*1092 O'Neill and Another v Phillips and Others [On appeal from In re A Company (No. 00709 of 1992)]

Positive/Neutral Judicial Consideration

Court
House of Lords

Judgment Date
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House of Lords

Lord Hoffmann , Lord Jauncey of Tullichettle , Lord Clyde , Lord Hutton and Lord Hobhouse of Woodborough

1999 Feb. 22, 23; May 20

Company—Unfair prejudice—Conduct of affairs—Private company—Withdrawal by majority shareholder from negotiations with petitioner for equal shareholding and profit-sharing—Whether conduct "unfairly prejudicial" to petitioner's interests as shareholder—Whether petitioner having legitimate expectation— Companies Act 1985 (c. 6), s. 459(1) (as amended by Companies Act 1989 (c. 40), s. 145, Sch. 19, para. 11)

In 1983 P. Ltd., a private company, employed O. as a manual worker. P., who owned the entire issued share capital of the company of 100 £1 shares, in 1985 gave O. 25 shares and appointed him a director. He expressed the hope that O. would take over the running of the company, in which case he would be allowed to draw 50 per cent. of the profits. O. took over the running of the company and was credited with half the profits. In 1989 and 1990 there were negotiations in which P. indicated that he was in principle willing to increase O.'s shareholding and voting rights to 50 per cent. when certain targets were reached. In 1991, however, he became concerned about O.'s management of the company and decided to resume personal command. He told O. *1093 that he would no longer receive 50 per cent. of the profits but only his salary and any dividends payable on his 25 per cent. shareholding. O. issued a petition under section 459 of the Companies Act 1985 [1] complaining, inter alia, of P.'s termination of equal profit-sharing and repudiation of an alleged agreement for the allotment to him of more shares. The judge dismissed the petition, holding that P. had not committed himself permanently and unconditionally to equal profit-sharing or the allotment to O. of more shares and that accordingly it had not been unfair of him to redraw O.'s responsibilities and remuneration and to retain his own majority shareholding. He further held that any prejudice to O.'s interests had not been suffered by him in his capacity as a shareholder. The Court of Appeal allowed an appeal by O. and ordered P. to purchase O.'s shares, holding that O. had had a legitimate expectation that he would receive more shares and 50 per cent. of the profits when the targets were reached and had suffered unfair prejudice as a shareholder.

On appeal by P.: —

Held , allowing the appeal, that, although it might in certain circumstances be unfair for those conducting the affairs of a company to rely on their strict legal powers, ordinarily unfairness to a member required some breach of the terms on which

he had agreed that the company's affairs should be conducted; that, since P. had not agreed unconditionally to give O. more shares or to share equally in the profits, he could not be said to have acted unfairly in withdrawing from the negotiations to that end; and that a member of a company who had not been dismissed or excluded from participation in its management was not entitled to demand the purchase of his shares simply because of a breakdown in trust and confidence between the parties (post, pp. 1098H–1099A , 1103D–E , 1104G , 1108C–F).

In re Westbourne Galleries Ltd. [1973] A.C. 360, H.L.(E.) applied .

Decision of the *Court of Appeal [1997] 2 B.C.L.C. 739* reversed.

The following cases are referred to in the opinion of Lord Hoffmann:

Astec (B.S.R.) Plc., In re [1998] 2 B.C.L.C. 556
Blisset v. Daniel (1853) 10 Hare 493
Cade (J. E.) & Son Ltd., In re [1992] B.C.L.C. 213
Calderbank v. Calderbank [1976] Fam. 93; [1975] 3 W.L.R. 586; [1975] 3 All E.R. 333, C.A.
Company (No. 006834 of 1988), In re A, Ex parte Kremer [1989] 5 B.C.L.C. 365
Company (No. 00314 of 1989), In re A, Ex parte Estate Acquisition and Development Ltd. [1991] B.C.L.C. 154
Harmer (H. R.) Ltd., In re [1959] 1 W.L.R. 62; [1958] 3 All E.R. 689, C.A.
Harrison (Saul D.) & Sons Plc., In re [1995] 1 B.C.L.C. 14, C.A.
R. & H. Electrical Ltd. v. Haden Bill Electrical Ltd. [1995] 2 B.C.L.C. 280
Virdi v. Abbey Leisure Ltd. [1990] B.C.L.C. 342, C.A.
Westbourne Galleries Ltd., In re [1973] A.C. 360; [1972] 2 W.L.R. 1289; [1972] 2 All E.R. 492, H.L.(E.)
Wondoflex Textiles Pty. Ltd., In re [1951] V.L.R. 458

The following additional cases were cited in argument:

Company (No. 002567 of 1982), In re A [1983] 1 W.L.R. 927; [1983] 2 All E.R. 854
Company (No. 007623 of 1984), In re A [1986] B.C.L.C. 362 ****1094***
Company (No. 008699 of 1985), In re A [1986] B.C.L.C. 382
Company (No. 00477 of 1986), In re A [1986] B.C.L.C. 376
Eiserman v. Ara Farms Ltd. (1988) 52 D.L.R. (4th) 498
Elgindata Ltd., In re [1991] B.C.L.C. 959
Jesner v. Jarrad Properties Ltd. [1993] B.C.L.C. 1032
Noble (R. A.) & Sons (Clothing) Ltd., In re [1983] B.C.L.C. 273
Posgate & Denby (Agencies) Ltd., In re [1987] B.C.L.C. 8
Tay Bok Choon v. Tahansan Sdn. Bhd. [1987] 1 W.L.R. 413, P.C.
Vujnovich v. Vujnovich [1990] B.C.L.C. 227
Walker v. Walker [1997] 3 W.W.R. 342
Western Excavating (E.C.C.) Ltd. v. Sharp [1978] Q.B. 761; [1978] 2 W.L.R. 344; [1978] 1 All E.R. 713, C.A.
Woods v. W. M. Car Services (Peterborough) Ltd. [1981] I.C.R. 666, E.A.T.

