COMMERCIAL CHAMBERS

“Good faith” between shareholders

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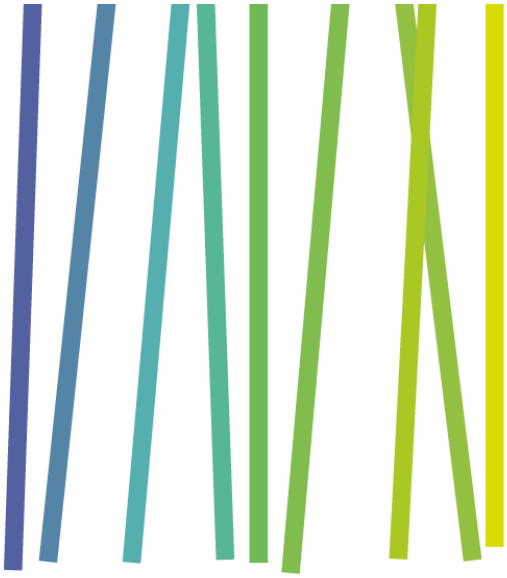

When it is owed, what it involves and its growing importance in claims for relief from unfairly prejudicial conduct pursuant to section 994 Companies Act 2006

Historically, the courts of England and Wales were not prepared to imply a duty of “good faith” as between contracting parties. So, in the absence of an express contractual provision, a contracting party did not owe a duty to act in “good faith” and so was not required to act in “good faith” towards other contracting parties.

In 2013, Leggatt J (now Lord Leggatt of the Supreme Court) challenged that orthodox view with his decision in Yam Seng Pte Ltd v International Trade Corp Ltd [2013] EWHC 111. He held that where the relevant contract was “relational” in character the court might well be prepared to imply a duty of ‘good faith’ between the parties. The rational for such implication seems to be the fact that trust and confidence is key to such long lasting relationships.

A shareholders’ agreement might be said to be, perhaps, a paradigm example of a “relational” contract and the courts have now shown themselves to be willing to imply a term requiring the parties to act in ‘good faith” towards one another even where the relevant shareholders’ agreement does not expressly seek to impose such a duty.

Indeed, the courts have been prepared to imply a duty of “good faith” in appropriate circumstances even where a written shareholders’ agreement was professionally drawn up but didn’t contain an express duty of “good faith” and even if the shareholders’ agreement contained an entire agreement clause.

Where a duty of “good faith” is either expressly provided for in or is to be implied into a shareholders’ agreement a breach of that duty may involve unfairly prejudicial conduct of the relevant company’s affairs

contrary to the interests of the other shareholders party to that agreement such that a victim is likely to be afforded relief under section 994 of the Companies Act 2006.

So what does fulfilment of a duty of “good faith” require from the shareholders in a company? In particular, what behaviour is likely to be considered as amounting to a breach of a duty of “good faith” such that it might constitute unfairly prejudicial conduct of the affairs of a company?

On one level it might be said that a breach of a duty of “good faith” requires the demonstration of “bad faith”. Such an observation is a bit circular to be particularly helpful but it does suggest at least suggest a subjective element to the establishment of a breach of a duty of “good faith”.

In the Yam Seng Pte Ltd v International Trade Corp Ltd itself, the court emphasised that the requirements of a duty of ‘good faith” were sensitive to the context in which that duty was owed. Relying on the decision in Royal Brunei Airlines Sdn Bhd v Tan [1995] 2 AC 378, Leggatt J held that the requirements of a duty of “good faith” did not depend on a party’s own perception of whether particular conduct was improper but on whether the conduct concerned would be regarded as commercially unacceptable by reasonable and honest people. That decision seemed to require an objective assessment of whether a party to a contract had fulfilled a duty of “good faith” owed to other parties.

In Re Coroin Ltd [20130 EWCA Civ 781, a case actually concerning an express contractual duty of “good faith” owed between shareholders in a company, the Court of Appeal indicated that the duty of “good faith” involved an obligation to act honestly in a subjective sense as that was the natural meaning of the clause in the context of that case which did not suggest some wider meaning or objective test had to be applied to it. The court seemed to be of the view that in the circumstances of that case a lack of “good faith” required conscious “bad faith”. Negligence or oversight was not sufficient in that case to amount to a lack of “good faith”.

Two recent cases have, however, suggested that a much more objective test of “good faith” might be adopted in other circumstances. They are both decisions of courts junior to that in Re Coroin Ltd and so one would have considered themselves bound by the decision in that case. But, in each case, the decisions of the courts of first instance seem to have been able to distinguish Re Coroin Ltd and apply a much more objective assessment of whether there had been an absence of “good faith”.

The first is Unwin v Bond [2020] EWHC 1768. Again the case concerned an express duty of “good faith”. It was accepted that in dismissing the petitioner from his employment the respondent had not been improperly motivated by a desire to obtain the petitioner’s shareholding cheaply pursuant to “bad leaver” provisions but with a genuine view to preserving the business of the company. The court held that the extent of a contractual duty of “good faith” depended on the context in which it was owed. The duty of “good faith” was made up of a number of potentially overlapping elements. Those elements included requirements to act “honestly”; “faithfully to the agreed common purpose of the parties”; not for an “ulterior purpose” and “fairly and openly taking into account the other shareholders’ interests as well as their own”.

There was no need to show dishonesty or even an improper purpose behind the actions said to be in breach of the duty of "good faith". Rather, a breach of a duty of "good faith" was held to have occurred in circumstances where one shareholder had simply not dealt fairly and openly with another and had not had regard for that other's interests when dismissing him from his position as an employee.

In Faulkner v Vollin Holdings Ltd [2021] EWHC 787 the court seems, perhaps, to have gone further still. In that case a director appointed by the minority shareholder was removed from office by the majority shareholder. That removal was clearly effective. However, it was held to have involved a breach of, again, an express contractual duty of "good faith" imposed by the terms of the shareholders' agreement. The judge determined that, whilst the majority shareholder clearly had the power to remove the director, the express contractual duty of "good faith" required that the majority shareholder in exercising that power was bound to act with "fidelity to the bargain" he had struck with his fellow shareholders. That again seems to involve an objective analysis to what "bargain" has indeed been concluded between the shareholders as it is expressed within the shareholders' agreement as well as the memorandum and articles of association of the company and whether or not a shareholder has acted in a manner consistent with or contrary to that "bargain". The court also, seemingly, went so far as to identify the duty of "good faith" as requiring a shareholder to consider and act "in accordance with all relevant factors" and "in accordance with due process". Those concepts seem to accord with the standards one might expect to be required of public officers or bodies in an administrative law context. It certainly goes well beyond a subjective assessment as to whether there has been "good faith" or "bad faith".

The decisions in Unwin v Bond and Faulkner v Vollin Holdings Limited certainly suggest a potentially much broader scope to an express or implied duty of "good faith" and a more objective content to the duty imposed. The decision in Faulkner v Vollin Holdings Ltd is currently subject to an appeal. We will have to wait for further decisions to see whether a narrower subjective or a broader objective approach will prevail and for clarity as to the circumstances in which either approach is to be preferred. In the interim, it seems certain that allegations of breaches of an express or implied duty of "good faith" are likely to be relied upon more and more in claims for relief from unfairly prejudicial conduct of the affairs of a company pursuant to section 994 of the Companies Act 2006.

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