KINGS CHAMBERS

LIMITATIONS ON THE UNFAIR PREJUDICE REMEDY

The factual background to *Re Hut Group* and *Taylor Goodchild v Taylor* and a summary of other recent unfair prejudice decisions of interest

A SUMMARY OF RE HUT GROUP AND TAYLOR GOODCHILD

Re Hut Group [2021] EWCA Civ 904

Facts

- The petitioner (P) was a minority shareholder in a company (C)
- The Respondents (Rs) were C and 14 existing or former directors
- P made three essential complaints in its petition (P was also a corporate entity):
    - That Rs had acted in bad faith/with improper purpose in relation to share issues which had proportionately reduced the size of P's shareholding
    - That Rs had failed to comply with an obligation in the shareholders' agreement to provide information to P
    - Regarding the removal of "co-sale" rights from the classes of shares held by P.
- By its petition P sought compensation and/or an order that C should issue shares restoring P's proportionate shareholding
- Rs applied to strike out the petition on the following grounds:
    - The petition was in reality a derivative claim for which permission would not have been given
    - The claim for compensation amounted to impermissible reflective loss
    - The allegations were insufficiently particularised

- Elements of relief sought were outside the court's power and would affect the rights of shareholders were not parties to the proceedings

Held at the hearing of the strike-out application

- The application for strike-out was dismissed[1], and in respect of each ground:
  - It was not a derivative claim in disguise – the body of the petition was clear that the complaints related to the impact on P *qua* shareholder rather than the impact on C.
  - Also, the relief sought was for orders against C (not available in a derivative claim) and damages for breach of shareholders' agreement (also not available in a derivative claim)
  - Whilst P had sought an order for payment of equitable compensation by the director Rs to C, that did not convert it into a derivative claim. Not least because P then sought an order for payment to it out of any payment into C
  - There was no reflective loss - it was fundamental to P's pleaded position that its alleged loss came from ways in which its shareholding had been affected <u>without</u> the shareholdings of others being affected. That was not a loss which was reflective of Cs, on the contrary it was unique to P
  - The petition was sufficiently pleaded
  - Even if the court granted the relief sought, whether the shareholders who would be affected should be joined was a case management decision, not one sufficient to strike out the petition
- Rs appealed

Held on appeal

- The appeal was allowed in part, although in reality quite limited parts namely:
  - Paragraph 4 of the prayer as pleaded was struck-out, on the basis that it sought an order for payment of compensation to C by the remaining Rs which pre-supposed an independent liability of Rs to C. The prayer which sought payment from Rs to P (directly) was sufficient for the court to be able to award compensation to P if found
  - The paragraphs alleging bad faith in respect of the share issues did not plead sufficient facts from which bad faith/improper purpose could be made and were struck out
- However (as will be relevant to the later discussions in this talk) the claims based on alleged breaches of the shareholders' agreement for failing to provide information to P was essentially a claim for breach of contract and could be better proceeding as a Part 7 claim – it was to be considered at the CMC whether that should proceed as a separate claim

[1] Reported as ***<u>Re Hut Group Ltd</u>*** [2020] EWHC 5 (Ch)

Taylor Goodchild Ltd v Taylor [2021] EWCA Civ 1135

Facts

- Company (C) set up to take over solicitors' practice which Taylor (T) had been carrying on in partnership with Goodchild (G).
- T and G were 50/50 shareholders in C and sole directors
- Relations between T and G deteriorated and agreement in principle to go separate ways
- T founded a further company (C2) and took work from C to C2 by taking client files and instructing clients of C to instruct C2
    - Notably, he also did all of this prior to resigning as a director of C
- G brought unfair prejudice proceedings against T and C2

Held at first instance[2]

- Unfair prejudice found as:
    - The agreement in principle to part ways did not extend so far as G acquiescing to T founding C2 and taking C's work and staff with him. G had not consented to any such matters
    - T's actions clearly represented breach of directors' fiduciary and statutory duties amounting to unfair prejudice.
- The Order made was for G (i.e. the petitioner) to purchase T's shareholding for a value in the middle of the two valuations which the expert had arrived at (the expert had not expressed a preference for either valuation). This is as was sought by G and in effect reflected the agreement that had been reached in principle (i.e. that G would end up owning C).