Appeal from the Court of Appeal.

This was an appeal by the respondents, Michael Phillips, Lisa Phillips and Pectel Ltd. (“the company”), by leave of the House of Lords (Lord Slynn of Hadley, Lord Hoffmann and Lord Hutton) given on 27 October 1997 from the decision of the Court of Appeal (Nourse, Potter and Mummery L.JJ.) on 1 May 1997 allowing an appeal by the petitioners, Mark Anthony O'Neill and Linda Ann O'Neill, from the decision of Judge Paul Baker Q.C. sitting as a judge of the Chancery Division on 27 July 1995. The judge had dismissed the petitioners' petition under section 459(1) of the Companies Act 1985 claiming that the affairs of the company were being or had been or were proposed to be conducted in a manner unfairly prejudicial to its

members including the petitioners within the meaning of section 459(1) and seeking, inter alia, an order under Part XVII of the Act that the first respondent or the company purchase the petitioners shares in the company at a fair value to be fixed by the court, alternatively an order that the company be wound up pursuant to the provisions of the Insolvency Act 1986 on the ground that it was just and equitable to do so within section 122(1)(g) .

The facts are stated in the opinion of Lord Hoffmann.

Representation

Peter Ralls Q.C. Timothy Walker and for the respondents.
R. F. Hollington for the petitioners.

Lord Hoffmann

Their Lordships took time for consideration.

20 May. Lord Hoffmann . My Lords, this appeal raises, for the first time in your Lordships House, a question on the scope of the remedy which Part XVII (sections 459–461) of the Companies Act 1985 provides for a member of a company, typically holding a minority of the shares, who considers that the company's affairs are being conducted in a manner unfairly prejudicial to his interests.

1. The statute

Section 459(1) (as amended by the Companies Act 1989, Schedule 19, paragraph 11) reads:

> "A member of a company may apply to the court by petition for an order under this Part on the ground that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself) or that any actual or proposed ***1095*** act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial"

Section 461(1) provides that if the court is satisfied that a petition under Part XVII is well founded, it may make "such order as it thinks fit for giving relief in respect of the matters complained of." Without prejudice to the generality of this jurisdiction, the court may make all or any of a number of orders specified in subsection (2) . These include orders regulating the future conduct of the company's affairs, requiring the company to do or refrain from doing some act and, the remedy most commonly sought, an order under section 461(2)(d) providing for the purchase of the petitioner's shares by other members of the company or the company itself.

2. The facts

The issue in this appeal is whether the company's affairs were conducted in a manner "unfairly prejudicial" to the petitioner's interests within the meaning of section 459(1). Since on any view this must depend upon the particular facts of the case, I must start with a summary of the findings *[1997] 2 B.C.L.C. 739* of Judge Paul Baker Q.C., who heard the petition.

Pectel Ltd. (“the company”) operates in the construction industry, providing specialist services for stripping asbestos from buildings. In 1983 it employed the petitioner Mr. O'Neill as a manual worker. The respondent to the petition and appellant before your Lordships is Mr. Phillips, an accountant. In 1983, having bought out another shareholder, he held the entire issued share capital of 100 £1 shares. Mr. Phillips was impressed by Mr. O'Neill's energy and ability and advanced him rapidly to foreman, site supervisor and contracts manager. In January 1985. Mr. Phillips gave Mr. O'Neill 25 shares and appointed him a director. In May of that year they had an informal discussion at which Mr. Phillips expressed the hope that Mr. O'Neill would be able to take over fully the day-to-day running of the company. He also indicated that on that basis he would allow him to draw 50 per cent. of the company's profits.

Mr. O'Neill did take over the running of the business and on 30 December 1985 Mr. Phillips retired from the board, leaving Mr. O'Neill as sole director. Although not so described, he was in effect managing director. During the construction boom of the late 1980s, the company prospered. Mr. O'Neill was credited with half the profits, some of which he drew in the form of salary and dividends and some of which he left in the company. When a dividend was declared, Mr. Phillips would waive a third of his 75 per cent. entitlement in favour of Mr. O'Neill to produce equality. In 1988 £49,900 of retained profits, which partly represented Mr. O'Neill's undrawn entitlement, was capitalised by the issue of bonus shares to increase the company's issued share capital to £50,000. They were allotted in the same proportions as their existing holdings. In September 1990 another £50,000 was capitalised in the same way, except that this time non-voting shares were issued. Mr. O'Neill also guaranteed the company's bank account and he and his wife mortgaged their house in support of the guarantee. So that by 1990 Mr. O'Neill had put some of his own earnings into the capital of the company and was potentially liable to contribute more under the guarantee.

For two years, between the beginning of 1989 and the end of 1990, there were discussions with a view to Mr. O'Neill obtaining a 50 per cent. shareholding. Solicitors, counsel and the company's accountants were ***1096*** consulted. Draft documents were prepared. By October 1990 negotiations had reached a point at which Mr. Phillips indicated that in principle he was willing to increase Mr. O'Neill's shareholding to 50 per cent. when the company's net asset value reached £500,000 and his voting rights to 50 per cent. when it reached £1,000,000. These figures were referred to as the targets. It was contemplated that a formal agreement would be drafted to embody these terms and any others which might be found desirable. But this did not happen. At that point, the negotiations stopped. The judge found that there was never any concluded agreement for the allocation of more shares to Mr. O'Neill.

