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Companies act obligations and unfairly prejudicial conduct:
Croly v Good [2010] 2 B.C.L.C. 569

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Introduction

Croly is yet another decision in the continuous stream of cases involving allegations of unfairly prejudicial conduct in "quasi partnership" companies. That stream in turn implies that the Companies Act obligations incumbent upon directors are often not well understood by company promoters. *Croly* is of particular interest because of the attention paid by the court to the issue of whether the company was in fact a "quasi partnership" and the appropriate date for valuation of shares.

Background

The company's business was the sale of postal franking machines pursuant to a franchise agreement with the German manufacturers. Its issued share capital was 100 ordinary shares of £1 each, 75 called A and 25 called B; the articles provided that the two classes ranked pari passu but that shareholders could declare different dividends on them. G and his wife acquired the company in 2001 and took on C as an employed salesman. By 2004 C had purchased 30 A shares; the foundation of C's case was that he and G had agreed at a restaurant meeting at that time that C would be entitled to participate in the management of the company, would be designated sales director and would be entitled to be fully informed and consulted in relation to matters material to the company's business and affairs. In addition, his shareholding would in future be increased to 40 per cent of the issued share capital and profit would be divided equally between them with both drawing equal amounts of cash as remuneration (which would appear in their director's loan accounts) on account of dividends to be declared at the year end. C argued that at that point the company became a quasi partnership between himself and G. G and C subsequently agreed a "remuneration strategy" whereby C gave up his substantial commission payments in return for an equal profit share with both he and G drawing a defined amount each month; this "strategy" sowed the seeds of their later dispute because they fell out over the level of G's drawings and, in November 2007, G expelled C from the company's premises and any effective role in it. By that date, no dividends had been declared on the A shares he held, and a balance of over £200,000 had accrued on his loan account in respect of the payments received on account of dividend and other matters; £400,000 had accrued on G's account.

C made a number of requests to G to buy him out, none of which led to a proper offer, and he eventually sought by petition an order under s.994 of the Companies Act 2006 that G buy out his shares in the company at a value determined as at November 2007, in other words, at the time of his exclusion from the company.

The law

To be relevant for the purposes of s.994(1) of the 2006 Act, the conduct complained of must be both prejudicial to the member's interests qua member (rather than any other capacity such as an employee) and unfair. The unfairness is usually with reference to a breach of an agreement establishing how the affairs of the company would be run. While a company is a separate legal entity and its constitution, most particularly its articles of association, forms the contract between the members, in some companies (referred to as "quasi partnership") there are additional equitable considerations stemming from the nature of the relationship that the parties entered into with a view to carrying on business through the company and which enable the court to subject the exercise of legal rights to equitable considerations; "considerations, that is, of a personal character arising between one individual and another, which may make it unjust, or inequitable, to insist on legal rights, or to exercise them in a particular way." (Lord Wilberforce in *In re Westbourne Galleries Ltd* [1973] A.C.

360 at [379], approved by Lord Hoffmann in *In O'Neill v Phillips* [1999] 1 W.L.R. 1092). There is no universal definition of which companies fall into the "quasi partnership" category; in *Westbourne Galleries*, Lord Wilberforce at [379] described the following features of such companies:

> "(i) An association formed or continued on the basis of a personal relationship, involving mutual confidence … often … where a pre-existing partnership has been converted into a limited company; (ii) an agreement, or understanding, that all … of the shareholders shall participate in the conduct of the business; (iii) restriction upon the transfer of the members' 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."

If a company satisfies the definition of a quasi partnership, the court is more likely to find that it is unfair to fail to give effect to arrangements which have been made on an informal basis or to exclude a participator from the management or conduct of the company's business, if it was part of the arrangement that he should take part in it. Hence the reliance often placed in s.994 applications on the company coming within the definition of a quasi partnership.

Decision

H.H.J. David Cooke (sitting as a High Court judge) noted at [88] that, in deciding whether the company was a quasi-partnership, the appropriate question was whether it had become a quasi partnership by the time the relationship between C and G had reached its fully developed form, i.e. in the early part of 2006 when the "remuneration strategy" had been put into effect. He rejected C's pleaded case that they had agreed the relationship between them was to be one of mutual trust and confidence and that the company would be operated as a partnership, finding that these were matters for the court to determine. The judge held that the question had to be decided as, "an overall judgment on the totality of the arrangements made" [89]; he concluded that C was a quasi partner, since their relationship was personal rather than purely commercial. The relationship was, as a matter of law, one of mutual trust and confidence because the remuneration strategy in particular relied on not abusing his position, and it was personal rather than commercial because, to all intents and purposes, G and C paid no attention whatsoever to their obligations owed pursuant to the Companies Acts and articles of association:

> "Insofar as they recognised any limits at all on what they could do in relation to the company and its assets … they arose only because of what they had agreed between themselves." [92]

The judge concluded that C's expulsion from the company was prejudicial to his interests as a member since it prevented him from participating in management and contributing to profit generation and was unfair because his participation in management was part of the agreed basis of operation. The failure to declare dividends was also prejudicial to his member's interests and unfair as a breach of what they had agreed, as too was G's drawing further sums after C's expulsion but without proper approval of directors or shareholders.

Relief

G accepted that, if an order to purchase shares was to be made, the valuation should not be discounted for C's minority holding. However, he disputed the valuation date of November 2007 rather than the date of the court's order to purchase. The retrospective valuation was material because since that date the company's fortunes had declined to the point where in August 2009, two months before trial, it had been put into administration by G for the purposes of implementing a "pre-pack" sale of its assets to a new company owned by G and his wife. G argued that the insolvency was solely due to uncertainty about recovery of the principal item in the company's balance sheet, the director's loan accounts. At [105] the judge noted that, on the basis of established authority and in particular the Court of Appeal decision in *Profinance Trust SA v Gladstone* [2001] EWCA Civ 1031, the starting point was a valuation at the date of the court's order unless that would be unfair to the one or other party in all the circumstances of the case and the other date was, overall, fairer. At [113] he concluded that there was a very substantial risk that a valuation at a date after his expulsion would be seriously unfair to C because G had had sole control of the company for the ensuing two years and, while there was no clear evidence of impropriety in the company's apparent financial decline, the circumstances "excite suspicion" and G had failed to make available all the relevant financial information after March 2008. In addition, G had added to the company's financial difficulties by drawing cash from the company since the expulsion that was far in excess of any cash generated, while the "pre-pack" sale gave rise to legitimate suspicions that it was designed to isolate a business which, despite appearances, still had substantial value, from C's claim.

Conclusion

Croly offers an interesting analysis of what constitutes a quasi partnership, particularly by highlighting that it may be so constituted at a later stage than when the protagonists first go into business together with a view to profit. Valuing the shares at the date of expulsion illustrates the danger of continuing to treat a company as a personal vehicle even after the understanding has come to an end and the partner excluded.