SMITH & KEENAN'S
COMPANY LAW

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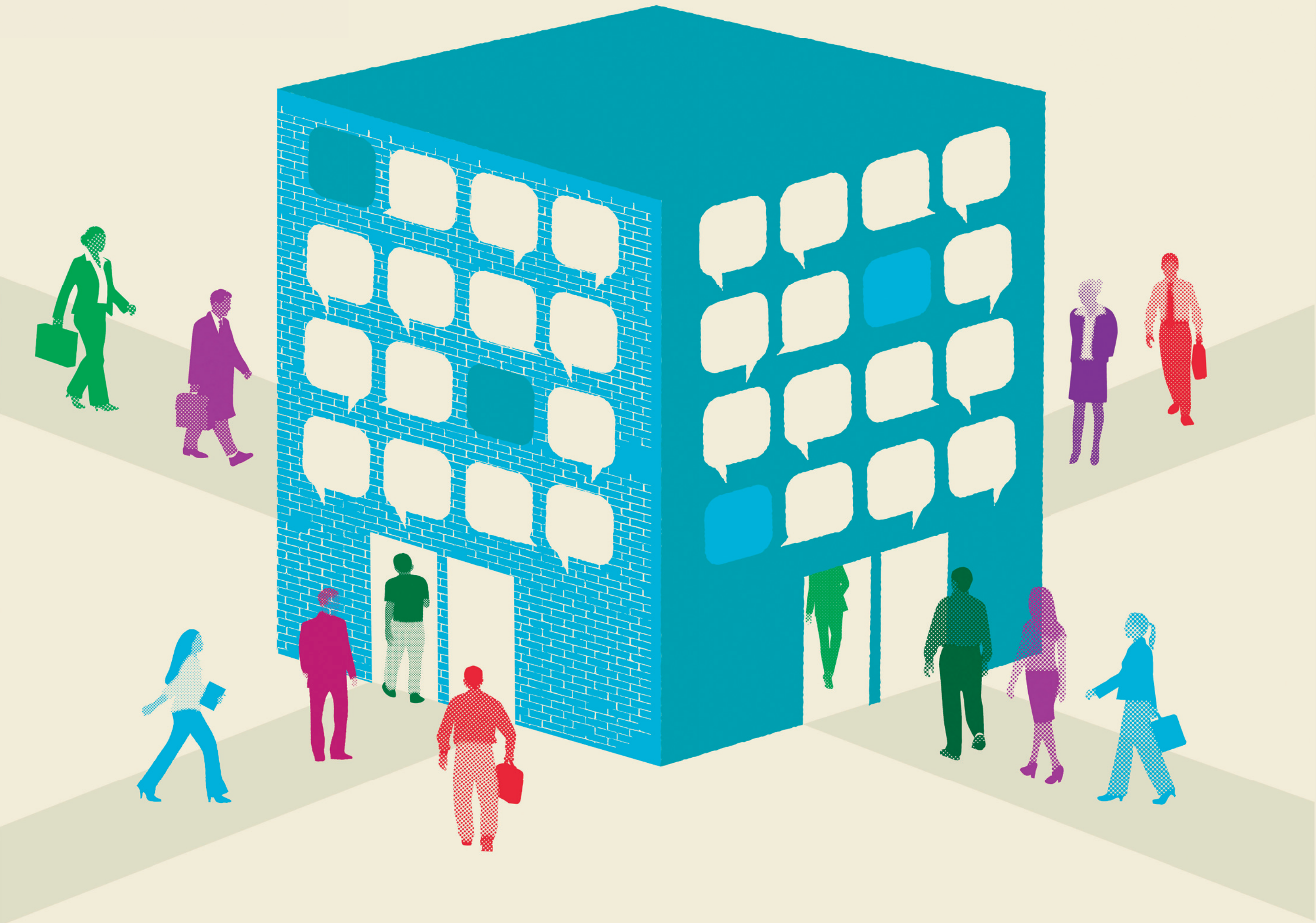

Pearson

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Smith and Keenan's

COMPANY LAW

If there is a dispute between shareholders, it will often be the case that the shareholders' agreement will be referred to first, between the constitutional documents. This could cause a problem, however, if there is a conflict between the terms of the articles and the terms of the external agreement. The key case concerning shareholder agreements is ***Russell* v *Northern Bank*.**

CASE

Russell v *Northern Bank Development Corporation Ltd* [1992] 1 WLR 588

Five individuals agreed to refrain from voting to increase the company's share capital, unless all parties agreed to the increase (in writing). Subsequently, the company sought to increase capital, but one member of the agreement was against this increase. In court, he argued that the fellow members were acting contrary to the terms of the membership agreement. The other members of the agreement counter-claimed by saying that by enforcing the terms of the shareholders' agreement, the court would in effect restrict the court from acting within its statutory power.