1989–90 was the last good year before the construction boom came to an end. The retained profits were £158,759. The company extended its business to Germany. In 1991, however, the industry went into recession and the company was struggling. Mr. Phillips became alarmed about its financial position and concerned about Mr. O'Neill's management. At the beginning of August 1991 he decided, as controlling shareholder, to resume personal command. He gave Mr. O'Neill the option of managing, under him, the U.K. or the German branches of the business. Mr. O'Neill chose to go to Germany. Mr. Phillips became in effect managing director and assumed that title in November. Mr. O'Neill remained on the board as an ordinary director.

It is clear that Mr. Phillips was not as impressed with Mr. O'Neill's energy and commitment when times were bad as he had been when they were good. He was critical of his conduct of the German side of the business and matters came to a head at an acrimonious meeting on 4 November 1991. Mr. Phillips, as he himself put it in his evidence, “ranted and raved.” He made his criticisms forcibly and pungently. He also told Mr. O'Neill that as he was no longer acting as managing director he would no longer receive 50 per cent. of the profits. He would be paid only his salary and any dividends payable upon his 25 per cent. holding. Mr. O'Neill made no comment. The meeting came to an end and he went back to his work in Germany.

Mr. Phillips heard no more on the subject from Mr. O'Neill until he received a letter dated 17 December 1991, which Mr. O'Neill had written after consultation with his sister, who is a solicitor. In the meanwhile, however, Mr. O'Neill had prepared

to sever his links with the company. He gave notice to terminate his guarantee of the bank account, which was at the time in credit. He made arrangements with two other employees to set up a competing business in Germany. They negotiated for financial support from a bank. There was nothing wrong in this: Mr. O'Neill had not entered into any covenant with the company not to compete after he left its employment.

The letter of 17 December 1991 was in effect a letter before action. It said that Mr. Phillips had broken his promises to pay Mr. O'Neill 50 per cent. of the profits and to allot him (subject to reaching the targets) 50 per cent. of the shares. He had thereby reduced his position to that of an employee. He also made a number of allegations of financial abuse, amounting to dishonesty, on the part of Mr. Phillips and ended by saying that he had "no alternative but to seek legal advice and instigate the dissolution of our partnership." On 22 January 1992, without further correspondence, Mr. O'Neill issued a petition under section 459 . He also issued a writ claiming damages for anticipatory breach of an alleged oral agreement to allot him more shares when the targets had been reached.

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3. The petition

The petition, like the letter of 17 December 1991, contained a number of allegations of financial impropriety on the part of Mr. Phillips. But these were abandoned at the hearing. Both shareholders gave evidence. The judge found that he much preferred the evidence of Mr. Phillips, which he said was careful and straightforward, to that of Mr. O'Neill, who was on some matters unsatisfactory and prevaricating. He was, the judge said, "inclined to see base motives in everything that Mr. Phillips did"

In the end, therefore, the allegations of unfairly prejudioial conduct came down to two complaints. The first was Mr. Phillips's termination of equal profit-sharing and the second was his repudiation of the alleged agreement for the allotment of more shares. The judge rejected these and dismissed the petition on two grounds. One was that it fails on the facts. Mr. Phillips had not committed himself permanently and unconditionally to an equal sharing of profits. Mr. O'Neill's expectation was to receive 50 per cent. while he acted as managing director. But if circumstances changed, Mr. Phillips was entitled as controlling shareholder to redraw his responsibilities and remuneration. He had made no commitment which made it unfair for him to exercise this power. Likewise in the case of the additional shares. The matter had never gone beyond negotiation and Mr. Phillips had made no promises. It was therefore not unfair for him to retain his majority holding. For the same reason, the judge dismissed the claim to damages in the writ action but made by consent an order for an account on undrawn profits. An appeal against the judgment in the writ action was not pursued.

The judge's second ground for dismissing the petition was that the prejudice to Mr. O'Neill's interests from the reduction in his profit-share and refusal to give him more shares was not suffered in his capacity as a shareholder, as a member of the company. The profit-share was his remuneration for acting as managing director and the additional shares were likewise a reward and incentive for working for the company. They did not derive from his previously having had a 25 per cent. shareholding. On the contrary, that too had been a reward for his services as an employee. Mr. O'Neill's membership of the company was therefore irrelevant to the expectations which he claimed it would be unfair to deny. They would have been exactly the same if he had not previously held any shares at all.

