need to be fought to a conclusion before the court can decide whether or not the plaintiff should be permitted to prosecute it. In the latter case the purpose of the rule in ***Foss* v *Harbottle*** disappears. Either the fraud has not been proved, so *cadit quaestio*; or the fraud has been proved and the delinquent is accountable unless there is a valid decision of the board or a valid decision of the company in general meeting, reached without impropriety or unfairness, to condone the fraud [. . .]

We desire, however, to say two things. First, as we have already said, we have no doubt whatever that Vinelott J erred in dismissing the summons of 10 May 1979. He ought to have determined as a preliminary issue whether the plaintiffs were entitled to sue on behalf of Newman by bringing a derivative action. It cannot have been right to have subjected the company to a 30-day action (as it was then estimated to be) in order to enable him to decide whether the plaintiffs were entitled in law to subject the company to a 30-day action. Such an approach defeats the whole purpose of the rule in ***Foss* v *Harbottle*** and sanctions the very mischief that the rule is designed to prevent . . .

The second observation which we wish to make is merely a comment on Vinelott J's decision that there is an exception to the rule in ***Foss* v *Harbottle*** whenever the justice of the case so requires. We are not convinced that this is a practical test, particularly if it involves a full-dress trial before the test is applied. On the other hand, we do not think that the right to bring a derivative action should be decided as a preliminary issue upon the hypothesis that all the allegations in the statement of claim of 'fraud' and 'control' are facts, as they would be on the trial of a preliminary point of law. In our view, whatever may be the properly defined boundaries of the exception to the rule, the plaintiff ought at least to be required before proceeding with his action to establish a prima facie case (i) that the company is entitled to the relief claimed, and (ii) that the action falls within the proper boundaries of the exception to the rule in ***Foss* v *Harbottle***. On the latter issue it may well be right for the judge trying the preliminary issue to grant a sufficient adjournment to enable a meeting of shareholders to be convened by the board, so that he can reach a conclusion in the light of the conduct of, and proceedings at, that meeting.

The statutory derivative action

The new action is found within ss 260–264 of the Companies Act 2006. It is worth noting though that in the Explanatory Notes to the CA 2006, it is noted that 'the sections in this Part do not formulate a substantive rule to replace the rule in ***Foss* v *Harbottle***, but instead reflect the recommendations of the Law Commission that there should be a "new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue an action" (Shareholder Remedies, paragraph 6.15).' However, in ***Stainer* v *Lee*** [2010] EWHC 1539 (Ch), Roth J stated: 'The jurisdiction governing derivative claims in England and Wales is now comprehensively governed by Chapter 1 of Part 11 of the Act: sections 260–264. Such claims may be brought only under the provisions in that chapter or pursuant to a court order in proceedings on an "unfair prejudice" petition under section 994; section 260(2).'

Section 260(1) defines a derivative claim as '[. . .] proceedings by a member of a company (a) in respect of a cause of action vested in the company, and (b) seeking relief on behalf of the company'. Accordingly, there are three elements to the derivative claim: the action is brought by a member of the company; the cause of action is vested in the company; and relief is sought on the company's behalf. With respect to the term 'member', while this is defined in s 112 of the 2006 Act, s 260(5) extends the scope of this to include 'a person who is not a member but to whom shares in the company have been transferred or transmitted by operation of law'. This would include, for example, where a trustee in bankruptcy or the personal

representative of a deceased member's estate acquires an interest in a share as a result of the bankruptcy or death of a member.

Section 260(2) goes on to state that a derivative claim may only be brought under this chapter (of the 2006 Act) or s 994 (unfairly prejudicial conduct).

However, a key provision in relation to the statutory derivative action is s 260(3) which states that: '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.' This section states that the cause of action must be against the director or another person (for instance if a third party dishonestly assisted a director in breaching his fiduciary duties). Therefore, s 260(3) provides shareholders with a statutory right to sue directors for negligence (in itself a change from pre-existing common law; ***Pavlides* v *Jensen*** [1956 1 Ch 565), default, breach of duty (see directors' duties, ss 170–176) or breach of trust.

The remaining subsections in s 260 read as follows. Section 260(4) goes on to state that 'it is immaterial whether the cause of action arose before or after the person seeking to bring or continue the derivative claim became a member of the company'. Section 260(5) clarifies those persons whom may be included within the terms used by the section. For example, for the purposes of this chapter (of the 2006 Act), the term 'director' includes a former director; a shadow director is treated as a director; and references to a member of a company include a person who is not a member but to whom shares in the company have been transferred or transmitted by operation of law.

However, it is important to realise that members do not have unfettered discretion to bring a derivative action. The member must apply to the court for permission to bring the action. Section 261(1) states that 'a member of a company who brings a derivative claim under this chapter must apply to the court for permission to continue it'. Section 261(2) goes on to note that if it appears to the court that the application and the evidence filed by the applicant in support of it do not disclose a prima facie case for giving permission (or leave), the court (i) must dismiss the application; and (ii) may make any consequential order it considers appropriate.

Section 261(3) goes on to note that if the application is not dismissed under s 261(2) then the court may give directions as to the evidence to be provided by the company, and may adjourn the proceedings to enable the evidence to be obtained.

On hearing the application, the court may according to s 261(4) give permission to continue the claim on such terms as it thinks fit; refuse permission and dismiss the claim; or adjourn the proceedings on the application and give such directions as it thinks fit.

As such, this clause provides that, once proceedings have been brought, the member is required to apply to the court for permission to continue the claim. This reflects the current procedure in England and Wales under the Civil Procedure Rules. The applicant is required to establish a prima facie case for the grant of permission, and the court will consider the issue on the basis of his evidence alone without requiring evidence to be filed by the defendant. The court must dismiss the application at this stage if what is filed does not show a prima facie case, and it may make any consequential order that it considers appropriate (for example, a costs order or a civil restraint order against the applicant). If the application is not dismissed, the court may direct the company to provide evidence and, on hearing the application, may grant permission, refuse permission and dismiss the claim, or adjourn the proceedings and give such directions as it thinks fit.

Section 262 concerns the alternative scenario of a company commencing an action, only for a member to take it forward as a derivative action. This section is unlikely to be relied

upon to a great extent. Under both s 261 and s 262, the member must demonstrate two points before action can commence. First, the member has sufficient evidence to establish a prima facie case and secondly, the member needs to persuade the court that a derivative action is appropriate. The advantages of this two-stage test are that it will limit actions and minimise the initial expenditure of the company.

Section 263 outlines the considerations which the court must weigh up under an application from both s 261 and s 262. Section 263(2) states that a court must refuse permission for a derivative action if the court is satisfied:

(a) that a person acting in accordance with s 172 would not seek to continue the claim; or
(b) where the cause of action arises from an act or omission that is yet to occur, that the act or omission has been authorised by the company; or
(c) where the cause of action arises from an act or omission that has already occurred, that the act or omission (i) was authorised by the company before it occurred, or (ii) has been ratified by the company since it occurred.

If any of these three situations are met, then the court must refuse to allow the derivative action to proceed.