Subsequent proceedings

- Subsequently, C issued proceedings against T and C2 seeking payment for work in progress and an account for profits and also further monies which C said were still owed to it by T/C2 following the petition
- T/C2 applied for summary judgment on the basis that the claims should have been determined in the petition (and so were barred *res judicata*) or were an abuse of process or otherwise bound to fail

The first hearing[3]

[2] Reported as ***Goodchild v Taylor*** [2018] EWHC 2946 (Ch)
[3] Reported as ***Taylor Goodchild Ltd v Taylor*** [2020] EWHC 2000 (Ch)

- Snowden J (as he then was) considered that the claims for work in progress and an account of profits were an abuse of process and struck those elements of the claim out under the principle in *Henderon v Henderson* on the basis that:
    - G should have sought that relief for the benefit of C in the s994 petition
    - If it was intended that, once C was wholly owned by G, C should be entitled to bring those claims it should have been disclosed in the petition proceedings
- The other claims were not struck out

Held on appeal

- Appeal allowed
- Although the relief that C now sought <u>could</u>, in principle, have been pursued in the petition proceedings and the relief under s996 is wide enough to permit the court to grant that relief, it does not follow that the claims <u>should</u> have been brought in the petition proceedings such that a failure to do so would be considered an abuse
- There were particular circumstances which may have even made it undesirable for those claims to have been brought in the petition, such as the fact that the petition was primarily seeking a remedy by a shareholder in respect of wrongs done to him as a shareholder, the fact that the proceedings may have been delayed

The significance of these two decisions is discussed in far more detail in Mark Harper QC's handout and talk which should be read in conjunction with the brief summaries below.

<u>**OTHER RECENT UNFAIR PREJUDICE DECISIONS OF INTEREST**</u>

1. ***<u>Re Macom GmBH (UK) Ltd</u>*** [2021] EWHC 1661 (Ch)

Facts

- Petitioner (P) was a German corporate entity and majority shareholder in company (C).
- Pursuant to a shareholder's agreement, P had validly appointed a director (D2).
- Petition was brought against the other director (D), due to:
    - Unauthorised remuneration, in particular payments of dividends to D on account made without prior authority of board or shareholders and similarly unauthorised withdrawal of further sum
    - D's misunderstanding of the shareholders' agreement and the clause by which D2 was appointed, which resulted in him doubting and querying D2's position and authority as a director and so excluding D2 from management and governance
    - Unauthorised disclosures of confidential information made by D to D's father, a retired businessman, with an associated knock-on impact on the relationship between P and D.

Held

- Petition granted, and in particular:
  - The persistent undermining of D2's position and role was unfairly prejudicial to P's interests, as D2 was a director properly appointed by P pursuant to the shareholders' agreement
  - The unauthorised disclosures made to D's father were not reasonably necessary for D to perform his duties, but were for his own personal benefit in dealing with P. This involvement of D's father worsened the relationship between the parties
  - Unauthorised dividends were <u>not</u> unfairly prejudicial, as they merely anticipated a future dividend entitlement (and had been disclosed to P) and caused no financial loss to the company. The further unauthorised withdrawal did however constitute unfair prejudice

Why it is interesting/notable

- Firstly, it is a good example of the established principle that prejudice is not limited to cases involving a diminution in value of P's shareholding, but extends to cover breakdown of the relationships of trust and confidence.
  - This was found notwithstanding R's position that this was not a 'quasi-partnership' case. That was probably uncontroversial but in any event the QP label was considered by HHJ Hodge QC to be an 'unhelpful' label as to whether relief should be granted (para. 74).
  - Here, there was a shareholders' agreement which regulated the relationship between the parties, and the conduct of D had gone against its provisions and the effect it was designed to achieve. That was enough to ground a finding of unfair prejudice.
- Secondly, it is of interest for the remedy:
  - P had sought a buy-out of its shares by D (clearly wishing an exit)
  - However, the relief granted was an order regulating the future conduct of the company's affairs
  - It was held that section 996 requires the court to consider the proportionality of any remedy
  - It was considered that a buy-out would be a disproportionate response to the unfair prejudice found, in particular where no provable financial loss to P could be found
  - An order regulating future conduct was considered more appropriate
  - Although a 'clean break' (i.e. buy-out) is often sought, desirable and an appropriate remedy, it is far from a given even where the relationship between the parties had significantly broken down.