4. The Court of Appeal

The *Court of Appeal (Nourse, Potter and Mummery L.JJ.) [1997] 2 B.C.L.C. 739* allowed the appeal and ordered Mr. Phillips to buy Mr. O'Neill's shares. Nourse L.J. gave the judgment. He said, at p. 767, that although there was no concluded agreement about giving him more shares, he had a "legitimate expectation" that he would receive them when the targets were reached. Likewise, he had a legitimate expectation of receiving 50 per cent. of the profits. It was therefore unfairly prejudicial of Mr. Phillips to deny these expectations without giving Mr. O'Neill "notice and an opportunity to defend himself" or offering to buy his shares at a fair value: p. 770. The Court of Appeal made the important additional finding, at p. 767, that Mr. O'Neill

had been in effect "forced out of the company." In view of the denial of his legitimate expectations, he could no longer be expected to remain with the company and "was bound to engage himself elsewhere"

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Nourse L.J. also rejected the judge's second reason. One took, he said, a broad view of the interests of a member. They were not necessarily limited to his strict legal rights. So, for example, a member who had subscribed for shares on the understanding that he would take part in the management of the company might have an interest as member in his continuing participation, though this was not a right attached to his shares under the articles of the company. Nourse L.J. considered that there was no other relevant capacity in which the unfair prejudice of which Mr. O'Neill complained could have been suffered. He did not expressly deal with the possibility that it might have been as an employee. It must of course be borne in mind that whereas the judge was considering only the prejudice arising from the termination of the profit-sharing and share allocation arrangements. the Court of Appeal was taking a more global view and treating them as part of conduct by which Mr. O'Neill was deprived of all participation in the affairs of the company by a kind of constructive expulsion.

5. "Unfairly prejudicial"

In section 459 Parliament has chosen fairness as the criterion by which the court must decide whether it has jurisdiction to grant relief. It is clear from the legislative history (which I discussed in *In re Saul D. Harrison & Sons Plc. [1995] 1 B.C.L.C. 14* , 17–20) that it chose this concept to free the court from technical considerations of legal right and to confer a wide power to do what appeared just and equitable. But this does not mean that the court can do whatever the individual judge happens to think fair. The concept of fairness must be applied judicially and the content which it is given by the courts must be based upon rational principles. As Warner J. said in *In re J.E. Cade & Son Ltd. [1992] B.C.L.C. 213* , 227: "The court … has a very wide discretion, but it does not sit under a palm tree"

Although fairness is a notion which can be applied to all kinds of activities its content will depend upon the context in which it is being used. Conduct which is perfectly fair between competing businessmen may not be fair between members of a family. In some sports it may require, at best, observance of the rules, in others ("it's not cricket") it may be unfair in some circumstances to take advantage of them. All is said to be fair in love and war. So the context and background are very important.

In the case of section 459, the background has the following two features. First, a company is an association of persons for an economic purpose, usually entered into with legal advice and some degree of formality. The terms of the association are contained in the articles of association and sometimes in collateral agreements between the shareholders. Thus the manner in which the affairs of the company may be conducted is closely regulated by rules to which the shareholders have agreed. Secondly, company law has developed seamlessly from the law of partnership, which was treated by equity, like the Roman societas, as a contract of good faith. One of the traditional roles of equity, as a separate jurisdiction, was to restrain the exercise of strict legal rights in certain relationships in which it considered that this would be contrary to good faith. These principles have, with appropriate modification, been carries over into company law.

The first of these two features leads to the conclusion that a member of a company will not ordinarily be entitled to complain of unfairness ***1099** unless there has been some breach of the terms on which he agreed that the affairs of the company should be conducted. But the second leads to the conclusion that there will be cases in which equitable considerations make it unfair for those conducting the affairs of the company to rely upon their strict legal powers. Thus unfairness may consist in a breach of the rules or in using the rules in a manner which equity would regard as contrary to good faith.

This approach to the concept of unfairness in section 459 runs parallel to that which your Lordships' House, in *In re Westbourne Galleries Ltd. [1973] A.C. 360* , adopted in giving content to the concept of "just and equitable" as a ground for

winding up. After referring to cases on the equitable jurisdiction to require partners to exercise their powers in good faith, Lord Wilberforce said, at p. 379:

> "The words ['just and equitable'] are a recognition of the fact that a limited company is more than a mere legal entity, with a personality in law of its own: that there is room in company law for recognition of the fact that behind it, or amongst it, there are individuals, with rights, expectations and obligations inter se which are not necessarily submerged in the company structure. That structure is defined by the Companies Act [1948] and by the articles of association by which shareholders agree to be bound. In most companies and in most contexts, this definition is sufficient and exhaustive, equally so whether the company is large or small. The 'just and equitable' provision does not, as the respondents [the company] suggest, entitle one party to disregard the obligation he assumes by entering a company, nor the court to dispense him from it. It does, as equity always does, 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."

I would apply the same reasoning to the concept of unfairness in section 459. The Law Commission, in its Report on Shareholder Remedies (1997) (Law Com. No. 246), p. 43, para. 4.11, expresses some concern that defining the content of the unfairness concept in the way I have suggested might unduly limit its scope and that "conduct which would appear to be deserving or a remedy may be left unremedied …" In my view, a balance has to be struck between the breadth of the discretion given to the court and the principle of legal certainty. Petitions under section 459 are often lengthy and expensive. It is highly desirable that lawyers should be able to advise their clients whether or not a petition is likely to succeed. Lord Wilberforce, after the passage which I have quoted, said that it would be impossible "and wholly undesirable" to define the circumstances in which that application of equitable principles might make it unjust, or inequitable (or unfair) for a party to insist on legal rights or to exercise them in particular way. This of course is right. But that does not mean that there are no principles by which those circumstances may be identified. The way in which such equitable principles operate is tolerably well settled and in my view it would be wrong to abandon them in favour of some wholly indefinite notion of fairness.

