>114</sup> [2000] 2 BCLC 321, 357.

By reinforcing the point about ‘no-fault divorce’ in practice *O’Neill v Phillips* enhanced legal certainty to some extent as to the scope of the section. To obtain relief under the provision it is necessary to prove that the conduct is unfairly prejudicial to the interests of the petitioner [M].<sup>115</sup>

#### 6.5.2.2 Early fair offers to buy-out:

*O’Neill v Phillips* provides considerable judicial support for early fair buy-out offers as a means of settling shareholder disputes. Lord Hoffmann made it clear that he regarded a fair offer by the majority as an appropriate form of relief with the consequences that a refusal to accept the offer would be a ground for striking out the petition and awarding costs against the petitioner.<sup>116</sup>

Lord Hoffmann stated that unfairness lies in the exclusion of the minority without a reasonable offer. If a reasonable offer is made then the exclusion will not be unfairly prejudicial.<sup>117</sup> It can be inferred that the court is accepting the strength of majority rule in shareholder disputes. In the event of relational breakdown leading to the exclusion of the minority from management the will of the majority will prevail, but the majority is legally bound to treat the minority fairly by providing a right to exit within a reasonable time after a fair valuation of their shareholdings.

The courts’ approach towards buy-out orders where there is relational breakdown that leads to unfairly prejudicial conduct is that it is quite reasonable for parties to depart after getting the fair value of their shareholdings in the company.<sup>118</sup> In *Grace v Biagioli*<sup>119</sup> it was stated that the buy-out would usually be the most appropriate order to deal with shareholder disputes.<sup>120</sup> In fact *O’Neill v Phillips* and *Grace v Biagioli* declared buy-out of minority shareholders to be an appropriate outcome of court proceedings and appropriate aim to achieve in out of court settlements in shareholder disputes.

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<sup>115</sup> There are benefits associated with enhanced legal certainty regarding the scope of the section, see above para 6.5.1 Impact of discontinuation of the concept of legitimate expectations.

<sup>116</sup> See below para 6.5.2.3.1 Strike-out application on the basis of fair offer.

<sup>117</sup> See above para 6.4.3 A fair offer to buy-out.

<sup>118</sup> See *Re a Company* [1986] BCLC 362, *Re a Company (No 004377 of 1986)* [1987] BCLC 94. See also above chapter 5 para 5.5.2 Jurisdiction of courts under section 461 of the CA 1985 to provide appropriate relief.

<sup>119</sup> [2005] EWCA Civ 1222; [2006] 2 BCLC 70.

<sup>120</sup> See below para 6.5.2.4 Buy-out as an appropriate relief in shareholder disputes.

Along with the strong judicial emphasis on buy-out as an appropriate form of relief in shareholder disputes, *O'Neill* has also had an impact on practice and procedure through the clear signal that it sends encouraging the use of buy-out offers at the earliest possible stage. This emphasis may enhance prospects for settlement through buy-out, at an early stage – either pre-action or after proceedings have been issued but before trial. Hanlon claims that Lord Hoffmann's guidance (although obiter) as to the circumstances in which a reasonable offer to buy the shares of the minority shareholder should be made, may be helpful in ensuring that disputes are settled before they reach the doors of the court.<sup>121</sup> By settling disputes either pre-action or pre-trial in circumstances where the court is highly likely to order a buy-out, the parties can avoid wasting time and money on continuing litigation.

However, shareholders' cannot be forced to settle the dispute even if an objectively fair buy-out offer is put forward. They may need to resort to court where issues regarding fair valuation of shares may also prolong the court proceedings and result in costly litigation. However, the fair valuation of shares can be dependent upon a range of factors namely, (i) any special issues that should be considered at the time of valuation in any particular business e.g., future return on investment (ii) whether a discount for minority holding is applicable or not, and (iii) most importantly whether or not there is any unfair prejudicial conduct that has affected the share price. These factors may obstruct the out of court settlement and may also lengthen the court proceedings as discussed below.

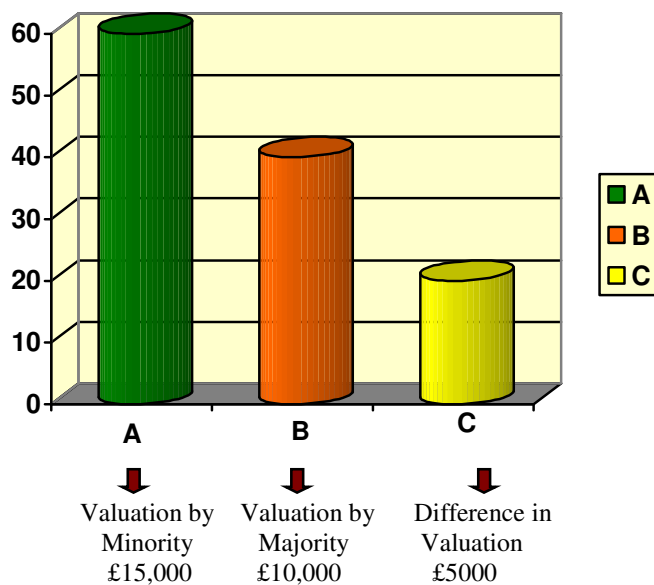
#### *6.5.2.2.1 The role of offers in settling shareholder disputes:*

Regardless of the fact that fair offers may be a promising means of settling shareholder disputes, shareholders cannot be compelled to make early fair offers or accept early offers in such disputes, especially where they have widely diverging views on the merits of the petition. Even if the parties are agreed in principle that one of them should exit, the dispute may focus on the valuation issue. One party's view of what is a fair offer may not coincide with the other party's. For instance, in a quasi-partnership company

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<sup>121</sup> See Hanlon J., 'The Protection of Minority Interests in Company Law' (2001) 35(1) Law Teach 83, 89-90.

dispute a minority shareholder may value his shareholding at £15,000 whereas the majority shareholders value it at £12,000 but offer £10,000 on the basis that it is a minority holding and a forced purchase because the minority is seeking an ‘exit at will’. The state of the negotiation is depicted in Figure 6.1 below. The minority shareholder claims that he is seeking to exit the company because the majority has engaged in unfairly prejudicial conduct and argues therefore that it is not an ‘exit at will’ and that no discount should be applied. He also alleges that assets have been misappropriated from the company and argues that the value of these assets should be taken into account in arriving at a fair valuation.<sup>122</sup> Finally, the minority shareholder argues that the majority has failed to take into account the future return it will make on its enhanced investment.



**Figure: 6.1**

The difference is £5000: £2000 due to the discount for a minority shareholding; £2000 as the majority is claiming that nothing happened that is unfairly prejudicial to the interests of minority shareholders; and £1000 since the majority is not taking into account future returns upon the investment. The settlement of the dispute is possible if both parties agree upon a valuation figure that is acceptable to both. If they fail to do so, the basis upon which the shares are to be valued would have to be resolved by the court. Negotiations between the parties may assist them to agree upon a figure that is

<sup>122</sup> See also below para 6.5.2.3.1 Strike-out application on the basis of fair offer.

acceptable to both and may result in a compromise.<sup>123</sup> Shareholders cannot be forced to settle the dispute during negotiation. However, there are factors that may assist, persuade and motivate shareholders during negotiation to settle the dispute out of court by agreeing upon a figure that is acceptable to both parties, notably the costs and risks associated with litigation. Lengthy, complex and therefore costly section 459 proceedings<sup>124</sup> and the danger of an adverse costs order in the event of losing at trial, may persuade shareholders to settle the dispute out of court by negotiation.

These factors are in fact means to an end that is a settlement by exit after fair valuation of shares. Moreover, the means to settle the dispute at an early stage are also introduced by the Civil Procedure Rules 1998 (CPR). The procedural rules under the CPR emphasise early settlement of disputes and are therefore reinforced by *O'Neill v Phillips*, a point that is discussed further in chapter 7.<sup>125</sup>

Interviewees stated that *O'Neill v Phillips* reinforced prevailing practices by encouraging early offers to buy-out. That had an impact in practice since (i) it enhanced the legal certainty as to way of resolving these disputes and (ii) helped to promote a settlement culture as regards these disputes. The development was welcomed by almost all interviewees because (i) provision of fair exit often to minority shareholder was an appropriate way of resolving these disputes given their characteristics<sup>126</sup> and (ii) *O'Neill* reinforced the practice of early fair offers to exit rather than late, to avoid the lengthy and expensive court proceedings.

It was stated that *O'Neill v Phillips* was a logical addition that had reinforced the prevailing practices but got the House of Lords stamp of approval [E]. Interviewee R elaborated:

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<sup>123</sup> See below chapter 7 para 7.4.2.3.1 Negotiation.

<sup>124</sup> Shareholders generally do not realize the litigation costs of section 459 proceedings at the beginning. However, now front loading of costs under the CPR may assist parties to realize the litigation costs earlier rather than late. See below chapter 7.

<sup>125</sup> The role of these means to settle the disputes is discussed below in detail in chapter 7.

<sup>126</sup> See above chapter 3 Characteristics of shareholder disputes in private companies.

I think *O'Neill* re-emphasised the importance of the respondent trying to make an offer to dispose off the matter at an early stage... the need to try to find a sort of pragmatic way out of these disputes. Most of the disputes at the end of the day are going to be resolved by money changing hands therefore, I think the courts are emphasising need to think about that earlier rather than later [R].

Interviewee C stated that the practice of writing so-called *O'Neill* letters in 459 cases was followed even before *O'Neill v Phillips*. But *O'Neill v Phillips* was a significant case which had further reinforced the practice of pre-action letters offering a buy-out solution at fair value given that this was the relief most likely to be awarded if disputes are litigated to trial. Thus, by focusing lawyers' minds upon the process of making early fair offers to settle the dispute in minimum time and cost in fact, *O'Neill* had ensured good practice [C].

Interviewee J stated that he was not more careful after *O'Neill v Phillips* than before because he was already following the practice of writing a letter to offer a fair price for shares [J]. People who were practising in this area were consistently writing what are now known as *O'Neill* letters even before *O'Neill v Phillips* to settle these disputes. While explaining the reasons for emphasising early fair offers to buy-out to settle the dispute an interviewee stated that (i) section 459 proceedings were expensive and (ii) the judges did not like hearing these disputes:

I should tell you this that I don't really think that the judges like hearing cases under section 459. I think because most of them are very long. They are in effect a corporate divorce. So quite often there is a lot of personal animosity between the parties. The way in which section 459 case unfolds that quite often brings up a lot of bad history built up between the parties [C].

By encouraging the offers at much earlier stage *O'Neill v Phillips* has promoted a culture of early settlement in 459 cases, to avoid the lengthy, complex and costly section 459 proceedings and by resolving the disputes in minimum time and cost. That was beneficial not only for shareholders and companies, but also contributed towards saving of court resources. Early settlement therefore provides an effective resolution to shareholder disputes<sup>127</sup> and is consistent with the Woolf objectives.<sup>128</sup> Interviewee F stated that in the past courts emphasised the need to settle early and proceedings were

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<sup>127</sup> Resolution of shareholder disputes in minimum time and costs to shareholders, companies and the administration of justice by the courts is considered effective. See above chapter 1 para 1.1.

<sup>128</sup> See below chapter 7 para 7.2.1 The Woolf Reforms.

prevented from going to trial when the court realised the impracticability of the parties' aspirations and there was a sensible offer on the table. Furthermore, the court's practice had long been to stay proceedings on grounds of just and equitable winding up since section 459 provided a suitable and less drastic alternative remedy. Interviewee E further stated that:

An O'Neill offer letter provides to buy that person out, value to be assessed by accountant usually upon various parameters. Then continued pursuit of the petition would be abuse of process and would face costs at the end of the day [E].

*O'Neill* focused the lawyers' mind to contemplate traditional modes of settlement. However, shareholders could not be forced to settle the dispute at early fair offer to buy-out if in their opinion the offer made was not fair.<sup>129</sup> Finally, to obtain the fair value for their shares shareholders need to resort to courts [C].

However, as opposed to the common view that welcomed the development, a couple of practitioners pointed out that from one aspect it was unfortunate since, it was the basis of assertion that exclusion was permissible if you made an acceptable offer. It was in their view a charter for bullies. If you were prepared to pay, you could get rid of that person [F]. This was a situation that the majority could exploit:

If you behave badly you can buy the shares of others even with a discount if it is not a quasi-partnership. Sometimes clients are not worried about what would happen if they have done wrong since, they are happy to buy the minority out [C].

#### 6.5.2.3 *Fair valuation of shares at offer to buy-out:*

Lord Hoffmann encouraged early offers to settle and stated that it was very important that participants in such companies should be able to know what counts as a reasonable offer and provided guidance in this context.<sup>130</sup> This guidance has been well received. Two well respected commentators have written that:

The guidance provided by the House of Lords on what constitutes a reasonable offer in the context of section 459 is both imaginative and commercially sensible and will go a long way to dealing with one of the worst shortcomings of section 459 proceedings, namely their costs.<sup>131</sup>

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<sup>129</sup> See also below 6.5.2.3 Fair valuation of shares at offer to buy-out.

<sup>130</sup> [1999] 2 BCLC 1, 16-17.

<sup>131</sup> See also Prentice D. and Payne J., 'Section 459 of the Companies Act 1985 – the House of Lords' View' (1999) 115 Law Quarterly Review 587, 590.

In *O'Neill v Phillips*,<sup>132</sup> Lord Hoffmann considered the issue carefully and described the ingredients of a fair valuation of shares. Lord Hoffmann explained that it was very important that shareholders in small private companies should be able to know what counts as a reasonable offer. According to Lord Hoffmann the main elements of a “reasonable offer” are as follows:

(i) *No discount for being minority holding in quasi-partnership company.*<sup>133</sup>

Lord Hoffmann stated in *O'Neill v Phillips*, unless special circumstances existed, the offer must represent an equivalent proportion of the total issued share capital without any discount for being a minority holding. In a recent Companies' Court decision, the court ordered the respondent to buy out the petitioner's shares in the company without applying any discount as the petitioner's interest was not a majority interest.<sup>134</sup> Where a shareholder had voluntarily exited from the company in *Phoenix Office Supplies Ltd v Larvin*<sup>135</sup> it was held, that section 459 did not provide a member of a quasi-partnership company who wished voluntarily to sever his connection with the company for personal reasons, with the means of forcing the other members to purchase his shareholding at its full undiscounted value, when he had no contractual right to do so.

(ii) *Determination of value by an expert:*

Lord Hoffmann stated that the share value, if not agreed, should be determined by a competent expert. Here the court opens up the possibility of valuation of the shares by a competent expert to settle the valuation disputes between the shareholders. The expert would determine the value as an expert. The objective here should be economy and expedition even if this carries the possibility of a rough edge for one side or the other (and both parties in this respect take the same risk) compared with a more elaborate procedure.

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<sup>132</sup> [1999] 2 BCLC 1, 16-17.

<sup>133</sup> See also above chapter 5 para 5.5.2.1 Valuation of shares, (i) Discounts

<sup>134</sup> *Balvinderjit Singh Nagi v Bhupinderjit Singh Nagi and Adlink Ltd*, Chancery Division- Companies court (unreported) 17/10/ 2006.

<sup>135</sup> [2003] 1 BCLC 76, 91.



(iii) *Access to information:*

Lord Hoffmann stated that both parties should have the same access to information that might have an impact upon the value of the shares. Access to information will provide minority shareholders equal opportunity to value their shares more fairly. However, in quasi-partnership companies minority shareholders are also directors of the company and they have enough knowledge of company affairs and access to necessary information. Moreover, refusing access to information can itself be unfairly prejudicial conduct.<sup>136</sup>

(iv) *Offer to pay costs:*

If the majority had not made an offer within a reasonable time after the breakdown then a buy-out offer must be accompanied by an offer to pay the costs. Lord Hoffmann here is contemplating costs of the proceedings initiated by the petitioner under section 459 before the offer to buy shares is made in any case. Costs associated with late offers to buy shares may increase the possibility of early offers by majority shareholders in these disputes.

In *O'Neill*, Lord Hoffmann's guidance about what counts a fair offer at the time of buy-out was an important consideration in this context. The interview evidence confirms that valuation is often a key issue for practitioners seeking to resolve shareholder disputes. One interviewee put it bluntly:

Often the practical problem in these cases is not so much, what is the appropriate remedy or who should buy the other out, but it is a question of price. The real battlefield is over the value of shares [G].

His experience was that the majority usually bought out the minority. The majority shareholders were happy with it since it was not a punishment and they were getting something in return e.g., control of the whole of the company. On the face of it, it was not a harsh remedy. The harshness arose in the price. Too higher price for the shares was a 'win' for the minority and too lower price was a 'win' for the majority. So that was

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<sup>136</sup> See above chapter 3 para 3.4.1.1.1 Disregard of minority shareholders' participation in the company.

often the sticking point in these cases. The same interviewee mentioned a recent case where in a 50/50 company each side made allegations of wrong doing. The problem was not who should buy the other out but what the parties could not agree was on how much [G].

6.5.2.3.1 *Strike-out application on the basis of fair offer:*

Interviewees stated that now after *O'Neill v Phillips* courts were more ready to entertain strike out applications. *O'Neill v Phillips* particularly encouraged parties to make offers and to look at strike out possibly on the basis of offers [M]. Interviewee E added that:

I cannot say the Civil Procedure Rules have changed a lot at all. The biggest change in section 459 was undoubtedly the development of *O'Neill v Phillips* style of strike out application and offers that force people to agree to accountant valuations [E].

In practice strike-out applications were very much more common now than in the past and there was much greater willingness of the courts to entertain a strike out application. There were a variety of grounds on which a strike out application could be made. Reasons for applying strike-out include (i) lack of evidence of unfair prejudice (ii) evidence of unfair prejudice but a fair offer had been made for the petitioner's shares [T]:

There are cases now where the courts are ready to listen to strike out applications. I wouldn't say encourage them but you have got to think if you are the respondent majority now, whether I just put in a defence or should I apply to strike out. [T]

It is evident from the case law that provision for striking-out was available before *O'Neill v Phillips*. However, it appears that exploitation of the procedure has become more common after *O'Neill*. Long before *O'Neill v Phillips* in *Re a Company (No 005685 of 1988)*, *ex parte Schwarcz (No 2)*<sup>137</sup> it was stated that the developing jurisprudence on section 459 petitions had established that the court, even on a striking-out application, would consider whether the relief sought by a petitioner was inappropriate. Whether it was unreasonable to pursue a petition when it was clear that the petitioner must leave the company and a fair offer had been made for the petitioner's shares<sup>138</sup> or when a petitioner seeking an order for the sale of his shares might have

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<sup>137</sup> [1989] BCLC 427.

<sup>138</sup> *Re a Company (No 003843 of 1986)* [1987] BCLC 562 as cited in the judgment.

achieved that result by invoking the transfer machinery available in the articles but failed to do so.<sup>139</sup> If the court was of the view that the relief sought was wholly inappropriate and the petitioner was acting unreasonably in pursuing the petition, it might stay or strike out the petition as being an abuse of the process.<sup>140</sup>

Problems were identified in making fair offers to strike out the petition and to end the dispute. An interviewee stated that it was difficult to make a fair offer on which majority shareholders could rely to strike out the petition. Shareholders making the fair offer had to concede certain allegations made by the petitioner otherwise it was a complete waste of time. To strike out an otherwise good petition, shareholders needed to make a fair offer that gave some sort of recompense to the petitioner for being unfairly prejudiced. So shareholders had to make admissions as part of the offer. If a petitioner alleged that directors were in breach of fiduciary duty by taking a lot of money out of the company, a 'fair offer' would be to have the petitioner's shares valued on the assumption that, that money was still in the company. Otherwise it was not a fair offer.

If you are not going to give any compensation to the petitioner what is fair about that? Furthermore, the judge can hold it against you because the petitioner is going to admit that on an open basis. The petitioner would say that the majority shareholders have offered to settle on the basis of compensating him, having regard to this particular unfair prejudice [H].<sup>141</sup>

#### 6.5.2.4 Buy-out as an appropriate relief in shareholder disputes:

After *O'Neill v Phillips* in *Grace v Biagioli*,<sup>142</sup> the Court of Appeal stated that the most appropriate order to deal with shareholder disputes in small private companies was normally a buy-out order. In *Grace v Biagioli*<sup>143</sup> the Court of Appeal discussed the issue regarding the need for buy-out orders in detail. The court stated that in most cases, the usual order to make would be the one requiring the respondents to buy out the petitioning shareholder at a price to be fixed by the court. This was normally the most appropriate order to deal with shareholder disputes involving small private companies.

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<sup>139</sup> *Re a Company (No 007623 of 1986)* [1986] BCLC 362 and *Re a Company (No 004377 of 1986)* [1987] BCLC 94, [1987] 1 WLR 102 as cited in the judgment.

<sup>140</sup> [1989] BCLC 427, 437.

<sup>141</sup> See also above para 6.5.2.2.1 The role of offers in settling shareholder disputes.

<sup>142</sup> [2005] EWCA Civ 1222; [2006] 2 BCLC 70.

<sup>143</sup> *Grace v Biagioli* [2006] 2 BCLC 70.

This was the relief which the petitioner shareholder sought on this appeal. The reasons for making such an order were in most cases obvious. It would free the petitioner shareholder from the company and enable him to extract his share of the value of its business and assets in return for foregoing any future right to dividends. The company and its business would be preserved for the benefit of the respondents, free from the petitioner's claims and the possibility of future difficulties between shareholders would be removed. In cases of serious prejudice and conflict between shareholders, it was unlikely that any regime or safeguards which the court can impose would be as effective to preserve the peace and to safeguard the rights of the minority shareholder.<sup>144</sup> Therefore, after taking everything into account the court held that nothing short of a buy-out order would ensure that the petitioner's rights were respected in the future.<sup>145</sup> There was a considerable judicial support for buy-out to resolve these disputes even in the past but the Court of Appeal reinforces the clear judicial preference for this form of relief.<sup>146</sup> This sends out a clear message to the parties to disputes to consider a buy-out solution early on rather than bothering the courts as more often than not buy-out is the solution that will be imposed.

Interviewees stated that *O'Neill v Phillips*<sup>147</sup> supported early fair offers to buy-out as an appropriate way of settling disputes and *Grace v Biagioli*<sup>148</sup> held that under section 461, buy-out is an appropriate order to resolve minority shareholder disputes in private companies. It was stated that shareholder disputes were usually resolved through buy-out and buy-out was an appropriate relief in these disputes. In experience of some interviewees in 90% of cases the order made by the court was buy-out [C, G, H]. Interviewees stated that:

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<sup>144</sup> *Grace v Biagioli* [2006] 2 BCLC 70, 96-97.

<sup>145</sup> *Grace v Biagioli* [2006] 2 BCLC 70, 100. See also below para 6.5.2.3 Fair valuation of shares at offer to buy-out. Lord Hoffmann in *O'Neill v Phillips* [1999] 2 BCLC 1 also provided guidelines as to fair valuation of shares at offers to buy-out.

<sup>146</sup> See above chapter 5 para 5.5.2 Jurisdiction of courts under section 461 of the CA 1985 to provide appropriate relief.

<sup>147</sup> *O'Neill v Phillips* [1999] 2 BCLC 1.

<sup>148</sup> *Grace v Biagioli* [2006] 2 BCLC 70.

The usual outcome of these disputes whether in courts or in settlements is buy-out. It is very unusual for either the minority or majority to want anything less than divorce or separation, therefore buy-out is the most common order in these cases [G].

It is common for shareholders at that stage of litigation to prefer exit. However, in family companies if disputes are not that severe, people want to stay in the same company as they are a family and they have to get on with things [E].

While explaining the logic behind buy-out, interviewee H stated that in a company where shareholders were not on harmonious terms, the obvious answer was that the majority had to buy out the minority otherwise, even the majority shareholder was going to 'have an unpleasant life'. Other interviewees added that:

Disputes are usually resolved through buy-out which is appropriate relief, as these companies are formed on the basis of mutual trust and confidence of shareholders and disputes arise as a result of the end of that mutual trust. When people fall out it will not be possible to make them work together, it will become necessary to effect some sort of parting of ways. In private companies if the minority shareholder wants to leave the company, the majority shareholder is the only buyer in the market for the shares and it is in his interests to buy the shares. It is quite wrong to keep some poor minority shareholder in a company with some unpleasant majority shareholder [H].

Buy out is a final outcome in these cases since due to the end of mutual trust and confidence shareholders do not desire to stay in the same company and work together. There is constant possibility of future conflicts as the mutual trust has severely damaged, the basis upon which the company was once formed. In the event of a dispute, for the majority it is better to do away with the minority by buying him out since the minority may start proceedings against the majority again and for the minority even if the minority has a good case he should try to be bought out and invest somewhere else [B].

Clients are advised firmly by any sensible solicitor or barrister that it is preposterous for them to stay in the same company. As the minority is never going to trust the majority again and they both can never get on with one another [K].

The courts' stance as to the outcome of shareholder disputes was extremely well settled.

One interviewee stated that:

I think the courts are right to say that in the great majority of cases the right solution is a clean break. Courts are very pragmatic about it; that these guys are not going to carry on the business and this is not going to be the last piece of litigation. The courts are very anxious not to create a situation that will lead to further litigation [G].

Legal certainty regarding buy-out as an appropriate relief in shareholder disputes can assist to settle the disputes out of court since the way of resolving these disputes is well-established.

*6.5.2.4.1 Relief other than buy-out:*

Interviewees stated that in shareholder disputes forms of relief other than buy-out available under section 461(2) were very rarely encountered in practice such as orders regulating the management of the company. If there would be a breach against that order parties would be in courts again. However, there were cases where the court had ordered the company to change the articles of association [C]. In these disputes any order other than buy-out could not be helpful because it was not possible to make the parties work together. Therefore, courts usually said that shareholders had to bring an end to an impossible relationship [D]. Parties to these disputes often expect buy-out. However, sometimes a petitioner who was a minority shareholder desired to buy the company. Minority shareholders virtually never or very rarely sought relief under which they would stay in the company [K].

It was possible that in some cases, the departing shareholder, due to the commitment of time and money to the company, might consider the valuation of shares at that particular time to be against his interests and would prefer to stay in the company. However, such concerns regarding the fair valuation might be reflected in the share price at the time of the valuation of shares.<sup>149</sup> As opposed to the majority view, one interviewee's isolated view was that in his experience in one third of cases shareholders did not want to leave the company and desired other remedies under section 461 of the CA 1985 [F]. Interviewee F stressed the point that it should not be the problem of courts or judges what would happen next if there were not a buy-out order. Courts should decide the matter by using the discretion available to them regarding other forms of relief under section 461. It was a defeat of the system if shareholders end up in court at trial but some compromises reached were not very good. There were situations where shareholders did not want to leave the company and where they should be granted some other remedy under section 461 but present case law was not taking it into account. Courts should be prepared to provide protection by amending the articles. Furthermore, if someone had worked hard and the fruits would be evident in profits some time in the future then he would prefer staying in the company to enjoy profits later. Courts should provide him

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<sup>149</sup> See above para 6.5.2.2.1 The role of offers in settling shareholder disputes.

protection by permitting him to stay and should impose certain provisions for his protection in articles which the statute allowed the court to do [F]. Interviewee F was keen to labour the point:

A much more interventionist judiciary is needed. If the shareholder wants to stay in the company, then it should not be the judge's problem. Everybody thinks in terms of divorce instead of reconciliation. Their whole intention is to keep people out of court and it's like one size fits all. Each set of proceedings should be dealt with to get a fair and just outcome. The law should be much more adaptable and much more flexible. Case law sets the framework and case law can be more imaginative in terms of remedy. When the section was introduced, parliament thought there were other alternatives "courts should make such order as they think fit". Courts should exercise the discretion they have been given [F].

Furthermore, wide exercises of the discretion might involve curbing the power of the majority, curbing the power of wrong doers, insisting on proper corporate governance and regulating procedures in private companies. A lot of disputes arose in companies having no shareholders' agreements. In large joint ventures people dealt with every eventuality with the assistance of highly sophisticated solicitors and spent months before they set up the joint venture. In small private companies that seldom happened. When there were less protections the court could impose them in articles. Interviewee F mentioned that Hart J said in *Re Regional Airports Ltd*,<sup>150</sup> 'it was surprising that all that was asked for was buy-out because alternative remedy might be a good idea'.

In response to this, it can be argued that as evident above in the majority of cases at the stage of conflict when shareholders are thinking to start court proceedings, shareholders do not prefer to stay in the company. *Grace v Biagioli*<sup>151</sup> is a judicial endorsement of the view that buy-out will ordinarily be the appropriate practical solution. However, buy-out may not be an appropriate solution in every case and courts are not always inclined to separate the shareholders through buy-out. In exceptional cases courts considered to order otherwise. The interviewee himself gave the example of *Re Regional Airports Ltd*<sup>152</sup> where the petitioner asked for buy-out, but the court was considering exploiting the wide discretion provided to court under section 461. It is also evident from *Re*

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<sup>150</sup> [1999] 2 BCLC 30, 81.

<sup>151</sup> *Grace v Biagioli* [2006] 2 BCLC 70.

<sup>152</sup> [1999] 2 BCLC 30.

*Metropolis Motorcycles Ltd*<sup>153</sup> that courts are not completely inclined only towards buy-out remedy but are also willing to use their discretion under section 461(1) and may refuse to order buy-out that was desired by the petitioner where circumstances of the case may suggest. Mann J in *Re Metropolis Motorcycles Ltd* stated in his judgment that:

It has not been demonstrated to me on the facts that the present situation is based on a degree of unfairness which requires or justifies the intervention of this court, particularly to order the buyout claimed by [the petitioner]. I have not come to this decision lightly. Where there is a degree of separation and distrust that now exists in this matter between two owners of a company it is not an easy conclusion to come to that they should, at least for the time being, not be separated.<sup>154</sup>

There is no doubt that there can be cases where minority shareholders will like to stay in the company but issue arises for courts to decide, whether such a course is in the commercial interests of shareholders and company. If yes, then courts should be willing to exercise their discretion under section 461. However, issue as to shareholders' investment and future return upon it can be addressed at the event share valuation.

A further point here is that relief, which involves the parties staying together, will usually involve some kind of order regulating the future affairs of the company. Consistent with the old internal management principle this is not the kind of relief, that courts will be keen to grant because it is too interventionist and will require policing. Moreover, breach of its terms will bring the matter back before the court with the implication that the court becomes a voice of last resort in the ongoing management of the company.

It is evident that at relational breakdown in private companies, shareholders often demand exit through buy-out and courts often prefer to order buy-out. Moreover, buy-out is considered an appropriate relief in these disputes. Such apparent consensus among shareholders, practitioners and courts upon the way of resolving these disputes through buy-out can assist to achieve an early compromise in negotiation and possibly will promote a number of settlements with time, as it seems rational, to obtain the

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<sup>153</sup> [2006] EWHC 364 (Ch).

<sup>154</sup> [2006] EWHC 364 (Ch) paras 91, 92.



appropriate relief by negotiation in an out of court settlement instead of through costly court process.

6.5.2.4.2 *Date of valuation of shares at buy-out order under section 461 of CA 1985*:<sup>155</sup>

After *O'Neill v Phillips*, in *Re Guidezone Ltd*<sup>156</sup> as to date of valuation at the end of proceedings where the buy-out was ordered, it was held that “given that the value of the shares has increased since the events complained of, I would have directed that the appropriate date is the date of the order”. In *Profinance Trust SA v Gladstone*<sup>157</sup> by referring to the judgment of Nourse J in *Re London School of Electronics Ltd*<sup>158</sup> the Court of Appeal held that subject to the overriding requirement that the valuation should be fair on the facts of the particular case, “Prima facie an interest in a going concern ought to be valued at the date on which it is ordered to be purchased”.<sup>159</sup> In *Profinance Trust SA v Gladstone*<sup>160</sup> the court provided a guideline when an earlier valuation date was appropriate<sup>161</sup> and stated that “the clearest reason for selecting an early valuation date is that there has been a major change (whether for the better or for the worse) in a company’s capital structure and business”.<sup>162</sup> Therefore, the general principle remains the same as pre-*O'Neill* that the valuation should be fair on the facts of the particular case.<sup>163</sup>

Interviewees mentioned that as to valuation and date of valuation there had been a change through case law in *Profinance Trust SA v Gladstone*<sup>164</sup> in the Court of Appeal that has had an effect in practice. An interviewee stated as a general rule for the court, the only date of valuation of shares was the date when the court would give the judgment on the petition. It was not the date when the petitioner was excluded and not the date the petitioner issued the petition or the date of the first day of the trial. It was the

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<sup>155</sup> See also above chapter 5 para 5.5.2.1 Valuation of shares, (iii) Date of valuation.

