EXCLUSIONS FROM PARTNERSHIPS AND QUASI-PARTNERSHIPS PRACTICAL POINTERS AND PITFALLS

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EXCLUSION FROM QUASI-PARTNERSHIPS

Introduction

1. Exclusion from management is one of (if not the) most frequent complaints relied upon to found a shareholder's unfair prejudice petition under Part 30 of the Companies Act 2006, the usual relief for which is a share purchase order.

2. A shareholder's status as such does not, however, confer upon him or her any right of participation in management and any exclusion from management will generally only amount to unfair prejudice in the context of those companies conveniently referred to as quasi-partnerships.

3. Exclusion from management need not take any particular form (though it will frequently involve removal of the relevant member as a director of the company and his dismissal as an employee) and can include failing to keep a minority shareholder fully and accurately informed about the true state of the company's finances, failing to call a shareholders' meetings, failure to table accounts at any such meetings[1], holding meetings in that shareholder's absence and so forth. It may also include a situation where board meetings have become a charade, with the discussion a foregone conclusion[2]. Repeated out-voting of a minority shareholder at board meetings does not, however, of itself, connote exclusion; a director cannot expect to control, but only to participate in, the direction of a company.[3] Less obviously perhaps, exclusion may sometimes take the form of a complaint by a minority shareholder with no management participation about the non-payment of dividends coupled with the payment of allegedly excessive remuneration to the controlling shareholders[4]. For such a case it is not necessary to prove that the company is a quasi-partnership.

4. It is not the exclusion alone which gives rise to the unfairness necessary for relief under the 2006 Act; it is the exclusion (assuming it to be unjustified) without a reasonable offer to acquire the excluded shareholder's shares[5].

5. Solicitors acting for majority shareholders were found negligent in failing to advise their clients that it would be unfairly prejudicial to remove a director without making a fair offer for his shares[6].

6. What is a reasonable offer for these purposes is discussed below.

What is a quasi- partnership?

7. The phrase 'quasi-partnership' is nothing more than a convenient label or shorthand for saying that the relationship between the shareholders in such a company is such that the exercise of strict legal rights under the Companies Act or the articles of association are subject to equitable constraints developed from the law of partnership (e.g. obligations of good faith and mutual confidence).

8. What, then, are the features which give rise to such a special relationship between the shareholders?

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[1] *Fowler v Gruber* [2010] 1 BCLC 563 at [129]-[130].
[2] *In re LCM Wealth Management Ltd* [2013] EWHC 3957 (Ch) at [118].
[3] *Ibid*.
[4] *Oppressions of Minority Shareholders – Reflections on Blisset v Daniel*, Robin Hollington QC, Denning Law Journal 2007, vol 19, 5, at p 6.
[5] *O'Neill v Phillips* [1999] 1 WLR 1092 at 1107 C per Lord Hoffmann.
[6] *Magical Marking Ltd (in liquidation) and anr v Ware & Kay LLP* [2013] EWHC 59 (Ch).

9. In *Ebrahimi v Westbourne Galleries Ltd*[7] (where the issue was whether or not the relevant company should be wound up on a just and equitable basis) Lord Wilberforce observed[8] that it would be impossible, and wholly undesirable, to define the circumstances in which these equitable considerations may arise. What he did make clear is that the fact the relevant company is a small one, or a private one, is not enough – "There are very many of these where the association is a purely commercial one, of which it can be safely be said that the basis of association is adequately and exhaustively laid down in the articles."[9]

10. Lord Wilberforce went on:

    The superimposition of equitable considerations requires something more, which typically may include one, or probably more, of the following elements:

    (i) An association formed or continued on the basis of a personal relationship, involving mutual confidence – this element will often be found where a pre-existing partnership has been converted into a limited company;

    (ii) An agreement, or understanding, that all, or some (for there may be "sleeping" members), of the shareholders shall participate in the conduct of the business;

    (iii) Restriction upon the transfer of the member's interest in the company – so that if confidence is lost, or one member is removed from management, he cannot take out his stake and go elsewhere.

11. As the reference to "formed or continued" suggests, over a time the relationship between the shareholders can change meaning that a company can become a quasi-partnership or cease to be one[10].

12. Restrictions on the transferability of a member's shares frequently take the form of pre-emption provisions in the company's articles of association which oblige a departing member first to offer his shares to the remaining shareholders and often on terms as to valuation which might depress the price below what would otherwise be a 'fair' value.