2. ***<u>Il v Yesilkaya</u>*** [2021] EWHC 1695 (Ch)

Facts

- A “catastrophic” breakdown in trust and confidence between directors founded the basis for D1 bringing a petition primarily seeking the just and equitable winding up of company (C) (under section 124 of the Insolvency Act 1986) and alternatively an order that D2 purchase D1’s shares at fair value on the basis of unfair prejudice (i.e. a section 994 claim)
- A cross-claim was also brought against D1 by C for his conduct as a director/shareholder and other matters

Held

- It was held that company was run as a quasi-partnership
- Despite the breakdown of trust and confidence (and so *prima facie* suitability of the section 124 remedy), that remedy in this case would be inequitable and unjust.
- D1 had not come to court with ‘clean hands’ – he had deliberately taken actions to e.g. strip the business when temporarily left in charge, and written misleading correspondence to D2 justifying his actions
- It would be further unfair to wind C up because D1 was only a 30% shareholder and C was linked to a successful corporate group – winding up would inevitably cause wider stigma to that group
- There were no distinct grounds for s994 action, and so this also failed
- P (now ousted as a director) remained a shareholder, and if his interests disregarded this could found future s994 petition (on new grounds)

Why it is interesting/notable

- The clue is in the name – despite having a statutory footing just and equitable winding up is an equitable remedy and so the court will not opt for this nuclear option where the petitioner’s hands are plainly unclean.
- It is also interesting to note the court’s consideration of the potential stigma that would be attached to the wider corporate group if C were wound up. In some cases that stigma would be unavoidable but here and in light of D1’s own conduct it clearly fortified and bolstered the Judge’s conclusion

3. ***Bell v Qureshi*** [2021] EWHC 2515 (Ch)

Facts

- This was a particularly egregious example of unfairly prejudicial conduct
- Petitioners (Ps) were husband and wife in their 70s with experience of running care homes but had essentially retired
- Respondents (Ds) were two brothers who had befriended Ps and borrowed large sums of money from them

- Ps and Ds decided to go into business together (it was found as a quasi-partnership) to operate a nursing home, with the intention being that Ps would have initial heavy involvement and leverage their skills and experience and then step back as Ds gained experience
- Ds set-up two companies, F (to own the freehold of nursing home) and L (to lease nursing home and run the business).
- Unknowingly, Ps not made directors or shareholders of F, but were of L
- Ds essentially transferred large sums from L, excluded Ps from its management and generally ran home very poorly to the extent that a damning CQC report was issued
- Ultimately the business ceased trading and liquidators were appointed

Held

- Unfair prejudice was found as:
    - The parties' understanding and agreement at the outset was not followed
    - The ownership structure created did not reflect that agreement (i.e. Ps having no interest in F).
    - That structure caused Ps unfair prejudice, as they had no interest in or control over the entity which provided the means to run the business
    - Numerous breaches of fiduciary duty found in respect of Ds' conduct in running the nursing home and transferring sums of money

Why it is interesting/notable

- It provides a useful compare and contrast with the above case (***<u>Il v Yesilkaya</u>***), and is a recent example of a case where Ps' hands were entirely clean and Ds' anything but.
- The flexibility in the remedy under s996 can in such circumstances be awarded in a way which can be deliberately particularly 'favourable' to Ps
    - As unfair prejudice was readily and easily found, the proportionate remedy here was as favourable to Ps as reasonably possible, i.e. the relief was granted with aim of putting Ps in the position they would have been in absent the unfair prejudice (effectively akin to expectation measure of damages in contract cases)
    - In this case:
        - Ds ordered to buy-out Ps 50% interest in L, but on basis of a valuation at June 2018 (prior to substantial transfers out to Ds) and on the basis that F was subsidiary of L and other assumptions so as to negative Ds wrongful conduct.
- Ds ordered to pay costs to P on indemnity basis, as their conduct during case had been serious and highly culpable (e.g. failures to comply with disclosure orders, making extremely serious and unfounded allegations against Ps close to trial).

4. ***<u>Faulkner v Vollin Holdings Ltd</u>*** [2021] EWHC 787 (Ch)

Facts

- Two petitioners (P1 and P2) - P1 was former chairman of company (C) and P2 the former CTO
- C was advancing technology developed by P2 and funded by majority shareholders
- C's constitution was contained in its articles and a shareholders' agreement – it was carefully drafted and of particular importance to the case. It provided *inter alia*:
    - The shareholders obliged to act in "good faith" in all dealings
    - Quorum of any board meeting had to include P1 and P2
    - The joint approval of P1 and P2 was required to appoint new directors
- Prejudice alleged in respect of:
    - Majority shareholders became disappointed with progress of the technology development, threatened withdrawal of funding unless P2 resigned, which he did
    - Majority shareholders' nominee directors then took over management, and by a shareholder vote P1 was also later removed
    - Further allegations of sale of fabrication plant at an undervalue (which are less interesting for present purposes)