<sup>156</sup> [2000] 2 BCLC 321, 360.

<sup>157</sup> [2002] 1 BCLC 141.

<sup>158</sup> [1985] BCLC 273, 281.

<sup>159</sup> [2002] 1 BCLC 141, 160.

<sup>160</sup> [2002] 1 BCLC 141.

<sup>161</sup> [2002] 1 BCLC 141, 160-161.

<sup>162</sup> [2002] 1 BCLC 141, 154.

<sup>163</sup> See above chapter 5 para 5.5.2.1 Valuation of shares (iii) Date of valuation.

<sup>164</sup> [2002] 1 BCLC 141.

date the court decided there had been unfair prejudice. That was the date of valuation for a going concern company. It was a general rule subject to exceptions but in practice, it was very difficult to shift the court. The court was faced with a number of competing dates and there were plenty of arguments about date of valuation. So the court imposed that general date [T].

## **6.6 Conclusion:**

Substantive law developments through case law, after the Law Commission Report have affected the way section 459 petitions are dealt with in practice. *O'Neill v Phillips* and *Grace v Biagioli* enhanced the legal certainty as to the scope of the provision and appropriate outcome of the shareholders' disputes. *O'Neill v Phillips* discontinued the wide use of the concept of legitimate expectations and reinforced some prevailing practices as regards early settlement. By circumscribing the meaning of unfairness *O'Neill* enhanced the legal certainty as to the scope of the provision. Enhanced legal certainty reduced the number of petitions commenced in courts and now there seems to be less scope for the minority to misuse the remedy<sup>165</sup> and has therefore reduced the case load upon courts. But proving unfairly prejudicial conduct can still be a lengthy and cumbersome process. Furthermore, increased legal certainty reduces the discretion of courts to which the courts were traditionally reluctant to exploit<sup>166</sup> and may assist shareholders while negotiating to reach a compromise.

*O'Neill v Phillips* and *Grace v Biagioli* considered buy-out an appropriate outcome in out of court settlements and court proceedings in shareholders' disputes. In practice relief other than buy-out is not common in shareholder disputes. Such legal certainty as to the outcome of these disputes enhances in practice the scope of achieving early compromise in negotiation and will promote a number of settlements in shareholder disputes with time.

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<sup>165</sup> See above chapter 5 para 5.6.2.1 Wide scope of the section.

<sup>166</sup> See above chapter 5 para 5.6.2.3 Courts' respect for majority rule.

*O'Neill v Phillips* strongly encourages early offers to buy-out to settle the disputes at an early stage to avoid the lengthy, complex and costly section 459 proceedings. Early settlement is beneficial not only for shareholders and companies but also assist to save court resources and therefore provide an effective resolution to shareholder disputes<sup>167</sup> and are also consistent with the Woolf objectives.<sup>168</sup> Practitioners were writing early offers letters to buy-out even before *O'Neill* but *O'Neill* reinforces the prevailing practices and articulates the courts' stance. It focuses the lawyers' minds on traditional modes of settlement and therefore assists in promoting a settlement culture in these disputes. However, in practice shareholders cannot be forced to settle the dispute at fair offer to buy-out if in their opinion offers are not fair. On the basis of fair offers shareholders may apply for strike-out and courts are more willing now to entertain strike-out applications. However, the success of a strike out application also depends upon evaluating whether the offer made is a fair one. As a result, to obtain a fair value of the shares shareholders may have to become involved in lengthy and expensive court proceedings. Even though *O'Neill v Phillips* encourages early offers to buy-out to settle it does not permit exit at will. It increases the legal certainty as to the scope of the section that to obtain relief there must be unfairly prejudicial conduct against the petitioner.

It can be asserted that although the enhanced legal certainty has proved helpful, establishing a cause of action under the provision to obtain relief or to get fair value of shares in the event of buy-out can still be subject to lengthy and costly proceedings. Therefore, settlement of disputes by negotiation is still a preferred way of resolving these disputes due to its cost effectiveness. Settlements may not be successful where the parties fail to reach a compromise. However, exploitation of other means may assist, persuade or motivate shareholders to reach a compromise in minimum time and cost. These means to settle the disputes, to avoid the time and costs involved in court proceedings, are introduced by Civil Procedure Rules 1998 for all kinds of civil disputes

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<sup>167</sup> Resolution of shareholder disputes in minimum time and costs to shareholders, companies and the administration of justice by the courts is considered effective. See above chapter 1 para 1.1.

<sup>168</sup> See below chapter 7 para 7.2.1 The Woolf Reforms

and have received an unequivocal welcome by the Law Commission.<sup>169</sup> *O'Neill v Phillips* encourages early fair offer to settle shareholder disputes and so reinforces the CPR. Lowry stated that from the wider perspective, the decision in *O'Neill* can be viewed as underpinning, for the purposes of section 459, the Woolf (the CPR) objectives of constructing a system of civil litigation that is accessible, speedy and certain.<sup>170</sup> The CPR also implemented procedural rules controlling the conduct of proceedings, to avoid the delay and cost involved in court proceedings. The next chapter will discuss the impact of the procedural law developments under the CPR upon section 459 proceedings. The chapter will explore (i) how effective these means are to settle shareholder disputes and (ii) whether the new procedural rules have enhanced the effectiveness of the unfair prejudice remedy to resolve shareholder disputes by courts.

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<sup>169</sup> As quoted by Lowry J., 'Mapping the Boundaries of Unfair Prejudice' in John de Lacy (ed) *The Reform of United Kingdom Company Law* (Cavendish Publishing Limited, UK 2002) 230.

<sup>170</sup> See *ibid* 247.

## Chapter 7

### Procedural law developments

#### **7.1 Scope of the chapter:**

The chapter mainly focuses upon the role of the Civil Procedure Rules 1998<sup>1</sup> in streamlining the effectiveness of section 459 proceedings by a resolution of shareholder disputes in minimum time and cost to shareholders, companies and the administration of justice by the courts.<sup>2</sup> After the introduction and discussion of the general procedural law developments under the CPR, the chapter analyses the nature and impact of the procedural law developments upon section 459 proceedings. The impact of the procedural developments in practice is evaluated in the light of the findings of the empirical investigation.

#### **7.2 Introduction:**

In shareholder disputes in private companies courts prefer to order the remedy of buy-out in the event of relational breakdown where a cause of action is proved under section 459 of the CA 1985.<sup>3</sup> Establishing a cause of action under section 459 can be a lengthy, cumbersome and costly process.<sup>4</sup> Therefore, the courts have encouraged the use of buy-out offers as a means of settling disputes at an early stage so as to avoid the time and costs inevitably involved in section 459 proceedings.<sup>5</sup> This is not only in the interests of shareholders and companies but also makes for the better exploitation of the courts' resources. However, shareholders cannot be forced to make early offers to buy-out as an instrument for settlement. The settlement of section 459 disputes comprises two ingredients. Firstly, the parties must accept that one buying out the other (or *vice versa*) is an appropriate solution. Secondly, the parties must agree a valuation that both can live with. As far as the first ingredient is concerned, it is evident from the discussion in previous chapters, that shareholders often prefer buy-out given the relational character of

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<sup>1</sup> Civil Procedure Rules 1998 were implemented on 26<sup>th</sup> April 1999. Hereinafter 'CPR'. See *Civil Procedure*, Vol 1, The White Book Service (Sweet and Maxwell, London 2004).

<sup>2</sup> See also above meaning of 'effectiveness' in chapter 1 para 1.2.

<sup>3</sup> See above chapters 3, 6.

<sup>4</sup> See above chapter 5.

<sup>5</sup> See *O'Neill v Phillips* [1999] 2 BCLC 1 and above chapter 6 para 6.5.2.2 Early fair offers to buy-out.

shareholder disputes. It is also well established, the leading case now being *Grace v Biagioli*<sup>6</sup> that courts also prefer to order buy-out at trial considering it an appropriate way to avoid continuing disputes within a company.<sup>7</sup> It appears also that there is rarely any issue concerning which party is to be bought out, often the minority shareholder.<sup>8</sup> Hence, the core of the dispute may not go to the question of who is to buy-out whom but instead be about the second ingredient, valuation. It is often hard for shareholders to agree a value for the shares that is acceptable to both sides.<sup>9</sup> If a valuation cannot be agreed, the basis and mechanism for arriving at a valuation may itself have to be resolved by the court. Effective dispute resolution in shareholder disputes will therefore often depend upon achieving a compromise regarding the value of shares as early as possible.

Various means can be exploited to assist, motivate and persuade shareholders to settle disputed issues as to buy-out and fair valuation of shares as early as possible, as emphasized by the courts. These means include *inter alia* pre-action correspondence and the costs incurred by shareholders in court proceedings, especially if there are significant costs involved in the initial stages of case preparation, may persuade shareholders to settle sooner rather than later.<sup>10</sup> However, shareholders cannot be forced to settle the dispute.<sup>11</sup> These means or methods that may assist to settle disputes along with means to control the conduct of litigation were proposed by Lord Woolf in his final Report.<sup>12</sup>

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<sup>6</sup> [2006] 2 BCLC 70.

<sup>7</sup> See above chapter 6 para 6.5.2.4 Buy-out as an appropriate relief in shareholder disputes.

<sup>8</sup> See *Re a Company (No 004377 of 1986)* [1987] BCLC 94, 101 above in chapter 3 para 3.4.3 Exit disputes following relational breakdown and the interviewee's response above in chapter 6 para 6.5.2.3 Fair valuation of shares at offer to buy-out.

<sup>9</sup> See above chapter 6 example that discusses obstacles on the way of settlement at fair offers to buy-out in para 6.5.2.2.1 The role of offers in settling shareholder disputes.

<sup>10</sup> See below para 7.4.1.1.

<sup>11</sup> See Menkel-Meadow C., 'Lawyers Negotiation: Theories and Realities – What We Learn From Mediation' (1993) 56 *Modern Law Review* 361, 376 where it was mentioned in findings that in one case of lengthy business partnership both lawyers and mediators were aligned in trying to work on relationship as well as monetary issues while the parties aligned themselves in their desires to perpetuate their conflicts and refusal to settle, demonstrating that if parties want something very badly (in this case vengeance and retribution) they may be powerful enough to defeat their own lawyers and any dispute resolution process.

<sup>12</sup> See Lord Woolf, 'Access to Civil Justice: Interim Report to the Lord Chancellor on Civil Justice in England and Wales' (June 1995) hereinafter '*Interim Report*' and Lord Woolf 'Access to Civil Justice, Final Report to the Lord Chancellor on Civil Justice in England and Wales' (London, TSO, July 1996) hereinafter '*Woolf Final Report*'.

### **7.2.1 The Woolf Reforms:**

The problems associated with section 459 as regards cost, delay and complexity<sup>13</sup> are problems that Lord Woolf identified as being endemic across the whole civil justice system. His recommendations for addressing these problems led to the fundamental overhaul of the civil justice system. Lord Woolf's interim Report stated that "The key problems facing civil justice today are cost, delay and complexity".<sup>14</sup> It further stated that:

The overall aim of my inquiry is to improve access to justice by reducing the inequalities, costs, delay and complexity of civil litigation and to introduce greater certainty as to timescales and costs.<sup>15</sup>

In his final report, Lord Woolf stated that

My approach to civil justice is that dispute should, wherever possible, be resolved without litigation. Where litigation is unavoidable, it should be conducted with a view to encouraging settlement at the earliest appropriate stage.<sup>16</sup>

Lord Woolf's proposals were therefore designed to achieve two main objectives: (i) the avoidance of litigation wherever possible; (ii) for litigation which cannot be avoided to be more focused and less costly.<sup>17</sup> These proposals were later implemented by the Civil Procedure Rules 1998.<sup>18</sup>

### **7.2.2 The Law Commission's proposals:**

As discussed in chapter 5 above the Law Commission in its final Report considered the problems of excessive length, cost and factual complexity of proceedings under section 459.<sup>19</sup> To streamline the effectiveness of the remedy by controlling the conduct of proceedings on procedural level the Law Commission proposed that such proceedings should be dealt with primarily by active case management by the courts as proposed in

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<sup>13</sup> For discussion as to length and complexity of section 459 proceedings see above chapter 5 para 5.6.2 The Law Commission's critique of section 459 of the CA 1985.

<sup>14</sup> *Interim Report* chapter 3 [1].

<sup>15</sup> *Interim Report* Chapter 5 [1].

<sup>16</sup> See *Woolf Final Report* Section III, Chapter 10, [2].

<sup>17</sup> See *Woolf Final Report* section 1 [9].

<sup>18</sup> SI 1998/3132. See also the enabling provisions in Civil Procedure Act 1997, section 1 and Schedule 1. S 1(3) of the Act states that "the power to make Civil Procedure Rules is to be exercised with a view to securing that the civil justice system is accessible, fair and efficient".

<sup>19</sup> See above chapter 5 para 5.6.2 The Law Commission's critique of section 459 of the CA 1985.

the Woolf Report regarding the management of proceedings.<sup>20</sup> The proposal was later also supported by the Company Law Review.<sup>21</sup> As discussed above the wide scope of the section 459 of the CA 1985 has increased the cost and length of the litigation under the section.<sup>22</sup> The Woolf reforms<sup>23</sup> implemented by the CPR and were further supplemented by practice directions<sup>24</sup> along with the additional practical information provided by the Chancery Guide 2005.<sup>25</sup> The following proposals of the Law Commission in relation to section 459 proceedings were implemented within the civil justice system as a whole for civil disputes by the CPR.

1. To control the conduct of section 459 proceedings firstly, the Law Commission recommended that greater use should be made of the power to direct that preliminary issues be heard, or that some issues be tried before others.<sup>26</sup> The CPR provide that the court may “direct a separate trial of any issue”<sup>27</sup> or “decide the order in which issues are to be tried”.<sup>28</sup>

2. The Law Commission recommended that in shareholder proceedings the court should have the power to dismiss any claim or part of a claim or defence thereto which, in the opinion of the court, has no realistic prospect of success at trial.<sup>29</sup> The CPR provide that “the court may dismiss or give judgment on a claim after a decision on a preliminary issue”.<sup>30</sup>

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<sup>20</sup> *The Law Commission’s Report* paras 2.2 and 2.4. The Law Commission’s reflections on the possible implications of the Woolf reforms for the law on shareholders remedies, and the resolution of shareholder disputes have been seen as significant. See Sugarman, D., ‘Reconceptualising Company Law: Reflections on the Law Commission’s Consultation Paper on Shareholder Remedies [Part 2]’ (1997) 18(9) *Company Lawyer* 274, 276.

<sup>21</sup> See Company Law Review ‘Modern Company Law for a Competitive Economy: Developing the Framework’ (URN 00/656, March 2000) [4.103].

<sup>22</sup> See above chapter 5 para 5.6.2 The Law Commission’s critique of section 459 of the CA 1985

<sup>23</sup> *Woolf Final Report*.

<sup>24</sup> See Practice Direction 49B- Applications under the Companies Act 1985 and other legislation relating to companies.

<sup>25</sup> See Chancery Guide 2005, Rule 1.7, Preface to the Chancery Guide states that “it seeks to give practical guidance on the conduct of cases in the Chancery Division within the framework of those rules and practice directions”.

<sup>26</sup> *The Law Commission’s Report* [2.10].

<sup>27</sup> CPR, r 3.1 (2)(i).

<sup>28</sup> CPR, r 3.1 (2)(j).

<sup>29</sup> *The Law Commission’s Report* [2.18]

<sup>30</sup> CPR, r 3.1 (2)(l). See also CPR, Part 24. CPR r 24.2 provides that the court may give summary judgment against a [petitioner] or [respondent] on the whole of the claim or on a particular issue if there is



3. The Law Commission encouraged the greater use of alternative dispute resolution (ADR) in shareholder disputes.<sup>31</sup> The Law Commission recommended the inclusion of an express reference in the 1986 Rules<sup>32</sup> “to the power to adjourn at any stage to enable the parties to make use of mechanisms for ADR for disposing of the case or any issue in it, together with provisions for reporting back to the court as to the outcome along the lines of the 1996 Commercial Court Practice Statement”.<sup>33</sup> The *Company Law Review* also recommended that the courts should encourage the parties once litigation has commenced, to take a step back and use ADR wherever possible.<sup>34</sup> Lord Woolf stated that to avoid litigation wherever possible and to make litigation less adversarial and more cooperative, parties would be encouraged to start court proceedings only as a last resort.<sup>35</sup> The courts would encourage the use of ADR at case management conferences and pre-trial reviews and would take into account<sup>36</sup> whether the parties had unreasonably refused to try ADR or behaved unreasonably in the course of ADR.<sup>37</sup> Therefore, the CPR encouraged the greater use of ADR in civil disputes backed by the threat of costs sanctions if not undertaken in circumstances where it was appropriate. The CPR provide that “active case management includes encouraging the parties to use an alternative dispute resolution procedure if the court considers that appropriate”.<sup>38</sup>

4. The Law Commission also recommended that the court’s power to determine how facts are to be proved should be used pro-actively by the court by giving court powers to control the evidence to be put before it.<sup>39</sup> The CPR contains such powers.<sup>40</sup>

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no real prospect of success and there is no compelling reason for the case or issue to be disposed of at a trial.

<sup>31</sup> *The Law Commission’s Report* [5.34]-[5.38]. ADR mechanisms here include mediation, conciliation and arbitration.

<sup>32</sup> Companies (Unfair Prejudice Applications) Proceedings Rules 1986.

<sup>33</sup> *The Law Commission’s Report* [2.22].

<sup>34</sup> *Company Law Review ‘Modern Company Law for a Competitive Economy: Final Report’* vol. 1 (URN 01/942, July 2001) [4.10]-[4.12].

<sup>35</sup> *Woolf Final Report*, section 1 [9].

<sup>36</sup> Following the line of cases discussed below in the context of cost sanctions for unreasonable refusal to mediate in para 7.4.2.5 Factors that contribute to successful outcomes in mediations.

<sup>37</sup> *Woolf Final Report*, section 1 [9].

<sup>38</sup> CPR, r 1.4 (2)(e), see also Chancery Guide chapter 17. ADR is discussed in detail below in chapter 8.

<sup>39</sup> *The Law Commission’s Report* [2.24].

<sup>40</sup> CPR, r 32.1.

5. The Law Commission recommended that in shareholder proceedings the court should have power to exclude an issue from determination if it can do substantive justice between the parties without considering that issue.<sup>41</sup> The CPR provide that “the court may exclude an issue from consideration”.<sup>42</sup>

6. The Law Commission recommended that “in proceedings under section 459 the court should have greater flexibility than it had previously to make costs orders to reflect the manner in which the successful party has conducted the proceedings and the outcome of individual issues” echoing the Woolf Report.<sup>43</sup> This recommendation was also implemented by the CPR.<sup>44</sup>

Below after outlining the main changes brought about generally by the CPR, the chapter considers the nature and impact of the CPR upon section 459 proceedings to effectively resolve shareholder disputes.

### **7.3 Overview of the changes to civil procedure brought about by the CPR:**

#### ***7.3.1 Case management powers of courts:***

The CPR introduced two types of developments: firstly parties were encouraged to settle their dispute early, so reinforcing *O’Neill v Phillips* early offers to buy-out<sup>45</sup> and secondly rules were implemented to control the conduct of proceedings. The CPR consist of (i) an overriding objective; (ii) principles to further the overriding objective and (iii) detailed supplementary rules and practice directions. The CPR have the overriding objective of enabling the court to deal with cases justly.<sup>46</sup> CPR rule 1.1(2) defines the overriding objective of dealing with cases justly to include *inter alia* saving expense, ensuring that the case is dealt with expeditiously and fairly and efficient use of court resources. Rule 1.1(2) states that:

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<sup>41</sup> *The Law Commission’s Report* [2.27].

<sup>42</sup> CPR, r 3.1 (2)(k).

<sup>43</sup> *The Law Commission’s Report* [2.32].

<sup>44</sup> CPR, r 44.3 (4) (5).

<sup>45</sup> See above chapter 6 para 6.5.2.2 Early fair offers to buy-out.

<sup>46</sup> See CPR, r 1.1(1).

Dealing with a case justly includes, so far as is practicable

- (a) ensuring that the parties are on an equal footing;
- (b) saving expense;
- (c) dealing with the case in ways which are proportionate to
  - (i) the amount of money involved;
  - (ii) the importance of the case;
  - (iii) the complexity of the issues;
  - (iv) the financial position of each party;
- (d) ensuring that it is dealt with expeditiously and fairly
- (e) allotting to it an appropriate share of the court's resources, while taking into account the need to allot resources to other cases.

Clearly, these matters may be of relevance to section 459 proceedings given the tenor of the Law Commission's critique. The CPR provide that the court must seek to give effect to the overriding objective while exercising its powers and interpreting any of its specific rules.<sup>47</sup> The CPR set out the courts' duty and powers to manage cases.<sup>48</sup> CPR rule 1.4 states that to meet the overriding objective courts will actively manage cases. Rule 1.4(2) of the CPR defines the scope for active case management by the courts. By enhancing the case management powers of the court the CPR provide that active case management includes *inter alia* helping the parties to settle the whole or part of the case<sup>49</sup> and giving directions to ensure that the trial of a case proceeds quickly and efficiently<sup>50</sup>. These powers of courts may be useful particularly in controlling the length and costs of section 459 proceedings.<sup>51</sup> The courts have acknowledged the utility of these powers in the specific context of section 459 proceedings.<sup>52</sup>

Rule 1.4(2) of the CPR provides the basic principles of active case management to achieve the overriding objective that (i) encourage the parties to co-operate with each other in the conduct of proceeding<sup>53</sup> and help the parties to settle the whole or part of the case and also give proper consideration to ADR<sup>54</sup> and (ii) enhance the courts powers to

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<sup>47</sup> See CPR, r 1.2.

<sup>48</sup> See CPR, r 1.4, 3.1.

<sup>49</sup> CPR, r 1.4(2)(f).

<sup>50</sup> CPR, r 1.4(2)(l).

<sup>51</sup> See above chapter 5 para 5.6.2 The Law Commission's critique of section 459 of the CA 1985.

<sup>52</sup> See below *North Holdings Ltd v Southern Tropics Ltd* [1999] 2 BCLC 625 and *Re Rotadata Ltd* [2000] 1 BCLC 122 in para 7.4 The nature and impact of procedural developments under the CPR regarding section 459 proceedings.

<sup>53</sup> See CPR, r 1.4 (a).

<sup>54</sup> See CPR, r 1.4 (e)(f).

manage the proceedings<sup>55</sup> in contrast to the pre-CPR system where it is generally thought that parties and their lawyers controlled the pace of litigation which often resulted in lengthy and costly litigation.<sup>56</sup> Under the current system co-operation between the parties before or during the proceedings seems to be fundamental to meet the overriding objective. The court<sup>57</sup> can actively manage cases at the pre-trial stage by (i) identifying the issues at an early stage and deciding promptly which issues need full investigation and/or need to be set down for trial and disposing summarily of the others; (ii) deciding the order and manner in which issues are to be resolved to ensure the quick and efficient progress of the case.<sup>58</sup>

The court's general powers of management are further explained in rule 3.1(2)(m) of the CPR which provides that except where the rules provide otherwise, the court may take any other step or make any other order for the purpose of managing the case and furthering the overriding objective.<sup>59</sup> The Chancery Guide further describes the scope of case management and states that the key feature of the CPR is that cases are closely monitored by the court.<sup>60</sup> By defining the duties of the parties the CPR provide that the parties are required to help the court and to co-operate with each other to further the overriding objective.<sup>61</sup>

Reading the CPR along with the pre-action protocols,<sup>62</sup> it seems evident that two broad measures have been introduced under the CPR, to achieve the overriding objective of saving expense and efficient use of court resources. These are: (i) promotion of early settlement of disputes especially at the pre-action stage and encouragement towards the use of ADR mechanisms and (ii) courts' control over the proceedings through enhanced case management powers.

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<sup>55</sup> See CPR, r 1.4 (2)(b-d)(g-l).

<sup>56</sup> See O' Hare, J., and Browne, K., *Civil Litigation*. ( 11<sup>th</sup> ed Sweet and Maxwell, London 2003) 7.

<sup>57</sup> Principally through the system of masters, registrars and district judges.

<sup>58</sup> See CPR, r 1.4 (2).

<sup>59</sup> The overriding objective of CPR was stated in r 1.1(1) of CPR.

<sup>60</sup> The Chancery Guide, Section A, chapter 3.1.

<sup>61</sup> CPR, r 1.3, 1.4(1) (2)(a).

<sup>62</sup> See Practice Direction – Protocols, para 4 and below para 7.4.2 Nature and impact of procedural developments at the pre-action stage.

In his commentary on the defects of the pre-CPR system, Zuckerman asserts that the courts' main concern was to deal with cases on the merits without giving much consideration to the issues of cost and delay in the proceedings unless the delay was really prejudicial to one or more of the parties.<sup>63</sup> To address this problem the CPR focuses upon the problems of costs and delay in civil proceedings. It has been rightly stated that case management was a corner-stone of Lord Woolf's procedural reforms.<sup>64</sup> Lord Woolf's reforms of civil procedure emphasised the need to resolve disputes quickly and cost effectively with proper consideration being given to the available resources of the parties and the courts in any particular case. The reforms have also tried to promote the early resolution of disputes. As Andrews has put it:

[B]y exercising its case management powers, the court is expected to curb the parties' tendency to take inappropriate steps or to prosecute the case in an oppressive, disproportionate, inefficient or unfair fashion".<sup>65</sup>

Hence, the objective to deal with cases justly includes (i) fair adjudication in accordance with particular facts and law (ii) decision within a reasonable time and (iii) use of proportionate resources in any particular case.<sup>66</sup> There can be conflict among these three elements when pursuing the overriding objective. For example just and fair adjudication of disputes may demand considerable time and resources of both courts and parties which as a result may increase the length and cost of litigation.

Zuckerman has suggested that to serve the community in a better way, there is considerable scope for simplifying and speeding up the process of litigation in order to yield more timely and less costly judgments even if it means some sacrifice in the quality of those judgments.<sup>67</sup> He has also proposed that empirical research should be undertaken to assess the extent to which accuracy and/or quality of judicial product

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<sup>63</sup> See Zuckerman, A., *Zuckerman on Civil Procedure* (2<sup>nd</sup> ed. Sweet and Maxwell, London. 2006) paras 1.57, 1.68-1.69.

<sup>64</sup> See Andrews N., *English Civil Procedure* (Oxford, US 2003) 337.

<sup>65</sup> See *ibid* 338.

<sup>66</sup> See discussion in Zuckerman, A., *Zuckerman on Civil Procedure* (2<sup>nd</sup> ed. Sweet and Maxwell, London. 2006) 3.

<sup>67</sup> Zuckerman, AAS 'Quality and Economy in Civil Procedure - The Case for Commuting Correct Judgments for Timely Judgments' (1994) 14 *Oxford Journal of Legal Studies* 353, 354, 386.

might be compromised in the interests of speed.<sup>68</sup> In fact the CPR confer on the courts a wide discretion to prefer any of these three elements in the event that they conflict.<sup>69</sup>

#### 7.3.1.1 Criticism of case management powers in legal literature:

Zuckerman stated that wide discretion of courts under the Rules does not signify that courts have unlimited discretion regarding case management decisions. The courts are supposed to make case management decisions according to established principles and guidelines laid down by the higher courts.<sup>70</sup> In the lead up to the adoption of the CPR, there was some scepticism about the likely efficacy of case management. One concern was that broad discretionary powers would lead to a huge increase in inconsistent decision making.<sup>71</sup> Such variations threaten to reduce the predictability of litigation especially where individual exercises of discretion are largely unregulated by the appellate courts.<sup>72</sup> In this context Lord Woolf has stated that:

...judges have to be trusted to exercise the wide discretions which they have fairly and justly in all the circumstances.... When judges seek to do that, it is important that the [Court of Appeal] should not interfere unless judges can be shown to have exercised their powers in some way which contravenes the relevant principles.<sup>73</sup>

In a section 459 case the Court of Appeal refused to interfere in the case management decision of the court of first instance. At the order of the court a joint expert was appointed to prepare a report as to the market value of the company's shares and a minority holding for the purposes of share valuation. Due to high costs of the joint expert the court ordered to dispense with expert services and to use a cheaper expert. On appeal from this order, the Court of Appeal held that it would not interfere where the judge exercised his discretion on such a case management decision in the absence of any serious procedural irregularity.<sup>74</sup>

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<sup>68</sup> *Ibid* 382, 387.

<sup>69</sup> See below para 7.3.1.1

<sup>70</sup> See Zuckermann A., *Civil Procedure*. (LexisNexis Butterworths, UK 2003) 15.

<sup>71</sup> Zander, M., 'Consistency in the Exercise of Discretionary Powers' (1996) 146 *New Law Journal* 1590, 1592.

<sup>72</sup> See Andrews N., *English Civil Procedure* (Oxford, US 2003) 343.

<sup>73</sup> *Biguzzi v Rank Leisure plc* [1999] 1 WLR 1926, 1934, CA, per Lord Woolf MR as quoted by Andrews N., *English Civil Procedure* (Oxford, US 2003) 343.

<sup>74</sup> See *Kranidiotes v Paschali* [2001] EWCA Civ 357

Sugarman expressed the concern that “the philosophy of greater court control may in practice elevate efficiency above the other goals of a civil justice system, such as fair justice”.<sup>75</sup> It was asserted that the “case management is unlikely to operate effectively unless it is properly tested<sup>76</sup> and refined in practice and is sustained by adequate resources, judicial training and careful monitoring”.<sup>77</sup> Judicial case management powers under the CPR were not considered a satisfactory solution to the problem since case management itself relied heavily on the exercise of discretion by the courts. As a result, a shareholder would need more rather than less evidence to persuade the court to exercise its discretion in his favour at the case management stage and this would also increase the cost of the litigation.<sup>78</sup> It was stated that “there is a tension between the extra emphasis on judicial discretion and the aim of reducing litigation costs”.<sup>79</sup> However, it can be argued that costs incurred up to and including the case management stage will be front end loaded and this may create incentives for the parties to consider settlement.<sup>80</sup>

It was also argued that there was no solid empirical evidence of any kind to back Lord Woolf’s diagnosis of the problem, that the chief cause of delay was the way the adversary system was played by the lawyers.<sup>81</sup> Research conducted in the US indicated “that case management increases the cost of litigation because it generates more work for lawyers”.<sup>82</sup> Zuckerman argued that the “history of law reforms shows that a simplification of procedure is not enough to produce savings as long as there are

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<sup>75</sup> Sugarman, D., ‘Reconceptualising Company Law: Reflections on the Law Commission’s Consultation Paper on Shareholder Remedies [Part 2]’ (1997) 18(9) *Company Lawyer* 274, 276. See below para 7.3.2 Existing research evaluating the impact of the CPR, a research study found that case management has improved the pace of litigation but at higher costs.

<sup>76</sup> See *Rotadata Ltd* [2000] 1 BCLC 122; *North Holdings Ltd v Southern Tropics Ltd* [1999] 2 BCLC 625 where Civil Procedure Rules 1998 have been applied in unfair prejudice case under section 459 of Companies Act 1985.

<sup>77</sup> Sugarman, D., ‘Reconceptualising Company Law: Reflections on the Law Commission’s Consultation Paper on Shareholder Remedies [Part 2]’ (1997) 18(9) *Company Lawyer* 274, fn 288.