I should make it clear that the parallel I have drawn between the notion of "just and equitable" as explained by Lord Wilberforce in *In re Westbourne Galleries Ltd.* and the notion of fairness in section 459 does ***1100** not mean that conduct will not be unfair unless it would have justified an order to wind up the company. There was such a requirement in section 210 of the Companies Act 1948 but it was not repeated in section 459. As Mummery J. observed in *In re A Company (No. 00314 of 1989), Ex. parte Estate Acquisition and Development Ltd. [1991] B.C.L.C. 154* , 161, the grant of one remedy will not necessarily require proof of conduct which would have justified a different remedy:

> "Under sections 459 to 461 the court is not … faced with a death sentence decision dependent on establishing just and equitable grounds for such a decision. The court is more in the position of a medical practitioner presented with a patient who is alleged to be suffering from one or more ailments which can be treated by an appropriate remedy applied during the course of the continuing life of the company."

The parallel is not in the conduct which the court will treat as justifying a particular remedy but in the principles upon which it decides that the conduct is unjust, inequitable or unfair.

An example of such equitable principles in action is *Blisset v. Daniel (1853) 10 Hare 493* to which Lord Wilberforce referred in *In re Westbourne Galleries Ltd. [1973] A.C. 360* , 381. Page Wood V.-C. held that upon the true construction of the articles, two-thirds of the partners could expel a partner by serving a notice upon him without holding any meeting or giving any reason. But he held that the power must be exercised in good faith. He said, *10 Hare 493* , 523, that "the literal construction of these articles cannot be enforced" and, after citing from the title "De Societate" in Justinian's *Institutes* , went on, at pp. 523–425:

> "It must be plain, that you can neither exercise a power of this description by dissolving the partnership, nor do any other act for purposes contrary to the plain general meaning of the deed, which must be this — that this power is inserted, not for the benefit of any particular parties holding two-thirds of the shares, but for the benefit of the whole society and partnership …"

In the Australian case of *In re Wondoflex Textiles Ltd. Ltd. [1951] V.L.R. 458* , 467, Smith J. also contrasted the literal meaning of the articles with the trud intentions of the parties:

> "It is also true, I think, that, generally speaking, a petition for winding up, based upon the partnership analogy, cannot succeed if what is complained of is merely a valid exercise of powers conferred in terms by the articles … Th hold otherwise would enable a member to be relieved from the consequences of a bargain knowingly entered into by him … But this, I think, is subject to an important qualification. Acts which, in law, are a valid exercise of powers conferred by the articles may nevertheless by entirely outside what can fairly be regarded as having been in the contemplation of the parties when they became members of the company; and in such cases the fact that what has been done is not in excess of power will not necessarily be an answer to a claim for winding up. Indeed, it may be said that one purpose of [the just and equitable provision] is to enable the court to relieve a party from this bargain in such cases."

I cite these references to "the literal construction of these articles" contrasted with good faith and "the plain general meaning of the deed" ***1101** and "what the parties can fairly have had in contemplation" to show that there is more than one theoretical basis upon which a decision like *Blisset v. Daniel* can be explained. Nineteenth century England law, with its division between law and equity, traditionally took the view that while literal meanings might prevail in a court of law, equity could give effect to what it considered to have been the true intentions of the parties by preventing or restraining the exercise of legal rights. So Smith J. speaks of the exercise of the power being valid "in law" but its exercise not being just and equitable because contrary to the contemplation of the parties. This way of looking at the matter is a product of English legal history which has survived the amalgamation of the courts of law and equity. But another approach, in a different legal culture, might be simply to take a less literal view of "legal" construction and interpret the article themselves in accordance with what Page Wood V.-C. called "the plain general meaning of the deed." Or one might, as in Continental systems, achieve the same result by introducing a general requirement of good faith into contractual performance. These are all different ways of doing the same thing. I do not suggest there is any advantage in abandoning the traditional English theory, even though it is derived from arrangements for the administration of justice which were abandoned over a century ago. On the contrary, a new and

unfamiliar approach could only cause uncertainty. So I agree with Jonathan Parker J. when he said in *In re Astec (B.S.R.) Plc. [1998] 2 B.C.L.C. 556* , 588:

> "in 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."

This is putting the matter in very traditional language, reflecting in the word "conscience" the ecclesiastical origins of the long-departed Court of Chancery. As I have said, I have no difficulty with this formulation. But I think that one useful cross-check in a case like this is to ask whether the exercise of the power in question would be contrary to what the parties, by words or conduct, have actually agreed. Would it conflict with the promises which they appear to have exchanged? In *Blisset v. Daniel* the limits were found in the "general meaning" of the partnership articles themselves. In a quasi-partnership company, they will usually be found in the understandings between the members at the time they entered into association. But there may be later promises, by words or conduct, which it would be unfair to allow a member to ignore. Nor is it necessary that such promises should be independently enforceable as a matter of contract. A promise may be binding as a matter of justice and equity although for one reason or another (for example, because in favour of a third party) it would not be enforceable in law.

I do not suggest that exercising rights in breach of some promise or undertaking is the only form of conduct which will be regarded as unfair for the purposes of section 459. For example, there may be some event which puts an end to the basis upon which the parties entered into association with each other, making it unfair that one shareholder should insist upon the continuance of the association. The analogy of contractual frustration suggests itself. The unfairness may arise not from what the parties have positively agreed but from a majority using its legal powers to maintain the association in circumstances to which the minority can ***1102*** reasonably say it did not agree: non haec in foedera veni. It is well recognised that in such a case there would be power to wind up the company on the just and equitable ground (see *Virdi v. Abbey Leisure Ltd. [1990] B.C.L.C. 342*) and it seems to me that, in the absence of a winding up, it could equally be said to come within section 459. But this form of unfairness is also based upon established equitable principles and it does not arise in this case.

