UK Shareholder Litigation: Latest Cases Reviewed

The purpose of this short editorial is to highlight a selection of recent UK court decisions pertaining to shareholder rights and disputes involving members. This corpus of this jurisprudence is invariably set against the context of a dispute relating to a **solvent private company**. Shareholder disputes involving public companies are less common in terms of reported litigation. The avenues in which these disputes involving private companies are played out in the courts will be familiar to readers of this Newsletter – for explanatory comment see our editorial in Issue 421 (September 2020). These avenues consist of the application of now well established statutory provisions and some even more venerable common law principles. That said, there is some innovation to note and fresh judicial insights upon familiar questions to reflect upon. Many of the cases noted below have been processed by the courts in the COVID 19 era; counsel and the judiciary are to be congratulated for the efficient way in which justice has been dispensed in this testing context.

Unfair prejudice; a major litigation driver

Cases pursued under Companies Act 2006 s. 994 on the grounds of alleged unfair prejudice are not hard to find when perusing the law reports. This statutory regime provides a flexible jurisdiction to resolve internal disputes involving the affairs of the company and offers a range of exit remedies for the successful petitioner.

The complaints raised in the petition in *Re Macom GmbH (UK) Ltd* [2021] EWHC 1661 (Ch) featured allegations of misconduct by a director. There was nothing unusual in that scenario; the novel point about this case however was the fact that the petitioner was a majority shareholder, who, because of the curious shareholder agreement/corporate governance arrangement in operation here, could not exercise the normal power held by a majority shareholder to rectify matters without recourse to the court. Section 994 allows any member to petition the court and is not restricted to minorities. We return to this case later.

We now move on to *Re Compound Photonics Group Ltd* (*Faulkner v Vollin Holdings Ltd* [2021] EWHC 787 (Ch). The complaint here related to the removal of a director from office. When considering whether this exclusion from management breached the protections afforded by s. 994 the court (Adam Johnson J) took into account an express good faith requirement included in a shareholder agreement; that requirement restricted the exercise of the usual statutory powers to remove directors. Exclusion from management was a central ground in the successful petition featured in *Re Gallium Funds Solutions Group Ltd (Dooley v Norris)* [2021] EWHC 765 (Ch), a decision of ICC Judge Jones.

A fair number of unfair prejudice petitions fail. In *Re Euro Accessories Ltd (Monaghan v Gilsenan)* [2021] EWHC 47 (Ch); [2021] BCC 401 Snowden J dismissed the petition, which was concerned with a dispute as to what constituted "fair value" under the terms of express buyout provisions in the articles. Snowden J ruled that this phrase meant market value and not the higher pro rata value of the shares. Those lawyers who draft such provisions in corporate constitutions should take note of this interpretation.

Procedural complications arose in *Re GO DPO EU Compliance Ltd et alia* [2021] EWHC 1765 (Ch) where ICC Judge Jones was faced with difficult issues featuring various parties, who were involved in four companies, issues that did not give rise to an immediate resolution. The judge found that the question of unfair prejudice could not be resolved until a full account had been taken of financial dealings between the various parties. He therefore adjourned the petition. See also the preliminary jousting in *Re Compound Photonics Group Ltd (Faulkner v Vollin Holdings Ltd)* [2020] EWHC 3176 (Ch); [2021] BCC 249 where Adam Johnson J refused to give summary judgment in favour of the petitioners. A different view was taken when the petition was heard (see below). Another "procedural" judgment was *Zedra Trust v The Hut Group* [2021] EWCA Civ 904 where the Court of Appeal was faced with an appeal against the dismissal of an application for the striking out of an unfair prejudice petition. In disposing of the appeal The Court of Appeal considerably reduced the scope of the matters complained of in said petition. The general problem here is that there can be a tendency to "throw in the kitchen sink" in such petitions and it is reassuring that the court will use its case management powers in such a way so as to place the focus on what are the key matters. Another procedural complication can arise where there are cross petitions – see *McMonagle v Harvey* [2021] EWHC 1374 (Ch) for the judicial approach in such an eventuality.

