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Validity of Amendment to Articles to Introduce Share Redemption

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The UK Privy Council recently upheld the validity of a special resolution to amend a company's articles of association to introduce a compulsory redemption power, which was then immediately invoked against a 20% minority shareholder (*Staray Capital Ltd v Cha*)[1]. It is an important judgment in the context of drag-along and compulsory buyout provisions in articles and shareholders' agreements. It reinforces previous case law on the scope of the power of majority shareholders to bind a minority but also certain of the constraints on that power. It suggests that it may, in certain circumstances, be possible to introduce compulsory buyout provisions into a pre-existing company's articles which bind a minority.

Background

The case involved the introduction from scratch of a compulsory redemption power in respect of members' shares, at the instigation of the 80% shareholder (S). This would be exercisable by the company (C) in certain circumstances. C could trigger the compulsory redemption power on 15 days' notice if a shareholder was found to have:

- made material misrepresentations in the course of acquiring his shares; or
- committed an act which could result in the company incurring any pecuniary, legal, regulatory or administrative disadvantage or negative publicity.

The buyout price would be the fair market value of the shares, without a discount being applied to a minority interest.

Facts

S had for some months previously been indicating that he wanted to buy M out. Against that backdrop, C served 15 days' notice to compulsorily redeem M's 20% shareholding on the same day that the special resolution was passed to first introduce the compulsory redemption power into C's articles. C based this on alleged "material misrepresentations" made by M in stating that he was a partner in a particular Chinese law firm and that he was qualified to practise in China and the United States respectively. The argument was that these attributes were relevant to plans for M to procure investors for the venture, provide legal advice and begin preliminary work on a listing. M challenged the validity of both the special resolution to amend the articles and the compulsory redemption notice which was subsequently served on him.

1 [2017] UKPC 43.

Decision

The Privy Council upheld the decisions in the lower courts that it was reasonable for a company to take the view that members who had acquired their shares by misrepresentation, or had committed acts which could result in the company suffering detriment or negative publicity, should have their shares redeemed at fair value. Just because the majority shareholder wanted the minority shareholder out did not in itself mean that the resolution was passed in bad faith. It was not so extravagant to suggest that no reasonable person could really consider it for the benefit of the company. It did not matter that the amendment was directed at a particular shareholder nor that the minority was the only person who would be affected by it.

Whilst the Privy Council in *Staray* upheld the introduction of the compulsory redemption power, it decided on the facts that any misrepresentations by the minority shareholder had not been material to the company, meaning that the right to exercise the power had not in fact been triggered. The Privy Council held that you had to look at it from the point of view of the company to which the remedy was given, rather than individual shareholders. What mattered was any practical relevance to M's expected role with C. In short, the technical ability or otherwise to carry on formal practice in China or New York was held to be of no practical significance to C. Conversely, there was nothing to cast doubt on M's ability to carry out the specific tasks he was expected to perform.

Implications

The judgment supports previous case law that the power of majority shareholders to bind a minority by amending articles has to be exercised in good faith in the interests of the company (most recently *Re Charterhouse Capital Ltd: Arbuthnott v Bonnyman*[2]). However, what is in the interests of the company and what amounts to a benefit to the company is a decision for shareholders rather than the court, unless no reasonable person could consider it as such. The burden of proof is on the person challenging the validity of the provisions.

Interestingly, the outcome here in the *Staray* case suggests that it may be possible to introduce compulsory buyout provisions into a pre-existing company's articles which bind a minority, where there is a commercial purpose in doing so and it can be regarded as in the company's interests. This could be helpful when introducing drag-along rights requiring minority shareholders to sell their shares where the majority accept an offer from a third party, or even other compulsory buyout provisions, into inter-shareholder arrangements.

By contrast, the *Charterhouse* case had concerned amendments to pre-existing drag-along provisions in light of a forthcoming MBO transaction. The Court of Appeal in *Charterhouse* had treated those provisions as part of the original commercial bargain between the parties. A key feature of the changes had been to bring the articles into line with the shareholders' agreement, where lack of alignment had been regarded as an impediment to raising a new fund to secure the company's future. By upholding the introduction from scratch of compulsory buyout provisions by amending an existing company's articles, *Staray* goes further.

Key lessons

- How far a new or varied compulsory buyout provision may be open to challenge will depend on the particular facts of a case and whether it can be viewed as in the company's interests, for example to secure its future funding.
- Introducing a drag-along right or other compulsory buyout provision from scratch is still more likely to be susceptible to challenge than varying an existing provision.
- Introducing new inter-shareholder provisions which allow the majority to compulsorily acquire the minority's shares themselves may be more open to question than compulsory buyout provisions, such as drag-along rights, designed to facilitate a sale to a third party. Indeed, the share redemption power in the *Staray* case was a right of the company, not a shareholder party.
- The outcome in *Staray* provides welcome clarity in suggesting that it may be feasible to introduce new drag-along or other compulsory buyout provisions into an existing company's articles of association where this is done in good faith in the company's interests. The judgment also gives useful guidance on factors the court will take into account in deciding whether such changes are valid.

2 [2015] EWCA Civ 536.

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