The House of Lords (reversing the decision of the Court of Appeal) stated that shareholders' agreements were valid and enforceable. Lord Jauncey provided a quotation from Lord Davey in ***Welton* v *Saffery*** [1897] AC 299, who stated:

> Of course, individual shareholders may deal with their own interests by contract in such a way as they may think fit. By such contracts, whether made by all or only some of the shareholders, would create personal obligations, or an exception personalis against themselves only, and would not become a regulation of the company, or be binding on the transferees of the parties, or upon new or non-assenting shareholders.

Comment

Although, strictly speaking, the judgment says that a company may not be bound by one, it is without doubt that the company (practically speaking) is restricted, as it is the members who guide the company. Potentially, a member of a company could obtain an injunction to prevent other members of the company (party to a membership agreement) to restrain from allowing the company to perform an act, which it is statutorily able to do.

CASE

Euro Brokers Holdings Ltd v *Monecor (London) Ltd* [2003] 1 BCLC 506

So far as the facts of ***Euro Brokers*** are concerned, the matter in issue was a call made on the company's two shareholders requiring them to advance more capital. The finance director made the call by means of an email, though the shareholders' agreement required that the call be made by a notice from the board. Nevertheless, both shareholders regarded the call as valid and agreed to send the sums required to the company. Later, one of the shareholders failed to forward the full amount. Under the shareholders' agreement this triggered a right in the other shareholder to acquire the shares of the defaulter at an agreed price. The defaulter was not prepared to accept this situation and challenged the validity of the call in terms that it had not been made by the formal notice of the board. This defence was rejected by the Court of Appeal. The shareholders had accepted the call in the manner in which it was made and the ***Duomatic*** principle could therefore be applied. In consequence, the defaulting shareholder could be required to sell his entire holding to the claimant.

In ***Euro Brokers Holdings Ltd*** v ***Monecor (London) Ltd,*** above, the court applied the ***Duomatic*** principle to such a shareholders' agreement. The principle which is derived from the decision in ***Re Duomatic*** [1969] 2 Ch 365 states that the informal and unanimous assent of all the company's shareholders can override formal requirements as where a particular course of action requires a meeting and resolution of the shareholders, either under statutory provisions or because of the requirements of the company's articles, and no such meeting and/or resolution has been held or passed or written resolution made.

Nevertheless, if there is evidence that the shareholders were unanimously agreed on the matter, the court may accept the resulting transaction as valid.

Key provisions in a shareholders' agreement

A typical shareholders' agreement may include:

- Undertakings and agreements from prospective shareholders before the company is formed.
- A list of matters that require the consent of all (or a certain number or a majority) of the shareholders. Such provisions may also reserve particular matters concerning the day to day running of the business to the shareholders (i.e. matters that would usually be decided by the board of directors). Note that where a formal procedure for decision-making is set out in a shareholders' agreement but the shareholders fail to follow that procedure, provided that all the shareholders agree, their decision will be binding, notwithstanding the failure to follow the stipulated procedure.
- Internal management issues which the members wish to keep off the public record, e.g. who should be entitled to appoint a director, choice of bankers, and the policy of the company on loans and borrowing together with cheque signatories.
- Specific provisions relating to directors such as their appointment and removal as well as procedural issues relating to the day to day management of the company by the directors. Such provisions may include quorum, notice and voting provisions (these provisions may also be repeated in the articles). For example, above a certain percentage of shareholding, each shareholder is likely to be entitled to appoint a representative or representatives to the company's board or it may be provided that no director shall be appointed to the board or removed from the board except with the consent of all of the shareholders. If the company is deadlocked, each shareholder will normally be entitled to appoint the same number of directors or representatives. They will also have the right to appoint the chairman of the board without a casting vote but probably on a rotational basis for a fixed period.