6. Legitimate expectations

In *In re Saul D. Harrison & Sons Plc. [1995] 1 B.C.L.C. 14* , 19, I used the term "legitimate expectation," borrowed from public law, as a label for the "correlative right" to which a relationship between company members may give rise in a case when, on equitable principles, it would be regarded as unfair for a majority to exercise a power conferred upon them by the articles to the prejudice of another member. I gave as an example the standard case in which shareholders have entered into association upon the understanding that each of them who has ventured his capital will also participate in the management of the company. In such a case it will usually be considered unjust, inequitable or unfair for a majority to use their voting power to exclude a member from participation in the management without giving him the opportunity to remove his capital upon reasonable terms. The aggrieved member could be said to have had a "legitimate expectation" that he would be able to participate in the management or withdraw from the company.

It was probably a mistake to use this term, as it usually is when one introduces a new label to describe a concept which is already sufficiently defined in other terms. In saying that it was "correlative" to the equitable restraint, I meant that it could exist only when equitable principles of the kind I have been describing would make it unfair for a party to exercise rights under the articles. It is a consequence, not a cause, of the equitable restraint. The concept of a legitimate expectation should

not be allowed to lead a life of its own, capable of giving rise to equitable restraints in circumstances to which the traditional equitable principles have no application. That is what seems to have happened in this case.

7. Was Mr. Phillips unfair?

The Court of Appeal found that by 1991 the company had the characteristics identified by Lord Wilberforce in *In re Westbourne Galleries Ltd. [1973] A.C. 360* as commonly giving rise to equitable restraints upon the exercise of powers under the articles. They were (1) an association formed or continued on the basis of a personal relationship involving mutual confidence; (2) an understanding that all, or some, of the shareholders shall participate in the conduct of the business; and (3) restrictions on the transfer of shares, so that a member cannot take out his stake and go elsewhere. I agree. It follows that it would have been unfair of Mr. Phillips to use his voting powers under the articles to remove Mr. O'Neill from participation in the conduct of the business without giving him the opportunity to sell his interest in the company at a fair price. Although it does not matter, I should say that I do not think that this was the position when Mr. O'Neill first acquired his shares in 1985. He received them as a gift and an incentive and I do not think that in making that gift Mr. Phillips could be taken to have surrendered his right to dismiss Mr. O'Neill from the management without making him an offer ***1103*** for the shares. Mr. O'Neill was simply an employee who happened to have been given some shares. But over the following years the relationship changed. Mr. O'Neill invested his own profits in the company by leaving some on loan account and agreeing to part being capitalised as shares. He worked to build up the company's business. He guaranteed its bank account and mortgaged his house in support. *In re H. R. Harmer Ltd. [1959] 1 W.L.R. 62* shows that shareholders who receive their shares as a gift but afterwards work in the business may become entitled to enforce equitable restraints upon the conduct of the majority shareholder.

The difficulty for Mr. O'Neill is that Mr. Phillips did not remove him from participation in the management of the business. After the meeting on 4 November 1991 he remained a director and continued to earn his salary as manager of the business in Germany. The Court of Appeal held that he had been constructively removed by the behaviour of Mr. Phillips in the matter of equality of profits and shareholdings. So the question then becomes whether Mr. Phillips acted unfairly in respect of these matters.

To take the shareholdings first, the Court of Appeal said that Mr. O'Neill had a legitimate expectation of being allotted more shares when the targets were met. No doubt he did have such an expectation before 4 November and no doubt it was legitimate, or reasonable, in the sense that it reasonably appeared likely to happen. Mr. Phillips had agreed in principle, subject to the execution of a suitable document. But this is where I think that the Court of Appeal may have been misled by the expression "legitimate expectation." The real question is whether in fairness or equity Mr. O'Neill had a right to the shares. On this point, one runs up against what seems to me the insuperable obstacle of the judge's finding that Mr. Phillips never agreed to give them. He made no promise on the point. From which it seems to me to follow that there is no basis, consistent with established principles of equity, for a court to hold that Mr. Phillips was behaving unfairly in withdrawing from the negotiation. This would not be restraining the exercise of legal rights. It would be imposing upon Mr. Phillips an obligation to which he never agreed. Where, as here, parties enter into negotiations with a view to a transfer of shares on professional advice and subject to a condition that they are not to be bound until a formal document has been executed, I do not think it is possible to say that an obligation has arisen in fairness or equity at an earlier stage.

The same reasoning applies to the sharing of profits. The judge found as a fact that Mr. Phillips made no unconditional promise about the sharing of profits. He had said informally that he would share the profits equally while Mr. O'Neill managed the company and he himself did not have to be involved in day-to-day business. He deliberately retained control of the company and with it, as the judge said, the right to redraw Mr. O'Neill's responsibilities. This he did without objection in August 1991. The consequence was that he came back to running the business and Mr. O'Neill was no longer managing director. He had made no promise to share the profits equally in such circumstances and it was therefore not inequitable or unfair for him to refuse to carry on doing so. The Court of Appeal seems to have contemplated that Mr. Phillips might have been entitled to do what he did if he had given Mr. O'Neill notice of his intentions and treated him more politely at the meeting on 4

November 1991. But these matters cannot affect the question of whether a change in the profit-sharing arrangements was a breach of faith.