If the situation the court is presented with does not fall within one of the three situations as listed in s 263(2), then the court can proceed to consider a number of discretionary factors listed in s 263(3), which states that in considering whether to give permission (or leave) the court must take into account, in particular:

(a) whether the member is acting in good faith in seeking to continue the claim;
(b) the importance that a person acting in accordance with s 172 (duty to promote the success of the company) would attach to continuing it;
(c) where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be –
 (i) authorised by the company before it occurs; or
 (ii) ratified by the company after it occurs;
(d) where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company;
(e) whether the company has decided not to pursue the claim;
(f) whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.

The case of ***Airey* v *Cordell*** [2006] EWHC 2728 (Ch) considers the approach courts should take in deciding whether or not to permit a derivative action. In this case the court decided that where a shareholder applies to the court for permission to bring a derivative claim he is required to establish both that there is a prima facie case that the company is entitled to the relief sought and that the action falls within the boundaries of one of the exceptions to the rule that a member cannot bring an action on behalf of a company. If no reasonable board would bring proceedings then, even if there is a prima facie case, the court should not sanction proceedings. Where, however, the court is satisfied that a reasonable board of directors could bring the action; the court should not shut out the shareholder on the basis of its own view of what it would do if it were the board.

Section 263(4) reads as follows: 'In considering whether to give permission the court shall have particular regard to any evidence before it as to the views of members of the company

who have no personal interest, direct or indirect, in the matter.' It is interesting to note that the court must pay particular regard to the views of the 'independent' members of the company and there is not merely a requirement to take into account their views. It could be argued that this should be the most prevalent thought in the mind of the judges as they decide whether a derivative action should proceed or not.

Future interpretation and implementation of s 260

During the early stages of the Companies Bill, there was concern that this new statutory derivative action would open the floodgates to litigation. However, it seems that the 'checks' provided by the court will prevent this. Earlier concerns that the rule, together with the exceptions to ***Foss*** v ***Harbottle***, would be removed are unfounded and it seems that the Companies Act 2006 has merely established a new derivative procedure.

To date, there have been a small number of reported cases which have considered the new derivative action. In the first couple of reported cases, ***Franbar Holdings Ltd*** v ***Patel and Others*** [2008] EWHC 1534 (Ch), ***Mission Capital plc*** v ***Sinclair and Another*** [2008] All ER (D) 225 (Mar), and ***Stimpson*** v ***Southern Landlords Association*** [2009] EWHC 2072 (Ch), permission to continue derivative actions was refused.

Franbar Holdings Ltd v ***Patel and Others*** [2008] EWHC 1534 (Ch)

Following consideration of the matters contained within s 263 of the Companies Act 2006, the court ruled that the claimant had not been shown that the hypothetical director would have attached great importance to the continuation of the derivative claim at the instant stage in the proceedings. In this regard, considerable weight had to be given to the fact that the claimant could achieve all that it could properly want through the s 994 petition and the shareholders' action. Accordingly, the application for permission to continue the derivative action would be dismissed.

In this respect, Mr William Trower QC noted:

> [. . .] I am required to take into account is the importance that a person acting in accordance with section 172 would attach to continuing the derivative claim. I have already concluded that I cannot be satisfied that such a person would not seek to continue it, but section 263(3)(b) requires me to form a judgment as to how important the hypothetical director would regard the continuation of the proceedings as being. This is not a particularly easy exercise, but if he would not attach very much importance to the continuation of the claim, that is likely to count against the grant of permission. If, in fulfilling his duty to promote the success of the company, he would attach substantial importance to the continuation of the claim, that factor is likely to count in favour of granting permission.
>
> In my judgment, the hypothetical director acting in accordance with section 172 would take into account a wide range of considerations when assessing the importance of continuing the claim. These would include such matters as the prospects of success of the claim, the ability of the company to make a recovery on any award of damages, the disruption which would be caused to the development of the company's business by having to concentrate on the proceedings, the costs of the proceedings and any damage to the company's reputation and business if the proceedings were to fail. A director will often be in the position of having to make what is no more than a partially informed decision on continuation without any very clear idea of how the proceedings might turn out [. . .]
>
> In conclusion, I take the view that there is substance in the complaints which have been made by Franbar and that some of those complaints would, if established, give rise to breaches of duty which are incapable of ratification on the votes of Casualty Plus. I also take the view that there is work still to be done in formulating a clear claim for breaches which have caused actionable loss to Medicentres, and that it would be open to the hypothetical director to decline to proceed with the

> derivative claim at this stage. While he may attach importance to its continuation at some stage in the future, I am not satisfied that he would attach great importance to its continuation now. I also give considerable weight to the fact that Franbar should be able to achieve all that it can properly want through the section 994 petition and the shareholders' action. Having regard to all of these considerations, and carrying out the balancing exercise as best I can on the information currently available, it is my judgment that justice is best achieved by refusing permission to continue.

Comment

The acquisition of evidence relating to the affairs of an insolvent debtor for use in other proceedings was capable of being a legitimate use of Rule 7.31(4) of the Insolvency Rules so long as that evidence was probative of (or at least related to) a fact or matter in issue in those proceedings, and so long as the person to whom material on the court file related was not able to point to any countervailing prejudice. Inspection in those circumstances was consistent with the purpose for which the right was given, that was to enable persons with a legitimate interest in a particular insolvency proceeding to discover what had taken place. Those criteria were met in this case.

Accordingly, the order would be made subject to the condition that, in the absence of further order, the copies and the information obtained were to be used only for the purposes of the s 994 petition and the shareholders' action.

Mission Capital plc* v *Sinclair and Another [2008] All ER (D) 225 (Mar)

The defendants had been the executive directors of the claimant company and clause 16.1.6 of their contracts provided that the board could terminate them if they engaged in conduct that was unacceptable in the reasonable opinion of the board. Clause 18 provided that if the defendants' contracts were so terminated they were immediately to resign all directorships. At a board meeting in February 2008, the three non-executive directors of the company purported to remove the defendants from the board pursuant to cl 16.1.6 and on the basis that they had allegedly failed to submit financial information and to meet financial forecasts. Those allegations were disputed by the defendants. P was appointed to the board as a new director with executive powers. Subsequently, the company issued a claim against the defendants and obtained interim injunctive relief. The defendants issued a counterclaim by which they sought injunctions obliging the company to continue to employ them and to re-appoint them to the board. The defendants also issued a derivative claim under the Companies Act 2006. A number of interim applications in both actions fell to be determined.

The principal issues that fell to be determined were: (i) whether the defendants were to be granted interim injunctions restoring them to their positions before the meeting of February 2008; (ii) whether the non-executive directors and P were to be joined as parties to the defendants' counterclaim in the company's action; and (iii) whether the defendants were to be granted permission to continue their derivative action under s 263 of the 2006 Act.

The court ruled that the injunctions sought by the defendants essentially amounted to orders for specific performance of their service contracts with the company. In relation to the injunction pertaining to their employment, the defendants had failed to show, on the evidence, that there was a seriously arguable case that they would succeed in obtaining the relief sought at trial. In relation to the injunction as regards the directorships, while the defendants had demonstrated an arguable case, the balance of justice weighed against the grant of the interim injunctions sought. The non-executive directors and P would be joined as parties to the defendants' counterclaim.