- Matters that it would be inappropriate to put on the public record such as confidentiality undertakings and non-competition restrictions, the right of certain shareholders to appoint directors and dispute resolution, or the financing of the company. In an investment arrangement or a joint venture arrangement, the shareholders' agreement is often made conditional upon receipt of the financing. The types of provisions will depend upon the reason for which the shareholders' agreement is being entered into.
- Quorum requirements may also be included. Whilst the Model Articles set out quorum requirements for company meetings, it is common in a shareholders' agreement to set overriding quorum requirements that provide that certain persons (or their representatives) from each party to the shareholders' agreement must be present in order for a quorum to be reached. This is particularly the case with joint venture arrangements. A deadlocked company may often provide that no decision of a meeting can be taken unless a representative of each shareholder is present throughout the meeting. If the company is not deadlocked, it may be the case that a representative of the minority shareholder will be required to be present for the meeting to be quorate or have the right to receive notice of the meeting and decide whether to attend or not. It should be noted if the minority shareholder's representative is required to be present before the meeting is quorate, this can effectively give it a right of veto over decisions.
- Protection of minority shareholders if required. Thus, although alteration of the articles requires a special resolution, i.e. a 75 per cent majority of votes, a shareholders' agreement can require written consent from all shareholders so protecting those with minority holdings.

Shareholders' agreements and minority protection

Finally, it is worth noting the role that a shareholders' agreement may play in the area of minority protection. First of all, a shareholders' agreement provides a right of action which enables one member to enforce the provisions of the shareholders' agreement directly against another member. This right of action may not arise under the articles. Therefore, due to the difficulties shareholders can encounter in enforcing the provisions of the articles under s 33 CA 2006, a shareholders' agreement can be used in order to ensure the enforceability of provisions that would not be regarded as membership rights, such as the right to be appointed as the company's solicitor or the right to approve certain transactions.

If a term contained in a shareholders' agreement is breached it can be enforced in the usual way under a normal contract. A shareholder will be able to claim for breach of contract, or alternatively could apply to the court for an injunction to prevent a breach of the terms of the agreement.

As mentioned above, certain matters can be reserved in a shareholders' agreement as requiring the consent of all shareholders or certain individual shareholders (e.g. amendments to the articles of association, the issue of new shares, or the appointment or removal of a director). This is an additional way in which minority shareholder rights can be protected. For example, if we have a company (X) with a minority shareholder (Y) who only holds 5 per cent of the shares, he will be unable to prevent the company from removing a director from office via an ordinary resolution as required under s 168 CA 2006. However, if there is a shareholders' agreement that provides for the unanimous consent of all shareholders before the company is able to remove a director this may influence the result. It should be noted that such a provision does not remove the statutory right of the majority to remove a director under s 168 CA 2006, since the company is required to accept the vote of a shareholder even if this is in breach of the provisions of the shareholders' agreement. Consequently, the resolution would be valid and the director would be removed from office

However, if such a resolution is passed without the required unanimity outlined in the shareholders' agreement it will be contrary to the terms of the contract between the members. The disgruntled minority shareholder (who may very well be the director in question) would then have a claim against the other shareholders for breach of contract (i.e. breach of the shareholders' agreement). The threat of a breach of contract claim provides the minority shareholder with some degree of influence as to whether or not the resolution is passed, since the members of company (X) must be prepared to defend such a claim in the courts from the minority shareholder (Y). To this end a shareholders' agreement could be said to impact on the principle of majority rule, though in reality only to a very small extent.

Finally, and in many respects linked to the discussion outlined above, a shareholders' agreement will also carry a considerable amount of weight in terms of the court determining whether or not 'unfairly prejudicial' conduct has occurred under CA 2006, s 994. (Refer to Chapter 21 for further discussion of this point.)

Suggested further reading

Brookes and Davies, 'When are pre-emption rights triggered?' (2012) *Accountancy* 148(1424), 57.

Cheung, 'The use of statutory unanimous shareholder agreements and entrenched articles in reserving minority shareholders' rights: a comparative analysis' (2008) *Company Lawyer,* 234.

Cheung, 'Shareholders' agreements: Shareholders' contractual freedom in company law' (2012) JBL (6) 504.