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It follows in my opinion that there was no basis for the Court of Appeal's finding that Mr. O'Neill had been driven out of the company. He may have decided that he had lost confidence in Mr. Phillips and that he could no longer work with him. After Christmas 1992 Mr. Phillips said that he recognised that Mr. O'Neill had come to this conclusion and that there was no way in which he could put their relationship together again. But Mr. O'Neill's decision was not the result of anything wrong or unfair which Mr. Phillips had done.

8. No-fault divorce?

Mr. Hollington, who appeared for Mr. O'Neill, said that it did not matter whether Mr. Phillips had done anything unfair. The fact was that trust and confidence between the parties had broken down. In those circumstances it was obvious that there ought to be a parting of the ways and the unfairness lay in Mr. Phillips, who accepted this to be the case, not being willing to allow Mr. O'Neill to recover his stake in the company. Even if Mr. Phillips was not at fault in causing the breakdown, it would be unfair to leave Mr. O'Neill locked into the company as a minority shareholder.

Mr. Hollington's submission comes to saying that, in a "quasi-partnership" company, one partner ought to be entitled at will to require the other partner or partners to buy his shares at a fair value. All he need do is to declare that trust and confidence has broken down. In the present case, trust and confidence broke down, first, because Mr. Phillips failed to do certain things which, on the judge's findings, he had never promised to do; secondly, because Mr. O'Neill wrongly thought that Mr. Phillips had committed various improprieties; and finally because, as the judge said *[1997] 2 B.C.L.C. 739* , 742, he was "inclined to see base motives in everything that Mr. Phillips did." Nevertheless it is submitted that fairness requires that Mr. [Phillips] or the company ought to raise the necessary liquid capital to pay Mr. O'Neill a fair price for his shares.

I do not think that there is any support in the authorities for such a stark right of unilateral withdrawal. There are cases, such as *In re A Company (No. 006834 of 1988), Ex parte Kremer [1989] B.C.L.C. 365* , in which it has been said that if a breakdown in relations has caused the majority to remove a shareholder from participation in the management, it is usually a waste of time to try to investigate who caused the breakdown. Such breakdowns often occur (as in this case) without either side having done anything seriously wrong or unfair. It is not fair to the excluded member, who will usually have lost his employment, to keep his assets locked in the company. But that does not mean that a member who has not been dismissed or excluded can demand that his shares be purchased simply because he feels that he has lost trust and confidence in the others. I rather doubt whether even in partnership law a dissolution would be granted on this ground in a case in which it was still possible under the articles for the business of the partnership to be continued. And as Lord Wilberforce observed in *In re Westbourne Galleries Ltd. [1973] A.C. 360* , 380, one should not press the quasi-partnership analogy too far: "A company, however small, however domestic, is a company not a partnership or even a quasi-partnership …"

The Law Commission Report on Shareholder Remedies to which I have already referred considered whether to recommend the introduction of a statutory remedy "in situations where there is no fault" *1105 (paragraph 3.65) so that members of a quasi-partnership could exit at will. They said, at p. 39, para. 3.66:

> "In our view there are strong economic arguments against allowing shareholders to exit at will. Also, as a matter of principle, such a right would fundamentally contravene the sanctity of the contract binding the members and the company which we considered should guide our approach to shareholder remedies."

The Law Commission plainly did not consider that section 459 already provided a right to exit at will and I do not think so either.

9. Capacity in which prejudice suffered

The judge, it will be recalled, gave as one of his reasons for dismissing the petition the fact that any prejudice suffered by Mr. O'Neill was in his capacity as an employee rather than as a shareholder. The Court of Appeal's rejection of this reason was, I think, influenced by its view that Mr. O'Neill had been constructively expelled. In a case of expulsion, where the equitable restraint on the exercise of the power is based upon the terms upon which the petitioner became or continued as a member of the company, the prejudice will be suffered in the capacity of a member. It is the terms, agreement, or understanding on which he became associated as a member which generates the restraint on the power of expulsion. But the judge was considering only the prejudice suffered through not getting a half-share in the profits or the additional shares. It is somewhat unreal to deal with the capacity in which prejudice was suffered in these respects when there was no entitlement in law or equity in the first place. But assuming there had been a contractual obligation, I would not exclude the possibility that prejudice suffered from the breach of that obligation could be suffered in the capacity of shareholder. As I have said, the initial gift of 25 shares in 1985 did not in my view change the essential relationship between the parties. Mr. Phillips remained controlling shareholder and Mr. O'Neill remained an employee who had some shares. If at that stage Mr. Phillips had promised another 25 shares and then broken his promise, I do not think that Mr. O'Neill would have suffered prejudice in his capacity as an existing shareholder. I agree with the judge that the case would have been no different if Mr. O'Neill had had no shares and Mr. Phillips had broken a promise to give him 50. On the other hand, once Mr. O'Neill had invested his own money and effort in the company, the situation may have changed. A promise to give Mr. O'Neill more shares or a larger share in the profits may well have been based not merely upon his position as an employee but on the fact that he already had a stake in the company. As cases like *R. & H. Electrical Ltd. v. Haden Bill Electrical Ltd. [1995] 2 B.C.L.C. 280* show, the requirement that prejudice must be suffered as a member should not be too narrowly or technically construed. But the point does not arise because no promise was made.

10. The offer to buy

Mr. Ralls, who appeared for Mr. Phillips, submitted that even if his conduct had been unfairly prejudicial, the petition should have been dismissed because he had made an offer to buy the shares at a fair price, which was the whole of the relief to which Mr. O'Neill would have been entitled. In view of the conclusion I have reached about the absence of unfair prejudice, with which I understand your Lordships to agree, this ***1106** point does not need to be decided. Nevertheless, the effect of an offer to buy the shares as an answer to a petition under section 459 is a matter of such great practical importance that I would invite your Lordships to consider it.