<sup>78</sup> *Ibid* 276.

<sup>79</sup> Roberts, P., and Poole J., ‘Shareholders Remedies- Efficient Litigation and the Unfair Prejudice Remedy’ (1999) *Journal of Business Law* 38, 48.

<sup>80</sup> See below para 7.4.2.1 Pre-action co-operation and 7.4.2.1.1 Front loading of costs.

<sup>81</sup> See Zander, M., ‘Woolf on Zander’ (1997) 147 *New Law Journal* 768, 769.

<sup>82</sup> Sugarman, D., ‘Reconceptualising Company Law: Reflections on the Law Commission’s Consultation Paper on Shareholder Remedies [Part 2]’ (1997) 18(9) *Company Lawyer* 274, 276.

incentives to devise new complications”.<sup>83</sup> Lawyers had economic incentives since their remuneration rose as litigation became more complicated and lengthy.<sup>84</sup> Therefore, lawyers who are trained to deal with cases in an adversarial manner may exploit new techniques to litigate the issue for their own financial advantage.<sup>85</sup>

### ***7.3.2 Existing research evaluating the impact of the CPR:***

Research has been conducted to evaluate whether the procedural developments under CPR at pre-action and case management stages were as effective as anticipated.<sup>86</sup> One qualitative empirical research project commissioned by the then Department of Constitutional Affairs considered case management in eight county courts.<sup>87</sup> Concentration of the research was on the typical experience of case managed litigation in county courts across England.<sup>88</sup> As to case management it was stated that it is an art and not science and each case depends on its own facts. Practitioners expressed some concern as to inconsistency particularly as between courts or in very large trial centres where it could not be predicted what the outcome would be and this brings a lot of uncertainty.<sup>89</sup>

However the research concluded that case management powers under the CPR had been successful in reducing delay and had made the process more certain.<sup>90</sup> The settlement rate was found to be very high and that was felt to be a result of the CPR.<sup>91</sup> The majority of cases considered settled pre-issue and only a minute number of multi-track cases had

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<sup>83</sup>Zuckerman, AAS., ‘Lord’s Woolf’s Access to Justice: Plus ca Change ...’ (1996) 59 *Modern Law Review* 773, 795.

<sup>84</sup>*Ibid.*

<sup>85</sup> Interviewees stated that lawyers should behave in a responsible manner to save time and expense involved in section 459 proceedings. See below para 7.4.3.3.4 Lawyers’ responsibility to manage petitions.

<sup>86</sup> See above para 7.2.1 The Woolf Reforms.

<sup>87</sup> See Peysner J., and Seneviratne M., ‘The management of civil cases: the courts and post-Woolf landscape’ (DCA Research Series 9/05, Nov 2005). Series of in-depth interviewees and focus groups were carried out with a wide range of practitioners, judges and court officers.

<sup>88</sup> See *ibid* chapter 2 para 2 Methodology.

<sup>89</sup> See *ibid* para 3.11.

<sup>90</sup> See *ibid* chapter 4.

<sup>91</sup> Foskett asserted that since 1999 the landscape of civil litigation has changed significantly. Less cases are being dealt with in courts which means that more cases are being settled or at least are being settled earlier. See Foskett D., *The Law and Practice of Compromise* (6<sup>th</sup> ed Sweet and Maxwell, London 2005) chapter 13 para 13-03 and n 3.



gone to trial. In most areas of civil litigation, demands of the CPR required substantial work. Evidence from interviewees as to their impressions of the overall position suggested that costs had increased overall due to the CPR and cost per case was higher than it had been pre-CPR.<sup>92</sup> It was stated that justice required accurate judgments at a reasonable cost. Case managed court based dispute resolution system was delivering quality at a much improved pace but not anymore cheaply and possibly, at higher costs than pre-CPR.<sup>93</sup>

Another research project commissioned jointly by the Law Society and the Civil Justice Council to provide an initial evaluation of the reforms concentrated on the pre-action stages of litigation, particularly protocols and offers to settle disputes.<sup>94</sup> The research focused on three areas of practice namely personal injury, clinical negligence and housing. A theme emerging from the study is that procedural rules rarely change cultures on their own. The possibilities for cultural change were greatest when reforms work with other structural and economic transformations. The court reforms had been most successful where they have worked alongside legal aid and managerial changes which also emphasised early focus on and a pragmatic approach to settlement.

This research found that practitioners generally regarded the Woolf reforms as a success. The reforms were liked for providing a clearer structure, greater openness and making settlements easier to achieve. Interestingly, the housing practitioners interviewed reported similar experiences to the practitioners in other areas of work even though housing litigation was not at the time subject to a protocol.<sup>95</sup> However, the picture was qualified in that many respondents reported that change had been patchy. Respondents

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<sup>92</sup> It was stated that “the impact of the arrangements in the CPR to divert cases from litigation, or to ensure that litigated cases were better prepared and disclosed more information relevant to liability and quantum, not least so that an opponent could make a better informed offer to settle, the inevitable result was that costs per case were higher”. See Peysner J., and Seneviratne M., ‘The management of civil cases: the courts and post-Woolf landscape’ (DCA Research Series 9/05, Nov 2005) chapter 6 para 6.6.

<sup>93</sup> See Peysner J., and Seneviratne M., ‘The management of civil cases: the courts and post-Woolf landscape’ (DCA Research Series 9/05, Nov 2005) chapter 6 para 6.6.

<sup>94</sup> Goriely T., Moorhead R., and Abrams, P. ‘More Civil Justice? The impact of the Woolf reforms on pre-action behaviour’ (Research Study 43, commissioned by The Law Society and Civil Justice Council, 2002).

<sup>95</sup> A Housing Disrepair Protocol was subsequently brought into force on 8<sup>th</sup> December 2003.

frequently criticised some their counterparts for failing to adapt to the new culture. Some litigants, especially specialists, had adapted while others maintained pre-Woolf attitudes and approaches.

Respondents criticised the lack of sanctions on those who failed to act reasonably in the course of pre-action negotiations. Secondly, although case management was not explored in any depth in the research, interviewees frequently highlighted perceived failings within the courts and criticised the courts for inefficiency and delay. Case management was far more positively received in London than outside, where there were problems with providing experienced judges and apparently inconsistent decisions. Thirdly, respondents complained that the Woolf reforms had failed to reduce the cost of litigation.<sup>96</sup> It was also confirmed that the study showed how intractable was the problem of cost. Although the reforms were well liked, and might have led to perceived ‘soft’ improvements in, for example, the level of co-operation and settlement, it was much more difficult to make litigation cheaper.

### ***7.3.3 Empirical evaluation of the impact of the procedural developments under the CPR***

In my empirical research I explored the impact of the procedural developments under the CPR on both general Chancery practice and specifically in relation to section 459 practice. Here, the chapter discusses the findings of the research regarding the impact of the CPR upon general Chancery practice.

The majority of the interviewees confirmed that they had experienced changes in their chancery practice as a result of the CPR. Interviewees stated that following the CPR the amount of litigation had decreased and there were more settlements of disputes due to

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<sup>96</sup> It was stated in the report that “each potential saving in the reform is offset by other changes that require more work, or bring forward work to an early stage”. See Goriely T., Moorhead R., and Abrams, P. ‘More Civil Justice? The impact of the Woolf reforms on pre-action behaviour’ (Research Study 43, commissioned by The Law Society and Civil Justice Council, 2002) executive summary at xxvii.

increased costs of litigation.<sup>97</sup> The emphasis upon pre-action co-operation along with appropriate exploitation of ADR, in order to settle the dispute under risk of cost sanctions had increased early settlements of disputes. Moreover, pre-action correspondence and pre-trial preparations to control the conduct of trial had made costs front end loaded and this had also contributed to the settlement of disputes at an early stage. Pre-trial preparations had increased the pace of the trial and cases took less time in courts. Against this prevailing view, there were some practitioners who were less convinced about the extent and depth of the general impact. One interviewee described CPR as a bit of a ‘damp squib’ that had not significantly affected her practice [R]. These responses are discussed below in detail.

Interviewees stated that following the CPR practice had changed because the amount of litigation had decreased substantially and fewer cases were starting now in courts due to increased litigation costs [P, J]:

The CPR was intended to make the litigation cheaper but there was a perception it had made it more expensive and cost had gone up with the CPR because of front loaded costs. Parties have to follow cards on the table approach [G]

I think my general view in relation to the Civil Procedure Rule is that the rules contributed considerably to the cost of litigation, and that has resulted in people being less willing to litigate. Now you have to have done the work for the trial upfront. Therefore, instead of getting a legal decision on their disputes people try to reach some sort of commercial compromise [P].

The prevailing view was that the CPR had promoted a settlement culture in chancery practice. The following extract suggests that pre-action protocols have been particularly significant in this regard.

One of the objectives of the rules has been met, which is to make people think before they issue proceedings. In the past you could issue and then your negotiations could catch up. Nowadays, because of pre-action protocols, people go through very lengthy correspondence before issuance of proceedings and that promotes settlement [J].

However, while interviewees regarded the emphasis on pre-action correspondence and ADR in particular mediation as the biggest change brought about by the CPR, the

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<sup>97</sup> Interviewees also confirmed other small changes in terminology regarding civil cases such as terms of plaintiff and pleadings have been replaced by the terms of claimant and statement of case respectively though this would not impact upon matters within the scope of the research questions.

general impression was that there was no great appetite for forcing people to mediate in chancery division [A].

Interviewees stated that following the CPR costs of litigation were front end loaded due to pre-action co-operation and pre-trial preparations that increased the settlements and decreased the amount of litigation. Due to the pre-action protocols litigants had to engage in quite a lot of expense before they actually started the litigation and this, in turn, operated as an incentive to avoid litigation [R]. Secondly, the rules require much of the preparation for trial to be done at the outset rather than just before trial [P]. This further accentuated the tendency for the CPR to lead to front loading of costs and inclined the parties and their lawyers to think about settlement early rather than later in the proceedings stage [C, P]. Interviewee T explained the reasons behind the front loading of costs:

Under the CPR before you issue any proceedings generally speaking you have got to have your whole case ready since, for CPR purposes once the case is issued the court takes hold of it. In case management terms, which is another difference now, courts get the cases by the scruff of the neck by applying their cases management powers available under the CPR. So under the CPR there is more front loading of the work, you have got to do more work before you issue proceedings than you used to do. Under the old procedure you could issue proceedings and you could go slowly and be very tactical, the parties would control the litigation [T].

Interviewees were strongly of the opinion that the rules on pre-trial preparations had reduced the time in which cases were processed through the court system. However, their general view was that costs had not been reduced but merely shifted to an earlier stage of the process. The requirement for early filing of witness statements, for example forced parties to have to incur significant costs [G, M].

It is evident that following the CPR due to enhanced litigation costs there is less litigation and more settlements in chancery practice. Encouragement to co-operate at pre-action stage and front loading of costs are other factors behind early settlement of disputes. Due to pre-trial preparations cases proceed in a swift manner at trial and take less time in courts. This evidence tends to confirm the findings of the earlier research on

the impact of Woolf reforms – ie there are more settlements and less delay in court proceedings without reducing litigation costs.<sup>98</sup>

The research to date has not focused specifically on litigation in the corporate context. In the context of section 459 proceedings the question that remains unanswered is whether these procedural developments have improved the effectiveness of shareholder disputes resolution mechanism by controlling the length and cost of section 459 cases.<sup>99</sup> The empirical investigation also evaluated the impact of the procedural developments under the CPR in this context. This thesis therefore contains the first attempt to assess the effectiveness of section 459 proceedings in the light of the procedural reforms of the late-1990s. Below the chapter discusses in detail the impact of the CPR upon section 459 proceedings by considering the nature of procedural law developments and empirical findings.

#### **7.4 The nature and impact of procedural developments under the CPR regarding section 459 proceedings:**

The procedure under section 459 is governed by the Companies (Unfair Prejudice Application) Proceedings Rules 1986.<sup>100</sup> Rule 2(2) of the Companies (Unfair Prejudice Application) Proceedings Rules 1986 provides that except so far as inconsistent with the Act and the 1986 Rules, the Rules of the Supreme Court (RSC) and the practice of the High Court apply to the proceedings.<sup>101</sup> It is now clear from the decisions in *North Holdings Ltd v Southern Tropics Ltd*<sup>102</sup> and *Re Rotadata Ltd*<sup>103</sup> that the CPR apply to section 459 petitions and the reference in rule 2(2)<sup>104</sup> to the RSC and the practice of the High Court should be read as a reference to the CPR given that rule 1.1(1) of the CPR states that these Rules are a new procedural code.<sup>105</sup> Accordingly, there are five main

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<sup>98</sup> See above para 7.3.2 Existing research evaluating the impact of the CPR.

<sup>99</sup> See above, chapter 5 para 5.6.2 The Law Commission's critique of section 459 of the CA 1985.

<sup>100</sup> SI 1986/2000.

<sup>101</sup> SI 1986/2000, r 2(2).

<sup>102</sup> [1999] 2 BCLC 625.

<sup>103</sup> [2000] 1 BCLC 122.

<sup>104</sup> SI 1986/2000.

<sup>105</sup> See also Joffe V.H., *Minority Shareholders: Law Practice and Procedure* (3<sup>rd</sup> ed Oxford University Press, Oxford 2008) para 6.12 including n 29 and Copp S., 'Company Law and Alternative Dispute Resolution: An Economic Analysis' (2002) 23(12) *Company Lawyer* 361, 369.

sources of procedural law which affect section 459 cases. These are: (i) the CPR; (ii) relevant Practice Directions under the CPR; (iii) the Companies (Unfair Prejudice Application) Proceedings Rules 1986; (iv) the Chancery Guide and (v) case law<sup>106</sup> that further interprets the rules by applying them in particular situations and establishing procedural principles to be adhered to by the courts in future. The Chancery Guide echoing the Law Commission states that cases under section 459 of the CA 1985 are often liable to involve extensive factual enquiry. Many of the measures proposed in section A of this guide regarding general civil work, which are designed to avoid unnecessary cost and delay, are particularly relevant to them.<sup>107</sup>

As to the application of the CPR in 459 cases in *Re Rotadata Ltd*<sup>108</sup> it was stated that:

[S]ection 459 petitions can, and frequently do, involve a substantial number of allegations and counter allegations, substantial costs and lot of court time; not to mention the strain and emotion on the parties involved. Anything which can be done fairly and consistently with justice to cut down the cost and time involved in connection with disposing of a s 459 petition is to be applauded.<sup>109</sup>

In *North Holdings Ltd v Southern Tropics Ltd*<sup>110</sup> it was stated that:

[T]he new Civil Procedure Rules 1998, SI 1998/3132, have been introduced which represent a new way of conducting litigation. At the heart of those rules is the requirement of the courts to manage cases actively. That will require a new approach by the registrar to proceedings such as this one. He will need to give directions to enable petitions to come on for trial efficiently, quickly and as inexpensively as possible.<sup>111</sup>

In *Rotadata Ltd* it was stated that the Civil Procedure Rules 1998 imposed a duty on the court to manage cases actively and a duty on the parties to agree as much as possible with a view to avoiding the necessity of going to court, or at least minimising the cost of

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<sup>106</sup> See *Rotadata Ltd* [2000] 1 BCLC 122; *North Holdings Ltd v Southern Tropics Ltd* [1999] 2 BCLC 625; *Halsey v. Milton Keynes General NHS Trust* [2004] EWCA Civ 576; *Susan Jane Dunnett v Railtrack PLC* [2002] EWCA Civ 303; *Hateley v Morris* [2004] 1 BCLC 582; *Hickman v Blake Laphorn* [2006] EWHC 12; *Dunnett v Railtrack plc* [2002] EWCA Civ 303; *Societe Internationale de Telecommunications Aeronautiques SC (SITA) v Wyatt* [2002] EWHC 2401 (Ch); *Regina v Plymouth City Council* [2001] EWCA Civ 1935.

<sup>107</sup> The Chancery Guide, chapter 20, para 20.22 *Procedure for relief from unfairly prejudicial conduct under the Companies Act 1985, section 459.*

<sup>108</sup> [2000] 1 BCLC 122.

<sup>109</sup> [2000] 1 BCLC 122, 124.

<sup>110</sup> [1999] 2 BCLC 625.

<sup>111</sup> [1999] 2 BCLC 625, 638.

so doing.<sup>112</sup>

The overriding objective of the CPR requires the courts to deal with cases justly by exercising their case management powers.<sup>113</sup> To achieve the overriding objective pre-action protocols in CPR<sup>114</sup> states that the parties should try to avoid the litigation by settling the dispute at the pre-action stage. This serves to underpin the emphasis in *O'Neill v Phillips* upon early offers to buy-out and may have an impact on section 459 practice by increasing the number of settlements reached even before proceedings are formally commenced. Furthermore, it may be thought that the emphasis on case management powers and pre-trial preparations in the CPR, should lead to section 459 proceedings becoming more focused once they are commenced with the consequence that the parties may be more inclined to settle in the pre-trial phase.

The procedure for section 459 cases can be divided into three distinct stages (i) the pre-action stage (ii) the proceedings stage (iii) the assessment of costs stage. The CPR have enhanced the case management powers of courts at all three of these stages. The proceedings stage can be further divided into three sub-stages: (i) commencement of proceedings stage; (ii) allocation and pre-trial process stage; (iii) the trial stage. Under the CPR at the pre-action stage the rules encourage the parties to seek a settlement without proceedings having to be issued. Assuming that the dispute does not settle the CPR encourage the courts at the proceedings stage to actively control the conduct of the action by exploiting their case management powers, for example by excluding particular matters that have been raised in the petition. At the assessment of costs stage the courts are specifically empowered by the CPR to make issue based costs order and these orders can be made on interim applications as well as at the conclusion of proceedings. The old Rules of the Supreme Court did not make explicit provision for such orders.

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<sup>112</sup> See *Rotadata Ltd* [2000] 1 BCLC 122, 126. See also *Blythe v Sams*, December 15, 1999 (CA) LexisNexis Butterworths transcript can be accessed at [www.lexisnexis.com/uk](http://www.lexisnexis.com/uk).

<sup>113</sup> See above para 7.3.1 Case management powers of courts.

<sup>114</sup> Pre-action protocols are defined by glossary to the CPR as “statements of understanding between legal practitioners and others about pre-action practice and which are approved by a relevant practice direction”. Although protocols cannot be enforced but where the proceedings are started, parties can be penalized for failure to follow pre-action protocols. Practice Direction to the protocols para 2.2 provides that the court will expect all parties to have complied in substance with the terms of an approved protocol.

The empirical research confirmed that as well as impacting general chancery practice, the CPR has also affected section 459 practice. Interviewees experienced two fundamental developments in section 459 practice as a result of the CPR, namely the encouragement of early settlements of section 459 disputes and enhanced case management powers of courts with the consequence that cases have been processed more quickly through the courts than they were pre-CPR. One interviewee put it thus:

In 459 practice I think the CPR has probably added in the sense that it encourages the parties to cooperate with each other to settle disputes, enables the courts to manage the cases in a bit more proactive way and people now have to set out their cases more thoroughly before the actual trial [R].

There was a consensus that settlement was very common in 459 disputes even pre-CPR due to the expensive nature of section 459 proceedings but the CPR had tended to encourage settlements pre-action or early in the proceedings stage rather than just before trial at the door of the court. By encouraging early settlement the CPR tended to be consistent with the principles laid down in *O'Neill v Phillips* about early fair offers to settle shareholder disputes.<sup>115</sup>

Even though the CPR encouraged early offers to settle and enhanced courts' powers controlling the conduct of the proceedings, the CPR had not any obvious impact on the costs of section 459 proceedings.<sup>116</sup>

#### ***7.4.1 Settlement of shareholder disputes before the CPR:***

Interestingly, there was a complete consensus among interviewees that settlement was very common in section 459 disputes even before the CPR. According to their own estimates, between 70 to 90 percent of the section 459 disputes that interviewees had dealt with had settled usually because the parties did not wish to incur further costs. But the CPR has promoted early settlement culture in section 459 disputes by emphasising co-operation at pre-action stage along with appropriate exploitation of ADR under the

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<sup>115</sup> See above chapter 6 para 6.5.2.2 Early fair offers to buy-out.

<sup>116</sup> This tends to corroborate the finding of the research reports discussed above that civil litigation is not cheaper after the CPR.



pressure of cost sanctions and due to front loading of costs. Emphasis upon pre-action co-operation had also accelerated the number of settlements in section 459 disputes.

An interesting finding was that settlement was also very common in section 459 disputes even before the introduction of CPR. In the personal experience of interviewees the vast majority of section 459 disputes in their caseloads settle and only a small percentage possibly as little as 5% or less actually got to court [B, M, G, T].

It is extremely unusual for these cases to go to court. In my twenty years of experience hundreds of cases were settled and just four cases went to trial. Two of them were before CPR and two were after CPR. I get two or three cases a month... 30 cases a year... therefore over 18 years of practice 500 cases and it is not any exaggeration. It means just one percent went to trial [B].

Disputes regularly settled after the issuance of proceedings and often in the period immediately before trial once the issues and evidence had been clarified. Two main reasons were explained behind high settlement rate of section 459 disputes pre-CPR. Due to relational breakdowns section 459 disputes were almost invariably about ‘separation’ and ‘money’<sup>117</sup> that had contributed to the fact that majority of these cases settle [S]. If it is inevitable that there must be separation and that one party must buy the other out this is what the court would order and so there is no point in litigating the dispute to trial. Secondly section 459 disputes were very expensive to litigate [B, C, G, J]. Interviewees stated that shareholders were always advised by their lawyers that a trial should be a last resort because the proceedings were going to cost them a lot. In the interviewees’ experience, clients who were not put off by this at the outset would often become convinced of the merits of a buy-out solution once they had incurred and paid the initial legal costs. [B, S].<sup>118</sup>

One practitioner stated that:

In practice, most disputes never reach trial. The costs of the dispute are always a great incentive for the parties to reach a deal. The most common form of relief ordered by the courts is a buy-out of the petitioning shareholder’s shares. This has led to a practice whereby the respondent, at an early stage, is likely to make a fair offer that complies with the House of Lords guidance in *O’Neill*.<sup>119</sup>

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<sup>117</sup> See above chapters 3 and 6. See also *O’Neill v Phillips* [1999] 2 BCLC 1 and *Grace v Biagioli* [2006] 2 BCLC 70.

<sup>118</sup> These views are discussed below in detail.

<sup>119</sup> Personal email correspondence 14<sup>th</sup> March 2007.

#### *7.4.1.1 The expensive nature of section 459 petitions:*

There was a complete consensus that the expensive nature of section 459 petitions was always a main factor that persuaded parties to settle the disputes and, that in this respect, the CPR has not reduced the costs of litigation. The following cluster of extracts from the interviews are illustrative:

Due to their nature section 459 petitions were ludicrously expensive before the CPR and they still are after the CPR... The nature of a section 459 petition is that lawyers usually have to trawl back through the history of the relationship between the parties... setting up the company, the falling out of the parties and how it all went wrong... that makes them expensive [S].

The costs of section 459 proceedings are high and the CPR has not reduced them therefore it is still an important factor behind the settlement of disputes [C].

In a small family company dispute, probably worth five million pounds, litigation costs on our side at an early stage were one and a half millions pounds, absolutely ludicrous, costs on the other side were much greater. Now witness statements have added quite substantially to the burden of litigation costs [P].

Section 459 proceedings are very long and expensive for most litigants. Section 459 disputes are prohibitively expensive to litigate. So parties realize before they get to trial that life is too short and they are wasting so much time and money upon litigation that lead them to some negotiated settlement. After the CPR litigation costs have not reduced but now there is more pressure to settle early [M].

If parties were very rich then it would not matter for them, but normally litigation costs would be a big influence upon any negotiated settlement [E].

It was explained that section 459 proceeding were lengthy and complex therefore expensive because they are often about relational breakdowns:

Shareholders tend to throw the kitchen sink at the other side to prove unfairly prejudicial conduct, when they decide to litigate. Section 459 petitions are like divorce petitions where allegations start from the first day of marriage [B].

Interviewees stated that settlement was almost always in the parties' interests in section 459 cases since they were usually meeting legal costs out of their own pockets though sometimes due to high emotions at relational breakdown parties did not exercise good judgment at an early stage [C]. However, the risk of incurring costs generally persuaded parties sooner or later to settle the dispute. Sometimes a 'stick and carrot' approach was needed and parties might not be prepared to make or consider a settlement offer until

they were in court proceedings and facing the immediate prospect of having to pay legal bills [H, M].

The common experience was that section 459 cases that are fully prepared for trial cost a fortune. Therefore, efforts to settle were common even before the CPR. The client might have a fantastic case in terms of legal merits but by the time they had gone through the litigation process they might have no money left [K].

Disputes settle near the trial because very often when the trial is approaching certainly then the clients turn their minds to how much it is costing them, how much it had cost them and how much it is going to cost them [P].

Most of the cases that went to trial settle on the first day of the trial. Clients ought to settle at an earliest stage but the difficulty was that some clients and some opponents would not do so [K, S].

Interviewee H stated that people sometimes just got bored of the litigation:

At the beginning of the dispute there is a big fight... everybody intends to [fight] the claim vigorously. After paying lawyers fee for about six months the [parties] think it is pointless exercise, [the majority is] going to buy [the minority's] shares at the end of the day. Why don't they just add the costs incurred to date to the price and do a deal... A very simple 459 petition can cost a minimum of £50,000 to one side... in practice it is always more than that amount. In a small company where the £50,000 is a significant proportion of the share price it is sensible to get rid of the minority by paying him that amount for the shares. Costs are a deterrent and make parties settle but clients do not realise this until they start writing cheques [H].

Interviewee E stated that at the start of the dispute clients are often seeking moral satisfaction which may cloud their assessment of the legal merits of their case. E continued:

Usually, at the start parties have an unrealistic assessment about the worth of their own shares or the position of the other side. Experience shows that over the course of section 459 dispute the position of each side are likely to close together. In other words, they would become more realistic about their position and risk of their loss. When these disputes settle as they more often do is, because the parties realize that what causing their wide position to get closer at that stage is not just the fact they are becoming more realistic, but because they are paying lawyers and accountants a lot of money to litigate the dispute. If they actually just decided to stop paying lawyers and accountants and treat it as a commercial enterprise they realize they actually could meet in middle. Cut lawyers and accountants out of the equation and do a deal and go their separate ways [E].

It is evident that litigating section 459 disputes was expensive and is still expensive following the CPR. Moreover, partial costs orders at the event of assessment of costs also persuade shareholders to settle the dispute. Interviewee C stated that litigation was a very stressful exercise for the clients, it was stressful for barristers but clients were paying for it in real money. Moreover the winning party would not be able to get all of the costs at the event of assessment of costs. Solicitors always told clients that they would not necessarily recover all their costs. Most of the clients realised that the likely solution was separation. So if clients got a good part of their costs and a fair price for their shares at settlement they would feel they had been vindicated. They realized that even if they won the case at the end they would recover 60% to 70% of costs and 30% they had to pay themselves. An exception might be where due to bad behaviour of the other side in conducting the litigation, an indemnity costs order was made in their favour. However indemnity costs orders were unusual in these cases according to the interviewees.

#### ***7.4.2 Nature and impact of procedural developments at the pre-action stage:***

Interviewees stated that pre-CPR settlement was something that might happen near trial whereas after the CPR parties now focused on settlements at an earlier stage [C, M]. Along with the expensive nature of section 459 petitions that contribute to settlement interviewees further identified two other factors which contribute powerfully to earlier settlements of section 459 disputes following the CPR namely (i) pre-action co-operation and (ii) the role of ADR. These factors are discussed below in detail.

##### ***7.4.2.1 Pre-action co-operation:***

As to pre-action behaviour the Practice Direction - Protocols states that to meet the overriding objective of the CPR, the court will expect the parties to act reasonably in exchanging information and documents relevant to the claim and upon which they rely generally in trying to settle their dispute without proceedings having to be

commenced.<sup>120</sup> The parties often face the problem that they lack information regarding the stance of their opponent and the matters in issue which in turn may prompt them to seek the assistance of the court. The pre-action correspondence can assist shareholders to identify their conflicting issues and to clarify the respective strengths and weaknesses of their cases and their likely prospects in court. This may convince them that settlement is possible and so increase the scope for early settlement. However, it also contributes to the front loading of costs, a point picked up further below. Foskett a leading authority on dispute resolution, asserts that generally speaking satisfactory settlement only occurs when the parties have had a fair opportunity to appraise the strengths and weaknesses of their cases and this at least partly depends upon the availability of relevant information and documentation to each of them.<sup>121</sup> In *Charles Church Developments Limited v Stent Foundations limited and Peter Dann Limited*<sup>122</sup> it was held that if the Protocol for Construction and Engineering Disputes had been followed, formal proceedings would probably have been avoided. The court had little difficulty reaching this conclusion, apparently considering that compliance with the protocol resulted in settlement in most cases.<sup>123</sup>

It has been seen that minority shareholders often seek an exit based on a fair valuation of their shares a course of action seemingly given judicial endorsement by the House of Lords in *O'Neill v Phillips*.<sup>124</sup> The requirements of the CPR as regards pre-action behaviour may accelerate such outcomes and therefore reinforce such course of action. Such early settlement at pre-action stage may save the parties' considerable time and costs that they would otherwise have to expend at the proceedings stage. A further consequence in theory is that, through mutual reinforcement, the CPR and *O'Neill* may lessen the burden on the courts in terms of the resource that would otherwise have to be

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<sup>120</sup> Practice Direction- Protocols, para 4.1. There is no separate pre-action protocol for s 459 cases. Hence, Practice Direction- Protocols para 4 regarding pre-action behaviour in other cases would be applicable to cases under s 459 of the CA 1985.

<sup>121</sup> It was stated that whilst opposing sides will still frequently arrive at different perceptions of those strengths and weaknesses, the process often revealed an acceptable middle ground resulting in a compromise. See Foskett D., *The Law and Practice of Compromise* (6<sup>th</sup> ed Sweet and Maxwell, London 2005) para 13-05.

<sup>122</sup> [2007] EWHC 855.

<sup>123</sup> [2007] EWHC 855 paras 30-32.

<sup>124</sup> [1999] 2 BCLC 1.

devoted to case management and trial. Moreover, if by settling at the pre-action stage the parties can agree a roughly similar outcome to that which would be imposed by a court after a trial, then any rules that increase the inclination of the parties to settle at this stage may be judged effective.

Pre-action protocols outline the steps parties should take to seek information from and to provide information to each other about a prospective legal claim.<sup>125</sup> The objectives of pre-action protocols include the following.<sup>126</sup>

- (1) To encourage the exchange of early and full information about the prospective claim. In section 459 disputes the exchange of information can help shareholders to understand the stance of opposite party and to value the shares fairly. *O’Neill v Phillips*<sup>127</sup> placed emphasis on the use of detailed letters before action for this purpose.<sup>128</sup>
- (2) To enable parties to avoid litigation by agreeing a settlement of the claim before the commencement of proceedings. Again the *O’Neill* letter before action proposing buy-out terms serves a similar purpose.<sup>129</sup>
- (3) To support the efficient management of proceedings where litigation cannot be avoided.<sup>130</sup>

Practice Direction- Protocols, para 4.2 states, that “parties to a potential dispute should follow a reasonable procedure, suitable to their particular circumstances, which is intended to avoid litigation” again providing specific underpinning in the rules for the detailed guidance on letters before action and buy-out offers given by Lord Hoffmann in *O’Neill v Phillips*.<sup>131</sup> The Practice Direction further states that the procedure adopted

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<sup>125</sup> Practice Direction- Protocols, para 1.3.

<sup>126</sup> Practice Direction- Protocols para 1.4.

<sup>127</sup> *O’Neill v Phillips* [1999] 2 BCLC 1.

<sup>128</sup> See above chapter 6 para 6.5.2.2 Early fair offers to buy-out.