Furthermore, the court held that the basis for the mandatory refusal of permission to continue the defendants' derivative claim under s 263(2) of the 2006 Act had not been made out. However, having considered the discretionary factors set out in s 263(3)(a)–(f) of the 2006 Act, and the circumstances of the instant case, the defendants' application for permission to continue the derivative action would be refused.

Other cases have included ***Iesini* v *Westrip Holdings Ltd*** [2009] EWHC 2526 (Ch) and ***Fanmailuk.com Ltd* v *Cooper*** [2008] EWHC 2198 (Ch), in which applications for permission to continue derivative claim were adjourned. However, in more recent cases, ***Kiani* v *Cooper*** [2010] EWHC 577 (Ch) and ***Stainer* v *Lee*** [2010] EWHC 1539 (Ch), the courts have appeared far more open to the prospect of granting permission to minority shareholders to continue with derivative actions, though permission extended only to the conclusion of disclosure, at which point further permission to continue should be sought.

Kiani* v *Cooper [2010] EWHC 577 (Ch)

The applicant shareholder and director (K) of the second respondent company (X) applied under s 261 of the Companies Act 2006 for permission to continue a derivative claim under s 260 of the Act on behalf of X against the first respondent shareholder and director (C) of the same company for breach of duty. K and C were the sole directors and equal shareholders in X, a property development company. C was also the director of another company (D) which billed X for services. A dispute arose between K and C. K alleged that C had wrongly allowed a judgment in default to be entered against X in respect of a debt allegedly owed to D. The default judgment was later withdrawn. K also alleged that, through his control of X's accounts, C had caused a further debt to be entered into X's accounts in respect of unsubstantiated services rendered to it by another company. K further obtained an injunction restraining C from presenting a winding-up petition in respect of monies allegedly owed to him in his personal capacity by X. Proudman J stated:

> A derivative claim is defined by s 260 as a claim brought by a member seeking relief on behalf of a company in respect of a cause of action vested in the company. Although the cause of action may be against a director of the company or another person or both, it must arise from an actual or proposed act or omission by the director involving negligence, default, breach of duty or breach of trust (see s 260(3)).
>
> Permission to continue a derivative action is required by s 261. The court must by that section dismiss the application for permission if there is no prima facie case for giving permission. Otherwise it may give directions as to the evidence to be provided and adjourn the proceedings to enable such evidence to be obtained. It has very wide powers to adjourn the application, to give directions and to give or refuse permission. It has wide powers to impose terms on the grant of permission.
>
> Section 263 specifies the criteria for permission. Section 263(2) is mandatory and states that permission must be refused if the court is satisfied that a person acting in accordance with the duty imposed by s 172 to promote the success of the company would not seek to continue the claim, or where the cause of action arises from an act or omission which has been pre-authorised or has been ratified by the company.
>
> Section 263(3) sets out the factors which the court must in particular take into account in deciding whether to give permission. They are: whether the member is acting in good faith in seeking to continue the claim, the importance that a person acting in accordance with s 172 would attach to continuing it, whether the cause of action could be authorised or ratified by the company, whether the company has decided not to pursue the claim and whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company. Further, the court is required by s 263(4) to have particular regard to any evidence before it as to the views of members of the company who have no personal interest, direct or indirect, in the matter. In this case there are no such persons.
>
> Although Mrs Kiani and Mr Cooper were the only two directors and members of the company, Mr Kiani was the driving force behind his wife's involvement and for present purposes they have an identity of interest. No question of authorisation or ratification arises or is likely to arise. The crucial

factors of those listed in s 263(3) are therefore likely to be good faith, the availability of an alternative remedy and, in particular, the attitude of a person acting in accordance with the duties imposed by s 172 of the Act . . .

In all the circumstances of this case it seems to me is that Mrs Kiani is acting in good faith in making the present application.

Another factor prescribed by s 263(3) is the availability to Mrs Kiani of an alternative remedy in respect of the alleged breaches of duty. Mr Irvin submits that one proper remedy would be a personal action under the shareholders' agreement. However, it seems to me that such an action could meet real difficulties in that the loss claimed could be viewed as loss reflective of the company's loss, irrecoverable under the principle enunciated in ***Johnson* v *Gore Wood & Co*** [2001] BCC 820; [2002] 2 AC 1.

Mr Irvin's principal submission is however that Mrs Kiani's proper remedy is an unfair prejudice petition under s 994 of the Companies Act 2006. Under s 996 the court has a very wide discretion as to the relief it may grant, including, by s 996(2)(c), authorising civil proceedings in the name of and on behalf of the company.

There is a lot to be said for this procedure in a case of a two-person company where the real dispute is between those two persons alone. However, the jurisdiction to make an order under s 996(2)(c) can only be exercised if the court is first satisfied that the unfair prejudice petition is well-founded. Mrs Kiani would not therefore have standing on behalf of the company to restrain a winding-up petition. It may well be the case that the court would have jurisdiction on her application to restrain a winding-up petition pending the outcome of s 994 proceedings. I have not been addressed on that issue. Moreover, yesterday Mr Cooper and DPM, through Mr Irvin, said for the first time that they were willing to offer an undertaking not to present creditors' petitions pending s 994 proceedings.

Taking all those factors into consideration, it seems to me that Mrs Kiani's position is this. She says that she and the company have been deprived of the opportunity to pursue the development venture. She does not want the company to be wound up on the petition of Mr Cooper, at whose door she places responsibility for the deadlock which has occurred. She wants her opportunity to be preserved. She wishes to pursue Mr Cooper on behalf of the company in a derivative action. It seems to me that the fact that she could in a more roundabout way achieve the relief she seeks does not mean that she ought not to be granted permission in the present case . . .

It seems to me that, balancing all the relevant factors, Mrs Kiani's application to continue the action in the name of the company ought to be granted. However, I am prepared to give permission only down to disclosure in the action, for the reasons I have already explained.

Held – Application granted.

(1) C had failed to adduce any corroborative evidence in support of his defence to the allegations against him. In respect of X's dealings with D, C should, as one of X's signatories, at least have ensured that cogent evidence of any transaction between those parties was well documented in light of the possible conflict of interests. In pursuing the case it was clear that K had been acting in good faith; C's actions having deprived her of an opportunity to pursue a number of development ventures. Although it was possible for K to pursue a petition under the Companies Act 2006, s 994 as opposed to bringing her derivative action, the existence of an alternative remedy was only one factor to consider. Finally, it was obvious that a notional director, acting in accordance with his duties under s 172 would wish to continue with the claim against C, at least, down to the disclosure stage where corroborative documents might be produced. Balancing those facts together, K would be allowed to pursue her derivative claim.

(2) In a case where the dispute was between two people, the court ought to take a reasonable view as to whether to grant the petitioner an indemnity in respect of her costs. In the instant case it was fair, in light of the court's conclusion, that K should be indemnified for her costs but that she should have no indemnity in respect of a potential adverse costs order.