A side issue that often arises in unfair prejudice litigation is whether there is a quasi-partnership in existence – for discussion of this phenomenon in Corporate Law see generally Milman [2019] 414 Co L N 1. This can affect both the substantive question of whether unfair prejudice has occurred by introducing additional equitable considerations and it can also impact upon various consequential matters if unfair prejudice is established. For instance, in *McMonagle v Harvey* [2021] EWHC 1374 (Ch) ICC Judge Mullen found that there was a quasi-partnership. That said, it is clear that the existence of a quasi-partnership is not a sine qua non of a successful unfair prejudice petition.

Unfair prejudice proceedings have to be funded and the financial consequences of success or failure of a s. 994 petition can trigger consequential litigation. The issue of liability for costs looms large for the unsuccessful party. In *Sprint Electric Ltd v Buyer's Dream Ltd (Potamianos v Prescott) (Re Sprintroom Ltd)* [2021] EWHC 960 (Ch) Richard Spearman QC (sitting as a Deputy Judge of the High Court) was concerned with costs in the wake of a successful unfair prejudice petition (see *Re Sprintroom Ltd* [2019] EWCA Civ 932) and complex related litigation (see [2020] EWHC 3465 (Ch). Costs determination had to take account of offers by the respondent to settle with the petitioner.

Much of the reported unfair prejudice litigation relates not to whether unfairly prejudicial conduct has occurred, but rather the remedial consequences available to the court in the event of that complaint by the petitioner having been established. Indications of the remedial options open to the court are to be found in Companies Act 2006 s. 996. The most commonly invoked remedy is an order by which the respondents are required to buy out the petitioner at fair value, a so-called "buyout order" (see s. 996(2)(e). Where the court makes a buyout order the question of the valuation of the petitioner's shareholding will inevitably arise. The most common valuation question is whether it is to be a pro rata valuation of the minority shareholding, or should a discount be applied? The court refused to order a minority discount in *Re Gallium Funds Solutions Group Ltd* (supra). But other valuation questions (for instance determining the real worth of the company) may need resolution. This was so in the case of *Re ICamera Ltd* [2021] EWHC 1762 (Ch). Here ICC Judge Jones explained how expert valuation evidence should be approached when attempting to place a value on the future profitability of a company. This assessment was needed in order to place a fair value on a successful petitioner's shares. On this same area see *Oberman v Collins* [2021] EWHC 2298 (Ch) and the earlier judgment in the case reported in [2020] EWHC 3533 (Ch).

It is sometimes overlooked that remedial options specified under s. 996 are broad and, indeed, are not exhaustive. Buyout/sellout orders are not the only possible outcomes of a successful petition. There is, for example, an explicit power in s. 996(2)(a) to regulate the future management of the company's affairs. This option was pursued in *Re Macom GmbH (UK) Ltd* (supra). HHJ Hodge QC felt that the clean break option of a buyout order was not appropriate in the circumstances of the case and he encouraged the parties to agree to a modus vivendi for the future. That turned out to be a difficult solution to achieve, but it does show commendable creativity on the part of the court in trying to promote such an outcome.

Where a trial judge has determined the issue of unfair prejudice and an appropriate remedy an appeal court must consider carefully whether that remedy should be varied on appeal. This need for caution to be exercised by the appellate court would appear to be the message offered by Lord Briggs in the Privy Council advice in *Ming v JF Ming Inc* [2021] UKPC 1; [2021] BCC 438.

Remedies under s. 994 must be understood in their proper remedial context when compared to other potential shareholder remedies. On the relationship between unfair prejudice and derivative claims see *Taylor Goodchild Ltd v Taylor* [2021] EWCA Civ 1135, where the court indicated that a successful unfair prejudice petition does not necessarily block a later claim by the company in respect of matters coming to light in the hearing of the unfair prejudice petition. The respondent argued that this was unfair and that the petitioner in the s. 994 claim should have included a derivative claim in those proceedings to address the matter. On the facts of this case the Court of Appeal disagreed with that suggestion; to have done so would have introduced complexity into the unfair prejudice trial.