<sup>129</sup> See above chapter 6 para 6.5.2.2 Early fair offers to buy-out.

<sup>130</sup> Courts acknowledged the utility of these new powers regarding section 459 proceedings. See above *North Holdings Ltd v Southern Tropics Ltd* [1999] 2 BCLC 625 and *Re Rotadata Ltd* [2000]1 BCLC 122 in para 7.4 Nature of procedural developments under the CPR regarding section 459 proceedings.

<sup>131</sup> See above chapter 6 para 6.5.2.2 Early fair offers to buy-out.

should not be regarded as a prelude to inevitable litigation.<sup>132</sup> It should normally include a requirement for a detailed letter before action with an express reference to ADR.<sup>133</sup>

The prospective respondent [defendant]<sup>134</sup> should acknowledge the petitioner's [claimant's] letter within 21 days of receiving the petitioner's letter. The acknowledgement should state when the respondent will give a full written response.<sup>135</sup> If the respondent does not accept the claim or part of it, the response should give detailed reasons why the claim is not accepted, identifying which of the claimant's contentions are accepted and which are in dispute.<sup>136</sup> The letter should also state whether the respondent is prepared to enter into mediation or another alternative method of dispute resolution.<sup>137</sup> As was indicated above the purpose of prescribing such a detailed pre-action procedure in the Practice Direction- Protocols is to encourage parties to settle the dispute at an early stage to avoid court proceedings and is consistent with the *O'Neill* guidance.

The CPR also allows a party to apply for pre-action disclosure of documents that may be useful and provide access to documents that may help the petitioner to assess the true

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<sup>132</sup> See Practice Direction- Protocols, para 4.2.

<sup>133</sup> Practice Direction- Protocols states that the letter should include the following. (i) The letter should give sufficient concise details to enable the recipient to understand and investigate the claim without extensive further information. PD-Protocols, [4.3 (a)]. (ii) The letter should enclose copies of the essential documents on which he relies on and may identify and ask for copies of any essential documents, not in his possession, which he wishes to see. PD- Protocols, [4.3 (b) (e)]. (iii) The letter should ask for a prompt acknowledgement, followed by a full written response within a reasonable stated period. (iv) The letter should state whether court proceedings will be issued if a full response is not received within the stated period and whether the petitioner wishes to enter into mediation or another alternative method of dispute resolution.<sup>133</sup> PD- Protocols, 4.3 (d) (f). (v) The letter should draw attention to the court's powers to impose cost sanctions for failure to comply with Practice Direction - Protocols and, if the recipient is likely to be unrepresented, enclose a copy of Practice Direction - Protocols. PD- Protocols, [4.3 (g)].

<sup>134</sup> The CPR and protocols refer generally to parties as claimant and defendant but in the context of s 459 petitions as evident from the case law terms petitioner and respondent are used. In the thesis I use the terms petitioner and respondent. These terms are also used regarding proceedings on other kinds of petitions such as winding up petitions. See Chancery Guide, chapter 20.

<sup>135</sup> See Practice Direction- Protocols, paras 4.4, 4.5.

<sup>136</sup> See Practice Direction- Protocols, para 4.6 (a). The respondent's letter should enclose copies of the essential documents on which the defendant relies and enclose copies of documents asked for by the claimant, or explain why they are not enclosed. See Practice Direction- Protocols para 4.6 (b)(c). It should further identify and ask for copies of any further essential documents, not in his possession, which the respondent wishes to see. See Practice Direction- Protocols para 4.6 (d).

<sup>137</sup> See Practice Direction- Protocols para 4.6 (e).

worth of his shareholdings and the likelihood of success in court proceedings.<sup>138</sup> In Hollington's view it might be expected that this pre-action disclosure requirement in CPR, rule 31.16 may assist minority shareholders – especially those who are not also directors and do not have ready access to company documents in that capacity – where they are contemplating legal proceedings.<sup>139</sup>

Furthermore, at the pre-action stage a petitioner may not only make a buy-out offer along the lines suggested by Lord Hoffmann in *O'Neill v Phillips*, the offer may be couched as an offer under part 36 of the CPR.<sup>140</sup> Both offers have similar effect at order of costs. However, part 36 offers are not made on an open basis like *O'Neill* early offers to settle but are without prejudice save as to costs ie can only be referred to in relation to order of costs.<sup>141</sup> The Part 36 process and the sanctions attached to it have been acknowledged as being effective in civil litigation.<sup>142</sup>

To increase the prospects for protocol compliance at the pre-action stage and therefore the prospects of avoiding proceedings in accordance with the overriding objective, the Practice Direction-Protocols provides that courts will consider the pre-action conduct of the parties at the time of determination of costs.<sup>143</sup> Rule 44.3 (4)(a) provides that in deciding what order (if any) to make about costs, the court must have regard to *inter alia*

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<sup>138</sup> See CPR, r 31.16.

<sup>139</sup> Hollington R., *Shareholders' Rights* (4<sup>th</sup> ed Sweet and Maxwell, London 2004) para 9-14.

<sup>140</sup> *Re Midland Linen Services Ltd* [2004] EWHC 3380 (Ch).

<sup>141</sup> A part 36 offer will be treated as “without prejudice except as to costs” see the CPR, r 36.19(1). The CPR, r 36.10 provides that “if a person makes an offer to settle before proceedings are begun which complies with the provisions of this rule, the court will take that offer into account when making any order as to costs”. The CPR, r 36.1 (2) states that if the offer to settle is not made in accordance with this part, it will only have the consequences specified in this part if the court so orders. The CPR, r 36.13 states, where a Part 36 offer is accepted without needing the permission of the court, the claimant will be entitled to his costs of the proceedings up to the date of serving notice of acceptance. Where a claimant fails to beat the offer at trial the court will order the claimant to pay any costs incurred by the defendant after the latest date on which the offer could have been accepted, see CPR, r 36.20. See generally CPR part 36.

<sup>142</sup> See Peysner J., and Seneviratne M., ‘The management of civil cases: the courts and post-Woolf landscape’ (DCA Research Series 9/05, Nov 2005) see Executive Summary. It was found that “claimant offers under Part 36 of the Civil Procedure Rules were singled out for praise; claimants saw them as a useful way of obtaining a response from the defendant, while defendants appreciated them for setting an upper limit to the bargaining range”, see Goriely T., Moorhead R., and Abrams, P. ‘More Civil Justice? The impact of the Woolf reforms on pre-action behaviour’ (Research Study 43, commissioned by The Law Society and Civil Justice Council, 2002) xiii.

<sup>143</sup> See Practice Direction- Protocols, para 4.7.



the conduct of all the parties. Rule 44.3 (5)(a) provides that the conduct of the parties includes *inter alia* conduct before, as well as during, the proceedings, and in particular the extent to which the parties followed any relevant pre-action protocols. In *Charles Church Developments Limited v Stent Foundations limited*<sup>144</sup> the defendant argued that it had been forced unnecessarily into the court proceedings because of the claimant's failure to comply with the relevant protocol. It was held that a claimant who issued proceedings without following a pre-action protocol can be penalized in costs even at an early or interim stage.<sup>145</sup> It was appropriate to make a costs order early in the proceeding stage for failure to follow a pre-action protocol rather than leave the issue outstanding for consideration at an impending mediation. Moreover, it will narrow the issues in dispute at mediation thus making settlement more likely.<sup>146</sup> The case is evidence of judicial support for the view that the making of interim costs order may increase settlement prospects by reducing the scope for later disputes about costs. The non-compliance with the pre-action protocol had led to costs being incurred in the proceedings that might otherwise have been avoided. The likelihood was that the matter would have been resolved without recourse to court proceedings.<sup>147</sup> As indicated above, it may be thought that this costs sanction could be an effective weapon in practice to encourage the parties and their legal advisors to settle the dispute at the pre-action stage. Costs sanctions can be imposed upon parties for failure to consider alternative means of resolving disputes at pre-action or proceedings stage. The role of these alternative means is discussed below.

The Practice Direction-Protocols provides that in accordance with the overriding objective parties will act reasonably in exchanging information relevant to claim in trying to avoid the necessity for the start of proceedings.<sup>148</sup> A clear theme emerging from the interviews was that the practice of writing pre-action letters with a view to early settlement was common in section 459 cases even before the CPR unless the petition needed to be issued urgently and coupled with an application for injunctive relief [B, C,

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<sup>144</sup> [2007] EWHC 855.

<sup>145</sup> [2007] EWHC 855 para 38.

<sup>146</sup> [2007] EWHC 855 paras 35-37.

<sup>147</sup> [2007] EWHC 855 para 31.

<sup>148</sup> Practice Direction-Protocols para 4.1.

G, S]. Therefore, the CPR had not led to the introduction of this practice. There was consensus that in the past as a result of pre-action correspondence parties often started negotiation that in most of cases resulted in settlement near the trial. Settlement was very common through inter-lawyer negotiations in section 459 disputes due to the distinct nature of section 459 disputes even before the CPR. The common experience was that section 459 disputes were usually about money for both respondent and petitioner: in other words the parties differed in their respective valuations of the shares. It was better to have money quickly and with certainty rather than going to court facing all the legal costs and uncertainty [E, T].

However, now shareholders were much more involved in the process because the protocol made it more explicit that there would be cost sanctions if parties would not comply with it [C, M, R]. The CPR cost rules imposing sanctions for failure to try to settle the dispute had not made a substantive difference in section 459 cases since the practitioners in the area were following the practice anyway. But after the CPR there was more pressure to settle at an early stage to avoid costs sanctions than in the past; therefore now disputes were settling early rather than later or at trial [H, M, S]. Moreover, the CPR allowed courts to award costs on the basis of individual issues and on an interim basis. The courts' ability to assess costs summarily on these individual issues after each stage of the proceedings also influenced parties to follow Practice Direction- Protocols in order to settle the dispute at an early stage.<sup>149</sup> Interim assessment of costs had enhanced early settlements in these disputes [J, R]. However, it was stated that costs would only be faced for not writing a protocol letter if it could be proved that a protocol letter would have led to a swift resolution of the dispute, which was very unlikely to happen in most cases [R]. Secondly, costs at pre-action stage are front end loaded and may persuade parties to settle early.<sup>150</sup>

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<sup>149</sup> See above *Charles Church Developments Limited v Stent Foundations limited* [2007] EWHC 855.

<sup>150</sup> See below front loading of costs.

Pre-action correspondence was considered very important in the context of section 459 disputes by offering buy-out which was the most common remedy awarded by judges in courts [B, C, J]. Interviewees stated that:

Instead of launching a petition if a protocol letter is sent to the other side, they may come back with an offer to buy the shares at that early stage whereas in the absence of a protocol letter the offer would be made later as a response to the petition [R].

If there is difference in value of shares due to any reason offer at an early stage can bring parties to negotiation.<sup>151</sup> During negotiation parties may agree to value the shares by an independent chartered accountant [C].

Pre-action letters included either *O'Neill*<sup>152</sup> or *Calderbank* offers to settle the dispute. Interviewees stated that the *Calderbank* offers followed the decision in *Calderbank v Calderbank*,<sup>153</sup> and were common before *O'Neill v Phillips*. After *O'Neill v Phillips*, *O'Neill* offers took the place of *Calderbank* offers which were by and large pretty much the same [C]. *Calderbank* offers were considered the blueprint for the part 36 offers now available under the CPR<sup>154</sup> and significant to settle these disputes [B, C]. Due to their usefulness in settling disputes and providing protection against costs at the end of court proceedings, these offers were used in almost every single case both before and after the CPR [B, C]. *O'Neill* offers were made on an open basis whereas part 36 offers were without prejudice except as to costs. On the basis of *O'Neill* offers an application could be made to strike out the petition – this is why tactically such offers are made in open correspondence as opposed to correspondence for which privilege is claimed. Both kinds of offers put the similar pressure as to cost consequences in the event of the assessment of costs on the opposite party, if it could not beat the offer at trial [C, D, G].<sup>155</sup>

Interviewees mentioned that in 459 cases part 36 offers were used but *O'Neill* offers were more common in practice and a preferred way if shareholders were looking for a buy-out because the offer can be drawn to the attention of the court as it is in an open

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<sup>151</sup> See above chapter 6 example that discusses obstacles on the way of settlement at fair offers to buy-out in para 6.5.2.2.1 The role of offers in settling shareholder dispute.

<sup>152</sup> *O'Neill* offers are discussed above in chapter 6.

<sup>153</sup> [1976] Fam. 93; [1975] 3 All E.R. 333; [1975] 3 W.L.R. 586.

<sup>154</sup> For discussion as to part 36 offers see Foskett D., *The Law and Practice of Compromise* (6<sup>th</sup> ed Sweet and Maxwell, London 2005) chapters 14-26 and para 26-05.

<sup>155</sup> *O'Neill v Phillips* [1999] 2 BCLC 1, 15-16. One interviewee had also made cost orders as a result of part 36 offers while sitting as a deputy high court judge [F].

letter [D, E, R]. Part 36 offers were used where there would be some other kinds of claims as well such as a claim for reimbursement to the company of excessive remuneration and/or misappropriated assets. As somebody had taken excessive money out of the company or had paid excessive remuneration and petitioner wanted to brought the money back and simply talking about dropping the charges if the other party was ready to pay the money back [R]. However, sometimes for better protection practitioners made both of these offers [C]. These offers were considered very crucial and practitioners spent much of their time drafting these offers [C, G]. Interviewees stated that:

Offer letters either *O'Neill* or under part 36 are considered very effective and basic to any method of settlement of disputes. These offers encourage parties to settle and can drive them towards negotiation [B].

These offers make the parties, their lawyers and accountants sit together and focus on whether an offer should be accepted or whether they are confident that they are going to beat it. These offers can also bring parties to the negotiation table [C].

Interviewee C further stated that:

A really clever and good offer was tempting and demanded clients' good judgment to decide to make it. Clients can drive lawyers mad in this regard, by instructing them to make as low an offer as possible... that was just a nightmare. Then the lawyer has to explain to the client what the tactics are and how they would be exposed on costs, if they lost [C].

A couple of interviewees stated that pre-action correspondence did not always work in practice but just added another layer of cost and delay [R]. It was stated that drafting a protocol letter and section 459 petition were equally expensive. Complying with the pre-action protocol incurred costs itself. It was not convenient to write a pre-action protocol letter before drafting a petition since getting to the stage of writing a pre-action protocol letter was possible once the petition was drafted. There was no point in sending a pre-action protocol letter which had to set out the detail of the main points being relied upon and the main documentation, unless the petition was drafted. Therefore, it was not saving costs associated with the drafting of the petition [S]. However, the view of this interviewee can be called into question. In *Charles Church Developments Limited v Stent Foundations limited*<sup>156</sup> it was stated that it was also failure to comply with pre-

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<sup>156</sup> [2007] EWHC 855 paras 51-52.

action protocol and inconsistent with the ethos of the pre-action protocol procedure, if the work and costs of the letter before action was equivalent to the work and costs that would be incurred in commencing High Court proceedings. If the costs were the same then there would be little benefit in having the informal exchange which the pre-action protocol procedure encouraged. Furthermore, the court stated that the costs incurred at the pre-action stage should be proportionate to the complexity of the case and the amount of money which was at stake. The protocol did not require disclosure of all details and evidence pre-action that might ultimately be required if the case proceeded to litigation.

#### *7.4.2.1.1 Front loading of costs:*

The requirement to clarify the matters that are in dispute and exchange information or documents before the commencement of proceedings tends to lead to front loading of costs. Compliance with the protocols requirements may well be a costly exercise and encourage the parties to consider settlement in order to avoid incurring further costs at the proceedings stage. Moreover, the courts power to make interim costs order in the event of non-compliance with the pre-action protocols also accentuates front loading of costs and may itself concentrate minds.<sup>157</sup>

Interviewees stated that litigation costs in section 459 proceedings were front end loaded even before the CPR but the CPR made front loading more obvious. Interviewee S stated as apposed to a general civil dispute in section 459 petition there was need to look at years of background which complicated it and made it front end loaded. The client had to incur those costs before they even get to issue the proceedings. Expensive nature of section 459 petitions along with front loading of costs was a key reason behind settlement of section 459 disputes. Interviewee S further explained that section 459 cases were notoriously expensive from a solicitor and counsel point of view as to the amount of costs incurred in connection with them. Part of the problem with section 459 petitions was that they tend to be extremely prolix because of the need to establish the detailed factual basis of the unfair prejudice complained of. Section 459 petitions that simply set

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<sup>157</sup> See *Charles Church Developments Limited v Stent Foundations limited* [2007] EWHC 855.

out the bare bones of the disputed issues would be vulnerable to a strike-out application. Therefore, the gathering of sufficient evidence to provide the necessary factual underpinning of the petition leads to costs being incurred up front by the petitioner.

[Section 459 cases] are very intensive in solicitors' and counsel time for example, drafting the petition takes a week, two weeks or whatever to get into the documentation to understand the history of it, to read all of documentation to try to get into chronological order and then try to reduce that into a petition. That is and always has been very cost intensive and it is upfront payment... That was the case before CPR and to my mind that is the case after CPR [S].

Majority of the interviewees stated that the even though the CPR has not decreased the costs of section 459 proceedings but changed the time the costs were incurred by parties due to emphasis upon pre-action co-operation. Litigation costs in shareholder disputes were more front end loaded after the CPR. The CPR persuaded the parties to co-operate at pre-action stage to settle early rather late at trial that made the costs front end loaded. Interviewee C added that now case had to be prepared before going to court and witness statements was a huge investment of time. In the past witness statements were exchanged relatively near the trial. Interviewee R emphasised the point that costs could be awarded on an interim basis following the CPR:

In the past litigants could make a lot of interim applications and they usually only had to pay costs if they lost on those applications at the end of proceedings. But now of course, if an applicant loses an interim application he will normally be ordered to pay the costs within 28 days... that has made the difference. The ability to assess costs summarily at each stage of the proceedings rather than waiting for a final assessment at the end, makes the costs front end loaded and [may] persuade parties to settle early [R].<sup>158</sup>

Interviewee J stated that the CPR did not save costs. Front loading of costs in the CPR just meant that substantial costs were incurred at particular points in the process. It took the cases out of court but what it did not do was costs saving. The same interviewee went on to say:

The difference front loading makes is that once people are paying bills they begin to get a sense of it. If the client is told that the petition will cost half a million the client will still go for it. If the client is told that it will cost half a million and... he is required to pay that all now he will say he does not have it and he would have to mortgage a few houses... that concentrates minds. So a certain amount of front loading is fine because it helps [clients] to settle [J].

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<sup>158</sup> See above.

The impression is that in section 459 petitions costs were front end loaded even before the CPR therefore it did not affect section 459 petitions to great extent except the interim assessment of costs. However, the CPR made the front loading more obvious that had an impact upon early settlement.

*7.4.2.1.2 Lawyers' enhanced awareness of the need to consider settlement:*

However, there was a consensus that negotiated settlement in section 459 disputes following the correspondence was useful for clients due to the expensive nature of the litigation. Interviewee P stated that due to expensive nature of section 459 proceedings lawyers should be more responsible in this context:

Section 459 litigation is lengthy and therefore expensive not only because clients are emotional and aggressive in proving unfair prejudice but because some lawyers are bullish and prefer to litigate instead of sorting out a commercial compromise. Lawyers often give bullish advice... they do not advise regarding the [high litigation] costs involved... they do not say it was just about money and do a commercial deal. Lawyers like going to court and some counsel and solicitors are more bullish than others [P].

All interviewees acknowledged that it was lawyers' professional responsibility to guide clients as to what was in their best interests and to assist courts to achieve the overriding objective. Moreover it was stated that following the CPR lawyers were most cost conscious and inform clients about costs at the start of the process in relation to section 459 proceedings [C, E, G, M]. Interviewees stated that practitioners had the following professional responsibilities towards their clients.

(i) Practitioners should be careful about wasting clients' money. Informing clients about the expense involved in bringing proceedings and to make clients realise as soon as possible that the professional costs of litigating a dispute would be high [E, F].

(ii) Practitioners should use legitimate tactical devices and pressures to put clients in the best negotiating position as soon as possible to facilitate a settlement [E].

(iii) Practitioners should fashion the proceedings in accordance with the size of the pockets of the client [F].

(iv) Practitioners should come up with imaginative solutions which did not necessarily just involve a path towards a trial [M].

The impression is that pre-action correspondence was common in section 459 cases before the CPR in order to settle the disputes. But the CPR has increased the clarity regarding pre-action behaviour and made it more explicit by introducing the costs sanction for failure to follow the practice. That has encouraged the early settlements of disputes in section 459 cases. Moreover the perception is that the CPR has increased the lawyers' awareness of the need to consider settlement.

#### *7.4.2.2 The role of Alternative Dispute Resolution (ADR) in settling shareholder disputes:*

The CPR provide that “active case management includes encouraging the parties to use an alternative dispute resolution procedure if the court considers that appropriate and facilitating the use of such procedure”.<sup>159</sup> Practice Direction- Protocols<sup>160</sup> states that the parties should consider whether some form of alternative dispute resolution procedure would be more suitable than litigation and if so, endeavour to agree which form of procedure to adopt. The parties may be required by the court to provide evidence that alternative means of resolving their dispute were considered.<sup>161</sup> The courts take the view that litigation should be a last resort, and that claims should not be issued prematurely when a settlement is still actively being explored. Parties are warned that if the protocol is not followed then the court must have regard to such conduct when determining costs.<sup>162</sup> In cases where proceedings are issued, a party may at filing the completed allocation questionnaire make a written request for the proceedings to be stayed while parties try to settle the case by ADR.<sup>163</sup> The CPR provides further opportunity to settle the dispute at that stage. Logically if non compliance with pre-action protocols may

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<sup>159</sup> CPR, r 1.4 (2)(e), see also Chancery Guide chapter 17.

<sup>160</sup> See Practice Direction- Protocols para 4.7.

<sup>161</sup> See Practice Direction- Protocols para 4.7.

<sup>162</sup> See Practice Direction- Protocols para 4.7. See above *Charles Church Developments Limited v Stent Foundations limited* [2007] EWHC 855, where the claimant was penalized on costs at an interim stage for failure to comply with the pre-action protocol.

<sup>163</sup> ADR is defined as a “collective description of methods of resolving disputes otherwise than through the normal trial process”. See Glossary in section G of the CPR.



attract costs sanctions then the same goes for non-compliance with rules applicable at the proceedings stage.

Practice Direction-Protocols expressly recognises that no party can or should be forced to mediate or enter into any form of ADR.<sup>164</sup> Article 6 of the European Convention on Human Rights (ECHR) provides that in the determination of his civil rights and obligations everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law. This right cannot be replaced by any form of ADR. The Chancery Guide states that “while emphasising the primary role of the court as a forum for deciding cases, the court encourages parties to consider the use of ADR (such as, but not confined to, mediation and conciliation) as a possible means of resolving disputes or particular issues”.<sup>165</sup> In *Exeter City AFC Ltd v The Football Conference Ltd*<sup>166</sup> it was said that “there is also inherent jurisdiction in the court to stay proceedings where there is a more suitable alternative means of resolving the dispute”. The courts cannot force but can merely encourage and facilitate the use of ADR and where the court is excessively forceful in its encouragement of the use of ADR, Article 6 of the ECHR may be engaged.<sup>167</sup> Courts encourage ADR by considering litigation as a last resort and by exercising their case management powers in accordance with the overriding objective and parties are under duty to help court in furthering the overriding objective. Legal representative should also ensure that their clients are fully informed as to the most cost effective means of resolving their disputes.<sup>168</sup> The Court of Appeal stated that:

All members of the legal profession who conduct litigation should now routinely consider with their clients whether their disputes are suitable for ADR.<sup>169</sup>

Boulle and Nestic argued that mediation, a common form of ADR, complemented access to the courts rather than displacing it. It was a first step towards resolution of disputes, if

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<sup>164</sup> See Practice Direction- Protocols para 4.7. As to form of ADR see below para 7.4.2.2.1 Definition of ADR.

<sup>165</sup> See Chancery Guide, chapter 17, para 17.1.

<sup>166</sup> [2005]1 BCLC 238; [2004] 4 All ER 1179 para 14.

<sup>167</sup> See *Civil Procedure*, Vol. 1 The White Book Service (Sweet and Maxwell, London 2001) section A, para 1.4.11.

<sup>168</sup> See Chancery Guide, chapter 17, para 17.4.

<sup>169</sup> See *Halsey v Milton Keynes General NHS Trust* [2004] EWCA Civ 576, para 11.

mediation failed, the parties could resume court proceedings.<sup>170</sup> Moreover, parties cannot be forced to achieve a compromise in mediation.<sup>171</sup> It was stated that the hallmark of ADR procedures and perhaps the key to the effectiveness of ADR is that it is voluntarily entered into by the parties and so is premised on the willingness of the parties to co-operate to achieve the result.<sup>172</sup> Therefore the courts can only encourage in the light of the overriding objective to an extent that parties take the possibility of using an ADR procedure seriously.<sup>173</sup> Pressure to exploit ADR is persuasive rather than mandatory in nature<sup>174</sup> the court's role is to encourage, not to compel.<sup>175</sup> In *Halsey v Milton Keynes General NHS Trust*,<sup>176</sup> Dyson LJ stated that:

We heard argument on the question whether the court has power to order parties to submit their disputes to mediation against their will. It is one thing to encourage the parties to agree to mediation, even to encourage them in the strongest terms. It is another to order them to do so. It seems to us that to oblige truly unwilling parties to refer their disputes to mediation would be to impose an unacceptable obstruction on their right of access to the court.

However, parties who do not consider seriously alternative means of resolving their dispute may be penalised in costs.<sup>177</sup>

There are different methods of ADR.<sup>178</sup> The important question for the parties is which of these methods may be most appropriate and effective for them. In section 459 disputes it has been seen that shareholders regularly demand buy-out and courts often order it where the cause of action is proved.<sup>179</sup> However, proving the cause of action as a

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<sup>170</sup> Boulle L. and Nestic M., *Mediation: Principles Process Practice*. (Tottel Publishing Ltd, UK 2001) 373.

<sup>171</sup> *Ibid* 376.

<sup>172</sup> See *Civil Procedure*, Vol. 1 The White Book Service (Sweet and Maxwell, London 2001) section A, para 1.4.11. See also Christou R., *Drafting Commercial Agreements*. (3<sup>rd</sup> ed Sweet and Maxwell, London 2005) chapter 17 para 17-3.

<sup>173</sup> See *Civil Procedure*, Vol. 1 The White Book Service (Sweet and Maxwell, London 2001) section A, para 1.4.11.

<sup>174</sup> Smith, Bailey and Gunn, *Modern English legal System*. (4<sup>th</sup> ed Sweet and Maxwell, London 2002) 686.

<sup>175</sup> See *Halsey v Milton Keynes General NHS Trust* [2004] EWCA Civ 576, para 11.

<sup>176</sup> [2004] EWCA Civ 576 para 9.

<sup>177</sup> See Practice Direction- Protocols para 4.7 and the CPR r 44.3 (5)(a). see below cost sanctions for unreasonably refusing to mediate, in para 7.4.2.5 Factors that contribute to successful outcomes in mediations.

<sup>178</sup> See below para 7.4.2.2.1 Definition of ADR. The most common ADR methods are negotiation, mediation; expert determination; evaluation that includes early neutral evaluation (ENE) and neutral fact-finding; arbitration; med-arb; and ombudsmen.

<sup>179</sup> See above chapter 6.

precursor to achieving such an outcome may well prolong the proceedings and increase costs. In *Re Rotadata Ltd*<sup>180</sup> it was stated that so far as ADR was concerned it was often appropriate, and indeed in accordance with the CPR, for a judge to express the view that it seemed highly desirable that costs and court time involved in a hearing should be avoided if possible by ADR. An unreasonable refusal to go to ADR could be taken into account by the court when considering costs.

Parties may have contradictory stances regarding the medium of resolution of dispute whether they want to resolve the dispute by ADR or by court. This is an important question to decide for the parties for which their legal advisors can help them. If only one party requests a stay the court is likely to try to ascertain why the other party is refusing, and if a party cannot offer a good reason for its refusal the stay will be ordered.<sup>181</sup> If all the parties to a case request a stay or the court on its own initiative considers such a stay appropriate, the court will stay the proceedings.<sup>182</sup> In *Shirayama Shokusan Company Limited v Danovo Ltd*, Blackburne J stated that the “court does have jurisdiction to direct ADR even though one party may not be willing to have the dispute submitted to ADR”.<sup>183</sup> Threatened with a stay, the reluctant or weak co-operation of the unwilling party in mediation might be an issue though this could be dealt with by the pressure of cost sanctions.<sup>184</sup> However, in *Halsey v Milton Keynes General NHS Trust*,<sup>185</sup> Dyson LJ stated that the exercise of such a jurisdiction might not be useful.<sup>186</sup> It was stated that “in such a case, the judge should explore the reasons for any resistance to

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<sup>180</sup> [2000] 1 BCLC 122, 132-133.

<sup>181</sup> See *Blackstone's Civil Practice* (Blackstone Press Limited, London 2001) chapter 70 para 70.10. Information about recent developments of ADR is available at Civil Justice Council website at [www.adr.civiljusticecouncil.gov.uk](http://www.adr.civiljusticecouncil.gov.uk).

<sup>182</sup> The CPR r 26.4 (1)(2)(3).

<sup>183</sup> See *Shirayama Shokusan Company Limited v Danovo Ltd* [2003] EWHC 3006, para 17.

<sup>184</sup> See below (iii) Active and bona fide participation of parties in mediation, in (3) Cost sanctions for unreasonably refusing to mediate, in para 7.4.2.5 Factors that contribute to successful outcomes in mediations.

<sup>185</sup> [2004] EWCA Civ 576.

<sup>186</sup> [2004] EWCA Civ 576, paras 9, 10. It was stated that “if the court were to compel parties to enter into a mediation to which they objected, that would achieve nothing except to add to the costs to be borne by the parties, possibly postpone the time when the court determines the dispute and damage the perceived effectiveness of the ADR process. If a judge takes the view that the case is suitable for ADR, then he or she is not, of course, obliged to take at face value the expressed opposition of the parties, para 10.

ADR. But if the parties (or at least one of them) remain intransigently opposed to ADR, then it would be wrong for the court to compel them to embrace it”.<sup>187</sup>

*O’Neill v Phillips* supports early offers to buy-out as a means of settling disputes and the CPR encourages avoidance of litigation through recourse to an appropriate method of ADR backed by pressure of costs sanctions. The judicial guidance in *O’Neill v Phillips* therefore reinforced the rules of procedure.<sup>188</sup> The pressure of cost sanctions in the CPR is likely to be a powerful factor influencing shareholders to take part in ADR and make efforts to settle the dispute.<sup>189</sup> Another factor that can persuade parties to use ADR is the usual costs and risks associated with protracted litigation including the risks which arise from the ‘loser pays’ or ‘costs follow the event’ principle.<sup>190</sup> In cases where ADR is appropriate, it may assist parties to resolve their dispute more effectively as compared to court proceedings.<sup>191</sup> Lord Woolf stated that ADR was usually cheaper than litigation and often produces quicker results.<sup>192</sup> It also enables parties to resolve their dispute outside the public domain of the court room.

#### 7.4.2.2.1 Definition of ADR:

The CPR defines ADR as a “collective description of methods of resolving disputes otherwise than through the normal trial process”.<sup>193</sup> As to the form of ADR Practice Direction- Protocols states that it is not practicable to address in detail what methods parties might decide to adopt to resolve their particular dispute. However, the following options are mentioned which is not an exhaustive list:<sup>194</sup>

- Discussion and negotiation

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<sup>187</sup> [2004] EWCA Civ 576, para 10.

<sup>188</sup> See above para 7.4.2.1 Pre-action co-operation

<sup>189</sup> See above para 7.4.2.1 Pre-action co-operation and see below para 7.4.2.5 Factors that contribute to successful outcomes in mediations.

<sup>190</sup> See above chapter 5 para 5.6.2 The Law Commission’s critique of section 459 of the CA 1985.