13. Reference may also be made to *Re Astec (BSR) plc*[11] where Jonathan Parker J, in a passage later approved by Lord Hoffmann in *O'Neill*[12], said this:

    [I]n order to give rise to an equitable constraint based on "legitimate expectation" what is required is a personal relationship or personal dealings of some kind between the party seeking to exercise the legal right and the party seeking to restrain such exercise, such as will affect the conscience of the former.

The power to expel

14. Irrespective of what a company's articles of association or any shareholders' agreement may provide, any director is at risk of removal by a majority of shareholders as s 168(1) of the Companies Act 2006 makes clear:

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[7] [1973] AC 360
[8] At p 379 E.
[9] For a recent example of a similar company where the court expressed doubts on the appropriateness of the "quasi-partnership" label see *In re LCM Wealth Management Ltd* [2013] EWHC 3957 (Ch) at [54].

[10] In *O'Neill v Phillips* [1999] 1 WLR 1092 Lord Hoffmann (who delivered the only substantive speech) agreed with the Court of Appeal's conclusion that the relevant company had become a quasi-partnership but observed (at p 1102 H to 1103 A) that he did not think that was the position when the (ultimately unsuccessful) petitioner originally acquired his shares. As to the position where a new shareholder has acquired his shares by way of inheritance, see *Irvine v Irvine* [2006] EWHC 406 (Ch); [2007] 1 BCLC 349 at para 257.
[11] [1998] 2 BCLC 556, at 588
[12] *Ibid* at 1101 E.

A company may by ordinary resolution at a meeting remove a director before expiration of his period of office, notwithstanding anything in any agreement between it and him.

15. It is where such removal occurs in the case of (a) a quasi-partnership formed on the basis of an agreement as to participation in management; (b) an express contractual right of participation that a member may have grounds for complaint.

16. Where the company in question is a quasi-partnership, a petitioner will sometimes seek to contend, by analogy with partnership law[13], that any power of expulsion must be restrictively construed and must not be exercised with an ulterior motive (financial or otherwise). This is frequently the case where dismissal/expulsion will trigger an obligation (contained in the articles or elsewhere) on the part of the petitioner to offer up his shares to the majority on terms disadvantageous to him or her.

17. Such terms may include a requirement, in the event that a member of the company is also an employee whose employment is terminated for any reason, to serve a transfer notice in respect of his shares at a price which is lower of the amount paid up on such shares or the nominal value of those shares.

18. As a matter of construction by reference only to the language used, such article would apply even where the relevant cessation of employment was the consequence of a wrongful or unfair dismissal[14].

19. Even where the company is not a quasi-partnership any power conferred on the majority directors must be exercised for a proper purpose: see *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821.

20. It follows that whatever the source of the power to remove a director etc, its exercise must not be capricious.

Exclusion v voluntary departure

21. Since *O'Neill v Phillips*[15] it has been clear that a mere breakdown of the relationship of trust and confidence is not sufficient to mount an unfair prejudice petition. There is no such concept as a "no-fault divorce" in this context under which a departing member can oblige the majority to acquire his shares at a fair price (or indeed at any price).

22. The petitioner must instead establish exclusion; a voluntary departure will generally be fatal to the granting of relief save, perhaps, where he or she has been forced out (constructively removed).

Injunctive relief

23. In appropriate cases the court will grant interim remedies on the application of a petitioner in unfair prejudice proceedings. Applications for injunctive relief will generally be governed by the well known principles in *American Cyanamid Co v Ethicon Ltd*[16] though recognising that consideration of the adequacy of damages as an alternative remedy (which is not available to a petitioner under Part 30 of the 2006 Act) will not strictly apply[17].