Davies, 'Entrenching provisions in the articles: the ultimate protection for the shareholder-director?' (2009) *Business Law Review* 30(8/9), 184.

Ferran, 'The decision of the House of Lords in *Russell v Northern Bank Development Corporation Limited'* [1994] CLJ 343.

Finn, 'Shareholder agreements' (1978) *Australian Business Law Review* 6, 97.

Goldberg, 'The enforcement of outsider rights under the section 20 contract' (1972) 35 MLR 363.

Goldberg, 'The controversy on the section 20 contract revisited' (1985) 48 MLR 158.

Gower, 'The contractual effect of article of association' (1958) 21 MLR 401.

Gower and Davies, *Principles of Modern Company Law* (2008) Sweet & Maxwell, London.

Gregory, 'The section 20 contract' (1981) 44 MLR 526.

Kahn-Freund, 'Some reflections on company law reform' (1944) 7 MLR 54.

Marsden, 'Does a shareholders' agreement require filing with the Registrar of Companies?' (1994) *Company Lawyer* 15, 19.

Prentice, 'The enforcement of outsider rights' (1980) 1 Co Law 179.

Rixon, 'Competing interests and conflicting principles: An examination of the power of alteration of articles of association' (1986) 49 MLR 446.

Sealy, '"Bona fides" and "proper purposes" in corporate decisions' [1989] *Monash University Law Review* 16.

Van Duzer, 'Shareholder agreements' (2011) *Company Secretary's Review* 35(18), 143.

Wedderburn, 'Shareholder rights and the Rule in *Foss v Harbottle*' (1957) CLJ 193.

Questions

1 Critically evaluate how the approach taken by the Companies Act 2006 to the notion of a company's constitution differs to that previously contained in the Companies Act 1985. Explain how the Model Articles can be utilised.

2 The company's constitution forms a contract between a company and its members. However, this contract is unusual due to its statutory nature. Despite efforts of the Companies Act 2006 to address this issue, it is still limited in terms of its scope and permanence.

Critically evaluate this statement

3 Section 33 of Companies Act 2006 provides that the company's constitution constitutes a binding and enforceable agreement between the company and its members, and between the members themselves, as if they had all signed and sealed a contract to abide by its provisions.

Critically evaluate this statement

4 Mr Orange, Mr Pink and Ms Green are all members of XYZ Ltd. The company has now discovered that Ms Green is also a major shareholder in a rival company. This discovery has caused concern that Ms Green might be extracting sensitive commercial information about XYZ Ltd's business which could give an unfair advantage to its rival. XYZ Ltd wishes to alter its articles of association so as to require any member competing with XYZ Ltd, to sell his or her shares, as required, to any person or persons named by the directors of the company, or to the directors themselves.

Advise XYZ Ltd.

Chapter 8

Altering the articles of association

Key topics and concepts

The following chapter will cover:

- implications of the statutory contract under s 33 of the Companies Act 2006
- breaches of contract arising from an alteration of a company's articles
- alterations of a company's articles by the courts

The articles of association may be amended by a special resolution in general meeting (s 21 of the Companies Act 2006). A copy of the revised articles must be sent to the registrar 'not later than 15 days after the amendment takes effect' (s 26(1)). If the company fails to comply with this requirement, then under s 26(1) an offence is committed by the company and every officer of the company who is in default. Section 27(1) goes on to note that the registrar may give notice to the company to comply with this requirement within 28 days of issue. Continued failure by the company to comply may result in a civil penalty of £200 in addition to criminal proceedings (s 27(4)).

Implications of the statutory contract

The important point to appreciate is that any member of a company enters into a contract, the terms of which may be amended by the company in general meeting at any time in the future. While this may appear to go against the most basic principles of contract law, it is important to remember that this is a statutory contract by virtue of s 33 of the Companies Act 2006. Indeed, as noted in ***Greenhalgh* v *Arderne Cinemas***, 1951 by Evershed MR, 'when a man comes into a company, he is not entitled to assume that the articles will always remain in a particular form'. If one takes time to reflect on the situation and to bear in mind the observations of Drury (see the suggested reading at the end of the chapter), the company represents a separate legal entity whose existence will, in most instances, extend far beyond either the involvement or life expectancy of the current members. As such, the company is subject to specific decision-making processes (in this instance s 21) that enable