<u>Derivative claims; increased usage but not a flood</u>

If a shareholder is looking to remedy an injustice to the company rather than an injury to that member personally we are looking at a so-called derivative claim. The derivative claim allows a member to seek compensation for the company. Its availability has long been recognised at common law, but it was hedged about by restrictive rules. The introduction of Part 11 of the Companies Act 2006 has led to an increase in the number of derivative claims coming before the courts. But the courts have been careful not to allow the floodgates to open. They are mandated to operate a filtering mechanism – note in particular the barriers set up by ss. 261, 262 and 263 of the 2006 Act. A prima facie must always be shown. A case that directors performing their duty under s.172 of the Companies Act 2006 would not support should not proceed, nor should a claim that the members are likely to vote against.

Thus, in *Re Capital Investment Centre Ltd* [2021] EWHC Misc 7 (CC) HHJ Matthews refused permission for a derivative claim to proceed. The claim appeared weak and no director taking account of that fact in the light of the parlous finances of the company would have allowed a claim by the company to proceed. Similarly, in *Hughes v Burley* [2021] EWHC 104 (Ch) permission to proceed was also refused by HHJ Pearce. This refusal again was because of the speculative nature of the claim and the financial position of the company. Again the s. 172 duty imposed on independent directors became a relevant consideration. More generally, however, the court made the point that the breach of duty mentioned in s. 260(3) might refer to a breach of <u>contractual</u> duty owed by a director to the company (see para [108] of the judgment). This decision is also of value for its discussion of the possibility of the Contracts (Rights of Third Parties) Act 1999 coming into play in the context of derivative claim litigation.

Not all derivative claims fall under Part 11 of the 2006 Act. So-called double derivative claims remain to be governed under the common law regime of *Foss v Harbottle* (1843) 2 Hare 461, as do claims featuring companies incorporated overseas. Part 11 of the Companies Act 2006 also does not apply to such claims featuring limited liability partnerships. This range of exclusions serves to complicate the law and should be tidied up in any future reform of Part 11.

In *Boston Trust Co v Verhoef* [2021] EWCA Civ 1176 the Court of Appeal was faced with the question whether the judge at first instance was correct in granting <u>conditional</u> permission to allow a common law derivative claim to proceed, subject to the condition that the status of the claimant as a member of the company be confirmed. Sir David Richards, speaking for the Court of Appeal rejected this type of conditional order. What should happen in such a case is that the permission to proceed hearing should be adjourned pending any rectification of the register of members. As it happened this status issue had already been resolved in this case by the time the case reached the Court of Appeal so unconditional permission to proceed with the claim could be granted.

<u>Winding up on the just and equitable ground; residual utility</u>

This 19th century statutory remedy has lost much of its relevance since the advent of the unfair prejudice jurisdiction in 1980. It is no longer necessary to wind up the company in order for an aggrieved member to extract his/her/its value from it. But odd cases involving the winding up outcome in the case of solvent companies do still crop up in circumstances where a buyout remedy under s. 996 is not available. This draconian winding up jurisdiction was reviewed by the Privy Council in *Chu v Lau* [2020] UKPC 24; [2021] BCC 146, a case that had originated in the British Virgin Isles. The advice of the Privy Council was delivered in main by Lord Briggs. The outcome here was that the winding up order of the trial judge was upheld. The Privy Council reviewed this extreme remedy from its earliest days of its operation in UK Company Law and offered further insights on its usage. The petitioner did not have to be entirely blameless to obtain such an order for, in a breakdown scenario in a quasi-partnership, that sharp binary distinction would rarely be so. This case is also of value in that Lady Arden offered her perspective on what was meant by "deadlock" in such cases.

By way of contrast the court in *Kuddusi Can IL v Yesilkaya* [2021] EWHC 1695 (Ch) refused to accede to a winding up petition. ICC Judge Prentis took into account a range of factors (see para [620] of the judgment): the petitioner was only a 30% shareholder and could still enjoy future protection in that capacity as a shareholder through less draconian measures. The petitioner had not facilitated a private resolution of the dispute between the parties and that counted against a winding up solution.