<sup>191</sup> See Genn H., ‘Twisting Arms: court referred and court linked mediation under judicial pressure’ (Ministry of Justice Research Series 1/07, May 2007) chapter 1. See also Christou R., *Drafting Commercial Agreements*. (3<sup>rd</sup> ed Sweet and Maxwell, London 2005) chapter 17 para 17-3.

<sup>192</sup> See *Interim report* chapter 18. However, ADR can add additional costs if dispute does not settle and has to go to trial.

<sup>193</sup> See section G of CPR.

<sup>194</sup> See Practice Direction- Protocols para 4.7.

- Early neutral evaluation by an independent third party (for example, a lawyer experienced in that field or an individual experienced in the subject matter of the claim).
- Mediation – a form of facilitated negotiation assisted by an independent neutral party.

There are other different methods of ADR that may be exploited depending on the needs of the parties and the particular nature of the dispute. The most common ADR methods are mediation; conciliation; expert determination; evaluation that includes early neutral evaluation (ENE) and neutral fact-finding; arbitration; med-arb; and ombudsmen.<sup>195</sup>

There is a contradiction in the literature as to the precise definition of ADR especially in relation to binding arbitration.<sup>196</sup> All these methods of ADR have one common feature namely that the parties are assisted in resolving their disputes by a neutral third party. This raises a question of how ordinary party and party negotiations (possibly conducted through or with the assistance of lawyers) are to be classified. ADR methods which involve a neutral third party as mediator, conciliator, expert and so on may well also involve negotiation as part of the process. However, it may be thought that ordinary party and party negotiations in the shadow or context of court proceedings are not ADR because they are not directly facilitated or assisted by a third party. Nevertheless, the CPR treat ‘discussion and negotiation’ as a method of ADR. In what follows, in the context of shareholder disputes, I take ADR to include negotiation, mediation, early neutral evaluation (ENE) and expert determination. Empirical findings confirm that in

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<sup>195</sup> See Brown, H., and Marriot, A.L., *ADR Principles and Practice*. (2<sup>nd</sup> ed Sweet and Maxwell, London 1999) 15; Smith, Bailey and Gunn, *Modern English legal System*. (4<sup>th</sup> ed Sweet and Maxwell, London 2002) 685 and Genn H., ‘Twisting Arms: court referred and court linked mediation under judicial pressure’ (Ministry of Justice Research Series 1/07, May 2007) chapter 1.

<sup>196</sup> Arbitration is a dispute resolution process in which issues are adjudicated upon by a neutral third party who acts under the rules of arbitration and whose decision is binding upon the parties. See Glossary to Brown, H., and Marriot, A.L., *ADR Principles and Practice*. (2<sup>nd</sup> ed Sweet and Maxwell, London 1999). See also Arbitration Act 1996 for legal framework of arbitration. On one view ADR can be thought of as an alternative to litigation (which would include arbitration). On another view, it can be thought of as an alternative to any process that involves adjudication which would therefore exclude arbitration which is a form of legally binding adjudication by an arbitrator rather than a court. In line with the second view, ADR has been defined as “any method of resolving an issue susceptible to normal legal process by agreement rather than by an imposed binding decision”. See The Language of ADR - an International Glossary, Glossary can be accessed at [http:// www. academy-experts.org/language.htm](http://www.academy-experts.org/language.htm) However, the CPR brings arbitration within the ambit of ADR. See *Civil Procedure*, Vol. 1 The White Book Service (Sweet and Maxwell, London 2001) Section G- Glossary. See also Genn H., ‘Twisting Arms: court referred and court linked mediation under judicial pressure’ (Ministry of Justice Research Series 1/07, May 2007) chapter 1.

practice negotiation, mediation and expert determination are the most common forms of ADR to settle shareholder disputes following the CPR. In the interviewees' experience of the pre-CPR period nearly all cases were settled by inter-lawyer negotiations although there were odd ones that were resolved by expert determination. Comparing it with the post-CPR period interviewees stated that more than 90% of their cases settled by inter-lawyer negotiations pre-CPR but post-CPR mediation had become an increasingly common means of settling shareholder disputes especially in cases where inter-lawyer negotiation failed. The nature of each of these methods and their role and potential in settling shareholder disputes is discussed below.

#### *7.4.2.3 Appropriate methods of ADR available to resolve shareholder disputes:*

##### *7.4.2.3.1 Negotiation:*

In interviewees experience the traditional mode of negotiation known as 'inter-lawyer negotiation' was the most common means of settling shareholder disputes both before and after the CPR. As interviewees put it:

The majority of shareholders' disputes are usually resolved by a technique known as 'horse trading' ... simply by negotiations [K].

If the parties can agree on terms of exit or how the shares should be valued, you can clearly settle the dispute by a normal process of negotiation [R].

In legal literature negotiation is defined as "the process whereby two or more parties work through their conflict or dispute (usually) with a view to coming to some agreement, or settlement about that conflict or dispute".<sup>197</sup> Negotiation can therefore be treated as a dispute resolution process in its own right and it is the principal alternative method to adjudication by the courts.<sup>198</sup> Negotiation between the parties or their representative with a view to settling disputes can be seen as a form of ADR since it avoids the necessity of adjudication by a court.<sup>199</sup>

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<sup>197</sup> Spencer D. and Brogan M., *Mediation Law and Practice*. (Cambridge University Press, New York 2006) 9. For general discussion as to negotiation process see Brown, H., and Marriot, A.L., *ADR Principles and Practice*. (2<sup>nd</sup> ed Sweet and Maxwell, London 1999) chapter 6.

<sup>198</sup> See *Civil Procedure*, Vol. 1 The White Book Service (Sweet and Maxwell, London 2001) section A para 1.4.11.

<sup>199</sup> Smith, Bailey and Gunn, *Modern English legal System*. (4<sup>th</sup> ed Sweet and Maxwell, London 2002) 686.

Negotiation can be adversarial or principled.<sup>200</sup> In adversarial negotiation parties argue from their particular positions to gain concessions from the opposing party before agreeing to a compromise solution.<sup>201</sup> Adversarial negotiation is frequently used in litigation as a means of avoiding the costs and risks of further proceedings and aims to arrive at a settlement somewhere between each party's initial demands.<sup>202</sup> These negotiations are conducted in the shadow of the law by bargaining identical to what the court would award in deciding the case.<sup>203</sup> Principled negotiation *inter alia* focuses upon interests not positions by identifying the underlying interests of the parties.<sup>204</sup> Negotiations to resolve legal disputes can be conducted with or without the presence of legal representatives.<sup>205</sup> Negotiation in the presence of lawyers is known as 'inter-lawyer negotiation'.<sup>206</sup> However instead of or in addition to an adversarial approach, lawyers may also adopt a principled approach in negotiation. Inter-lawyer negotiations are a traditional way of settling legal disputes. In these negotiations parties are led by their legal representatives. The factor that can obstruct shareholders to settle disputes out of court by inter-lawyer negotiation is their prospects of winning in a court of law. If any party or both of them are confident enough that they would win in a court then they will be less persuaded to change their positions e.g., by agreeing upon a valuation of shares that is less than what they think they deserve. Nevertheless given the costs and risks associated with protracted litigation it may be thought that negotiation is an effective alternative to court adjudication especially where any compromise is likely to approximate roughly to the solution that the court would impose after a full trial.

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<sup>200</sup> Spencer D. and Brogan M., *Mediation Law and Practice*. (Cambridge University Press, New York 2006) 9, 15.

<sup>201</sup> *Ibid* 9.

<sup>202</sup> *Ibid* 9,11.

<sup>203</sup> *Ibid* 10.

<sup>204</sup> *Ibid* 15.

<sup>205</sup> See *Civil Procedure*, Vol. 1 The White Book Service (Sweet and Maxwell, London 2001) section A para 1.4.11.

<sup>206</sup> In the presence of legal representatives, negotiations will probably be more adversarial since the lawyers are commonly trained in adversarial nature of litigation and may prefer to focus upon the legal merits of case instead of underlying commercial interests of the parties. See Genn H., 'Twisting Arms: court referred and court linked mediation under judicial pressure' (Ministry of Justice Research Series 1/07, May 2007) 125 and below para 7.4.2.3.4 Mediation.

#### 7.4.2.3.2. *Early neutral evaluation:*

In early neutral evaluation (ENE) parties refer their dispute to a neutral third party usually a Judge to assess the issues of fact and law in their case on the basis of agreed information provided by the parties regarding the dispute and to give a non-binding view of the possible legal outcome of the dispute.<sup>207</sup> These neutral evaluations of either issues of fact or law can assist the parties to achieve a compromise in any ongoing negotiations (be they in traditional form or facilitated in some other way such as through mediation). Interviewees stated that ENE could be exploited if needed but did not show clear enthusiasm for it.

#### 7.4.2.3.3. *Expert determination:*

During empirical investigation, interviewees stated that expert determination was very rare in practice in shareholder disputes, but if the circumstances suggested that it was appropriate, it was occasionally used.<sup>208</sup> In expert-determination a neutral third party appointed by the parties who has expertise in the subject matter of the dispute gives the decision. Expert determination differs from arbitration in that there is flexibility for the parties to agree whether the expert's decision will be binding or non-binding.<sup>209</sup> In section 459 cases where the parties have agreed in principle to a buy-out solution they may refer the matter to an expert to determine a value for the shares. This kind of approach was endorsed in *O'Neill v Phillips*<sup>210</sup> where it was stated that the share value, if not agreed, should be determined by a competent expert with the costs of the expert to be shared by the parties.<sup>211</sup> Expert determination may therefore be an effective means to resolve disputes where the only issue outstanding is a technical matter such as share

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<sup>207</sup> See Brown, H., and Marriot, A.L., *ADR Principles and Practice*. (2<sup>nd</sup> ed Sweet and Maxwell, London 1999) 19; Smith, Bailey and Gunn, *Modern English legal System*. (4<sup>th</sup> ed Sweet and Maxwell, London 2002) 688. In neutral fact-finding the neutral third party provides the parties with a non-binding view regarding the facts of the case, see Corbett J., and Nicholson R., 'Mediation and Section 459 Petitions' (2002) 23 (9) *Company Lawyer* 274, 275

<sup>208</sup> Interviewees stated that expert determination is very rare but could be exploited if the circumstances suggested, such as when parties were ready to buy, agreed who would buy the other out, who would determine the value and did not involve themselves in any other dispute that might affected the price of shares and decided let the expert determine the price.

<sup>209</sup> See Peysner, J., (editor). *Civil litigation Handbook*. (The Law Society, UK 2001) 445; Hill R., Wood, H. and Fine S., *A Practical Guide to Civil Litigation* (Jordan Publishing Limited, UK 2005) 14.

<sup>210</sup> [1999] 2 BCLC 1.

<sup>211</sup> [1999] 2 BCLC 1, 16.



valuation which if left to the court would require the parties to adduce costly expert evidence. In *Re Rotadata Ltd*<sup>212</sup> it was stated that it would be worse than regrettable if the only reason the parties were unable to resolve a protracted and expensive dispute was the objection by one party that the appointment of an independent accountant would be more expensive than having the outstanding matters resolved by the company's auditors. In that context the court directed that the parties should either agree to share the additional expense or the party who was insisting on an independent accountant should bear it.

Interviewees considered expert determination as third popular method to settle the shareholder disputes after negotiation and mediation. Expert determination could be useful where the circumstances permit but it was rarely exploited. The method of ADR chosen depended upon the nature of dispute. If the dispute was regarding unfair prejudicial conduct then the mediation would be about that conduct and after settling that issue, the mediation might also focus on share valuation issues or if the parties agreed, there could be expert determination on that point. Interviewee A stated that:

In a case where the issue as to the presence of unfair prejudice conduct still needed to be resolved there was no need for expert determination in advance [A].

In section 459 cases where parties are agreed that one should buy the other's shares, the valuation of the shares will be the most important issue to resolve. While interviewees suggested that expert determination was very rare in section 459 cases, it was sometimes considered as a means of resolving valuation issues [C, D, M]. However, interviewees' views about its utility were mixed:

Expert determination is possible but it is risky since parties do not know what the expert is going to come out with. The share valuation could be too low or too high or might be wrong and it can be disastrous if parties are bound by an expert determination [C].

I always resist expert determination and suggest that clients should not agree in advance to be bound by the decision of a third party [H].

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<sup>212</sup> [2000] 1 BCLC 122, 133.

Interestingly, interviewees also expressed their concerns as to the determination of share valuations by the courts which usually relied on the judge having to arrive at a view based on conflicting expert evidence adduced by either side [G].

Interviewee M regarded expert determination helpful where the only issue to resolve is valuation and in his experience, around 20% of his cases settled by expert determination.

#### 7.4.2.3.4. *Mediation:*

It is clear from what has been said already that shareholder disputes of the types under consideration often settled. From the interviewee evidence it appears that the main instrument of settlement before the CPR was inter-lawyer negotiations whereas mediation had become increasingly popular after the CPR in cases where inter-lawyer negotiations are unsuccessful. Interviewees stated that inter-lawyer negotiation was the traditional way of settling these disputes. Lawyers invariably seek to use inter-lawyer negotiation first in order to avoid the additional costs of mediation, notably the fees payable to the mediator. Interviewees further discussed the role of mediation to settle 459 disputes after the CPR and factors that contribute to successful mediations.

Interviewees considered that following the CPR mediation had become the principal method of resolving shareholder disputes either pre-action or at proceedings stage, where inter-lawyers negotiations did not prove successful.<sup>213</sup> In mediation with the assistance of a neutral third person, who is trained and accredited mediator, parties endeavour to achieve a consensual solution to their dispute instead of relying on court-based adjudication.<sup>214</sup> Mediation can be facilitative or evaluative.<sup>215</sup> In facilitative mediation a neutral third party assists the parties to identify the issues, facilitates communication among the parties, focuses parties on their interests and seeks creative

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<sup>213</sup> See detailed discussion below in para 7.4.2.4 The role of mediation in settling shareholder disputes: empirical evidence.

<sup>214</sup> See Genn H., 'Twisting Arms: court referred and court linked mediation under judicial pressure' (Ministry of Justice Research Series 1/07, May 2007) chapter 1. Mediation is also similar to conciliation but in conciliation the third party known as conciliator plays an active role in negotiations by providing the parties his opinion as to possible settlement options of dispute.

<sup>215</sup> See Brown, H., and Marriot, A.L., *ADR Principles and Practice*. (2<sup>nd</sup> ed Sweet and Maxwell, London 1999) 19.

problem-solving in order to enable the parties to reach their own agreement to resolve the dispute.<sup>216</sup> As stated above the Practice Direction- Protocols defines mediation as a form of facilitated negotiation assisted by an independent neutral party.<sup>217</sup> The objective of facilitative mediation is to avoid emphasis on the strict legal positions and negotiate in terms of parties' underlying needs and interests, instead of their strict legal entitlements. For this reason, the approach in mediation is said to be interest-based.<sup>218</sup> In evaluative mediation a neutral third party may express an opinion as to strength of the parties' respective cases and the likely outcome of the dispute using predetermined criteria to evaluate evidence and arguments presented by the parties.<sup>219</sup> The objective of evaluative mediation is to reach a settlement according to the legal rights and entitlements of the parties and within the anticipated range of court outcomes. Therefore this approach to mediation is said to be rights-based.<sup>220</sup> Both of these approaches to mediation can be exploited in a single mediation. Rights may significantly influence parties in civil and commercial mediations because parties mediate in the shadow of the law.<sup>221</sup> Boulle and Nestic stated that typical techniques in mediation include encouraging the parties to consider the strengths and weaknesses of their cases and stressing the consequences, particularly the costs, of failure to reach settlement in the mediation.<sup>222</sup> Mediation is the most common form of ADR to the extent that the expression 'ADR' is sometimes casually assumed to mean mediation.<sup>223</sup> In legal literature mediation is considered as a significant or principal form of ADR to settle disputes due to its apparent benefits e.g., it can save legal costs and lead to speedier settlements when compared with

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<sup>216</sup> Spencer D. and Brogan M., *Mediation Law and Practice*. (Cambridge University Press, New York 2006) 105.

<sup>217</sup> See above para 7.4.2.2.1 Definition of ADR.

<sup>218</sup> *Ibid* 101, 105.

<sup>219</sup> *Ibid* 105, 106.

<sup>220</sup> *Ibid* 101, 105.

<sup>221</sup> See Brown, H., and Marriot, A.L., *ADR Principles and Practice*. (2<sup>nd</sup> ed Sweet and Maxwell, London 1999) Chapter 9 para 9-010.

<sup>222</sup> Boulle L. and Nestic M., *Mediation: Principles Process Practice*. (Tottel Publishing Ltd, UK 2001) 157.

<sup>223</sup> Smith, Bailey and Gunn, *Modern English Legal System*. (4<sup>th</sup> ed Sweet and Maxwell, London 2002) 689.

litigation procedures.<sup>224</sup> Due to its significance as a form of ADR the role of mediation in the resolution of shareholder disputes merits further detailed consideration.

Mediation is initiated by the parties and mediators enter disputes as a result of *inter alia* direct invitation by one or more of the parties.<sup>225</sup> The process of mediation can be divided into three main stages.<sup>226</sup> The first stage is a preparatory stage. At this stage the mediator establishes a relationship with the disputing parties and collects and analyses relevant data about the substance of the dispute. The second stage is the beginning of the mediation session when negotiation starts in the presence of the mediator and options are generated for settlement. At the final stage compromise is achieved between parties in a formal manner.<sup>227</sup>

Courts have encouraged mediation as compared to simple negotiation process even though mediation involves additional costs – not only the parties’ lawyers but also the costs of the mediator. By explaining the significance of mediation in comparison to negotiation in *Hickman v Blake Laphorn*<sup>228</sup> mediation was strongly supported. The case provides a brief judicial account of how mediation can work. It was stated in that case that mediation was a comparatively recent introduction in English civil procedure. It involved the services of a skilled mediator. The process might take up time and could be expensive. In cases of difficulty, by reason of the ability of a mediator to oil the wheels of settlement in various ways, it was more likely to be effective than the simpler and more traditional process of negotiation by discussion and offer and counter-offer. The main task of a mediator was commonly to lower the expectations of the parties to a point where agreement was possible. However, as the process of settlement by negotiation

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<sup>224</sup> See Genn H., ‘Twisting Arms: court referred and court linked mediation under judicial pressure’ (Ministry of Justice Research Series 1/07, May 2007) chapter 1. See also Peysner, J., (editor). *Civil Litigation Handbook*. (The Law Society, UK 2001) chapter 14. For discussion as to mediation in Civil and Commercial disputes see Brown, H., and Marriot, A.L., *ADR Principles and Practice*. (2<sup>nd</sup> ed Sweet and Maxwell, London 1999) chapter 9.

<sup>225</sup> See Moore C. W., *The Mediation Process* (3<sup>rd</sup> ed Wiley: US 2003) 85.

<sup>226</sup> For detailed study of mediation stages see Moore C. W., *The Mediation Process* (3<sup>rd</sup> ed Wiley: US 2003) where mediation process is divided into twelve stages.

<sup>227</sup> For detailed study of the mediation process see Moore C. W., *The Mediation Process* (3<sup>rd</sup> ed Wiley: US 2003) and Boule L. and Nesic M., *Mediation: Principles Process Practice*. (Tottel Publishing Ltd, UK 2001) chapter 4.

<sup>228</sup> [2006] EWHC 12.

was less time-consuming and cheaper than mediation, it might be suggested that parties should have less reluctance to enter into it.<sup>229</sup>

Mediation is considered useful in resolving disputes where there is a communication breakdown.<sup>230</sup> As a consequence it can be useful in resolving shareholder disputes which often arise due to relational breakdown and in circumstances where shareholders are no longer communicating with one another. By shifting the focus of parties from right-based arguments to interest-based negotiation, facilitative mediation seeks to produce an agreement which meets the interest of both parties.<sup>231</sup> Mediation due to its interest based feature is thought to be suitable to settle section 459 disputes.<sup>232</sup> Mediation can assist parties to settle the dispute through buy-out after the fair valuation of shares this being the most common form of relief sought and awarded in shareholder disputes<sup>233</sup> Given the relative predictability of outcomes in section 459 cases bearing in mind their nature and characteristics, mediation therefore has the potential to be an effective alternative to court adjudication. This potential has been recognized in the legal literature.<sup>234</sup> Moreover, a survey of UK law firms in the year 2000 indicated that of the mediations with which the respondents had been involved, 8 per cent related to shareholder's disputes.<sup>235</sup>

In shareholder disputes during mediation, the mediator questions the parties whether they can work together in future if 'yes', then on what terms and if 'no', on what terms

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<sup>229</sup> [2006] EWHC 12 para 24.

<sup>230</sup> See Spencer D. and Brogan M., *Mediation Law and Practice*. (Cambridge University Press, New York 2006) chapter 1, Table 1.1 at 22. See also below para 7.4.2.5.5 The role of the mediator.

<sup>231</sup> See Fisher and Ury, "Getting to Yes" (2<sup>nd</sup> ed Random House 1991) as quoted by Corbett J., and Nicholson R., 'Mediation and Section 459 Petitions' (2002) 23 (9) *Company Lawyer* 274, 275. See also above definition of mediation. For general discussion about mediation see Brown, H., and Marriot, A.L., *ADR Principles and Practice*. (2<sup>nd</sup> ed Sweet and Maxwell, London 1999) chapters 7-9; Spencer D. and Brogan M., *Mediation Law and Practice*. (Cambridge University Press, New York 2006); Boulle L. and Nestic M., *Mediation: Principles Process Practice*. (Tottel Publishing Ltd, UK 2001).

<sup>232</sup> See Corbett J., and Nicholson R., 'Mediation and Section 459 Petitions' (2002) 23 (9) *Company Lawyer* 274.

<sup>233</sup> See above chapter 6 para 6.5.2.4 Buy-out as an appropriate relief in shareholder disputes.

<sup>234</sup> Boulle L. and Nestic M., *Mediation: Principles Process Practice*. (Tottel Publishing Ltd, UK 2001) 325. See also Corbett J., and Nicholson R., 'Mediation and Section 459 Petitions' (2002) 23 (9) *Company Lawyer* 274.

<sup>235</sup> Boulle L. and Nestic M., *Mediation: Principles Process Practice*. (Tottel Publishing Ltd, UK 2001) 325 fn 255.

they would be prepared to separate. If parties decide to separate they can stipulate the terms of separation namely who would buy the other out and at what value. The following issues may arise in the context of section 459 disputes.

- (i) Either any one party is not willing to separate or
- (ii) Parties are willing to separate but cannot agree who would buy the other out or
- (iii) Parties could not agree on the value of the outgoing shareholder's shares.

If parties cannot agree on these issues by negotiation in the presence of mediator they will resort to court. Here the mediator can motivate them to follow their best commercial interests instead of their legal rights to achieve a compromise. Lawyers may represent the parties during mediation. There is some evidence that the presence of legal representatives may hamper mediation either because of their tendency to concentrate on the legal merits or an ingrained preference for dealing with cases through ordinary litigation.<sup>236</sup> Mediators handle the negotiation by focusing upon the strengths and weaknesses of their cases as well as underlying commercial interests of the parties. However, mediators had acknowledged some helpful role of lawyers during mediation when they spoke on their clients' behalf about the merits of their case and matters relating to costs.<sup>237</sup> In mediation, the mediator informs parties that the resolution of disputes by court will be expensive. The parties may have to face the costs and what they will achieve at winning or losing in court.<sup>238</sup> If an outcome can be reached through mediation which will approximate to the outcome that would be imposed by the court it may be thought that the additional costs of the mediation are worth incurring to avoid the far greater costs of a trial process.

Bearing in mind the relative predictability of outcome in many section 459 disputes, it is likely to be sensible for minority and majority shareholders more often than not to achieve a compromise by means of a buy-out at an agreed value so as to avoid the costs

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<sup>236</sup> See Genn H., 'Twisting Arms: court referred and court linked mediation under judicial pressure' (Ministry of Justice Research Series 1/07, May 2007) 125.

<sup>237</sup> See *ibid* 124.

<sup>238</sup> See Corbett J., and Nicholson R., 'Mediation and Section 459 Petitions' (2002) 23 (9) *Company Lawyer* 274, 276.

of court proceedings that may only serve to produce a roughly equivalent result.<sup>239</sup> Mediation may even assist shareholders to settle their differences and to achieve reconciliation.<sup>240</sup> Brown and Marriot asserted that “the common experience is that the ADR process preserves or enhances personal and business relationships that might otherwise be damaged by the adversarial process”.<sup>241</sup> However, since these disputes usually arise as a result of relational breakdown<sup>242</sup> mediation may have a greater role to play in facilitating exit. Shareholders cannot be forced to reach a compromise during mediation. Their personal feelings as to the legal merits of their case may also influence the mediation and can obstruct the settlement. Therefore, mediation may fail because the parties are not willing to change their stance at all.<sup>243</sup> Genn stated that there were good chances of achieving settlement if parties attended mediation in a spirit of willingness to negotiate and compromise.<sup>244</sup> Even where mediation fails and parties have to resort to the court it may still have indirect benefits. So, for example, it may clarify the matters that are in dispute and speed up the litigation process or lead to a later settlement.

#### *7.4.2.4 The role of mediation in settling shareholder disputes: empirical evidence*

All the interviewees had experience of representing clients in a mediation and some had quite wide experience. Interviewees stated that mediation is useful because it helps to settle early shareholder disputes which are always about money and separation and expensive to litigate.<sup>245</sup> Two of the interviewees were trained mediators and one had a vast experience as a mediator. Interviewee G stated that even though the traditional methods of inter-lawyer negotiation were enough to settle disputes for ‘grown up’

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<sup>239</sup> See above example that discusses obstacles on the way of settlement at fair offers to buy-out in para 6.5.2.2.1 The role of offers in settling shareholder disputes.

<sup>240</sup> See Genn H., ‘Twisting Arms: court referred and court linked mediation under judicial pressure’ (Ministry of Justice Research Series 1/07, May 2007) chapter 1.

<sup>241</sup> Brown, H., and Marriot, A.L., *ADR Principles and Practice*. (2<sup>nd</sup> ed Sweet and Maxwell, London 1999) 13. See also Peysner, J., (editor). *Civil Litigation Handbook*. (The Law Society, UK 2001) chapter 14.

<sup>242</sup> See above chapter 3 Characteristics of shareholder disputes in private companies.

<sup>243</sup> See Menkel-Meadow C., ‘Lawyers Negotiation: Theories and Realities – What We Learn From Mediation’ (1993) 56 *Modern Law Review* 361, 376 and above para 7.2 Introduction n 11.

<sup>244</sup> Genn H., ‘Twisting Arms: court referred and court linked mediation under judicial pressure’ (Ministry of Justice Research Series 1/07, May 2007) chapter 3 at 103.

<sup>245</sup> See also above para 7.4.1 Settlement of shareholder disputes before the CPR and para 7.4.2.3.4 Mediation.

people mediation was good for cases, mainly due to the role of the mediator.<sup>246</sup> Mediation is successful in section 459 cases and it had to be a really unusual case or probably lawyers would have been negligent if the case went to court:

After the CPR the biggest change in the process is mediation which has proved very successful. Shareholder disputes are considered as prime examples where mediation is effective. Unless there is something really weird about the case it would settle by mediation. A vast majority of cases even really mad cases are settling through mediation now. It has also increased the number of settlements in the area [G].

Interviewee J added that:

Mediation was considered as a principal vehicle for settlement nowadays once inter-lawyer negotiations have failed [J].

Interviewee G making an assessment of his own cases stated that about half of the cases he was involved in settled through mediation and the other half by inter-lawyer negotiations. However, it could be a mixture of both since sometimes mediation did not work at first time and sometimes mediation was just a beginning of negotiated settlement [G].

A majority of the interviewees preferred facilitative mediation that focuses more upon underlying interests of the parties than the legal strengths of their cases. Interviewee J stated that mediations usually result in an agreement and the best point about mediation was that it was an interest based solution. Interviewee J who was one of the two interviewees who had acted as a mediator explained the actual process of mediation in section 459 disputes:

What I usually say to people [the majority shareholder] is ok, what you want is to have overall control of the company but the other party has got a stake in the company... Well... do you want to be working for their benefit for the rest of your life because that is what you are doing and every day that passes is a day waiting for a petition to land on the mat. What makes you think they [the minority shareholders] would just walk away and hand back their shares for nothing? To the other side, I say why do you want to keep a stake in the company? I am not saying you should not but tell me why? Then I examine the reasons with them and say why not get your money out and put it somewhere else instead... knowing that you are never going to get a fair crack of the whip out of this person. That's what I mean by interests... what do you want this for, not it's yours, but what do you want to do with it. At the end, if you are a respondent and you win what you have got is the same shareholder in the company, it is just they are several thousands of

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<sup>246</sup> See below the role of the mediator in discussion regarding factors that contribute to successful outcomes in mediations.



pounds poorer. You think that is going to promote greater understanding and cooperation or less? [J].

Interviewee J added:

Parties eventually realise that as a petitioner if they win, it's fine, but if they lose it would be dreadful and for a respondent if they lose it will be expensive but they can get rid of the petitioner and if they win... well what have they won? Often disputes eventually settle... Shareholders eventually realise it is a matter of business and money and there has to be a price that both sides could agree. It may not be on the day, but sooner or later parties will arrive at a figure with which ... they are both happy or unhappy but they can live with what ever it is [J].

Interviewees found mediation 'amazingly successful' in settling section 459 disputes.<sup>247</sup>

Due to the success of mediation in section 459 disputes, one interviewee suggested that it should be made compulsory. In his view, this would not contravene the right to a fair trial because shareholders would still have a right of recourse to courts. For this interviewee compulsory mediation would circumvent situations where there was still resistance to the mediation process:

In practice, where the mediation is suggested the other side may still perceive it as a sign of weakness. Compulsory mediation will solve the problem [H].

The enhanced role of mediation in 459 disputes increased the number of settlements by settling the difficult cases where inter-lawyer negotiation did not prove successful. Interviewees mentioned the following benefits of using mediation in section 459 cases:<sup>248</sup>

1. Mediation has a very high rate of success in section 459 disputes and even difficult cases successfully mediated [B, D].
2. Mediation might promote dialogue subsequently and courts were willing to stay the proceeding to mediate [D].
3. Bitter family disputes or personal disputes, where rational approaches to dispute resolution are overshadowed by personal feelings of betrayal or injustice, were hard to settle. But in those cases sometimes mediation could be helpful because it allowed

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<sup>247</sup> This confirms the impression gained from reading Corbett J., and Nicholson R., 'Mediation and Section 459 Petitions' (2002) 23 (9) Company Lawyer 274.

<sup>248</sup> See also above para 7.4.2.3.4 Mediation.

parties to sit together in the same room and to get some of those feelings off their chest [M].

4. Even if disputes were not resolved through mediation immediately they can help to overcome parties' completely unrealistic views about the worth of the company and lead to settlement shortly afterwards [M].

5. Mediation could provide more creative ways of resolving disputes whereas the courts tended to favour 'corporate divorce' [G].

6. Most parties whose shares are to be bought out wish to avoid paying capital gains tax on the purchase price. In these circumstances it is important to structure a deal in a tax efficient way and this was often capable of being achieved successfully through mediation [G].

Although the prevailing view was that mediation had proved very successful, three of the interviewees were rather more sceptical. Interviewee K stated that mediation was more common now but mediation could be a complete and utter waste of time if parties were not willing to compromise or the mediator was not experienced in resolving shareholder disputes.

Interviewees E argued that:

Cost and commercial pressures that make people to settle as compared to mediation. Lawyer to lawyer negotiations are more successful in my practice and cases that go to trial are very few [E].

Interviewees blamed the mediation process and mediators for failure to settle at mediation. In fact these interviewees preferred 'evaluative mediation' upon 'facilitative mediation'. It was stated that:

An evaluative mediation where someone is going to look at the legal merits of the case is worthwhile. That can be done by solicitors, barristers or even by retired judges [P].