Held

- Petition granted
- The Judge found that the constitution of C had been carefully and deliberately calibrated, such that the board was left to run C free from shareholder influence
    - The board itself was weighted in favour of P1 and P2
- By exercising their voting rights in a way in which impacted upon the constitution balance of C (i.e. by forcing out P1 and P2) the majority shareholders were in breach of the good faith clause
    - The good faith clause acted as a contractual restriction on the usual statutory majority shareholder rights to (e.g.) remove directors – they had not acted with accordance to the respect for the balance of power
- The presence of P1 and P2 on the board was considered to be critical in terms of the balance of power of C and as between the shareholders and the board, and the balance of power between minority and majority shareholders
- The removal of P1 and P2 analytically therefore deprived the minority shareholders of what the constitution had been designed to achieve – this was unfairly prejudicial

Why it is interesting/notable

- Not a case of interest for its remedy, as it was a trial on liability only
- Whilst decisions of this type are acutely fact sensitive, it is an interesting example of how important a company's 'constitution' (whether reflected in the Articles, a

shareholders' agreement or both) can be as a framing device through which any later conduct must be viewed
- In this case, the Judge undertook and a detailed and sensitive analysis of the constitution to make findings that e.g. an otherwise lawful and ordinary exercise of majority shareholder rights (i.e. removal of directors) contravened the constitution and was unfairly prejudicial.
- In other words, this company had been set up to enable P2's technological ideas to be advanced and developed with funding, but clear steps had been taken to place strictures (by way of the constitution) on usual shareholder rights to ensure that P1 and P2 had more control and influence than they otherwise would have
- Actions which were contrary to that balance were (on the facts) unfairly prejudicial.
- It emphasises the importance of the fundamental analysis of all relevant agreements - the constitution may mean that unfairly prejudicial conduct in one company may not be at unfairly prejudicial in another

5. ***Sprint Electric Ltd v Buyer's Dream Ltd*** [2021] EWHC 960 (Ch)

Facts

- This was the judgment given following costs submissions in respect of a s994 petition
- Former director (P) brought unfair prejudice petition against a company (C) and major shareholder (S) following successful claim to IP and source code from P and his service company to C's subsidiary

Held

- In the underlying action P was successful both on liability and quantum and had obtained an order for substantial recovery
- Both sides were open to criticism on conduct
- Held that losing respondents should pay 65% of costs at liability stage and 80% at quantum stage

Why it is interesting/notable

- It is a costs decision and so very much turns on its own facts and the outcome of the trial
- It is however a convenient summary and reminder of the usual principles as to costs as applied to s994 petitions (in particular summarised by Warren J in ***Re Southern Counties Fresh Foods Ltd*** [2011] EWHC 1370 (Ch), [3] – [22]
- As a reminder, the usual principles as to costs apply to s994 petitions like any other actions, but s994 petitions may be particularly prone to a number of issues being pursued and not all being successful but nevertheless enough being found sufficient to make a finding of unfair prejudice. Given as well the wide discretion that the court

has at the remedy stage, it is possible that the 'successful' party may not quite get the remedy they initially pursued, either in substance or in value (e.g. *Macom*, above)

- Consequently the costs of s994 petitions are prone to be challenged by the unsuccessful respondent where the petitioner failed on certain issues, or the remedy award was less than sought
- The takeaway is that if an approach is pursued that, whilst not necessarily being 'kitchen sink' certainly pleads and pursues a great number of issues to establish unfair prejudice it is important to be alive to the weaker points potentially taking up an unreasonable amount of time and exposing a successful party to issue based costs arguments for the unsuccessfully pursued issues/remedies
- It will always be a difficult judgment as to the strength of any issue weighed against the likely costs that could be apportioned to dealing with it, and it would be imprudent to discard potentially meritorious issues or arguments because of hypothetical costs concerns – it is clearly better to be successful and cross that bridge when it comes to it
- However, if a disgruntled petitioning client is pushing for a 'kitchen sink' approach with plainly unmeritorious issues it may be a helpful counter

Key takeaways from the above recent cases:

1. Unfair prejudice is not limited to diminished value of shareholdings, but if there has been no provable loss beware that a buy-out order may be harder to achieve as a remedy
2. Pursuing a just and equitable winding up where the petitioner has been anything but equitable or just will be a tall order
3. The court can use s996 to provide a remedy which achieves justice, and in egregious cases that power can be 'creatively' and favourably used in buy-out orders
4. The 'constitution' of a company is of fundamental importance to any unfair prejudice claim. Any conduct has to be viewed through the lens of the bargain that the relevant parties had agreed
5. A kitchen sink approach is to be avoided in litigation generally. It can be tempting in s994 petitions where there is a history of business relationships which have invariably broken down but doing so may have costs consequences

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