24. In the context of threatened removal (or a mandatory injunction seeking re-instatement) as a director or employee in a quasi-partnership it may not be that difficult to satisfy the serious issue to be tried threshold. Where, however, the final remedy sought by the petitioner is a

13 See also *Blisset v Daniel* (1853) 10 Hare 493.
14 See *In re A Company (No. 004377 of 1986)* [1987] 1 WLR 102 at 107 H to 108 C; *In re Robor Cartons Ltd* (unrep, David Mackie QC, 21.03.2000) at para 19.
15 [1999] 1 WLR 1092, at 1104 C to 1105 B per Lord Hoffmann..
16 [1975] AC 396.
17 See, for example, *Re Postgate & Denby (Agencies) Ltd* [1987] BCLC 8. A director with a service contract (and an employee) will, however, be able to rely on alleged breaches of contract in respect of which damages may be an adequate remedy.

buyout and the specific matters complained of can be taken into account in the valuation process, injunctive relief is likely to be refused[18]. As Arden LJ observed in *Pringle v Callard*[19], "In essence it is contrary to principle to impose a director on a company. It is highly impracticable so to do in any event where there are disputes between the directors or . . . allegations of improper conduct. Accordingly, a court would have to be extraordinarily cautious before imposing a director on a company by way of interim remedy . . ."[20]

Offers to purchase

25. As noted above, as a general rule the unfairness of exclusion lies in failing to make a reasonable offer to purchase the petitioner's shares. As Lord Hoffmann observed in *O'Neill v Phillips*[21], if the respondent to a petition has plainly made a reasonable offer, then the exclusion as such will not be unfairly prejudicial and he will be entitled to have the petition struck out. To put it another way, if the relevant offer is on terms which provide for all that the petitioner could reasonably hope to achieve at trial, its refusal will be unreasonable and justify a striking out of the petition.

26. What constitutes a reasonable offer may be affected by the terms of the articles of association or any separate shareholders' agreement to which careful attention must be paid in every case.

27. As to what will ordinarily constitute a reasonable offer (at least in those cases where the respondent majority are unable to rely on specific provisions within the articles of association or any shareholders or other agreement), Lord Hoffmann (in *O'Neill v Phillips*) offered the following guidelines:

    (1) the offer must be to purchase the shares at a fair value. This will ordinarily be a value representing an equivalent proportion of the total issued share capital, that is, without a discount for its being a minority holding. The Law Commission (paras 3.57 to 3.62) has recommended a statutory presumption that in cases to which the presumption of unfairly prejudicial conduct applies, the fair value of the shares should be determined on a pro rata basis. This too reflects the existing practice. This is not to say that there may not be cases in which it will be fair to take a discounted value. But such cases will be based upon special circumstances and it will seldom be possible for the court to say that an offer to buy on a discounted basis is plainly reasonable, so that the petition should be struck out.

    (2) the value, if not agreed, should be determined by a competent expert. The offer in this case to appoint an accountant agreed by the parties or in default nominated by the President of the Institute of Chartered Accountants satisfied this requirement. One would ordinarily expect the costs of the expert to be shared but he should have the power to decide that they should be borne in some different way.

    (3) the offer should be to have the value determined by the expert as an expert. I do not think that the offer should provide for the full machinery of arbitration or the half-way house of an expert who gives reasons. The objective should be economy and expedition, even if this carries the possibility of a rough edge for one side or the other (and both parties in this respect take the same risk) compared with a more elaborate procedure. This is in accordance with the terms of the draft regulation recommended by the Law Commission: see App C to the report.

    (4) the offer should, as in this case, provide for equality of arms between the parties. Both should have the same right of access to information about the company which bears upon the value of the shares and both should have the right to make submissions to the

[18] See *Pringle v Callard* [2007] EWCA Civ 1075; [2008] 2 BCLC 505 at [26] et seq per Arden LJ.
[19] *Ibid* at [33].
[20] See also *Mission Capital plc v Sinclair and anr* [2010] 1 BCLC 304.
[21] At p 1107 C.

expert, though the form (written or oral) which these submissions may take should be left to the discretion of the expert himself.

(5) there is the question of costs. In the present case, when the offer was made after nearly three years of litigation, it could not serve as an independent ground for dismissing the petition, on the assumption that it was otherwise well founded, without an offer of costs. But this does not mean that payment of costs need always be offered. If there is a breakdown in relations between the parties, the majority shareholder should be given a reasonable opportunity to make an offer (which may include time to explore the question of how to raise finance) before he becomes obliged to pay costs. As I have said, the unfairness does not usually consist merely in the fact of the breakdown but in failure to make a suitable offer. And the majority shareholder should have a reasonable time to make the offer before his conduct is treated as unfair. The mere fact that the petitioner has presented his petition before the offer does not mean that the respondent must offer to pay the costs if he was not given a reasonable time.