Interviewees mentioned the following reasons for not recommending mediation that also showed their preference for 'evaluative mediation'.

(i) As compared to mediations tough commercial negotiations were considered more helpful [E]

(ii) A lot of mediators were considered to be ‘touchy feely’ and too facilitative which did not work [E].

(iii) Many mediators did not have any real expertise in the area of shareholder disputes [K].<sup>249</sup>

These interviewees were in fact not opposing mediation but signaling a preference for evaluative over facilitative mediation. They did not acknowledge that the adversarial approach of practitioners towards negotiation could be one factor behind failure to settle the disputes at mediation. One of the trained mediators stated that the failure of disputes to settle on mediation was often attributable to lawyers representing the parties focusing on the legal merits of their client’s case [J].<sup>250</sup> On balance the interview evidence suggests that facilitative mediation has proved to be an effective tool in resolving cases that are not resolved through negotiation although there is still some resistance among lawyers who prefer ‘evaluative mediation’ upon ‘facilitative mediation’. Below the chapter discusses the factors that contribute to successful outcomes in mediations to resolve shareholder disputes.

#### *7.4.2.5 Factors that contribute to successful outcomes in mediations:*

Factors that contribute to settlement of disputes by inter-lawyer negotiation are also relevant here.<sup>251</sup> The expensive nature of section 459 proceedings may persuade shareholders to take part in mediation and may contribute to successful outcomes in mediations. Moreover as stated above due to communication breakdown in shareholder disputes where the role of the mediator can be helpful and relative predictability of outcomes in section 459 cases mediation is helpful in resolving shareholder disputes. The credit of successful mediations also goes to ADR bodies. These bodies provide skilled mediators and other services regarding ADR that play a crucial role for ADR

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<sup>249</sup> The role of mediator is discussed below in para 7.4.2.5 Factors that contribute to successful outcomes in mediations.

<sup>250</sup> See also Genn H., ‘Twisting Arms: court referred and court linked mediation under judicial pressure’ (Ministry of Justice Research Series 1/07, May 2007) 125.

<sup>251</sup> See above para 7.4.1 Settlement of shareholder disputes before the CPR.

methods to be successful. In the UK well known commercial ADR bodies are CEDR and ADR Group.<sup>252</sup>

Interviewees stated that issues like strong and weak case; poor and rich parties could play a role in deciding whether parties should go for mediation or not [D]. Interviewee H stated that preparation for mediation from both sides was also considered terribly important. Valuation documents and share sale agreement should be ready in advance and tax advice in place otherwise it would be a complete waste of mediation [H]. In addition to it, interviewees discussed the following six factors that contribute to the recent success of mediation in practice.

- (i) The role of the CPR in encouraging mediation in section 459 disputes
- (ii) Courts' encouragement of attempts to settle through mediation
- (iii) Cost sanctions for unreasonably refusing to mediate
- (iv) Clarification of conflicting issues in advance
- (v) The role of the mediator
- (vi) Low costs of mediation:

Interviewees' responses regarding the contribution of these factors are discussed below in detail.

#### *7.4.2.5.1 The role of the CPR in encouraging mediation in section 459 disputes:*

Pre-action Protocols under the CPR states that parties should consider alternative means of resolving disputes at the time of pre-action correspondence to avoid litigation and the court must have regard to such conduct at the time of determining costs.<sup>253</sup> Interviewees stated that now under the CPR encouragement of pre-action co-operation along with exploitation of ADR especially mediation at pre-action stage with threat of cost sanctions had increased the scope and number of early settlements, in difficult 459 cases

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<sup>252</sup> See discussion as to role of ADR providers in development of ADR and their required future role in, Partington M., 'Alternative Dispute Resolution: Recent Developments, Future Challenges' (2004) 23 (2) Civil Justice Quarterly 99.

<sup>253</sup> See above para 7.4.2.2 The role of Alternative Dispute Resolution (ADR) in settling shareholder disputes.

[C, R]. As to enhance role of mediation in section 459 disputes following the CPR interviewees responded that:

There are not many actual or physical changes in rules that apply to 459 petitions, but there are more mediations now in shareholders disputes than pre-CPR [D].

In section 459 disputes there are more settlements with the help of mediation nowadays, and credit goes to the CPR [J].

There is no dramatic procedural change following the CPR in section 459 cases. Except an enhanced willingness to make noises about mediation at pre-action stage and registrars are more interventionist than before in terms of settlement, especially by mediation [M].

As regards the pre-CPR situation interviewee D stated that:

Before the CPR there were negotiated settlements and mediation was virtually non-existent in these disputes. Mediation in section 459 cases started when idea of mediation generally became popular after the CPR [D].

However it was argued, that it was not yet clear whether the people were settling more or at least trying to settle more due to the CPR or due to a general change of culture:

The CPR did not introduce mediation. It was a change of culture and the CPR was part of it. In the late nineties, when the CPR were being introduced ADR techniques and institutions were coming forward such as ADR group, CEDR and all the other bodies and that was a recognised way forward [J].

Negotiated settlement either principled or adversarial<sup>254</sup> was already common in section 459 disputes before the CPR. Interviewee B mentioned that provisions as to mediation in the CPR had not changed her approach to petitions at all, because she had always taken a very pragmatic approach to these sort of disputes. She had always adopted an approach that involved some sort of settlement facilitation such as mediation. Long before the CPR in a partnership dispute she arranged a meeting similar to mediation meeting but without the presence of mediator. So the formal mediation process following the CPR was not a complete surprise for her but something that was to some extent already in her practice [B]. However, she acknowledged that the CPR had made a critical difference:

After the CPR everybody is aware of mediation... and there is now a widespread availability of formal mediation... with accredited mediators. Now solicitors often tell their clients about mediation before coming to counsel. Whereas, in the old times there was no regular process and there was no readily available third party to facilitate it [B].

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<sup>254</sup> See above para 7.4.2.3.1 Negotiation.

The perception is that the CPR did not invent ADR but sought to exploit its benefits and bring it into the mainstream of civil justice and civil procedure. Moreover, the CPR may have accelerated the change in culture by giving it force through procedural rules.

*7.4.2.5.2 Courts' encouragement of attempts to settle through mediation:*

Interviewees stated that following the CPR, courts were more willing to encourage mediation in section 459 disputes and were even prepared on occasions to stay the proceedings for mediation thus enhancing the prospects for out of court settlement. This also gives emphasis to the principle of judicial respect for commercial decisions due to which the courts have showed themselves unwilling to intervene in company's internal matters.<sup>255</sup> The impression is that judges are actually quite keen on driving shareholder disputes out of the courts because they do not like hearing and trying them. The following extracts from the interviews are illustrative:

There has been a change of approach of courts due to the CPR regarding resolution through ADR particularly mediation [B].

Now courts are also efficient and are willing to stay the proceedings to mediate the dispute either on their own initiative or when one party asks the court for mediation [D].

Stay of proceedings for mediation was common in the Commercial Court and now it is becoming much more common in the Companies Court as well [F].

In the Companies Court I got an order saying that if you want to mediate you can, but if you are not going to mediate you have to put in a witness statement saying why not [H].

Now a formal mediation process is really in the minds of people. It is possible to get a stay of the proceedings for mediation to take place. Registrars are excellent in this regard because if parties get the directions hearing and two months later decide to mediate, the registrar's reaction will generally be favourable. He will suspend the operation of the directions order for three months while the parties mediate. That was extremely rare before the CPR [C].

Interviewee C mentioned one of her cases, a few years ago, where the petition did not disclose a particularly strong case but equally it was not so weak as to be vulnerable to a striking out application. At the directions hearing the registrar told the petitioners that the defence was suggesting that mediation was an extremely good idea and he recommended that the parties go to mediation before bringing the matter back to the court.

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<sup>255</sup> See above chapter 5 para 5.6.2.3 Courts' respect for majority rule.

Interviewee B added to it that:

Courts are not only willing to stay proceedings for mediation but also like to know the efforts that are being made by the parties towards resolving their dispute through mediation. As a result of the courts' encouragement of mediation people may think that if they could settle at the door of court then why not settle before that... and it will also save time and expense [B].

In seeking to explain the courts' enthusiasm for mediation it was stated that:

Mediation is a good idea since it settles disputes [F] and judges love it because they find 459 petitions very boring<sup>256</sup> [K].<sup>257</sup>

Without going so far as to make mediation effectively compulsory, it appears then that the courts are doing much to support the process and 'twist the arms' of the parties. Interviewee D said that not only were the courts prepared to stay proceedings for a mediation, they would also make provision for the parties to apply to court in respect of the conduct of the mediation, for example, in relation to production of documents or resolving disagreements over the identity of the mediator. It seems that the courts have therefore sought to introduce an element of compulsion. Whilst the court cannot order the parties to sit in a room and mediate, it is clear that there are cases in which judges will do everything they can to push the parties into mediation. This particular interviewee was clearly strongly in favour of mediation and considered it entirely legitimate for the court to act in this way. Indeed he took the view that if the approach were challenged it would likely be sanctioned by the Court of Appeal. He further stated that:

The process of mediation... and what actually happens in the mediation is confidential... but the actual fact of mediation is not without prejudice or confidential and nor should be the fact that some parties are not taking it seriously. If one party is refusing to go to mediation for a whole load of absolutely pathetic excuses then why shouldn't the court know. It is not only relevant to costs but might be relevant to all sorts of other things [D].

Interviewees, who favoured mediation, acknowledged that judicial encouragement and active oversight of the process was very useful, and enhanced the prospects of settlement

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<sup>256</sup> In section 459 cases shareholders try to prove unfairly prejudicial conduct and breakdown of personal relationships therefore, by nature section 459 petitions are very fact sensitive and could be boring for judges. Moreover, owing to fact-sensitive nature of section 459 petitions judges are not exploiting their case management powers to strike-out issues from petitions rigorously therefore have to deal with lengthy section 459 proceedings. See below para 7.4.3.3 Powers to exclude issues from consideration.

<sup>257</sup> See also above para 6.5.2.2 Early fair offers to buy-out, where an interviewee explained the similar reason for courts' emphasis upon early fair offers to buy-out to settle shareholder disputes.

by mediation in shareholder disputes. Mediation both facilitative and evaluative, was considered suitable for settling shareholder disputes and it appears that judges are also promoting it because they are also not happy having their lists cluttered by these kinds of disputes which tend to be time consuming and highly fact sensitive.<sup>258</sup> Courts encouragement to settle shareholder dispute at an early stage by mediation is in accordance with the CPR and *O'Neill v Phillips* that also encourages early fair offers to settle these dispute.<sup>259</sup>

#### 7.4.2.5.3 Cost sanctions for unreasonably refusing to mediate:

CPR rule 44.5(3)(a)(ii) provides that in deciding the amount of costs the court must have regard to the conduct of all the parties, including in particular the efforts made, if any, before and during the proceedings in order to try to resolve the dispute. The courts have considered this rule in various cases and evolved principles for determining when costs sanctions can be imposed for refusal to participate in an ADR process, particularly mediation.

In *Burchell v Bullard*<sup>260</sup> the court emphasised the utility of mediation as a form of ADR. Referring to *Halsey v Milton Keynes General NHS Trust*<sup>261</sup> the court gave a strong endorsement of mediation and stressed the importance of the legal profession becoming fully aware of and acknowledging its value. The profession could no longer with impunity shrug aside reasonable requests to mediate. The parties cannot ignore a proper request to mediate simply because it was made before proceedings were issued.<sup>262</sup> There were many disputes where one party offered and desired mediation and was simply met by a blank refusal. The court was entitled to take an unreasonable refusal to mediate into account even when it occurred before the start of formal proceedings.<sup>263</sup> The principles evolved through case law regarding the use of ADR and in particular mediation, can be

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<sup>258</sup> See above chapter 5 para 5.6.2 The Law Commission's critique of section 459 of the CA 1985.

<sup>259</sup> See above para 7.4.2.1 Pre-action co-operation and chapter 6 para 6.5.2.2 Early fair offers to buy-out.

<sup>260</sup> [2005] EWCA Civ 358.

<sup>261</sup> [2004] EWCA Civ 576 see below.

<sup>262</sup> [2005] EWCA Civ 358 para 43.

<sup>263</sup> [2005] EWCA Civ 358 para 50.



regarded as a significant development in the field of civil justice generally.<sup>264</sup> These principles which are discussed further below have arguably enhanced the role of ADR as a set of tools for resolving legal disputes.

(i) Duty of litigants to consider mediation:

The courts have strongly emphasised the costs sanctions for failure to make effort to resolve the dispute through mediation and consider it a duty of the parties and their lawyers to consider seriously the prospects of mediation. In *Hurst v Leeming*<sup>265</sup> it was concluded that a party who refused to proceed to mediation without good and sufficient reasons might be penalised for that refusal most particularly, in respect of costs. Mediation was not compulsory in law but ADR said to be at the heart of today's civil justice system. Any unjustified failure to give proper attention to the opportunities afforded by mediation in any case where mediation afforded a realistic prospect of resolution of dispute, may therefore attract adverse consequences. In *Dunnett v Railtrack plc*<sup>266</sup> given the refusal of defendants to contemplate ADR no order as to costs were made in that case. Moreover, by emphasising the duties of lawyers to further the overriding objective of the CPR, Brooke LJ drew the attention of lawyers to the possibility that if they turned down the chance of ADR when suggested by the court, they might have to face uncomfortable costs consequences.<sup>267</sup>

(ii) Risks involved for parties who refuse to mediate:

Courts now believe in the utility of mediation to resolve disputes.<sup>268</sup> Refusal to mediate can be risky choice since the parties may face costs sanctions if the court finds otherwise. Lightman J stated in *Hurst v Leeming*,<sup>269</sup> if objectively viewed, mediation had no real prospect of success then a party might refuse to proceed to mediation. But refusal was risky since the party could be severely penalized if the court found otherwise. There

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<sup>264</sup> See Genn H., 'Twisting Arms: court referred and court linked mediation under judicial pressure' (Ministry of Justice Research Series 1/07, May 2007) chapter 1.

<sup>265</sup> [2003] 1 Lloyd's Rep. 379, [2002] EWHC 1051 (Ch).

<sup>266</sup> [2002] EWCA Civ 303.

<sup>267</sup> [2002] EWCA Civ 303 para 15.

<sup>268</sup> See above *Burchell v Bullard* [2005] EWCA Civ 358. That can be due to proportionate use of court resources consistent with the overriding objective.

<sup>269</sup> [2003] 1 Lloyd's Rep. 379, [2002] EWHC 1051 (Ch).

was also a hurdle in refusing mediation on this ground. In making this objective assessment of the prospects of mediation, the starting point must surely be the fact that the mediation process itself could and often did bring about a more sensible and more conciliatory attitude on the part of the parties than might otherwise be expected to prevail before the mediation. It might produce recognition of the strengths and weaknesses by each party of their cases and a willingness to accept the give and take essential to a successful mediation. What appeared to be incapable of mediation, before the mediation process began, often proved capable of satisfactory resolution later.<sup>270</sup>

The court further held that in this case the defendant was justified in taking the view that mediation was not appropriate because it had no realistic prospect of success. It was plain that the claimant had been so seriously disturbed, by the tragic course of events resulting from the dissolution of the partnership that his judgment in respect of matters concerning the partnership and partnership action and the conduct of that action on his behalf was seriously disturbed. He was obsessed with the injustice which he considered had been perpetrated on him and was incapable of a balanced evaluation of the facts.<sup>271</sup> The court findings here are also applicable to section 459 disputes where parties are often very emotional due to relational breakdown<sup>272</sup> and therefore unable to think clearly regarding the disputed issues. Therefore, to avoid the costs sanctions parties to section 459 dispute are supposed to be very careful in evaluating the facts of the case and deciding whether mediation is appropriate or not.

In *Halsey v Milton Keynes General NHS Trust*<sup>273</sup> the Court of Appeal set out guidelines to assist the courts in determining whether parties had acted unreasonably in refusing to mediate.<sup>274</sup> It was held that the burden was on the unsuccessful party to show why there should be a departure from the usual rule that costs follow the event depriving a successful party of some or all of his costs on the grounds that he had unreasonably

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<sup>270</sup> [2003] 1 Lloyd's Rep. 379, 381.

<sup>271</sup> [2003] 1 Lloyd's Rep. 379, 381.

<sup>272</sup> See above chapter 3.

<sup>273</sup> [2004] EWCA Civ 576.

<sup>274</sup> See also Grainger I., 'The Cost Consequences of a Failure to Mediate' (2004) 23 Civil Justice Quarterly 244.

refused to agree to ADR.<sup>275</sup> In *Halsey*<sup>276</sup> it was held that in deciding whether a party had acted unreasonably the court should bear in mind the advantages of ADR over the court process and have regard to all the circumstances of the particular case, such as (i) the nature of the dispute; (ii) the merits of the case; (iii) the extent to which other settlement methods had been attempted; (iv) whether the costs of ADR would be disproportionately high; (v) whether any delay in setting up and attending the ADR would have been prejudicial; (vi) whether the ADR had a reasonable prospect of success.<sup>277</sup>

*Halsey* suggests that in deciding whether a party had acted unreasonably in refusing ADR, significant role of mediation should be borne in mind. The court accepted that mediation and other ADR processes did not offer a complete solution. These methods could have disadvantages as well as advantages and were not appropriate for every case. Accordingly, there could be no presumption in favour of mediation. The court emphasised that in many cases no single factor would be decisive, and that these factors should not be regarded as an exhaustive check-list.<sup>278</sup>

(iii) Active and bona fide participation of parties in mediation:

In the light of the case law not only refusal to mediate but also inactive participation in mediation can result in costs sanctions. In *Re Midland Linen Services Ltd*<sup>279</sup> the respondent argued that the petitioner should be deprived of all or part of his costs on the grounds that *inter alia*, he had rejected offers made by the respondents to determine the dispute by mediation. It was established that the issue as to whether a party had acted unreasonably in refusing to mediate had to be determined having regard to all the circumstances of the particular case. Parties should not only show the willingness to negotiate but should actively take part in negotiation in good faith to settle the dispute. Applying the *Halsey* guidelines<sup>280</sup> it was held that the respondents had failed to engage seriously in the mediation process. Even though they had repeatedly stated their

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<sup>275</sup> [2004] EWCA Civ 576 para 13.

<sup>276</sup> *Halsey v Milton Keynes General NHS Trust* [2004] EWCA Civ 576.

<sup>277</sup> [2004] EWCA Civ 576 para 16.

<sup>278</sup> [2004] EWCA Civ 576 para 16.

<sup>279</sup> [2004] All ER (D) 406 (Oct).

<sup>280</sup> *Halsey v Milton Keynes General NHS Trust* [2004] EWCA Civ 576.

willingness to negotiate, their approach in negotiation had been inconsistent and uncertain. Moreover, successful mediation was doubtful to take place in the atmosphere that had been generated between the parties.<sup>281</sup> In the light of *Halsey* there were not reasonable prospects of success of mediation. Therefore, the judge declined to make an order depriving the successful party (the petitioner) of any of the costs for acting unreasonably in refusing to agree to mediation. Therefore, by applying this principle a successful party can be deprived of costs in circumstances where their participation in an earlier mediation had been half-hearted.

(iv) Parties' engagement in ADR other than mediation:

In *Corenso (UK) Limited v The Burnden Group Plc*<sup>282</sup> the court clarified that ADR did not mean only mediation and parties might avoid costs sanctions by resorting to another method of ADR suitable to settle their dispute. The court stated that it was possible that a failure to engage in mediation might have adverse costs consequences for a successful party. However, it was not, by any means inevitable. Parties' obligation is to consider ADR. ADR was not synonymous with mediation. Mediation was one form of ADR. A party could quite properly discharge the obligations to consider ADR, and to attempt to engage in it, without necessarily being prepared to enter into mediation, if the party took the view that there were other forms of ADR, which were more appropriate or more likely to produce the appropriately desired result.<sup>283</sup>

The requirement on parties was to attempt to resolve their differences without resorting to court by considering ADR. So long as parties were showing a genuine and constructive willingness to resolve the issues between them, they would not be automatically penalised for not adopting a particular form of ADR proposed by the other side. It was in any event a matter of speculation in *Corenso* as to whether or not a mediator would have achieved any better or quicker result or would have talked the defendants into making the offer, which they did eventually make at an earlier stage.<sup>284</sup>

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<sup>281</sup> See [2004] All ER (D) 406 (Oct) para 60.

<sup>282</sup> [2003] EWHC 1805 (QB).

<sup>283</sup> [2003] EWHC 1805 (QB) para 19.

<sup>284</sup> [2003] EWHC 1805 (QB) para 60.

So the question may arise, in section 459 cases if the parties' efforts to settle by negotiation fail whether costs sanctions could be imposed for failure to use a form of ADR involving a neutral third party such as mediation. In the light of the *Corenso* principle, it seems if parties' endeavour in good faith to settle the dispute by negotiation (which is another form of ADR under the CPR) does not succeed later on, they cannot be penalised in court for not entering into mediation.

(v) Deterring undue pressure to settle:

It is conceivable that a party may use the threat of costs sanctions to put undue pressure on parties to achieve a settlement through ADR. In *Hickman v Blake Laphorn*<sup>285</sup> the court tried to control the undue pressure of cost sanctions upon the parties for refusing to negotiate or mediate. The court was asked to order costs where a party had not taken a course to settle the dispute.<sup>286</sup> The court after considering *Halsey*<sup>287</sup> and *Hurst v Leeming*<sup>288</sup> held that given the difference between the claimant and the second defendant as to the value of the claim, it was not demonstrated that the second defendant's position as to mediation and negotiation was unreasonable.<sup>289</sup> The court held that it could not be right that to avoid being vulnerable on costs a defendant should always be prepared to pay more than a claim was worth, as that would enable claimants to put undue pressure on a defendant to settle at a higher figure than the claim merited.<sup>290</sup> The cases as a whole deliver the message that refusal to mediate without a genuine reason carries the potential risk of a costs penalty. There are situations where refusal to mediate is not considered unreasonable. Parties are required to consider carefully whether, mediation can assist to settle the dispute and the consequences of failure to mediate.<sup>291</sup>

During empirical investigation interviewees expressed that cost sanctions were helpful tools in influencing settlement although the CPR had not made a big difference generally

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<sup>285</sup> [2006] EWHC 12.

<sup>286</sup> [2006] EWHC 12 para 25.

<sup>287</sup> *Halsey v Milton Keynes General NHS Trust* [2004] EWCA Civ 576.

<sup>288</sup> [2003] 1 Lloyd's Rep. 379, [2002] EWHC 1051 (Ch).

<sup>289</sup> [2006] EWHC 12 para 30.

<sup>290</sup> [2006] EWHC 12 para 18.

<sup>291</sup> See Hughes P., 'When Will Courts Penalise Refusal of Mediation? New Court of Appeal Guidance', [May 2004] 6, can be accessed at [www.adr.civiljusticecouncil.gov.uk](http://www.adr.civiljusticecouncil.gov.uk) (category, selected articles).

as regards costs since cost rules and sanctions were already there under the old rules. However, now under the CPR cost sanctions could be imposed as a result of refusal to mediate which were helpful in resolving the dispute through mediation and enhanced the role of mediation to settle minority shareholders' disputes [B, C]. Interviewees added:

In 459 disputes mediation is a most common form of ADR... ADR is an umbrella term. The mediation process is much more formalised now... parties did try to settle the cases in past by mediation but it is much more formalised after the CPR. People will face penalties in costs if they refuse to go to mediation [C].

The CPR has encouraged good practices by introducing costs sanctions for refusing to mediate that enhance the pressure to settle now in practice [M].

If you don't consider mediation or ADR there may be cost penalties. If I offered you mediation and you say no and you win at trial, I might be able to get some costs from you, because you were unreasonable in refusing to mediate even though you won in the end. I think that is the only change really in relation to costs [T].

Interviewee C stated that sometimes clients were reluctant to mediate but after knowing about the cost sanctions under the CPR they agreed to go for mediation. There had also been a shift in lawyers' perceptions of their own responsibilities:

Now it is the responsibility of counsel to tell their clients to settle or to go for mediation to avoid costs at the end of the proceedings. Counsel should seek to convince clients of the virtues of mediation to avoid costs and to keep them out of court. Counsel may get into trouble for not encouraging the client to mediate.<sup>292</sup> However, there can be cases where mediation is pointless, but these cases are very rare [C].

Interviewee J stated that following the CPR, parties to disputes were more conscious about the impact of refusing to settle through mediation or by other methods of ADR. If parties would not try hard enough, then they would not get their costs even if they would win at trial. However people were learning to play a lot of these rules to their advantage rather than necessarily engaging in ADR because it was a good idea in its own right e.g., by agreeing to mediation but arguing about when, where and before whom.

Interviewee further stated that:

In a famous reported case for six months the petitioner was mucking about, a famous international firm acting for the petitioner was obviously bullying a much smaller firm acting for the company. I drafted the letter that finally resulted in the mediation. The letter reminded them of their agreement in previous correspondence to engage in mediation and that they were constantly putting up obstacles to it and the time had come for the posturing to stop. The letter

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<sup>292</sup> See Code of Conduct of the Bar of England and Wales, para 302.

proposed the name of mediator, the venue and the dates to mediate and if inconvenient, option was there to change any of them. Furthermore, it stated whether mediation would happen or not, the letter would be referred on costs [J].

Interviewee C stated that refusing to mediate was one thing and as a result of refusal a party might face costs sanctions whereas taking part in a mediation half-heartedly was another thing since the mediation was a private process. At the end of the trial where there had been a refusal to mediate the judge had wide discretionary powers regarding costs but the biggest disadvantage was that there were no costs sanctions against the pretty bad behaviour during mediation since it was not subject to sanctions of a judge.<sup>293</sup>

It is evident that pressure of costs sanctions for refusing to mediate is an important factor influencing parties to consider mediation as a means of settling the dispute. Indeed, in practice, it may be difficult for a party who refuses to mediate to resist cost sanctions because of the problem of establishing (counter-factually) that mediation would not have been appropriate or successful.<sup>294</sup> However, the potency of costs sanctions is qualified in a number of ways. Firstly, refusal to mediate would not result in costs sanctions if it was clear that the parties were negotiating or using some other method of dispute resolution. Moreover, a refusal to mediate before the issue of proceedings would not necessarily attract costs sanctions. Interviewee R explained:

Most protocols letters or letters before action do not contain an offer to mediate right at the beginning, since people feel they do not have sufficient information to mediate... offer to mediate come in at a later stage. In a lot of cases it is not unreasonable not to offer to mediate right at the outset, because parties do not have enough information and material about the parameters of dispute to make any sensible proposals. If parties cannot make sensible proposals there is not much point in having a mediation [R].

The same interviewee added that:

Costs sanctions are not the main driving force for mediation. The main driving force is to avoid the costs of losing at trial. This has not really been changed by the CPR [R].

The overall impression then is that mediation has proved a useful additional tool alongside traditional inter-lawyer negotiations as a means of resolving disputes. Costs

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<sup>293</sup> The way of dealing with this problem was provided in *Re Midland Linen Services Ltd* [2004] All ER (D) 406 (Oct), see above.

<sup>294</sup> See also above *Hurst v Leeming* [2003] 1 Lloyd's Rep. 379, in (ii) Risks involved for parties who refuse to mediate.

sanctions for refusal to mediate have an impact but it is the general culture of judicial support for ADR in this area rather than individual rules such as costs sanctions that are providing the institutional underpinning of its success.

#### 7.4.2.5.4 Clarification of conflicting issues in advance:

The success of mediation also depends upon its timing. At an early stage mediation may fail since the issues in disputes may not have been fully clarified between the parties.<sup>295</sup> Christou has stated that although ADR clauses were now being included in contracts more frequently, it was not necessarily the best course to commence ADR before resorting to litigation. The preliminary phases of litigation might assist to sufficiently clarify the real points of disputes between parties.<sup>296</sup> At a later stage mediation may prove unsuccessful, since parties may refuse to pay costs so far incurred in the court proceedings. In *Witham v Smith*<sup>297</sup> it was stated that a premature mediation simply wasted time and could lead to a hardening of the positions on both sides and resulted in failure of mediation. Conversely, a delay in any mediation until after full particulars and documents had been exchanged could mean that the costs which had been incurred to get to that point, become the principle obstacle to a successful mediation. The trick to success in many cases was to identify the happy medium. It was the point when the details of the issues were known to both sides, but before incurring the huge costs in proceedings that a settlement was no longer possible.<sup>298</sup> In section 459 cases the happy medium seems to be soon after the issuance of proceedings.<sup>299</sup>

Interviewees stated that timing of mediation was an important factor for mediation to be successful. The best time to start mediation, for mediation to be successful and focused was when the issues have already been clarified by the parties by exchange of information [B, C, H]. As to timing of mediation in shareholder disputes interviewees stated that:

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<sup>295</sup> See Christou R., *Drafting Commercial Agreements*. (3<sup>rd</sup> ed Sweet and Maxwell, London 2005) chapter 17 para 17-3.

<sup>296</sup> See *ibid*.

<sup>297</sup> [2008] EWHC 12.

<sup>298</sup> [2008] EWHC 12 para 32.

<sup>299</sup> See Corbett J., and Nicholson R., 'Mediation and Section 459 Petitions' (2002) 23 (9) *Company Lawyer* 274, 277.



It is not appropriate in section 459 cases to have mediation at very early stage since mediation needs a level playing field. Particularly in the exclusion cases, where the excluded party does not have access to any information and is therefore unable to make any assessment as to valuation and strength of their cases. In that sort of case mediation may have to wait until after disclosure [M].

Parties should have some idea of the fair value of their shares and the means to make an assessment of the strengths and weaknesses of their cases, for mediation to be successful. Early mediations may bring an unfair result since parties do not know the true strengths of their cases [F].

Issues are clarified often by the issue of the petition. Clarification of issues before mediation is considered an important factor for successful outcomes in mediation. Interviewees considered that the best stages for mediation were either (i) after the issue of proceedings when statements of case had been produced from both sides or (ii) later after the exchange of witness statements which gives the parties a clear idea of the supporting evidence for their respective cases. There was some difference of opinion over which of these two stages was best. The advantage of stage (ii) is that the parties have the benefit of both statements of case and evidence. However, stage (i) was preferred by some as a means of trying to avoid the substantial costs associated with the preparation of witness statements [C]. Moreover, preparation to issue the petition assists to settle the dispute. Interviewee S stated that:

Court preparation concentrates the minds of the parties as to what the strengths and weaknesses of their cases are and has an impetus to trying to get people to settle rather than actually fighting it out in court [S].

Interviewees stated that there was no purpose of going to mediation when the other side was not providing important information about the company. However, the general experience was that it was usually not difficult for parties to obtain information since most of the times shareholders were also directors of the company and know what was going on in the company, had all the necessary information to draft petition and had right to access to documentation. If the shareholder was not a director and faced problem as to acquiring information he could get it in the course of the proceedings, and that's good enough. At issuance of proceedings the opposite party would give the standard disclosure. If anything else was required then a party might apply for specific disclosure [D, S]. Moreover, withholding documents could create a terrible impression and would

be another ground for bringing a petition [J]. Interviewee B stated that it was always advised to disclose unless the information was sensitive or suspicion was, that opposite party was in competition with the company. It was better to disclose it voluntarily to defuse any suggestion that there was unfairness. It was a pragmatic approach and effort to do everything to appear fair [B].

Interviewees stated that now under the CPR, cards on the table approach before issuance of proceedings also assisted to get relevant information. In mediations at early stage, interviewees had never contested pre-action disclosure nor advised clients to go for it as pre-action disclosure was not common in 459 proceedings inter alia due to its expensive nature [S].<sup>300</sup> Only one interviewee used the pre-action disclosure in his practice and considered it helpful for non-directors who do not have enough information. It was thought that an effective pre-action disclosure could conclude a case very quickly for instance, if there was a smoking gun document and that was produced at an early stage rather than having to wait until you had pleadings. However, it was acknowledged that now under CPR in terms of protocols, there was also greater expectation on the parties to follow cards on the table approach and there was more willingness to give advance disclosure voluntarily than before CPR [M].<sup>301</sup> The impression is that for successful outcome in mediation information is needed to assess the merits of conflicting issues. Issues are often clarified by the issue of the petition. Moreover, court preparation concentrates the minds of the parties and assists to settle the disputes. Voluntary disclosure at an early stage under the CPR can be helpful in this regard. However, obtaining information is not difficult in shareholder disputes therefore provisions regarding pre-action disclosure have a marginal effect.