Stainer* v *Lee [2010] EWHC 1539 (Ch)

The applicant (S) applied under the Companies Act 2006, s 261 for permission to continue a derivative claim seeking relief on behalf of the relevant company (C) against the respondents, being C's two directors and a company (E) of which one of the directors (L) was the sole shareholder and director. S had a small shareholding in C. E had been established by L as a special-purpose vehicle for the acquisition of shares in C. By 2002, it had acquired a 65 per cent shareholding in C with the aid of a bank loan exceeding £4 million. The discharge of E's liability to its bank was achieved by a loan made by C to E. Between 2002 and 2008, C made substantial additional loans to E. S argued that L and his fellow director had acted in breach of their duties to C in allowing the lending to E to be on an interest-free basis and in lending sums to E for some purpose other than discharging or reducing the liability which E had incurred for the acquisition of shares in C, which purpose had not been approved by C's members and was not in its interests. E, S asserted, was a constructive trustee for C as regards the sums received by way of the additional lending.

Held – Application granted.

(1) The test to be applied was that set out by Lewison J in ***Iesini* v *Westrip Holdings Ltd*** [2009] EWHC 2526 (Ch), [2010] BCC 420, ***Iesini*** applied. As to the standard to be applied generally under s 263, Lewison J held that something more than simply a prima facie case was required and that the court had to form a view on the strength of the claim, albeit on a provisional basis. The necessary evaluation was not mechanistic and a range of factors would have to be considered to reach an overall view. If the case seemed very strong, it might be appropriate to continue it even if the likely level of recovery was not so large, as such a claim stood a good chance of provoking an early settlement or might qualify for summary judgment. On the other hand, it might be in the company's interests to continue a less strong case if the amount of potential recovery was very large.

(2) The failure to obtain interest over a period of almost nine years on lending to E that rose from £4.6 million to £8.1 million constituted very strong grounds for a claim that the directors were in breach of their fiduciary duties. It had been asserted that the outstanding interest had been repaid, but it was not clear whether that was so. It would therefore be appropriate to grant S permission to continue the derivative claim until the conclusion of disclosure.

(3) There was at least a well arguable case that the additional lending to E was made in breach of the directors' relevant duties. L's witness statement fell far short of explaining the purpose of the additional loans or why they were thought to be in C's best interests. There was no indication whatever of why E needed the sums in question or indeed what it was using the money for. L had sought to rely on a 'new loan agreement' between C and E, but that did not constitute ratification of the additional lending. It could not be said that the shareholders who had voted in favour of the resolution approving the agreement had given their informed consent: they appeared not to have been told the purpose of the agreement or of L's interest in E. If the resolution were vitiated for this reason, the entry into the new loan agreement might itself be contrary to C's best interests and the promotion of the agreement might be a further breach of the directors' duties.

(4) As the derivative action was to proceed, S was entitled to be indemnified by C as to his reasonable costs, subject to a limit of £40,000, ***Wallersteiner* v *Moir (No.2)*** [1975] Q.B. 373 applied.

Essay questions

1 Ben is a minority shareholder in App plc, whose directors are Charles, David and Edward. Though not the controlling shareholders the directors control the company in practice.

(a) Last year one of the company's employees was convicted of stealing property belonging to the company and was given a suspended sentence. A general meeting instructed the directors to bring civil proceedings to recover the value of property stolen but they refused to do so.

(b) It has also come to light that the directors have diverted to themselves contracts obtained by the company. Fearing litigation the directors called a general meeting and persuaded the shareholders to approve their actions by passing a simple resolution. The directors cast their votes in favour of the resolution.

Advise Ben whether he could sue the directors personally or on behalf of the company in respect of the two matters. (*University of Plymouth*)

2 Explain the rule in ***Foss* v *Harbottle*** and describe the limits to this rule.
(*The Institute of Company Accountants*)

3 'For a minority shareholder who has suffered a wrong at the hands of the majority to establish a case under the alternative remedy he must show both that he suffered "unfairly prejudicial conduct" and that this was suffered in his capacity as a member of the company.'
Discuss. (*The Institute of Chartered Secretaries and Administrators*)

4 Explain how the provisions of the Companies Act 1985 attempt to ensure that majority shareholders do not conduct the affairs of a company with complete disregard for the interests of minority shareholders. (*The Chartered Institute of Management Accountants*)

5 At first sight, the statutory contract may be viewed as an effective method of enforcing a shareholder's rights, especially when considered alongside s 630 and the application of General Equitable Principles. However, once other aspects of company law are examined and factored into this process, then it may be seen that there is a real need for other avenues of minority protection to be made available to shareholders, given their vulnerable position under s 33 (ex s 14). Discuss the accuracy of this statement.
(*University of Hertfordshire*)

Suggested further reading

Almadani, 'Derivative Actions: Does the Companies Act 2006 Offer a Way Forward?', 2009, 30, Co Law, 131

Baxter, 'The True Spirit of *Foss* v *Harbottle*', (1987) 38 NILQ 6

Boyle, 'The Prudential, the Court of Appeal and *Foss* v Harbottle', (1981) 2 Co Law 264

Boyle, 'The New Derivative Action' (1997) 18 Co Law 256

Gregory, 'What is the Rule in *Foss* v *Harbottle*?', (1982), 45 MLR 584

Hirt, H. C., 'Ratification of Breaches of Director's Duties: The Implications of the Reform Proposal Regarding the Availability of Derivative Actions', (2004) Company Lawyer 25(7) 197

Prentice, 'Shareholders' Actions: The Rule in *Foss* v *Harbottle*', (1988) 104 LQR 341

Wedderburn, 'Shareholders' Remedies and the Rule in *Foss* v *Harbottle*', (1957) CLJ 194

Wedderburn, 'Derivative Actions and *Foss* v *Harbottle*', (1981) 44 MLR 202

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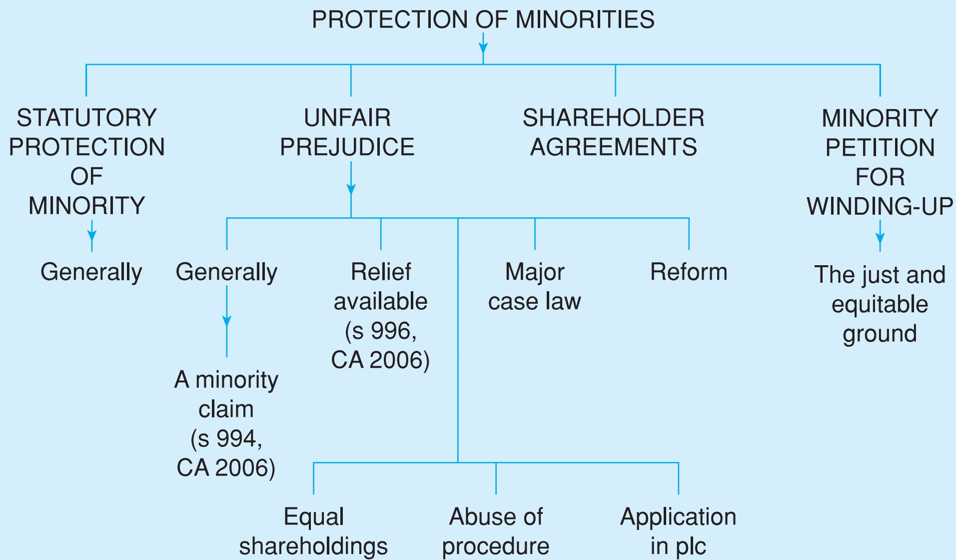
16 The protection of minorities



There are several other sections in the Companies Act 2006 which enable a number of shareholders to defy the majority, as discussed in previous chapters (e.g. s 633 where dissentient holders of 15 per cent of the issued shares of the class can apply for cancellation of the variation).

