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NO MINORITY DISCOUNT FOR QUASI-PARTNERSHIPS

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SUMMARY

In Gibbins v Tierney [2024] EWHC 2004 (Ch), the High Court reaffirmed the principles that apply when deciding whether there has been unfair prejudice, within the meaning of section 994 of the Companies Act 2006, in a quasi-partnership. This case is a good example of how unfair prejudice rules are applied by the Courts to quasi partnerships in circumstances where one party has allegedly sought to shut out another from management decisions.

THE FACTS

This case concerned a dispute between a mother ("P"), her son ("R1") and his partner ("R2"). In 2010, P, R1 and R2 began selling cosmetics as a partnership in which they all had an equal share of the business. To enable the partnership, and later the Company, to carry on business, P lent substantial capital sums to it. The capital introduced by P was financed by the encashment of P's private pension and by taking out a mortgage over a property owned by P. R1 and R2 did not contribute any capital.

At the outset, and prior to the commencement of the partnership, P, R1 and R2 orally agreed that:

a. they would jointly manage the business with each of them being entitled to participate in the management of the business;

b. P would manage the partnership's finances and accounts; and

c. each partner would have an equal share in the business.

After a few months, on 6 June 2011, the partnership was incorporated into the third respondent (the "Company") PHB Ethical Beauty Limited (and other companies not relevant to the matter before the Court). Pursuant to the agreement and understanding of P, R1 and R2:

a. P, R1 and R2 were appointed as directors of the Company holding one share each;

b. from 6 June 2011 until August 2020, P, R1 and R2 participated in the management of the Company and its business; and

c. from 6 June 2011 until August 2020, P was responsible for management of the finances and Company accounts.

In 2019, R1 and R2 found a property (the "Property") which they wanted to use as their residence but did not want to purchase themselves. R1 and R2 planned that the Company would take a loan for the sum of £250,000 and would transfer the loan monies together with £325,000 from the Company's own cash reserves to a special purpose vehicle (the "SPV") set up for the purchase and controlled by R1 and R2. R1 and R2 pressured P to agree.

Although P was not in favour, after being pressurised she ultimately agreed but on condition that the sums would be paid back to the Company within a reasonable period. R1 and R2 did not, however, stop there and, in addition to the loan and cash reserves, they also used the Company's funds to pay the stamp duty and conveyancing fees on the purchase, plus further sums for the Property's renovation and improvement.

Once it became clear to P that the SPV was not going to repay the Company within a reasonable period, R1 and R2 proposed that the Company pay back the loan using its own funds. P did not consent but she was worried that R1 and R2 would press ahead regardless, and she therefore transferred the Company's existing funds into a new bank account from which she paid Company expenses such as staff wages until those funds were exhausted. Subsequently, R1 and R2 took various steps to exclude P from the management of the Company, and also caused the Company to repay the loan without P's consent. R1 and R2 then arranged for a new company, Highest Value Holdings Limited ("HVHL") to be incorporated as a vehicle to divert business from the Company. R1 and R2 were the sole directors and shareholders of HVHL.

WHAT ARE QUASI-PARTNERSHIPS?

Quasi-partnerships arise when two or more individuals establish a company together with the following features:

a. a relationship of mutual confidence between shareholders;

b. an understanding that all or some of the shareholders will participate in the conduct of the business; and

c. restrictions on the transfer of shares.

One of key effects of a quasi-partnership is that a Court will grant additional protection to a minority shareholder from being "unfairly prejudiced" by the majority shareholders: in scenarios involving quasi-partnerships, the Court will not apply a minority discount when the minority shareholder's shares are being purchased by the majority or the company. Instead, the Court will value the shares pro rata to the value of the company's shares, therefore increasing the purchase price of the shares that would usually be achieved through a buy-out order.

In the case at hand, at all material times, the Company was a quasi-partnership. This was by reason of the prior partnership agreement, the parties' mutual understanding and the close relationship between P, R1 and R2.