The petition was presented on 22 January 1992 and points of defence were delivered on 16 March 1992. The points of defence contained no offer to buy but asked that Mr. Phillips or the company should be "at liberty" to buy the shares

> "at a fair value to be fixed by the court upon such basis as to the court shall seem just and equitable and depending upon its finding in respect of the various issues between the parties disclosed on the pleadings herein."

This plainly contemplated that the petition would go to full hearing and be decided on the merits. There was then considerable delay and a number of interlocutory hearings. On 28 November 1994, pursuant to an undertaking given to the court, Mr. Phillips made an offer in terms scheduled to a consent order of that date. The offer was to purchase at a price to be agreed or in default fixed by a chartered accountant as valuer on the basis that the value was one-quarter of the fair value of the entire issued share capital. The offer was rejected on various grounds, one being that it made no provision for Mr. O'Neill's costs. The result was that the petition went to a full hearing.

The judge, who dismissed the petition, did not find it necessary to deal with the offer. The Court of Appeal accepted the argument that Mr. O' Neill was justified in rejecting it because it did not provide for his costs.

In my opinion the Court of Appeal was right. The offer is only material to the outcome at the trial if the court considers that the petitioner is otherwise entitled to succeed. So the fact that he was made an earlier offer of the relief to which the court has now held him entitled after trial can logically go only to the question of costs. If the petitioner was offered everything to which he has been held entitled, the respondent may, as in the case of a *Calderbank* letter (*Calderbank v. Calderbank [1976] Fam. 93*), be entitled to say that the costs after the date of that offer should be borne by the successful petitioner, who ought to have accepted the offer and brought the litigation to an end. On the other hand, it seems to me that in the case of a petition which has been on foot for nearly three years, a petitioner who, we are assuming, has a well founded case will not obtain everything to which he is entitled unless there is an offer of costs. Mr. Ralls said that no such offer was made because there had been some orders for the petitioner to pay the costs of interlocutory applications in any event and Mr. Phillips took the view that on balance the petitioner would not be entitled to any costs. But Mr. O'Neill was not to be expected to guess what the results of a taxation would be. Mr. Phillips could have offered to pay the costs less any which had been awarded to him by interlocutory order. I therefore agree that the offer was inadequate.

In the present case, Mr. Phillips fought the petition to the end and your Lordships have decided that he was justified in doing so. But I think that parties ought to be encouraged, where at all possible, to avoid the expense of money and spirit inevitably involved in such litigation by making an offer to purchase at an early stage. This was a somewhat unusual case in that Mr. Phillips, despite his revised views about Mr. O'Neill's competence, was willing to go on working with him. This is a ***1107** position which the majority shareholder is entitled to take, even if only because he may consider it less unattractive than having to raise the capital to buy out the minority. Usually, however, the majority shareholder will want to put an end to the association. In such a case, it will almost always be unfair for the minority shareholder to be excluded without an offer to buy his shares or make some other fair arrangement. The Law Commission Report on Shareholder Remedies, at pp. 30–37, paras. 3.26–56 has recommended that in a private company limited by shares in which substantially all the members are directors, there should be a statutory presumption that the removal of a shareholder as a director, or from substantially all his functions as a director, is unfairly prejudicial conduct. This does not seem to me very different in practice from the present law. But the unfairness does not lie in the exclusion alone but in exclusion without a reasonable offer. 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. It is therefore very important that participants in such companies should be able to know what counts as a reasonable offer.

In the first place, 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 (paragraphs 3.57–62) 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.

Secondly, 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.

Thirdly, 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 119: Exit Right recommended by the Law Commission: see Appendix C to the report, p. 133.

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

Fifthly, 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 ***1108** 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.

11. Conclusion

I would allow the appeal and dismiss the petition.

Lord Jauncey of Tullichettle.

Lord Jauncey of Tullichettle. My Lords, I have had the advantage of reading in draft the speech prepared by my noble and learned friend, Lord Hoffmann. For the reasons he has given I, too, would allow the appeal and dismiss the petition.

Lord Clyde.

Lord Clyde. My Lords, I too have had the advantage of reading in draft the speech prepared by my noble and learned friend, Lord Hoffmann. I agree with it, and for the reasons he has given I, too, would allow the appeal and dismiss the petition.

Lord Hutton.

Lord Hutton. My Lords, I too have had the advantage of reading in draft the speech prepared by my noble and learned friend, Lord Hoffmann. I agree with it, and for the reasons he has given I, too, would allow the appeal.

Lord Hobhouse of Woodborough.

Lord Hobhouse of Woodborough. My Lords, I too, have had the advantage of reading in draft the speech prepared by my noble and learned friend, Lord Hoffmann. For the reasons he has given I, too, would allow the appeal and dismiss the petition.

M. G.

Representation

Solicitors: Lindop & Skinner, Southend-on-Sea; M. A. Plant, Southminster .

Appeal allowed. Order of Court of Appeal set aside save as to legal aid taxation. Order of Judge Paul Baker Q.C. restored. Appellants' costs in Court of Appeal and House of Lords to be paid out of legal aid fund in accordance with section 18 of the Legal Aid Act 1988, such order to be suspended for four weeks to allow Legal Aid Board to object if they wish.

Footnotes

1 Companies Act 1985, s. 459(1) , as amended: see post, pp. 1094H–1095A.