Statutory protection against unfair prejudice

Section 994 exists as an alternative to the statutory derivative action discussed in the previous chapter. This was of particular importance prior to the 2006 Act as it provided a relatively more accessible and straightforward route for shareholders than the complex and restrictive rule in ***Foss* v *Harbottle***. However, given the changes under the 2006 Act, the relative importance of this section could be called into doubt.

Section 994 was originally introduced in the form of s 210 of the Companies Act 1948 (and subsequently as s 459 of the Companies Act 1985) and was intended to provide more flexible remedies which were also free from the harshness of s 122(1)(g), also discussed in this chapter. The Cohen Committee (Cmnd 6659, 1945) had recommended this development in the area of minority shareholder protection but their views were based on the concept of 'oppression'. In other words, a member could bring an action where the affairs of the company were being conducted in a manner oppressive to some of the members (including the petitioner). However, the wording in s 210 proved to be a problem, resulting in the fact that there were only two successful cases under the section (***Scottish Co-operative Wholesale Society Ltd* v *Meyer*** [1958] 3 All ER 66; ***Re H R Harmer Ltd*** [1958] 3 All ER 689).

Consequently, s 210 was regarded as unsuccessful with the Jenkins Committee subsequently recommending that it should be replaced with a new remedy based on the notion of 'unfairly prejudicial conduct'. This led to the introduction of s 459 of the Companies Act 1985, which has been replaced by s 994 of the Companies Act 2006.

Scottish Co-operative Wholesale Society Ltd* v *Meyer [1958] 3 All ER 66

Per Lord Denning:

> Such being 'the matters complained of' by Dr Meyer and Mr Lucas, it is said: 'Those are all complaints about the conduct of the co-operative society. How do they touch the real issue – the manner in which the affairs of the textile company were being conducted?' The answer is, I think, by their impact on the nominee directors. It must be remembered that we are here concerned with the manner in which the affairs of the textile company were being conducted. That is, with the conduct of those in control of its affairs. They may be some of the directors themselves, or, behind them, a group of shareholders who nominate those directors or whose interests those directors serve. If those persons – the nominee directors or the shareholders behind them – conduct the affairs of the company in a manner oppressive to the other shareholders, the court can intervene to bring an end to the oppression.
>
> What, then, is the position of the nominee directors here? [. . .] It is said that these three directors were at most only guilty of inaction – of doing nothing to protect the textile company. But the affairs of a company can, in my opinion, be conducted oppressively by the directors doing nothing to defend its interests when they ought to do something – just as they can conduct its affairs oppressively by doing something injurious to its interests when they ought not to do it.
>
> The question was asked: What could these directors have done? They could, I suggest, at least on behalf of the textile company, have protested against the conduct of the co-operative society.

They could have protested against the setting up of a competing business. But then it was said: What good would that have done? Any protest by them would be sure to have been unavailing, seeing that they were in a minority on the board of the co-operative society. The answer is that no one knows whether it would have done any good. They never did protest and it does not come well from their mouths to say it would have done no good, when they never put it to the test [. . .] So I would hold that the affairs of the textile company were being conducted in a manner oppressive to Dr Meyer and Mr Lucas [. . .]

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. Once the oppressor has bought the shares, the company can survive. It can continue to operate. That is a matter for him. 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.

True it is that in this, as in other respects, your Lordships are giving a liberal interpretation to section 210. But it is a new section designed to suppress an acknowledged mischief. When it comes before this House for the first time it is, I believe, in accordance with long precedent – and particularly with the resolution of all the judges in ***Heydon***'s case – that your Lordships should give such construction as shall advance the remedy and that is what your Lordships do today. I would dismiss the appeal.

Generally

Any member or personal representative may petition the court on the grounds that the affairs of the company are being, or have been, or will be, conducted in a manner unfairly prejudicial to the interests of its members generally, or of some part of its members, including the petitioner himself. The court must, among other things, be satisfied that the petition is well founded.

The provision relating to a petition by personal representatives of a deceased shareholder is important because a major form of abuse in private companies has been the refusal by the board, under powers in the articles, to register the personal representatives of a major deceased shareholder and also to refuse to register the beneficiaries under the will or on intestacy. Although personal representatives have some rights, e.g. to receive dividends, they cannot vote unless they are registered, nor can a beneficiary. The holding is therefore rendered powerless and the motive of the board is often to purchase the holding themselves at an advantageous price.

The provisions apply to conduct past, present or future. In ***Re Kenyon Swansea Ltd*** (1987) *The Times*, 29 April, the High Court decided that it was sufficient to support a petition that an act had been proposed which if carried out or completed would be prejudicial to the petitioner. Thus the giving of notice of a meeting at which the directors propose to use their majority power to introduce policies allegedly unfair to the minority is probably enough for the minority to commence a claim under s 994. The court also decided that it was enough that the affairs of the company had, in the past, been conducted in such a way as to be unfairly prejudicial to the petitioner, even though at the date of the petition the unfairness had been remedied. The court could still make an order to check possible future prejudice.

The use of the word 'conduct' is important since it covers both acts and omissions, e.g. failure to pay proper dividends when profits allow.

Of even greater importance, however, at least in terms of the case law, is the interpretation placed by the courts, in particular by Mr Justice Hoffmann in ***Re A Company (No 00477 of***

1986) [1986] PCC 372, on 'interests of its members'. Many of the petitions presented under the unfair prejudice provisions have been in regard to the removal of a director from the board of a private company. The director concerned has been able to establish that the conduct relating to him as a director was also unfairly prejudicial to him as a member because the 'interest' of a member in a private company legitimately includes a place on the board.

The requirement that the petition be 'well founded' is to ensure that the provisions are not abused or used for a wrongful purpose. An earlier case under different legislation provides a valid illustration. In ***Re Bellador Silk Ltd*** [1965] 1 All ER 667 a member of the company presented a petition to the court for relief, but mainly as a form of harassment of the board in order to make them pay an alleged debt to one of his companies. The court decided that the petition had a collateral purpose and dismissed it as not a bona fide attempt to get relief.

The test for unfairness is objective and thus the fact that the minority feel that they are being unfairly treated is not enough. The starting point is whether or not the conduct of the majority is in accordance with the articles (as Hoffman LJ said in ***Saul D Harrison*** [1995] 1 BCLC 14). The matter often turns upon whether the powers which the shareholders have entrusted to the majority shareholder/directors which are fiduciary powers have been exercised for the benefit of the company as a whole.