UNFAIR PREJUDICE AND BUY-OUT PRINCIPLES

Under section 994(1) of the Companies Act 2006 (the "CA 2006"), a member of a company may apply to the Court by petition for an order on the ground that:

a. the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of members generally or of some part of its members (including at least herself); or

b. an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

For relief to be granted, the petitioner has to show that both prejudice and unfairness have been caused. When considering whether there has been prejudice, the Court will consider damage to the financial position of a member and may consider damage to the value of their shares, but it may also be of non-financial character such as disregard of rights without any financial consequences. When considering whether there has been unfairness, the Court will look at the terms on which the parties agreed to do business together and will take an objective approach applying established equitable principles.

When deciding whether unfair prejudice occurred, the Court will also consider any breach of directors' duties including those set out in sections 171 – 177 of the CA 2006, for example the duties to:

a. act within powers;

b. promote the success of the company;

c. exercise independent judgment;

d. exercise reasonable care, skill and diligence; and

e. avoid conflict of interest.

Non-compliance by the respondents with these duties will often indicate that unfair prejudice has occurred.

In the case at hand, R1 and R2 failed to observe their directors' duties to promote the success of the Company, exercise independent judgment, exercise reasonable care, skill and diligence, and avoid conflicts of interest.

Where unfair prejudice has occurred and the Court makes a buy-out order, the starting point for valuation is that the petitioner's shares should be valued on the date of the Court's order to purchase the shares.

However, the Court has a wide discretion to depart from this and can order an earlier valuation date, for example where:

a. a company is deprived of its business or assets;

b. a company's business has changed significantly, so that it has a new economic identity; and

c. a minority shareholder has a petition on foot and there is a general fall in the market.

THE UNFAIR PREJUDICE PETITION

In June 2022, P presented an unfair prejudice petition and sought an order from the Court that, as the majority shareholders, R1 and R2 purchase her shares in the Company at fair value with the following assumptions:

a. that there was a willing seller and buyer;

b. 100% value of the shares in the Company were to be valued as a going concern taking into account the assets, profitability and future prospects of the Company at the date properly selected;

c. that there was no discount for minority; and

d. after taking account of and making due allowances for the unfairly prejudicial conduct of the Company's affairs.

THE DECISION

LIABILITY

The High Court accepted P's arguments (which were uncontested, R1 and R2 having taken no part in the proceedings) finding that:

a. the Company is and was at all material times a quasi-partnership;

b. in August 2020, R1 and R2 wrongfully excluded P from participation in the Company, contrary to the agreement and understanding that they would all participate in the management of the

Company;

c. the exclusion of P from participation in the Company's management from August 2020 onwards was prejudicial to her interests and, in the absence of any persuasive evidence of a legitimate reason for the exclusion, that prejudice was unfair;

d. since (at the latest) August 2020, R1 and R2 had used Company funds for their own benefit, and also diverted business of the Company to HVHL;

e. such conduct caused prejudice to P's interests in the Company and, in the absence of any persuasive evidence of a legitimate explanation or reason for the exclusion, the prejudice was unfair;

f. by excluding P from participation in the management of the Company without legitimate reason, and by using its funds for their own benefit and by diverting business to HVHL, R1 and R2 were in breach of their directors' duties under sections 172 - 175 of the CA 2006;

g. such non-compliance with their duties was prejudicial to the interests of P and such prejudice was unfair.

REMEDY

In considering a remedy, the High Court held that the shares should be valued as if the unfairly prejudicial conduct had not taken place, and therefore the appropriate date for valuation purposes was 1 August 2020, a date predating the unfairly prejudicial conduct relied upon and around the date that P was excluded from the management of the Company.

Accordingly, the Court made a buy-out order requiring R1 and R2 to purchase P's shares at face value on the basis that:

a. there was a willing seller and willing buyer;

b. 100% value of the shares in the Company were to be valued as a going concern taking into account its assets, profitability and future prospects as at 1 August 2020; and

c. with no minority discount.

TAKEAWAYS

This judgment helpfully summarises the principles the Courts will apply when considering an unfair prejudice petition, and particularly how they will approach valuation on a buy-out order concerning a quasi-partnership. The judgment highlights that where a company has been deprived of its business or assets as a result of unfairly prejudicial conduct, the Courts are willing to depart from the usual starting point on a buy-out order that the shares should be valued on the date of the purchase, and will order an earlier valuation date if that is required as a matter of "fairness" to the petitioner.

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