#### *7.4.2.5.5 The role of the mediator:*

In section 459 disputes involving relational breakdown there is likely to be considerable acrimony between the parties and so it may be difficult for them to conduct successful

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<sup>300</sup> Interviewee S stated that parties applying for disclosure had to provide witness statements explaining nature of their case and details of documents they were after and they had to pay costs to other side for complying with pre-action disclosure.

<sup>301</sup> See above para 7.4.2.1 Pre-action co-operation.

principled negotiation. A mediator can bring the parties to the negotiating table and can facilitate the negotiations by identifying the issues in dispute. A mediator assists the parties to recognise where their respective interests lie and seeks to reconcile those interests to their mutual benefit.<sup>302</sup> Even though mediation is primarily viewed as an interest-based method of dispute resolution parties can influence the negotiation with the strength of their rights if they are advised that they have a strong legal case, by offering terms that reflect their opponent's risk of losing in a court. At this stage the mediator can play a role by enabling the parties to bridge this gap between their stances. A mediator's neutral role and expertise are crucial to achieving compromise in mediations.<sup>303</sup> A mediator cannot force the parties to reach an agreement but can inform them about the factors they should or should not bring under consideration to achieve a compromise.

The Court of Appeal in *Dunnett v Railtrack plc*<sup>304</sup>, also cited by *Halsey v Milton Keynes General NHS Trust*,<sup>305</sup> while acknowledging mediator's role, stated that a mediator might be able to provide solutions, which were beyond the powers of the court to provide. Skilled mediators were now able to achieve results satisfactory to both parties in many cases which were quite beyond the power of lawyers and courts to achieve. The court had knowledge of cases where intense feelings had arisen, for instance in relation to clinical negligence claims. But when the parties were brought together on neutral soil with a skilled mediator to help them resolve their differences, it might very well be that the mediator was able to achieve a result by which the parties shook hands at the end and felt that they had gone away having settled the dispute on terms with which they were happy.<sup>306</sup> There seems every reason to suppose that mediators may be able to play a helpful role in resolving shareholder disputes.<sup>307</sup>

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<sup>302</sup> Corbett J., and Nicholson R., 'Mediation and Section 459 Petitions' (2002) 23 (9) Company Lawyer 274, 275.

<sup>303</sup> See Christou R., *Drafting Commercial Agreements*. (3<sup>rd</sup> ed Sweet and Maxwell, London 2005) chapter 17 para 17-3.

<sup>304</sup> [2002] EWCA Civ 303.

<sup>305</sup> [2004] EWCA Civ 576 para 16.

<sup>306</sup> [2002] EWCA Civ 303 para 14.

<sup>307</sup> See Corbett J., and Nicholson R., 'Mediation and Section 459 Petitions' (2002) 23 (9) Company Lawyer 274.

Interviewees greatly acknowledged the demanding and engaging role of mediators in successful section 459 mediations. In a pre-CPR section 459 case need for a third person as a mediator, to handle the situation during negotiation and to quickly settle the dispute, was seriously felt in inter-lawyer negotiation [B]. Interviewee J who was an experienced mediator stated that the best kind of mediation was one in which both parties really wanted to try it. If parties were there only for protection against costs later in court then there was a problem. If parties were not fully engaged in the process the biggest task of the mediator was to get them to engage fully. These types of situation demand considerable skills from the mediator:

I ask them, what are your prospects of success? They say, 60%. I say yes, it is pretty good, but 60% chance of a win is also... 40% chance of losing. I say I tell you what, we go downstairs to the curb and if I told you, you have a 60% chance of getting to the other side of the road alive if you cross, would you regard it as a good or bad risk and at that point people begin to get it. People respond differently to different things and a mediator has to spot who is going to respond better to what. That is a part of mediator's technique you have to speak the right language depending on the person [J].

Mediators inform the clients that they have to face expensive litigation and to pay lawyers if they will not settle. Most people actually prefer to settle than to pay lawyers. Mediators try to focus the minds of both sides on the weaknesses of their cases and what would happen if they do not settle [G].

In 459 disputes sometimes parties do not agree that tomorrow is Thursday and would have a debate about that. Therefore the mediator's role and skills in facilitating negotiations will be critical in facilitating negotiations towards a compromise [C]

Mediators basically listen to both sides and then find the common ground. It is about money at the end of the day and the mediator by doing his job properly manages people's claims, frustrations and defences [T].

Interviewees stated that good mediation needs a good mediator therefore the quality and skill of mediator had a crucial role to play for any successful outcome in mediation.

Interviewees further stated that a good mediator needed the following qualities.

(i) A mediator should be a facilitator who did not just sit there and waited for the parties to make offers [M].

(ii) A mediator should be on top of the issues and be able to appreciate quickly what issues were dividing the parties [M].

(iii) A mediator should be empathetic and inspire confidence in the parties [M].

(iv) A mediator needs to be able to tell the parties hard truths in terms of strengths and weaknesses of their cases [M].

(v) A good mediator could see where really parties' interests lie [J].

(vi) A good mediator was really dedicated, sincere and patient about mediation [G].

Interviewee D stated that mediation was a successful method and could possibly be more effective than lawyer to lawyer negotiation since lawyers were trained in adversarial process. Mediator had a role to play during mediation and CEDR mediators were preferred since they were considered sensible mediators. In the experience of one interviewee mediation was not developed two years ago but now virtually 100% mediations were successful since good mediators were available:

A lot depends upon the quality of mediator and not everybody is good at mediation. In fact people get very personal and emotional in these cases and the skill of the mediator is to take the emotions out of it and ask them to look at it on a commercial basis and forget about "principles" and "personal animosities". The best thing to do is to move on in life, settle this and move on [G].

The identity and competence of the mediator was considered very important. In very bitter disputes sometimes a good mediator could help by providing parties at least an opportunity to express themselves in an effort to settle the dispute [C, M]. Two interviewees shared their recent experiences:

In one case it was not possible to get the parties in the same room but a mediator who was a commercial solicitor and was very good at negotiating deals amazingly got them to agree [C].

In one case both clients were completely mad... they were going to litigate all the way to the House of Lords if need be and were not ready to concede even a single point. But the mediator did a really good job and sorted it out [H].

For a successful outcome in mediation, the role quality and skill of the mediator was acknowledged by almost all interviewees. Therefore, it can be asserted that the future success of mediation in shareholder disputes may depend on commercial ADR bodies such as CEDR and ADR Group who have the capacity to provide well-trained mediators to the market.

#### *7.4.2.5.6 Low costs of mediation:*

Most interviewees considered the costs of mediation to be cheap compared to the cost of a court process although if the mediation failed and the parties continued to litigate it

would generally increase the overall costs. There might, however, be circumstances where even if the mediation failed it would at least clarify the issues in dispute and so not add significantly to costs. It is common in the section 459 context for mediations to last between two and three days. One of the interviewees who was a mediator stated that he charged between £3,000 to £5,000 for preparation and for the first day of the mediation and £1,500 per day thereafter. Another interviewee drew the comparison between the costs of mediation and the costs of a full trial:

The costs for taking a section 459 case to court are high. Mediation lasts two or three days whereas a trial lasts for three to four weeks... therefore mediation is an attractive option. Cases involving companies that are not of such a high value... do not get to trial because the parties do not have money to litigate and hence mediation is more sensible [M].

However, the costs of the mediation were not limited to the mediator's fee. Taking into account the parties' legal representatives, mediation could cost around £10,000 for one day:

The mediation process and good mediators are expensive and not only will the parties have to pay the mediators but also their lawyers if the lawyers are to be involved. This adds to the cost especially when the parties do not settle... at least the courts are free [G].

It can be asserted that easy availability of well-trained mediators in the market possibly will help to control the level of the costs of mediation. Below the chapter discusses the nature and impact of case management powers under the CPR to manage section 459 proceedings.

#### ***7.4.3 Nature and impact of case management powers to manage section 459 proceedings:***

Here the chapter discusses the nature of the procedural law developments under the CPR at proceedings stage and their impact upon section 459 proceedings, in the light of the findings of the empirical investigation. Empirical research is conducted to evaluate whether the availability of case management powers has in practice led to greater judicial control to manage section 459 proceedings.

#### *7.4.3.1 Commencement of section 459 proceedings:*

If the parties have recourse to litigation then proceedings under section 459 must be commenced in the Chancery Division of the High Court in London<sup>308</sup> (in the Companies Court) or if outside London in a Chancery District Registry or in a County Court having the jurisdiction to wind up the company in question.<sup>309</sup> The Practice Direction that supplements CPR Part 49 states that applications under sections 459 and 460 of the Companies Act 1985 must be made by petition.<sup>310</sup> The petition must specify the grounds on which it is presented and the nature of the relief which is sought by the petitioner, and must be delivered to the court for filing with sufficient copies for service.<sup>311</sup> Rule 3(3) provides that “the court shall fix a hearing for a day (“the return day”) on which, unless the court otherwise directs, the petitioner and any respondent (including the company) shall attend before the registrar in chambers for directions to be given in relation to the procedure on the petition”.<sup>312</sup> There is no requirement to file a defence in response to a section 459 petition since proceedings under section 459 come within the scope of specialist proceedings under part 49 of the CPR.<sup>313</sup> Rule 3(4) of the 1986 Rules provides that “on fixing the return day, the court shall return to the petitioner sealed copies of the petition for service, each endorsed with the return day and the time of hearing”.<sup>314</sup> Rule

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<sup>308</sup> Practice Direction 49B- Applications under the Companies Act 1985 and other legislation relating to companies, this Practice Direction Supplements CPR Part 49, para 3.

<sup>309</sup> Practice Direction 49B- Applications under the Companies Act 1985 and other legislation relating to companies, this Practice Direction Supplements CPR Part 49, para 1(2). Under s 117 of the Insolvency Act 1986 a company can be wound up in the county court if its paid-up capital is not more than £120,000.

<sup>310</sup> Practice Direction 49B- Applications under the Companies Act 1985 and other legislation relating to companies, this Practice Direction Supplements CPR Part 49, para 4(1).

<sup>311</sup> Companies (Unfair Prejudice Applications) Proceedings Rules 1986, r 3(2).

<sup>312</sup> Companies (Unfair Prejudice Applications) Proceedings Rules 1986. The Companies Court registrar means any officer of the High Court who is a registrar within the meaning of any rules for the time being in force relating to the winding-up of companies, Practice Direction 49B- Applications under the Companies Act 1985 and other legislation relating to companies, this Practice Direction Supplements CPR Part 49, para 1(1). In the High Court in London these judicial officers are known as Masters and in District Registries of the Chancery Division of the High Court they are known as District Judges.

<sup>313</sup> As stated above section 459 proceedings are governed by the Companies (Unfair Prejudice Applications) Proceedings Rules 1986. Practice Direction 15.1 para 1.2 that supplements CPR part 15 states that the provisions of part 15 relating to the ‘Defence and Reply’ apply only to the extent that they are not inconsistent with the rules and practice directions applicable to those specialist proceedings. The Companies (Unfair Prejudice Applications) Proceedings Rules 1986 have no such requirement for the filing of a defence and as a consequence the petitioner cannot obtain default judgment under the CPR part 12 in section 459 proceedings, see CPR, part 12, r 12.3.

<sup>314</sup> Companies (Unfair Prejudice Applications) Proceedings Rules 1986, r 3(4). The petitioner shall serve a sealed copy of the petition on the company and on every respondent named in the petition at least 14 days before the return day. See Companies (Unfair Prejudice Applications) Proceedings Rules 1986, r 4.

5 of the 1986 Rules provides that on the return day or at any time after it the court shall give such directions as it thinks appropriate with respect to service, general procedure, advertisement of the proceedings and as to evidence to be adduced regarding the petition.<sup>315</sup>

As to case management it is provided that petitions under section 459 of the CA 1985 shall be allocated to the multi-track and the general provisions of the CPR relating to allocation questionnaires and track allocation will not apply.<sup>316</sup> The purpose of case management by allocating the case to multi-track is to conduct procedural hearings either to identify or settle the issues between the parties or to prepare the case for the trial stage. To meet this end at the multi-track case management stage (pre-trial hearings) procedural judges may either give simple directions or may hold case management conferences along with possible pre-trial reviews.<sup>317</sup> Parties have to prepare their cases for case management by the court and so, for example, they will be required to file evidence in the form of witness statements well before the trial.<sup>318</sup> The exchange of witness statements will assist the parties to assess the merits of their case and to explore the scope and advantages of settlement between them. Filing written statements is an expensive process and the costs associated with it may persuade shareholders to settle the dispute before starting actual trial.<sup>319</sup>

Courts mainly engage in active judicial case management at two stages of the proceedings. However, the court can manage cases at any time from commencement of proceedings until final judgment at trial stage. Firstly the courts manage the cases after allocating the case to the procedural track by giving directions to identify, limit or settle

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<sup>315</sup> Companies (Unfair Prejudice Applications) Proceedings Rules 1986, r 5.

<sup>316</sup> Practice Direction 49B- Applications under the Companies Act 1985 and other legislation relating to companies, this Practice Direction Supplements CPR Part 49, para 10.

<sup>317</sup> CPR, r 29.2 (1) and Practice Direction 29 para 5.1.

<sup>318</sup> By applying its case management powers the court will order a party to serve on the other parties any written statement of the oral evidence which the party serving the statement intends to rely on, in relation to any issues of fact to be decided at the trial. See CPR, r 32.4 (2). Rule 32.4(1) of CPR provides that a witness statement is a written statement signed by a person which contains the evidence, and only that evidence, which that person would be allowed to give orally.

<sup>319</sup> The present use of witness statements in CPR has also lessened the use of affidavits in the chancery matters. See Sime, S., *A Practical Approach to Civil Procedure* (Oxford, US 2005) para 29.1.3.



as many issues between the parties as possible prior to the trial stage which should be the last resort.<sup>320</sup> Secondly where a trial is inevitable, courts will seek to expedite the process by giving directions regarding pre-trial arrangements and actual conduct of the trial.<sup>321</sup> At the case management conference (CMC) the court will review the steps which the parties have taken in the preparation of the case and the parties' compliance with any directions given by the court.<sup>322</sup> The court will decide and give directions about the steps which are to be taken to secure the progress of the claim in accordance with the overriding objective.<sup>323</sup> The costs of preparing and attending CMC can be very significant.<sup>324</sup>

In theory, the courts' case management powers should serve to focus the issues in dispute and speed up the litigation process. Zuckerman has stated that as a result of the case management powers in the CPR the courts now control the conduct of the proceedings whereas under the pre-CPR system the parties largely controlled it.<sup>325</sup> This may help to process cases faster in courts. In order to further process the litigation and to determine the issues between the parties, courts are no longer supposed to wait for the parties to make an application but may give directions on their own initiative.<sup>326</sup> This may assist the determination of issues in a swift manner. Now under the CPR pre-trial process is greatly linked with the trial stage. In the pre-trial process parties have to submit their evidence and arguments in the court well before the actual commencement of trial providing the court in advance of trial comprehensive information about the parties' respective cases.<sup>327</sup> The courts may order disclosure and inspection of document

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<sup>320</sup> See below 7.4.3.3 Power to exclude issues from consideration.

<sup>321</sup> The parties are required to consider whether at the case management conference provision of a case summary not exceeding 500 hundred words designed to assist the court to understand and deal with the questions before it, will be useful, see PD 29 paras 5.6, 5.7.

<sup>322</sup> PD 29 para 5.1(1).

<sup>323</sup> PD 29 para 5.1 (2). At the case management conference (CMC) the court will consider various topics such as whether the claimant has made clear the claim he is bringing; whether any amendments are required to the claim; what disclosure of documents if any is necessary; whether expert evidence is required and if so then how it is to be adduced; what factual evidence should be disclosed. See PD 29 para 5.3.

<sup>324</sup> Bramley, M., Gouge, A., *The Civil Justice Reforms One Year On* (Butterworths, London 2000) 87.

<sup>325</sup> See Zuckermann A., *Civil Procedure*. (LexisNexis Butterworths, UK 2003) 358. See also CPR, r 1.4 (1)(c) and (l) and above para 7.3.1 Case management powers of courts.

<sup>326</sup> CPR, r 3.3.

<sup>327</sup> See CPR, part 31; CPR, r 32.4(2).

at the first return date or at a case management conference.<sup>328</sup> A party does not have an automatic right to disclosure but only if the court orders and to the extent the court orders disclosure.<sup>329</sup> In the meantime, at this stage parties may settle their dispute any time by making offers under part 36 of CPR or by exploiting other methods of settlements.<sup>330</sup>

#### 7.4.3.2 Pre-trial review and efficient trial:

The timetable for trial is generally prepared at the time of the pre-trial review.<sup>331</sup> Pre-trial review provides a further opportunity for settlement before the full trial costs are incurred and where the settlement is not possible timetable for trial is prepared at pre-trial review.<sup>332</sup> The pre-trial process also includes, filing the skeleton arguments<sup>333</sup> and chronologies<sup>334</sup> by the parties and filing the trial bundle of documents<sup>335</sup> in accordance with practice direction 39 para 3.2 by the claimant. In cases where the parties fail to settle their dispute by negotiation or by exploiting other means of settlement, then the dispute is finally determined after trial by the judgment of the court. Due to pre-trial preparation judges would be in a good position to conduct the actual trial efficiently by appropriate use of the court's and parties' time during the trial. The court may also control the conduct of a trial by using its powers as to controlling evidence by giving directions as to presentation of evidence during the trial.<sup>336</sup> In theory, these requirements should enhance the efficiency of the trial process. Under the CPR, the court may give

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<sup>328</sup> See CPR part 31, Disclosure and Inspection of Documents in *Civil Procedure*, Vol 1, The White Book Service (Sweet and Maxwell, London 2004).

<sup>329</sup> CPR, r 31.5. The general rule is that an order to give disclosure amounts to an order to give standard disclosure however a court may order specific disclosure if standard disclosure is inadequate, CPR, r 31.5; CPR, r 31.12 and Chancery Guide 2005, para 4.3. Standard disclosure requires a party to disclose only (a) the documents on which he relies; and (b) the document which (i) adversely affect his own case (ii) adversely affects another party's case; or (iii) support another party's case; and (c) the document which he is required to disclose by a relevant practice direction, CPR, r 31.6. The cost of any specific disclosure should not outweigh the benefits to be obtained from such disclosure, Chancery Guide 2005, para 4.4.

<sup>330</sup> Under the CPR part 36, a party to a claim may make part 36 offer at any time during the proceedings stage to settle the dispute and to put the other side at risk on costs. See discussion about part 36 offers above in para 7.4.2.1 Pre-action co-operation. As to form and content of a part 36 offer see CPR, r 36.5.

<sup>331</sup> CPR, rr 29.7-29.8.

<sup>332</sup> *Civil Procedure*, Vol. 1 The White Book Service (Sweet and Maxwell, London 2001) para 29.7.1.

<sup>333</sup> See appendix 3 para 25 and appendix 7 to Chancery Guide 2005.

<sup>334</sup> See appendix 3 para 25 and appendix 7 to Chancery Guide 2005 .

<sup>335</sup> CPR, r 39.5.

<sup>336</sup> CPR, r 32.1.

summary judgment against a petitioner or respondent.<sup>337</sup> This power can be useful in section 459 cases because shareholders' generally raise the issues in petitions to prove unfairly prejudicial conduct in which there is no real prospects of success.<sup>338</sup>

Interviewees confirmed that the introduction of case management powers had only a limited impact upon section 459 proceedings. The CPR had not made any changes to the rules that applied to section 459 petitions. Unfair prejudice petitions continued to be conducted in the Companies Court in the way that they were conducted before the rules changed. Case management conferences had not made any significant difference, as under the rules applicable to section 459 cases, judges who heard these cases always had powers how evidence was going to be called. Section 459 practice had not changed a lot after the CPR or did not become easier [C]. Interviewees stated that now in practice the courts were actually more willing to listen to summary judgment applications, by the petitioner in classic unfair prejudice cases. Such as where the directors were placing corporate opportunities in their own pocket or issuing shares for an improper purpose and it was obvious that there had been unfair prejudice [T].<sup>339</sup>

It was added that CPR has no real impact on conduct of section 459 petitions in any particular way apart from reinforcing the determination of judges to try to get the grip on cases by exercising their case management powers [F]. Interviewees stated that after the CPR section 459 cases proceeded faster than pre-CPR due to case management powers of courts controlling the conduct of proceedings, including the rules on pre-trial preparation. In the context of section 459 the most relevant case management power of courts was the power to exclude issues regarded by court as unimportant or irrelevant

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<sup>337</sup> CPR, r 24.3 (1)(2). CPR r 24.2 provides that the court may give summary judgment on the whole of the claim or on a particular issue if there is no real prospect of success and there is no compelling reason for the case or issue to be disposed of at a trial. See also above para 7.2.2 The Law Commission's proposals.

<sup>338</sup> The law Commission stated that proliferation of weak or insubstantial allegations relating to the conduct of parties is a particular problem in section 459 cases, see *The Law Commission Report* para 2.31. In *Re a Company* (No 004415 of 1996) [1997] 1 BCLC 479, 493 Sir Richard Scott V-C stated that "there has been a tendency in some past s 459 cases for the litigation to become a Chancery version of a bitterly contested divorce with grievances from the history of the marriage dredged up and hurled about the court in an attempt to blacken the opposing party". See also above chapter 3 para 3.2 Introduction and above para 7.4.1.1 The expensive nature of section 459 petitions.

<sup>339</sup> *Dalby v Bodily* [2005] BCC 627, was referred as an example where shares were issued for an improper purpose, the court stated the trial would not be required and gave a summary judgment.

from the petition in order to streamline the proceedings. However, in the interviewees' experience, there was a general judicial reluctance to exercise this power because of the open ended nature of the enquiry that the court is required to carry out under section 459 and the point that a finding of 'unfair prejudice' will often be based on the cumulative nature of the supporting allegations rather than on any one particular factor in isolation.<sup>340</sup> Moreover, the interviewees thought that the court powers to make issue based costs orders had had a greater impact in focusing the parties on the real issues in dispute.<sup>341</sup> Interviewees focused upon the impact of courts' case management powers *inter alia* to strike out the issues from the petition and to make issue based costs order, upon section 459 proceedings, which are discussed below.

#### *7.4.3.3 Powers to exclude issues from consideration:*

Courts are granted considerable powers under the CPR to manage cases effectively by controlling the conduct of proceedings. In *North Holdings Ltd v Southern Tropics Ltd*<sup>342</sup> Morritt LJ reiterated the observations of Aldous LJ in the same case that a new approach to manage section 459 cases actively was both possible and necessary. It will be recalled that one of the Law Commission's principal criticisms of section 459 proceedings arose from the fact that the section permitted the applicants to put in issue anything that might be remotely relevant.<sup>343</sup> That resulted in problems associated with the section discussed above.<sup>344</sup> In this context, to control the conduct of proceedings rule 3.1 (2)(k) of the CPR grants the court an important case management power. The rule provides that the court may exclude an issue from consideration. Rule 32.1 of the CPR further provides that the court may control the evidence by giving directions as to the issues on which it requires evidence and the nature of such evidence.<sup>345</sup> By controlling the conduct of section 459 proceedings under this rule courts may increase the effectiveness of the remedy since proceedings will be more focused and timely and cost-effective resolution will be achievable. Writing extra judicially Lord Neuberger (as he now is) has stated that

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<sup>340</sup> See below para 7.4.3.3 Powers to exclude issues from consideration.

<sup>341</sup> See below para 7.4.3.4 Assessment of costs and issue based costs orders.

<sup>342</sup> [1999] 2 BCLC 625, 640.

<sup>343</sup> See *The Consultation Paper* [14.5]. See also above chapter 5, para 5.6.2.1 Wide scope of the section.

<sup>344</sup> See above chapter 5 para 5.6.2 The Law Commission's critique of section 459 of the CA 1985.

<sup>345</sup> CPR, r 32.1 (a)(b).

to achieve the aim of quick and cheap litigation it seemed attractive to cut down the matters from the petition but in many cases it would be difficult to achieve. He stated that in *Re Rotadata Ltd*,<sup>346</sup> a case in which he was a judge, a series of actions by the respondents, when taken together, constituted a breach of applicant's rights such that a purchase order ought to be made in respect of his shares:

In order to assess the seriousness of the allegations, and the reliability of the evidence called on behalf of the parties, I concluded that it would be very dangerous to remove some of the matters complained of from the dispute.<sup>347</sup>

This may cast doubt on the efficacy of this case management power in meeting with the Law Commission criticism.

It was hoped that if the parties failed to settle and case proceeded to court then the case management powers of courts to strike out the unnecessary issues from the petition under CPR would assist in streamlining the litigation. Interviewees stated that courts already had such powers to strike out the issues from the petition pre-CPR. The CPR had not introduced anything new but just had made these powers more obvious. Exploitation of case management powers to strike out the issues could be useful in section 459 cases. However, in practice judges were not exercising such powers rigorously in 459 cases due to fact-sensitive nature of shareholder disputes which are about relational breakdowns and unfairly prejudicial conduct. Exploitation of these powers also depends upon the attitude of individual judges towards 459 petitions some judges are pro-active and are interested in excluding issues from the petition but majority of judges are not. Interviewees' responses regarding courts' powers to strike out the issues are discussed below in detail.

#### *7.4.3.3.1 Utility of powers to strike out:*

Interviewees stated that section 459 petitions were long and covered even the irrelevant grievances against the respondents therefore exploitation of case management powers could be useful in section 459 petitions [E, M]. In the recent reported case where counsel

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<sup>346</sup> [2000] 1 BCLC 122.

<sup>347</sup> See Neuberger D., 'Company Law Reform: The Role of the Courts' in John de Lacy (ed) *The Reform of United Kingdom Company Law* (Cavendish Publishing Limited, UK 2002) 67.

was instructed, complaint was as to excessive remuneration and non payment of dividend. The petition was really short but the defence that came in raised the kitchen sink. Then the counsel had to prepare to meet the case that was then put back against the petitioner. It just led to prolong the proceedings and costs. It was stated that if the core issues were being focused in that case then the proceedings would have been much shorter [C]. In a practitioner's perspective it was not quite sensible to crowd the petition with small matters as this tended to detract from the 'big picture'. It was always better to focus on main grievances in section 459 petitions [M].

#### 7.4.3.3.2 *Impact of powers to strike out:*

Interviewees stated that case management had been carried out in the same way after the CPR as it was before because the petitions were always returnable to the registrar for directions anyway unlike things in the Chancery generally [M]. Some judges were keen to manage the cases even before the CPR and CPR had just enhanced the willingness of those judges to exploit these powers and therefore it had made some difference [E]. However there was no major impact of case management powers upon section 459 cases. It had not reduced the length and costs of 459 proceedings because of the difficulty in severing allegations that may contribute cumulatively to a finding of unfair prejudice. The courts were therefore not exercising these powers rigorously in section 459 cases:

There are limits on case management powers since courts cannot limit issues without hearing them, by saying that some or all of these issues are irrelevant [D].

In practice the exploitation of these powers was so limited in section 459 cases due to courts' conscious approach towards section 459 petitions. An experienced practitioner pointed out that even in *North Holdings Ltd v Southern Tropics Ltd*<sup>348</sup> case the Court of Appeal had said that new rules or proactive case management should have a big impact on section 459. But since then there had been remarkably few reported or unreported cases where courts had used their pro-active case management powers in section 459 cases, so as to make them quicker and cheaper [G].

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<sup>348</sup> [1999] 2 BCLC 625.

Interviewees stated that in section 459 cases exploitation of these powers also depended upon the conduct of individual judges; some judges exploit these powers and tried to confine it to two or three complaints [E, F]. In the real world, generally judges were considered 'hopeless' in exercising pro-active case management powers [B, G, P]. Moreover, courts were more willing to entertain applications to strike out whole petitions but generally not to strike out parts of the petition [T]. Good judges acted in certain ways to control the conduct of the proceedings. They tried to educate parties when they saw there was better way of dealing with the case by suggesting it to the parties almost like a second opinion. However, the worst judges imposed solutions and thought they knew better than the parties [G].

There was a consensus among majority of the interviewees that courts were not exercising these powers to strike out weak issues from the petitions in section 459 cases. Interviewees explained the following reasons behind lack of exploitation of these powers by judges in section 459 cases.

*7.4.3.3.3 Reasons behind lack of use of powers to strike out issues:*

(i) Interviewee M explained that:

The complex nature of section 459 petitions where parties have to either prove or defend a breakdown of relationship or unfairly prejudicial conduct, does not permit judges to exercise their case management powers with rigour. Registrars and judges are not pro-active in striking out issues from petitions on their own motion [M].

Interviewees stated that the courts simply declined to exercise their most powerful case management powers. The nature of section 459 allegations is such that they demand to be heard. Therefore it is difficult for judges to strike out allegations that, taken cumulatively with other matters, might later prove unfair prejudice. Judges were conscious of the fact that a seemingly weak point in a petition might later become very significant. However, interviewee J stated that he could not understand why judges faced with 50 allegations of unfair prejudicial conduct did not say to the petitioner and respondent that they should choose 10 each. If they could not win on their best 10 then they could not win. Some judges seemed quite interested in the idea but did not apply it in practice. In one of very early famous cases after the introduction of the CPR.

Interviewee J made an effort to try and press the courts to use the new case management techniques but he felt that he had not succeeded. J added that this did not mean that judges were uninterested but some judges are wary of being too robust about what appear to them to be weak allegations because judges did not know as much as the parties knew. Some judges ‘just sat back and took the view that if that was what the parties wanted to talk about and waste money on, then let them get on with it.’

As a part time judge interviewee G shared his experience that when a judge had a case in front of him nine out of ten times the judge did what the parties were ready to do. Judges were adjudicating just on what parties disagree on. A judge could not be sufficiently confident that he knew better than the parties even though he might be right.

(ii) The CPR had not really changed the threshold for allowing a case to go to trial which was very difficult to change, because of the idea that nobody must be prevented from their right to have a trial. Judges were constrained by the fact that the CPR had not changed the fundamental rule that a mini trial should not be conducted at an early stage in interim proceedings. Therefore, if judges felt the case arguable then it would be allowed to go on even if it was very likely that it was going to fail [R].

(iii) There could be at least three case management hearings in section 459 petitions which could be before different registrars. Pre-trial reviews would not necessarily take place before the trial judge. A judge would generally not take an interventionist approach when he knew he was not going to deal with it next time [G].

The impression is that judges are not exploiting their case management powers to strike out issues rigorously in section 459 cases mainly due to their fact-sensitive nature. Therefore, to avoid the lengthy and costly section 459 proceedings and to settle early they prefer to refer disputes to mediation which is also in accordance with the CPR and *O’Neill v Phillips*, that encourage early settlement in these disputes.<sup>349</sup>

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<sup>349</sup> See above courts’ encouragement of attempts to settle through mediation in para 7.4.2.5 Factors that contribute to successful outcomes in mediations.



#### *7.4.3.3.4 Lawyers' responsibility to manage petitions:*

Interviewee B pointed out that there was a need for case management not to be only by courts but by counsel themselves. Counsel should tell their clients to go for the five most important allegations instead of a number of small allegations to prove unfair prejudice and to save time and expense involved in these proceedings. Sometimes parties and their lawyers are not willing to accept the exercise of these powers by courts. Interviewee C stated that:

By exercising case management powers, if the court would not give a party enough time for cross examination it would be the first ground of appeal to the Court of Appeal [C].