Re Saul D Harrison and Sons plc [1995] 1 BCLC 14

Hoffman LJ observed:

> 'Unfairly prejudicial' is deliberately imprecise language which was chosen by Parliament because its earlier attempt in s 210 of the Companies Act 1948 to provide a similar remedy had been too restrictively construed. The earlier section had used the word 'oppressive', which the House of Lords in ***Scottish Co-operative Wholesale Society* v *Meyer*** [1959] AC 324 said meant 'burdensome, harsh and wrongful'. This gave rise to some uncertainty as to whether 'wrongful' required actual illegality or invasion of legal rights. The Jenkins Committee on Company Law, which reported in 1962, thought that it should not. To make this clear, it recommended the use of the term 'unfairly prejudicial', which Parliament somewhat tardily adopted in s 75 of the Companies Act 1980. This section is reproduced (with minor amendment) in s 994 (previously s 450 of the Companies Act 1985) [. . .]
>
> In deciding what is fair or unfair for the purposes of s 994 (previously 459), it is important to have in mind that fairness is being used in the context of a commercial relationship. The articles of association are just what their name implies: the contractual terms which govern the relationships of the shareholders with the company and each other. They determine the powers of the board and the company in general meeting and everyone who becomes a member of a 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 994 (previously 459) will be to ask whether the conduct of which the shareholder complains was in accordance with the articles of association [. . .]
>
> Although one begins with the articles and the powers of the board, a finding that conduct was not in accordance with the articles does not necessarily mean that it was unfair, still less that the court will exercise its discretion to grant relief. There is often sound sense in the rule in ***Foss* v *Harbottle***. In choosing the term 'unfairly prejudicial', the Jenkins Committee (at para 204) equated it with Lord Cooper's understanding of 'oppression' in ***Elder* v *Elder & Watson*** 1952 SC 49 at p 55: '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'. So trivial or technical infringements of the articles were not intended to give rise to petitions under s 994 (previously 459).
>
> Not only may conduct be technically unlawful without being unfair: it can also be unfair without being unlawful. In a commercial context, this may at first seem surprising. How can it be unfair to act

in accordance with what the parties have agreed? As a general rule, it is not. But there are cases in which the letter of the articles does not fully reflect the understandings upon which the shareholders are associated . . .

Thus, 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. I have in the past ventured to borrow from public law the term 'legitimate expectation' to describe the correlative 'right' in the shareholder to which such a relationship may give rise. It often arises out of a fundamental understanding between the shareholders which formed the basis of their association but was not put into contractual form, such as an assumption that each of the parties who has ventured his capital will also participate in the management of the company and receive the return on his investment in the form of salary rather than dividend. These relationships need not always take the form of implied agreements with the shareholder concerned; they could enure for the benefit of a third party such as a joint venturer's widow. But in ***Re Westbourne Galleries*** Lord Wilberforce went on to say: 'It would be impossible, and wholly undesirable, to define the circumstances in which these considerations may arise. Certainly the fact that the company is a small one, or a private company, is not enough. There are very many of these where the association is a purely commercial one, of which it can safely be said that the basis of association is adequately and exhaustively laid down in the articles. The superimposition of equitable considerations requires something more [. . .]

Thus, in the absence of 'something more', there is no basis for a legitimate expectation that the board and the company in general meeting will not exercise whatever powers they are given by the articles of association.

In this case, as the judge emphasised, there is nothing more. The petitioner was given her shares in 1960 pursuant to a reorganisation of the share capital which vested the entire control of the company in the A shareholders and the board whom they appointed. This scheme is binding upon her and there are no special circumstances to modify its effects. Although the petition speaks of the petitioner having various 'legitimate expectations', no grounds are alleged for saying that her rights are not 'adequately and exhaustively' laid down by the articles. And in substance the alleged 'legitimate expectations' amount to no more than an expectation that the board would manage the company in accordance with their fiduciary obligations and the terms of the articles and the Companies Act.

Essentially a minority claim – s 994

Section 994 of the Companies Act 2006 is essentially designed to protect the minority against unfairly prejudicial conduct by the majority. Indeed, s 994(1) states 'A member of a company may apply to the court by petition for an order under this Part on the ground (a) that the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of members generally or of some part of its members (including at least himself); or (b) that an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

The provisions will not normally be available to enable the majority to acquire the shares of a minority under a court order, even though there is evidence that the minority concerned is acting in an unfairly prejudicial way. This is because the majority control the company and can remove directors and so on and, in effect, put matters right without the aid of the court. Thus in ***Re Legal Costs Negotiators Ltd*** [1998] CLY 695 two partners converted their business into a limited company in which one held 75 per cent of the shares and the other 25 per cent. The majority shareholder alleged that the minority shareholder was not carrying out his duties properly and obtained his resignation from the board. He was also dismissed from his employment with the company. The majority shareholder then asked the court to use s 994 to grant him an order requiring the minority to sell his shares to him. The High Court refused

the claim as an inappropriate use of the provisions. After all, the majority shareholder had removed his ex-partner from the board and from his employment, and to that extent had removed any problems to the company that might have resulted from the alleged conduct of the minority.

Relief available under s 996

(a) Specific relief

This is as follows:

(i) The court may make an order regulating the company's affairs for the future (s 996(2)(a)).
(ii) The court may restrain the doing of or the continuing of prejudicial acts (s 996(2)(b)).

The above two heads are illustrated quite validly by the following case decided under earlier legislation.

Re H R Harmer Ltd [1958] 3 All ER 689

The company was formed in July 1947, to acquire a business founded by Mr H R Harmer, who was born in 1869. The business of the company was stamp auctioneering and dealing in and valuing stamps. Two of Mr Harmer's sons, Cyril and Bernard Harmer, went into the business on leaving school. The nominal capital of the company was £50,000, and Mr Harmer senior and his wife were between them able to control the general meetings of the company, and could even obtain special and extraordinary resolutions. Mrs Harmer always voted with her husband. The father and his two sons were life directors under the articles, the father being chairman of the board with a casting vote. The sons claimed that their father had repeatedly abused his controlling power in the conduct of the company's affairs so that they were bound to apply for relief. Mr Harmer senior had, they said, always acted as though the right of appointing and dismissing senior staff was vested in him alone, and this right he also extended to the appointment of directors. He also considered that no director should express a contrary view to that expressed by himself, and had generally ignored the views of his sons and the other directors and shareholders. In particular he had opened a branch of the company in Australia in spite of the protests by the other directors, and the branch had not proved profitable. In addition, he dismissed an old servant and procured the appointment of his own 'yes men' to the board. He drew unauthorised expenses for himself and his wife and engaged a detective to watch the staff. He also endeavoured to sell off the company's American business which severely damaged its goodwill. Roxburgh J, at first instance, granted relief under s 210 (see below), and the Court of Appeal confirmed the order, saying that the relief was properly granted because the circumstances were such that the court would have been justified in ordering a winding-up. Roxburgh J's order provided *inter alia* that the company should contract for the services of Mr Harmer senior as philatelic consultant at a salary of £2,500 per annum; that he should not interfere in the affairs of the company otherwise than in accordance with the valid decisions of the board; and that he be appointed president of the company for life, but that this office should not impose any duties or create any rights or powers to him.