28. There are, however, limits to this guidance. First, it does not refer to the date of valuation. Ideally any offer should identify at what date the shares are to be valued.

29. More generally, as the court observed in *Harbourne Road Nominees Ltd v Karvaski*[22] Lord Hoffmann's principles do not have the status of legislation. It was, said the judge in that case, a "cardinal error" to think that if a sufficient degree of compliance with the guidelines was achieved, the respondent(s) would inevitably be protected from any petition that might be presented. The judge went on:

The question for the court is always whether in all the circumstances of the case the applicant prospective or actual (respondent to the petition) has satisfied the conditions required to have the petition struck out, or summary judgment in his favour given on it. These [counsel for the petitioner] accurately summarised as being that it must be shown that the continued prosecution of the petition after the making of the offer amounts to an abuse of process, or was bound to fail. The issue is highly sensitive to the facts and circumstances of each case, and consideration of the nature and terms of any offer made can only ever be an intermediate step in the process.

One obvious difference between this case and *O'Neill* is that Mr Morris [the petitioner] is not a minority shareholder but an equal 50% shareholder, and he alleges that the company was established and run as a quasi partnership. In fact he is willing to consider the sale of his shares to Mr Karvaski (that is the order he seeks) but in such cases, it is by no means always obvious which of two equal holders should sell to the other. Lord Hoffmann's remarks were not made in this context, but were expressly about cases where there is a majority shareholder. Ultimately, in a breakdown of relations between a majority and a minority shareholder the solution is likely to be that the minority shareholder must exit the company, or be offered the opportunity to do so on fair terms. In the case of equal shareholders however, particularly if they are quasi partners, there is a clear potential for injustice if one of them is able to seize de facto control of the company and effectively force the other either to accept his offer to buy or be forever excluded from the participation that he bargained for and cut out from any remedy in respect of what would be a continuing breach of the quasi partnership arrangement originally made. Lord Hoffmann's remarks were not intended to have the effect of establishing a mechanism for seizure and exclusion.

30. In the context of a petition alleging exclusion from information, fairness may, according to the Court in *Harbourne*, require allowing the petitioner full access to the company's books and records before any offer has to be accepted. Otherwise, in circumstances where the petitioner suspects the majority of breaches of duty, he may be contractually committed to sell at a price which, after the access to books and records contemplated under the *O'Neill v Phillips* guidelines, will, if there is evidence of breach, at best reflect that the company has a disputed claim. If he has refused an offer and had his petition struck out, he has no remedy at all

[22] [2011] EWHC 2214 (Ch) at [26].

unless he can persuade the court to permit him to present another, which would not be a foregone conclusion. More generally, exclusion from information may mean that the petitioner is:

poorly placed to anticipate and cater for every means and mechanism by which the affairs of the company might be managed so as to disadvantage him in the valuation process. He may find that the language of an offer contains some pitfall that he could not have anticipated, or perhaps that the company's business has been changed to its disadvantage (an example might be that it had agreed to pay a commission on sales to a party connected with the other shareholder). If he accepts such an offer, he becomes bound by its terms (absent some special factor such as fraud or misrepresentation). In that respect he may be in a materially worse position than a litigant who will have been able to exercise rights of inspection and, if he obtains an order for sale, would have the opportunity to persuade the court that it should be crafted so as to undo the effects of any unusual transactions. He would be likely to have liberty to apply in the implementation of that order for sale and could therefore seek the assistance of the court if the valuation mechanism turned out to operate unfairly against him because of some matter he could not have known about.

Defences

1. Exclusion from management (even without an offer to purchase the member's shares) may be prejudicial to the member concerned but will not be unfair in all circumstances.

2. Although it may be difficult for the majority to justify exclusion simply on the basis it was a commercial decision reached in good faith[23], where the petitioner's conduct has been so serious as to warrant exclusion, no relief will be granted in respect thereof. Such (mis)conduct would include dishonesty (even where the sums involved are comparatively trivial)[24].

3. Where a quasi-partner is excluded from management but delays in presenting any petition the circumstances may be such as to render it inequitable for him or her to be granted relief[25].

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[23] See *In re Westbourne Galleries Ltd* at p 381 H per Lord Wilberforce.
[24] *Kelly and anr v Hussain and ors* [2008] EWHC 1117 (Ch).
[25] See *Re D.R. Chemicals Ltd* (1989) 5 BCC 39.