Interviewees had been instructed to strike out the whole petition as disclosing no cause of action but had never been instructed to think about striking out part of a petition [M, T]. It is possible that practitioners might not take seriously the harms of long petitions. Interviewee T considered no point in striking out part of petition when petition was going to be defended in a court anyway. The role of lawyers was considered important to control the conduct of proceedings by convincing clients to focus upon main issues in petitions. Lawyers should behave in a responsible manner for proceedings to be more focused and swift.

Courts had case management powers to strike-out the issue from the petition even before the CPR but the CPR had made these powers more obvious. It can be asserted that in practice courts are not exercising these powers mainly owing to fact-sensitive nature of these petitions. Exploitation of such powers also depends upon the approach of individual judges towards the petitions. Interviewees stressed that lawyers should act in a responsible manner by convincing clients to focus upon the main issues for proceedings to be swift.

#### *7.4.3.4 Assessment of costs and issue based costs orders:*

The CPR provide that in deciding what order (if any) to make about costs, the court must have regard to all the circumstances, including the conduct of all the parties before or

during the proceedings.<sup>350</sup> Where the parties fail to act reasonably either before or during the proceedings the court may take into account their conduct when it comes to determine the question of who pays the legal costs. The general rule is that the unsuccessful party will be ordered to pay the costs of the successful party although this is now qualified by the court's power to make issue-based costs orders regardless of the overall outcome.<sup>351</sup> In practice, the successful party will not usually recover all of their costs from the unsuccessful party. O'Hare and Brown state that "it is a fact of life that the costs recovered from a losing party are usually less than the costs actually incurred by the winning party's side".<sup>352</sup> In addition to this fact, the court has discretion as to (a) whether costs are payable by one party to another; (b) the amount of those costs; and (c) when they are to be paid.<sup>353</sup>

Under the CPR courts can now award an issue based costs order. The general rule that the successful party will always be awarded all the costs is thus qualified.<sup>354</sup> The CPR provide that in determining what order to make about costs, the court must have regard *inter alia* to the conduct of all the parties.<sup>355</sup> Rule 44.3(5) of CPR provides that the conduct of the parties includes *inter alia*.<sup>356</sup>

- (i) whether it was reasonable for a party to raise, pursue or contest a particular allegation or issue;
- (ii) the manner in which a party has pursued or defended his case or a particular allegation or issue;
- (iii) whether a claimant who has succeeded in his claim, in whole or in part, exaggerated his claim.

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<sup>350</sup> CPR, r 44.3(4)(5).

<sup>351</sup> CPR, r 44.3(2).

<sup>352</sup> O'Hare J. and Browne K., *Civil Litigation* (13<sup>th</sup> ed Sweet and Maxwell, London 2007) para 2.020.

<sup>353</sup> CPR, r 44.3(1).

<sup>354</sup> See CPR, r 44.3(2)(a)(b).

<sup>355</sup> CPR, r 44.3(4)(a).

<sup>356</sup> See CPR, r 44.3(5)(b)(c)(d).

In *AEI Rediffusion Music limited v Phonographic Performance Limited (Costs)*<sup>357</sup> Lord Woolf M.R. (as he then was) stated that:

I draw attention to the new Rules because, while they make clear that the general rule remains, that the successful party will normally be entitled to costs, they at the same time indicate the wide range of considerations which will result in the court making different orders as to costs... The most significant change of emphasis of the new Rules is to require courts to be more ready to make separate orders which reflect the outcome of different issues.

Lord Neuberger (as he now is), writing extra judicially, has stated that in *Re Rotadata Ltd.*<sup>358</sup>

[I]t did seem to me right to point out that certain issues were so marginal and so potentially expensive to deal with, not in terms of court time but in terms of having witnesses called from abroad, that I very much doubted that, even if a party would otherwise have been entitled to its costs, any order for costs would be made in its favour in relation to those items.<sup>359</sup>

Interviewees stated that following the CPR, courts' power to order costs on the basis of individual issues greatly assisted to focus the proceedings on the main conflicting issues. Interviewee G stated that after the CPR courts could award costs on more discretionary basis. Courts could not only regard who was winner or loser but also had to consider the way the parties conducted the case. Therefore in practice parties were conscious of wider discretionary powers of courts while conducting their 459 cases [G]. Interviewee R stated as opposed to tendency in past, courts' significant powers to award costs depending on whether a party won or lost on particular issues like in *Re Elgindata*<sup>360</sup> case, discouraged shareholders to raise every single little grievance that they ever had against the opposite party in section 459 petition. In practice after the CPR if there were ten issues in the petition and really only one of them was important and nine of them were just minor and petitioner lost all of them then petitioner was more in danger of costs than he was in past. Therefore, that had the effect of cutting down the number of issues from the petition and focusing the proceedings upon main conflicting issues and proceedings moved faster [R]. Due to issue based costs order after the CPR interviewee

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<sup>357</sup> *AEI Rediffusion Music limited v Phonographic Performance Limited (Costs)* Court of Appeal (Civil Division) [1999] 1 WLR 1507, 1522-1523.

<sup>358</sup> [2000] 1 BCLC 122.

<sup>359</sup> See Neuberger D., 'Company Law Reform: The Role of the Courts' in John de Lacy (ed) *The Reform of United Kingdom Company Law* (Cavendish Publishing Limited, UK 2002) 67-68. Neuberger J delivered the judgment in *Re Rotadata Ltd* [2000] 1 BCLC 122.

<sup>360</sup> [1991] BCLC 959.

H suggested that it was sensible if out of 20 allegations of unfair prejudice, petitioner include in the petition the five most important. It might have an adverse effect on the share price or the fair offer but it would remove the risk of facing costs for losing on those issues [H]. As stressed above that, lawyers should be more responsible by focusing upon the core conflicting issues in petitions.<sup>361</sup> The impression is that issue based costs orders are helpful in the context of section 459 cases by persuading parties and their lawyers to only include issues in petition that have good prospects of success. That assists to curtail the length of section 459 proceedings, concentrates the parties' minds upon key conflicting issues that may help to settle the disputes and makes the proceedings focused and swift.

### **7.5 Conclusion:**

In section 459 proceedings settlement was very common by inter-lawyer negotiation before the CPR. The main factors that contribute to settlement were nature of shareholder disputes and expensive nature of section 459 proceedings. Distinct nature of these disputes was one main factor behind settlement of these disputes. Minority shareholders' disputes are almost always about money and separation. After the CPR section 459 proceedings are still expensive but the following factors have enhanced the early settlements of disputes. Early settlement helps to avoid costs involved in court proceedings.

(i) The CPR emphasises pre-action co-operation to settle the disputes under pressure of cost sanctions to achieve overriding objective. *O'Neill v Phillips* also emphasises early offers to settle the disputes to avoid the expense inevitably involved in these proceedings. In the past shareholders were writing pre-action offer letters to settle disputes. However, there is more explicit pressure now to settle disputes at an early stage following *O'Neill v Phillips* and the CPR than there perhaps was in the past. That concentrates the minds of shareholders upon early settlement of disputes and has increased the early settlements of disputes.

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<sup>361</sup> See above para 7.4.3.3.4 Lawyers' responsibility to manage petitions.

- (ii) The CPR do not save costs but front loading of costs are more obvious following the CPR due to explicit pressure of early co-operation that persuade shareholders to settle early rather than late.
- (iii) Lawyers seem to be more aware and conscious of their responsibilities following the CPR to assist shareholders achieving compromise at an early stage, to avoid expensive court proceedings.
- (iv) Issue based costs order concentrates the parties mind upon key conflicting issues and may help to promote settlements in these disputes.
- (v) Emphasis of the CPR upon ADR particularly mediation to settle the dispute at an early stage has enhanced the scope of early settlements in shareholder disputes.

Following the CPR, mediation is becoming popular to settle shareholders disputes where inter-lawyer negotiations do not prove successful. People are now aware of mediation and now there is widespread availability of formal mediation process than in the past.<sup>362</sup> Prior to the CPR mediation was rarely exploited in shareholder disputes. Mediation has a high rate of success in shareholder disputes with a consequence that some practitioners favour compulsory mediation. Mediation is becoming popular to settle shareholder disputes mainly due to suitability of mediation for shareholder disputes and courts encouragement to settle these disputes by mediation. Mediation is suitable since it helps to settle at an early stage. Courts encourage parties to settle these disputes by mediation at an early stage (i) as emphasized by the CPR under the pressure of costs sanctions and reinforced by *O'Neill v Phillips* (ii) it settles disputes and therefore avoid lengthy and costly section 459 proceedings (iii) judges do not like hearing section 459 cases due their fact sensitive and time consuming nature. However, a few practitioners prefer evaluative mediation as oppose to facilitative mediation.

In practice success of mediation in shareholder disputes depends upon six factors. Following the CPR courts' role is useful to encourage attempts to settle through

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<sup>362</sup> It is consistent with the findings of Genn's report that legal profession has more knowledge and experience of mediation than was the case a decade ago. See Genn H., 'Twisting Arms: court referred and court linked mediation under judicial pressure' (Ministry of Justice Research Series 1/07, May 2007) chapter 6, 204.

mediation. Pressure of cost sanctions is effective and lawyers are under duty to inform their clients about the possible cost sanction for unreasonably refusing to mediate. Clarification of conflicting issues in advance is considered an important factor for successful outcomes in mediation. Issues are often clarified by the issue of the petition. Court preparation at issuance of the petition concentrates the minds of the parties and assists to settle the dispute. Now the CPR 'cards on the table' approach helps to clarify the issues at an early stage before the issuance of proceedings and has promoted early settlements through mediation. Other two factors are low costs of mediation and the role of mediator. The cost of mediation is considerably low as compare to court proceedings. However, at failure of mediation where parties continue to litigate it increases the overall costs. The role of mediator is very important in successful outcomes of mediation and well-trained mediators are available. It can be asserted that the present availability of professional mediators is a response to the demand for mediators in the market, after the CPR. Due to the increased demand of well-trained mediators, success of mediation in future as a method of ADR also depends upon the contribution of commercial ADR bodies, who trained the mediators.

Expert determination is rarely exploited in practice except where (i) parties are ready to buy-out and dispute is only regarding valuation of shares (ii) there is no factual dispute that affected the price of shares (iii) parties are agreed upon the identity of the expert.

To manage section 459 proceedings courts were able to strike-out issues from the petition even before CPR but the CPR has made these powers to strike out frivolous issues from the petitions more apparent. However, in practice judges were not exercising these powers in section 459 cases mainly owing to fact-sensitive nature of these petitions. Exploitation of such powers also depended upon the attitude of individual judges towards the petitions. Issue based costs orders are helpful in the context by persuading parties and their lawyers to only include issues in petition that have good prospects of success and to avoid frivolous issues. That concentrates the parties mind upon key conflicting issues. It assists to curtail the length of section 459 proceedings, may help to settle and makes the proceedings focused and swift.

## Chapter 8

### Conclusion

In the light of the findings of the research, the chapter seeks to address the fundamental question of the research, namely whether the present means of resolving shareholder disputes are effective to resolve these disputes in minimum time and cost to shareholders, companies and the administration of justice by the courts.<sup>1</sup> The effective resolution of shareholder disputes is consistent with the objective of the CPR that includes fair adjudication of disputes in minimum time and cost and by using proportionate court resources.<sup>2</sup> The research shows that in private companies relational breakdown of shareholders causes exit disputes. Relational breakdown often precipitates the squeeze-out behaviour of majority shareholders, which exacerbates the dispute. Resolution of shareholder disputes focuses almost invariably upon the terms of exit. *Ex ante* contractual arrangements in shareholders' agreements, although considered to be useful, cannot resolve shareholder disputes in an effective manner owing to a range of limitations associated with them. Therefore shareholders need to have recourse to courts to resolve their disputes.

Under the present law in England and Wales, the provision for relief from unfair prejudice in sections 994-996 of CA 2006 (formerly sections 459-461 of CA 1985)<sup>3</sup> is the principal mechanism for resolving shareholder disputes in private companies. Problems have been identified by the courts and the Law Commission with the operation of this court-based dispute resolution mechanism in practice, such as factual complexity, excessive length and cost of the proceedings. It may be thought that these problems may have diminished the effectiveness of the remedy for minority shareholders. Measures have been proposed on the level of both substantive and procedural law with the aim of

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<sup>1</sup> See also above meaning of 'effectiveness' in chapter 1 para 1.2.

<sup>2</sup> See above chapter 7 para 7.3.1 Case management powers of courts.

<sup>3</sup> The reenactment of sections 459-461 took place during the course of the research. The practice adopted in this thesis has been to refer to the old section numbers on the assumption that most readers will be more familiar with these. See n 35 to text in para 1.2 above.

streamlining the effectiveness of the dispute resolution mechanism under sections 459-461 of the CA 1985.

The question that was not addressed by the available literature and which therefore remained to be answered was whether these developments have in practice improved the effectiveness of this mechanism and therefore addressed the Law Commission's criticism. Hence, in the light of legal scholarship, an empirical evaluation of the current effectiveness of this mechanism through qualitative interviews was conducted to address this question in a manner designed to close the gap identified in the existing literature. The aim of the research was to evaluate the present effectiveness of section 459 in practice and the continuing validity of the Law Commission's criticisms of this dispute resolution mechanism in the light of subsequent substantive and procedural law developments.

Empirical investigation gives the impression that the developments under the case law and the CPR have an impact in practice upon section 459 proceedings. These new developments on both substantive and procedural levels sought to improve the effectiveness of section 459 proceedings. On the substantive level case law developments have enhanced the certainty of the section and on the procedural level the CPR enhanced courts' powers to manage section 459 cases by encouraging early settlement and conducting more focused trials where efforts to settle fail.

However, in practice the enhanced certainty of the section and the courts' case management powers have not proved successful to a significant extent in reducing the length and cost of section 459 cases which proceed to a full trial. *O'Neill v Phillips* enhanced the legal certainty as to the scope of the provision by defining more narrowly the meaning of 'unfairness' and by discontinuing the potentially open-ended concept of legitimate expectations. This has had the effect of reducing in practice the number of section 459 petitions that are commenced in the courts. However, where proceedings are commenced, proving the cause of action under the provision can still be a lengthy and costly process.



Judges are not using their case management powers under the CPR, to control the conduct of section 459 proceedings for effective resolution of the disputes, by striking out the frivolous issues from the petition. This is mainly, due to the fact-sensitive nature of section 459 petitions. However, powers under the CPR to award issue based costs orders have proved helpful to persuade parties to only include issues in the petition that have good prospects. That makes the proceedings focused and swift and will assist to curtail the length of section 459 proceedings.

A key finding of the research, which does not appear to have been fully recognised by in the Law Commission's report, is that negotiated settlement was very common in section 459 disputes before 1999 by inter-lawyer negotiations often at or immediately before trial. The Law Commission's criticisms of section 459 proceedings appear to have focused only on isolated cases that have led to lengthy trial proceedings and not on the extent to which cases were settling either pre-action or pre-trial.

The impression from the empirical investigation is that there were two major factors that guided shareholders towards settlement of disputes before 1999: (i) distinct nature of shareholder disputes that are almost always about 'money' and 'separation', (ii) and expensive nature of section 459 court proceedings. These factors still exist.<sup>4</sup> Section 459 proceedings are still expensive following the CPR. By negotiated settlement shareholders can avoid the time and money inevitably involved in the lengthy section 459 court proceedings at trial.

Cases were always settling on the basis of offers to buy-out but emphasis in the case law and the CPR to settle early reinforce this practice and enhance the early settlements of shareholder disputes rather than at trial. The real difference is that in the past cases that did not settle at an early stage, either pre-action or pre-trial, might have drifted towards trial whereas they are now being actively managed by courts to settle with enhanced exploitation of mediation. After the CPR section 459 court proceedings are still

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<sup>4</sup> *O'Neill v Phillips* and *Grace v Biagioli* declared buy-out after fair valuation at an early stage to be an appropriate method of resolving these disputes. See above chapter 6.

expensive but the impression is that the following factors enhance the early settlements of shareholder disputes. Early settlement assists to save the time and costs involved in court proceedings.

(i) *O'Neill v Phillips* emphasises early offers to settle the disputes to avoid the expense inevitably involved in these proceedings. *O'Neill* reinforces the CPR that emphasises pre-action co-operation to settle the disputes under pressure of cost sanctions. In the past shareholders were writing pre-action offer letters with a view to triggering a negotiated settlement. There is more explicit pressure now to settle disputes at an early stage under *O'Neill v Phillips* and the CPR than in the past. That concentrates the minds of shareholders to achieve compromise and has increased the tendency for parties to consider early settlement.

(ii) *O'Neill v Phillips* and *Grace v Biagioli* enhanced the legal certainty as to appropriate method of resolving these disputes and their outcome. It can assist to achieve an early compromise in negotiation and possibly will promote number of settlements with time.

(iii) The emphasis of the CPR and courts upon ADR particularly mediation to settle the disputes at an early stage with threat of costs sanctions has enhanced the exploitation of mediation, and therefore scope of early settlements in shareholder disputes. Following the CPR mediation is also becoming popular to settle shareholder disputes along with inter-lawyer negotiation. Mainly, due to (i) suitability of mediation for shareholder disputes since it helps to settle early and (ii) courts encouragement to exploit mediation to settle these disputes at an early stage, as emphasised by the CPR and *O'Neill v Phillips*, and judicial enthusiasm for out of court settlement to avoid fact-sensitive and time consuming section 459 proceedings.<sup>5</sup>

(iv) The front loading of costs is more 'felt' following the CPR e.g., an issue based interim assessment of costs, which persuades shareholders to settle early rather than late.

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<sup>5</sup> This also gives emphasis to the principle of judicial respect for commercial decisions due to which the courts have showed themselves unwilling to intervene in company's internal matters. See above chapter 5 para 5.6.2.3 Courts' respect for majority rule.

(v) In the light of the CPR lawyers are more aware of the need to consider settlement with a view to avoiding cost sanctions and seem to some extent to be more proactive in assisting shareholders to achieve a compromise at an early stage in section 459 cases.

In the light of the empirical investigation, the answer to the question as to whether the developments after 1999 improve the effectiveness of means to resolve shareholder disputes seems positive. Therefore, the Law Commission criticism upon section 459 proceedings in mid nineties is addressed by the subsequent developments. The impression is as discussed above, that there are significant developments as to alternative means of resolving shareholder disputes namely, the negotiated settlement often now achieved with the assistance of a mediator. The new legal developments persuade shareholders to settle the dispute at an early stage to avoid the time and costs inevitably involved in section 459 proceedings. This is also in the wider interests of the company because the company is likely to invest the considerable time in litigation instead of running the business. Moreover, by emphasising these developments courts are also keen to keep section 459 cases out of court due to their inherent fact-sensitive therefore lengthy nature to save court resources.

Even though shareholder disputes have tended to settle earlier, shareholders cannot be forced to settle their disputes as they are entitled to their day in court should they so wish. Hence, the early settlement of disputes also depends upon the rational and professional attitude of shareholders and their legal representative towards resolution of these disputes. As it was asserted above, that for cultural change along with procedural rules, pragmatic approach towards settlement is needed.<sup>6</sup> But shareholder disputes are now settling early and due to legal developments discussed above, the number of early settlements is expected to increase in future and cases that might in the past have been

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<sup>6</sup> See above para 7.3.2 Existing research evaluating the impact of the CPR. The evidence of Genn's report also suggested that the motivation and willingness of parties to negotiate and compromise is critical to the success of mediation and an effective mediation-promotion policy might combine education and encouragement. See Genn H., 'Twisting Arms: court referred and court linked mediation under judicial pressure' (Ministry of Justice Research Series 1/07, May 2007) chapter 6.

allowed to drift towards trial are more likely to settle at an earlier stage rather than at the door of the court.

## Appendix 1

### Clauses of shareholders' agreements

#### 1. Appointment of directors:

The parties shall procure that there shall be not more than (number) directors of the Company of whom not more than (number) shall be persons for the time being nominated by the Majority Shareholder and not more than (number) shall be persons for the time being nominated by the Minority Shareholder. The first such nominees are (name) and (name) appointed by the Majority Shareholder and [(name) appointed by the Minority Shareholder or the nominee of the Minority Shareholder shall be himself].<sup>1</sup>

1.1 Each shareholder shall be entitled by notice in writing addressed to the Company to replace any person nominated by him...<sup>2</sup>

#### 2. Matters requiring consent of both parties:<sup>3</sup>

2.1 The Shareholders shall exercise all voting rights and other powers of control respectively available to them in relation to the Company so as to procure (insofar as they are able by the exercise of such rights and powers) that the Company shall not without the prior written approval of each Shareholder:

2.1.1 sell, transfer, lease, assign or otherwise dispose of a material part of the undertaking, property and/or assets of the Company or any subsidiary (or any interest therein), or contract so to do whether or not for valuable consideration

2.1.2 do or permit or suffer to be done any act or thing whereby the Company may be wound up (whether voluntarily or compulsorily), save as otherwise expressly provided for in this Agreement or unless the Company is insolvent

2.1.3 enter into any contract or transaction except in the ordinary and proper course of its business on arm's length terms

2.1.4 borrow or raise money (which shall include the entry into of any finance lease but exclude normal trade credit)

2.1.5 take major decisions relating to the conduct (including the settlement) of material legal proceedings to which the company is a party (a potential liability, or claim, in excess of £... being regarded as material for these purposes)

2.1.6 incur capital expenditure in respect of any item or project in excess of £... or such other sum as may be agreed between the parties from time to time

2.1.7 hold any meeting of Shareholders or purport to transact any business at any such meeting unless there are present duly authorised representatives or proxies for each of the Shareholders

2.1.8 amend the memorandum or articles of association of the Company

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<sup>1</sup> See Butterworths, 291 Shareholders' agreement for minority protection clause 4.1.

<sup>2</sup> See Joffe's, Appendix 1, Precedent 24, clause 3.2.

<sup>3</sup> See Butterworths, 291 Shareholders' agreement for minority protection clause 3.

- 2.1.9 alter any rights or restriction attaching to any class of share in the capital of the Company
- 2.1.10 change the name of the Company
- 2.1.11 pass any resolution or engage in any other matter which represents a substantial change in the nature of the business of the Company or in the manner in which such business is conducted
- 2.1.12 remove any director appointed...
- 2.1.13 issue any additional shares...

### **3. Access to information:<sup>4</sup>**

3.2 The Directors appointed by the Majority Shareholder and the Minority Shareholder shall be entitled either in person or by means of an agent nominated by them in writing to have unrestricted access to:

- 3.2.1 all trading records and information relating to the operations of the Company
- 3.2.2 all accounts, books, bank statements and other financial records of the Company
- 3.2.3 records held in any form including those held in computer files controlled or used by the Company

### **4. The Company's business:<sup>5</sup>**

4.1. Except as the Shareholders may otherwise agree in writing or save as otherwise provided or contemplated in this Agreement [or in the Business Plan], the Shareholders shall exercise their powers in relation to the Company so as to ensure that:

- 4.1.1 the Company carries on and conducts its business and affairs in a proper and efficient manner and for its own benefit [and in accordance with the Business Plan];
- 4.1.2 the Company transacts all its business on arm's length terms;
- 4.1.3 Each of the parties covenants with each other to use all reasonable endeavours to promote and develop the business of the Company to the best advantage in accordance with good business practice and the highest ethical standards.<sup>6</sup>
- 4.1.4 the Company allots and issues its shares and other securities at the best price reasonably obtainable in the circumstances;
- 4.1.5 the Company shall not acquire, dispose of, hire, lease, licence or receive licences of any assets, goods, rights or services otherwise than at the best price reasonably obtainable in the circumstances;
- 4.1.6 the Company shall keep books of account and therein make true and complete entries of all its dealings and transactions of and in relation to its business;
- 4.1.7 the Company shall keep each of the Shareholders fully informed as to all its [material] financial and business affairs.

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<sup>4</sup> Butterworths, 291 Shareholders' agreement for minority protection, clause 4.2.

<sup>5</sup> Cadman's, Precedent A, Minority Protection Agreement, clause 10.

<sup>6</sup> Butterworths, Precedent 5, clause 9.1.

## **5. Matters requiring directors' approval:<sup>7</sup>**

The Shareholders shall exercise their powers in relation to the Company to procure that, save as otherwise provided or contemplated in this Agreement [or in the Business Plan] and save with the prior approval of a resolution of the Directors on which an 'A' Director and a "B" Director voted in favour or of a written resolution of the Directors, the Company will not and none of the other companies in the Group will:

5.1 pay any remuneration or expenses to any person other than as proper remuneration for work done or services provided or as proper reimbursement for expenses incurred in connection with its business;

5.2 create or allow to subsist any Encumbrance over any of its assets;

5.3 borrow any money or obtain any advance or credit in any form other than normal trade credit or other than on normal banking terms for unsecured overdraft facilities or vary the terms and conditions of any borrowings or bank mandates;

5.4 lend any money to any person (otherwise than by way of deposit with a bank or other institution, the normal business of which includes the acceptance of deposits) or grant any credit to any person (except to its customers in the normal course of business);

5.5 sell, transfer, lease, licence or in any other way dispose of any of its assets otherwise than in the ordinary course of its business.

## **6. Matters requiring Shareholders' approval:<sup>8</sup>**

Unless otherwise agreed between the Shareholders in writing, the Shareholders shall exercise their powers in relation to the Company to procure that (save as otherwise provided or contemplated in this Agreement [or in the Business Plan]) the Company will not and none of the other companies in the Group will:

6.1 issue, allot, redeem, purchase or grant options over any of its shares or other securities or reorganise its share capital in any way.

## **7. Dividend policy:<sup>9</sup>**

Subject to circumstances prevailing at the relevant time including, in particular, the working capital requirements of the Company, it is the intention of the parties that the Company shall distribute by way of dividend in respect of each financial year provided that the same will not contravene the Companies Act 1985 [not less than .....% of the post-tax [consolidated] profits of the Company [and its subsidiaries] for that financial year available for distribution].

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<sup>7</sup> Cadman's, Precedent A, Minority Protection Agreement, clause 12.

<sup>8</sup> Cadman's, Precedent A, Minority Protection Agreement, clause 12(2)(a).

<sup>9</sup> Butterworths, Precedent 8, clause 8.3.

**8. Pre-emption rights:**<sup>10</sup>

Each Shareholder shall have the option but not the obligation to subscribe at the price set forth in the Company's Notice for that proportion of the Shares proposed to be issued which the number of Shares held by him bears to the total number of Shares outstanding at the time the Company gives its notice. Such option may be exercised by notice to the Company given at any time within (*specify*) days following the Company's Notice accompanied by payment in full for the Shares to be subscribed for.

**9. Negotiation:**<sup>11</sup>

In any case of dead-lock each of the shareholders shall, within [14] days of such dead-lock having arisen or become apparent, prepare and circulate to the other shareholder a memorandum or other form of written statement setting out its position on the matter in dispute and its reasons for adopting such position. Such memoranda or statements shall be considered by the shareholders who shall use their reasonable endeavours to resolve such disputes within [seven] days of exchange of the memoranda. If the shareholders shall agree upon a resolution of the matter, they shall exercise their respective Voting Powers to procure (so far as they are able) that such resolution or disposition is fully and promptly carried into effect.

**10. Termination:**<sup>12</sup>

The agreement shall continue in full force and effect until terminated in accordance with the provisions of this clause...

The termination events are if:

10.1 any party shall commit [any (or) a material] breach of any of its obligations under this agreement and shall fail to remedy the breach, if capable of remedy, within 30 days after being given notice by the other party or parties to do so; or

10.2 any party, being a company, shall go into liquidation whether compulsory or voluntary (except for the purposes of a bona fide reconstruction or amalgamation with the consent of the other [party (or) parties], such consent not to be unreasonably withheld or delayed) or any party shall have an administrator appointed or shall have a receiver, administrative receiver or manager appointed over any part of its assets or undertaking; or

10.3 any party (being an individual) shall be adjudged bankrupt or shall die or become a patient for the purposes of any statute relating to mental health; or

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<sup>10</sup> Butterworths, 291 Shareholders' agreement for minority protection, clause 8.2.

<sup>11</sup> Butterworths, precedent 1 clause 13.2.

<sup>12</sup> Butterworths, precedent 5 clauses 14.1, 14.2.



10.4 any party (being an individual) shall cease for any reason to make his substantially full-time services available to the Company and/or any subsidiary of the Company or both; or

10.5 there shall be any change in control of any party.

## Appendix 2

### Interview schedule/aide memoire for use with barristers

#### Introduction

**1. Introduce myself:**

My name is Asim Iqbal. I am a PhD student at Nottingham Law School, Nottingham Trent University.

**2. General nature of my research:**

I am conducting research into the effective resolution of minority shareholders' disputes in private limited companies with particular reference to section 459 of the Companies Act 1985. I am carrying out a series of interviews with Chancery practitioners in order to evaluate empirically the effectiveness of shareholder dispute resolution in private companies.

**3. Ethical statement:**

Your participation in the present research is confidential and your responses would be mentioned in the PhD thesis anonymously. During the interview you have a complete right to refuse to answer any question and you may withdraw at any time between now and the submission of my PhD thesis in which case I would not use your interview in the writing up of my research.

**4. Seek consent for digital recording:**

Would you permit me to record our conversation for my future analysis? I will store the digital record on a password protected computer and destroy it once the PhD is completed. I ask you also to waive confidentiality to the extent necessary to allow me to quote anonymously from your interview transcript

**5. Please tell me a little bit about yourself – in particular, about your practice and experience:**

#### Questions

##### Changes in Chancery practice:

1. In your experience how has your practice changed as a result of the Civil Procedure Rules 1998 (i) generally (ii) in relation to section 459?

2. In your experience has the section 459 process been improved by the CPR?  
[Length, cost and complexity]
3. In your experience how has your practice changed as a result of substantive law developments through case law in this area? [O'Neill v Phillips (increased the certainty of legal principles) (encouragement towards early settlement)]

**Types of disputes and types of relief:**

4. From your experience tell me what kinds of disputes you have encountered in the section 459 context? Are there any common themes in terms of causes/factual basis of disputes?
5. In your experience, in terms of final outcomes, how are shareholders' disputes usually resolved? To what extent do you think these outcomes reflect client aspirations/expectations?

**Settlement processes including ADR:**

6. Explain the process by which section 459 cases settle? In your experience how has this changed (if at all) since 1999? Please give examples if possible.

[*Processes means:* Lawyer to lawyer negotiation, mediation, expert determination]

7. What is your experience (if any) of alternative methods of dispute resolution (ADR) as a means of resolving shareholders' disputes? Do you actively recommend the use of such processes for your clients and if so, why? Please give examples if possible.

[*a. If positive response:* Which ADR methods have you experienced and with what sort of results?

Do you consider that some methods are better than others and if so, why?

What do you consider are the benefits and pitfalls of ADR?

*b. If negative response:* how do you handle the risk of costs sanctions?]

**Specific aspects of the CPR:**

8. In your experience, how have the pre-action disclosure rules affected your practice in shareholder dispute?
9. In your experience, are Part 36 offers used by the petitioners and respondents in section 459 cases? Do you think they are useful?  
[If so, why?  
If not, why not?]

10. In your experience, are single experts appointed to resolve issues on share valuation? [If so, do you think that this has been a useful and welcome development?]
11. In your experience, how have the courts' case management powers affected the conduct of section 459 cases? Would you say — again from your own experience — that case management has reduced the length and cost of proceedings in line with the overriding objective?
12. In your experience, how have the CPR's costs rules and sanctions affected your conduct of section 459 cases?

**Shareholders' agreements:**

13. In your experience, does the existence of a shareholders' agreement improve the prospects for speedy and cost-effective resolution of shareholder dispute?

**Default rules in Table A/articles of association:**

14. Do you think that the inclusion of default provisions for buy-out and fair valuation by a competent expert (ie an exit mechanism) in Table A would assist parties to resolve their disputes with less cost and delay [and why]?

**Snowball Sampling**

Could you suggest to me names of other practising lawyers, especially solicitors who have experience of dealing with section 459 cases both pre- and post-CPR, whom I could approach with a view to them participating in the present research. It would be very helpful and greatly appreciated.

Thank you.

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