Comment

The court's order had the effect of changing the provision in the articles under which Mr Harmer was a director for life with a casting vote. The order also restrained him for the future from interfering with the valid decisions of the board.

(iii) The court may authorise a claim to be brought by the company under s 996(2)(c). This would appear to allow a minority to obtain redress for the company where it had been injured by the wrongful acts of the majority. It seems to provide another approach to that found in ***Foss* v *Harbottle***, though the claim would not be derivative because the court would authorise the company to commence the action as a claimant.

(iv) The court may, according to s 996(2)(e), order the purchase of the minority shares at a fair price either by other members or by the company itself, in which case the court would also authorise a reduction of capital. This remedy has been by far the most popular and has largely substituted for winding-up under the just and equitable rule which was formerly the only real way of compelling the majority to return the share capital of the minority (see below). The court will also give directions as to the basis of the valuation of the shares to produce a fair value. The court will often, for example, direct that the shares should not be valued as a minority interest for this purpose since this would depress the value in view of the lack of power in minority shareholders. Since the companies being dealt with by the courts in these minority problem areas are usually private companies with no stock market share price, the valuation is normally carried out by the company's auditors.

(b) General relief

In addition to the above, the court may make such order as it thinks fit for giving relief in respect of the matters complained of under s 996(1). Thus, in ***Re a Company (No 005287 of 1985)*** [1986] 1 WLR 281, the controlling shareholder took all the profits in management fees and was ordered to account for the money to the company and this although at the time of the action he had sold all his shares in the company concerned to his Gibraltar company. Thus, a petition can be presented even against a person who has ceased to be a member.

Where the shareholding is equal

The court has been faced with a claim under the unfair prejudice provisions where the members of a private company were equal shareholders and in deadlock in terms of their relationship. They could not agree who should buy out whom where each had made an offer to buy the other's shares.

West* v *Blanchet and Another [2000] 1 BCLC 795

The company's business was teaching English under the name of Leicester Square School of English Ltd. It was a joint venture between Jason West, the petitioner, and Stephen Blanchet. The nominal capital was £100 divided into 100 £1 shares. The paid-up capital was £2, of which West and Blanchet held one share each. West was responsible for marketing and Blanchet for management. The second respondent, who was a director with no shares, was responsible for teaching.

The parties' relationship broke down and the respondents terminated West's employment. He played no part in management after this but continued as a director/shareholder. West later offered to buy Blanchet's shares and Blanchet made an offer for West's. However, they could not agree who should leave the company. West applied to the court for an order under s 996 that Blanchet be required to sell him the shares, alleging that the two respondents had conducted the company's affairs in a manner prejudicial to him in that they had excluded him from the company's affairs and management decisions. The respondents asked the court to strike out the claim as an abuse of court process.

The judge reached the conclusion that in a case such as this the issue was which offer was the more reasonable and realistic. Blanchet had funds readily available to buy West's shares, but West had no available personal funds and his offer was short on details. Blanchet's offer was therefore the more reasonable and realistic, so the court should strike out West's claim.

Comment

The case perhaps illustrates the need to resolve disputes such as these by alternative dispute resolution. The High Court decision does not resolve the deadlock problem in the context of this case. It simply identifies a good defence against a s 994 claim brought with a request for an order for the purchase of the respondent's shares. To avoid being forced out of the company, all the respondent needs to do is make a more reasonable and realistic counter-offer, and then ask the court to strike out the petitioner's claim.

Maybe the petitioner in this case will now accept the respondent's offer. However, he has not been ordered to do so. The court was merely asked to strike out his claim.

The motives of the minority: abuse of procedure

The unfair prejudice procedures cannot be used where they would achieve a collateral purpose, as where the board of a company would be required to make a takeover bid at a higher price than that intended.

Re Astec (BSR) plc [1999] 2 BCLC 556

In 1989, Emerson Electric, a US company, acquired 45 per cent of the Astec shares. It made further acquisitions over the subsequent period so that in March 1997 it held 51 per cent of Astec. In January 1998, Emerson issued a press release stating that it would buy the remainder of the shares in Astec at no premium to market value, and would stop making dividend payments.

The minority shareholders petitioned the court under s 459, accusing Emerson of bullying tactics and asking the court to order it to purchase the remaining shares in Astec at a fair value – in effect, to undertake a takeover of Astec at an increased price.

Mr Justice Jonathan Parker decided, among other things, that the petition was an abuse of process and should be struck out. He said:

> I fully accept that the petitioners genuinely desire the relief claimed, that is to say an order for the buy-out of their own shares. Equally, however . . . they desire that relief not for itself but because they hope that, if granted, it will lead to something else, that something else being something which the court would not order under s 459, namely a takeover bid by Emerson. The petition is, in my judgment, being used for the purposes of exerting pressure in order to achieve a collateral purpose, that is to say, the making of a takeover bid by Emerson.

Comment

The court's ruling was a severe blow for the minority, who had costs awarded against them, and should give pause for thought to those minorities who may see the unfair prejudice procedures as available, not merely to achieve their own purposes, but to accomplish wider aims.

It is also an abuse of the unfair prejudice procedures to seek to obtain an order for purchase of shares simply because the claimant has lost trust and confidence in the way in which the company is being run by the other members. There must be some breach of the terms on which it has been agreed the company should be run.

O'Neill and Another* v *Phillips and Others [1999] 1 WLR 1092

The company, which provided specialist services for stripping asbestos from buildings, employed Mr O'Neill as a manual worker in 1983. Mr Phillips, who held the entire issued share capital of 100 £1 shares, was so impressed by Mr O'Neill that in 1985 he gave him 25 shares and appointed him a director. Shortly afterwards, Mr Phillips had informally expressed the hope that Mr O'Neill would be able to take over the day-to-day running of the company and would allow him to draw 50 per cent of the profits. Mr O'Neill took over on Mr Phillips' retirement from the board, and was duly credited with half the profits.

In 1991, the industry went into recession, the company struggled and Mr Phillips, who had become concerned by Mr O'Neill's management, resumed personal command. He told Mr O'Neill that he would only be receiving his salary and any dividends on his 25 shares, but would no longer receive 50 per cent of the profits.

In January 1992, Mr O'Neill petitioned the court for relief against unfair prejudice in respect both of his termination of equal profit-sharing and the repudiation of an alleged agreement for the allotment of more shares.

The House of Lords unanimously allowed an appeal by Mr Phillips and others from the Court of Appeal. Lord Hoffmann said that, as to whether Mr Phillips had acted unfairly in respect of equality of shareholding, the real question was whether in fairness or equity Mr O'Neill had had a right to the shares. On that point, one ran up against the insuperable obstacle of the judge's finding that Mr Phillips had never promised to give them. There was no basis consistent with established principles of equity for a court to hold that he had behaved unfairly in withdrawing from the negotiations. The same applied to the sharing of profits.