<u>Reflective loss; clarification and uncertainty</u>

Shareholder litigation can take many forms. So, for instance, it is possible for a member to pursue a <u>personal claim</u> against a wrongdoer who has been responsible for injuring a company in which that member had invested. Injury caused to a company will have a knock on effect on share values. But when we consider personal claims we are confronted with the so-called reflective loss barrier. This controversial rule prevents a shareholder from recovering for indirect loss to shareholding value where the primary damage was inflicted on the company itself and the loss to the shareholder merely reflects the loss caused to the company. The rule is clearly intended to prevent double recovery of compensation, but also to pay proper respect to the separate personality of the company. It has been the subject of judicial analysis in *Prudential Assurance v Newman Industries Ltd (No. 2)* [1982] Ch 204 and *Johnson v Gore Wood & Co* [2002] 2 AC 1. But the boundaries of this controversial rule are still not fully delineated. That is clear from recent case law. Reading the Supreme Court judgments in *Sevilleja v Marex Financial Ltd* [2020] UKSC 31 one gets a sense that the judiciary are divided on both the rule and its extent. This is particularly true of Lord Reed's judgment where the emphasis is that reflective loss rule is to remain narrow. Further illumination has been provided in *Broadcasting Investment Group Ltd v Smith* [2021] EWCA Civ 912. Here the Court of Appeal investigated the potential interplay between the reflective loss rule and the provisions of the Contracts (Rights of Third Parties) Act 1999. In a passing comment at the end of the judgment Arnold LJ opined (at para [66]) that there was no reason in principle why the reflective loss bar could not operate against claims by <u>indirect</u> shareholders.

One issue that required clarification concerned the time when the reflective loss rule should be applied. Was it to be applied at the date when the loss occurred or the date when the claim was made? This issue of timing could radically affect outcomes. Flaux LJ favoured the latter analysis in *Nectrus Ltd v UCP plc* [2021] EWCA Civ 57. Note in particular para [43] of his judgment. So, a former shareholder might be able to bring a claim without being caught by the reflective loss rule. Most recently, however, we have contrasting enlightenment offered in *Primeo Fund v Bank of Bermuda (Cayman) Ltd* [2021] UKPC 22. The Privy Council discussed the question of timing and it opted for a different solution from that suggested by Flaux LJ. According to the Privy Council, the time to focus upon when considering whether the reflective loss bar should be applied was <u>when the loss complained of occurred</u> and not when the claim was brought. So, a shareholder who becomes a member <u>after</u> suffering loss might escape the restrictions of the rule. This again favours a conservative view of the scope of the reflective loss bar. The Privy Council also advised that it can only come into operation where the alleged wrongdoer is the same person both as respects the claim by the company and the shareholder. There must be a common wrongdoer.

<u>Informal assent of shareholders</u>

The principle of informal assent is a utilitarian concept that allows technical breaches of Company Law to be forgiven in cases where the company is solvent. What matters is whether the shareholders approved a particular course of action rather than whether they had passed a formal resolution to that effect. This jurisdiction is often said to be derived from *Re Duomatic Ltd* [1969] 2 Ch 365, but, on closer analysis, it has a longer ancestry in UK Company Law. One question that has taken time to resolve is whether it can apply to the wishes of beneficial shareholders. It now seems clear from *Ciban Management Corp v Citco (BVI) Ltd* [2020] UKPC 21 and *Satyam Enterprises Ltd v Burton* [2021] EWCA Civ 287 that it has that potential. In an age of indirect shareholding that is a necessary extension of the concession.

<u>Shareholder agreements</u>

Many shareholder disputes can be resolved without reference to statute of common law principles of Company Law. Rather the solution is dictated by the application of principles of Contract Law. An important practical point emerges from the judgment of Huddleston J in *North South Pig Company (NI) Ltd v McAuliffe* [2021] NIQB 22. If there is to be a shareholder agreement to be used to govern internal matters within a company then there must be a single verified version. Multiple and varying drafts might suggest to the court that no such agreement was finally executed.

A vexed issue is whether a shareholder agreement embodies implied terms. The voluminous case law on Contract Law in general is relevant here. It is still the case that the court will take some persuading that sophisticated parties to a shareholder agreement had failed to spell out expressly how the relationship was to be structured.

Express good faith provisions are now common in shareholder agreements. These may be relevant when determining questions of whether there is a quasi-partnership in existence or whether unfair prejudice has occurred – see *Re Compound Photonics Group Ltd* (*Faulkner v Vollin Holdings Ltd)* [2021] EWHC 787 (Ch).

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