A member who had not been dismissed or excluded from management could not demand that his shares be purchased simply because he felt that he had lost trust and confidence in the others and in the way the company was run.

Per Lord Hoffman:

> In section 459 Parliament has chosen fairness as the criterion by which the court must decide whether it has jurisdiction to grant relief. It is clear from the legislative history (which I discussed in ***In re Saul D. Harrison & Sons plc*** [1995] 1 BCLC 14, 17–20) that it chose this concept to free the court from technical considerations of legal right and to confer a wide power to do what appeared just and equitable. But this does not mean that the court can do whatever the individual judge happens to think fair. The concept of fairness must be applied judicially and the content which it is given by the courts must be based upon rational principles. As Warner J said in ***In re J.E. Cade & Son Ltd*** [1992] BCLC 213, 227: 'The court [. . .] has a very wide discretion, but it does not sit under a palm tree.'
>
> Although fairness is a notion which can be applied to all kinds of activities its content will depend upon the context in which it is being used. Conduct which is perfectly fair between competing businessmen may not be fair between members of a family. In some sports it may require, at best, observance of the rules, in others ('it's not cricket') it may be unfair in some circumstances to take advantage of them. All is said to be fair in love and war. So the context and background are very important.
>
> In the case of section 459, the background has the following two features. First, a company is an association of persons for an economic purpose, usually entered into with legal advice and some degree of formality. The terms of the association are contained in the articles of association and sometimes in collateral agreements between the shareholders. Thus, the manner in which the affairs of the company may be conducted is closely regulated by rules to which the shareholders have agreed. Secondly, company law has 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 have, with appropriate modification, been carried over into company law.
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> 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 [. . .].

In ***In re Saul D. Harrison & Sons plc*** [1995] 1 BCLC 14, 19, I used the term 'legitimate expectation', borrowed from public law, as a label for the 'correlative right' to which a relationship between company members may give rise in a case when, on equitable principles, it would be regarded as unfair for a majority to exercise a power conferred upon them by the articles to the prejudice of another member. 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.

It was probably a mistake to use this term, as it usually is when one introduces a new label to describe a concept which is already sufficiently defined in other terms. In saying that it was 'correlative' to the equitable restraint, I meant that it could exist only when equitable principles of the kind I have been describing would make it unfair for a party to exercise rights under the articles. It is a consequence, not a cause, of the equitable restraint. 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. That is what seems to have happened in this case.

Comment

As seen in ***Re Astec (BSR) plc*** (above), the unfair prejudice provisions are not a 'cure-all' remedy for shareholders who are not satisfied for a variety of reasons with the way in which the company is run. In a quasi-partnership company, one 'partner' should not be entitled at will to require the other partners to buy his shares at a fair value. There is no support in previous decisions for such a right of unilateral withdrawal under the provisions. The courts will not construe the requirement of 'unfairly prejudicial conduct' so narrowly.

However, it is worth noting that such a breach does not have to be as straightforward as the breach of a prior agreement (either written or oral) as to the way in which the company is to be run. As per Mann J in ***Hale* v *Waldock*** [2006] EWHC 364 (Ch),

> Lord Hoffman was demonstrating that unfairness does not arise only out of a failure to comply with prior agreements or to fulfil prior expectations. The relationships between shareholders are more subtle than that, and Lord Hoffman was recognizing that unfairness can come out of a situation where the game has moved on so as to involve a situation not covered by the previous arrangements and understanding. In those circumstances the conduct of the affairs of the company can be unfairly prejudicial within [s 994] notwithstanding the absence of the prior arrangements, and the court can thus intervene.

Application in a public limited company

Re Blue Arrow plc (below) is one of the rare cases which involved the application of s 994 to a public limited company. It is worth noting that in this case the court took a far more restrictive view of the way in which the company was to be run and less willing to look beyond the company's memorandum and articles of association.

Re Blue Arrow plc [1987] BCLC 585

Vinelott J *held*:

> The petitioner claims that the affairs of the company are being conducted in a way unfairly prejudicial to some part of the members – that is herself – in that putting the resolution and the proposed amendments to the articles of association to the members, and if they are passed then removing her from the office of president, would be the culmination of the efforts of Mr Berry to exclude her.
>
> Mr Heslop, on behalf of the petitioner, has put forward three grounds in support of the petition. The first is that, it is said, her right to remain as president is a class right, and he referred me to a decision of Scott J in ***Cumbrian Newspapers Group Ltd*** v ***Cumberland & Westmorland Herald Newspaper & Printing Co Ltd*** [1987] Ch 1; (1986) 2 BCC 99, 227. I can see nothing in that case which supports the proposition that a right conferred on an individual by the articles of a company to remain as president until removed in general meeting, and which is unrelated to any shareholding, can, by any stretch, be described as a class right. A class right is a right attaching, in some way, to a category of the shares of the company. So far as that decision is material at all, it seems to me plainly against the submission advanced by Mr Heslop. The right claimed, to remain as president, falls, to my mind, quite clearly within the second category distinguished by Scott J and explained at p 99, 236 of the report. The article did not confer any right on the petitioner as a member of the company. She would in fact retain the right, even if she sold all her shares; and the office is not, in fact, an exclusive one.
>
> The second ground is that if the article is looked at in the light of the whole of the history, it becomes clear, it is said, that the petitioner has a legitimate expectation that she will remain president, unless and until she is removed by the machinery provided – that is by resolution of the members – and that an alteration to the articles which gives the power to the directors transgresses that legitimate expectation.
>
> As was pointed out by Hoffmann J in ***Re a Company No 00477 of 1986*** (1986) 2 BCC 99, 171, 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 member. If I may say so, I respectfully accept that approach, but it is to my mind impossible, on the face of the allegations in the petition, to apply it here. Of course, the petitioner had a legitimate expectation that the affairs of the company would be properly conducted within the framework of its constitution. I wholly fail to understand how it can be said that the petitioner had a legitimate expectation that the articles would not be altered by special resolution in a way which enabled her office to be terminated by some different machinery. No doubt there are cases where a legitimate expectation may be inferred from arrangements outside the ambit of the formal constitution of the company, but it must be borne in mind that this is a public company, a listed company, and a large one, and that the constitution was adopted at the time when the company was first floated on the USM. Outside investors were entitled to assume that the whole of the constitution was contained in the articles, read, of course, together with the Companies Acts. There is in those circumstances no room for any legitimate expectation founded on some agreement or arrangement between the directors and kept up their sleeves and not disclosed to those placing the shares with the public through the USM.
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> As regards those first two grounds, therefore, I think that the petition, on its face, is so hopeless that the only right course would be to strike it out.

The Jenkins Committee and unfair prejudice

Section 994 of the Companies Act 2006 (previously s 459, CA 1985) results from recommendations made by the Jenkins Committee which advocated the repeal of s 210 of the 1948 Act and the substitution of new statutory arrangements. It is of value, therefore, to consider what