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GUIDE

# Directors' concerns: Unfair prejudice and rights issues

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Directors are responsible for managing the business of their company and amongst the difficult problems that directors face in doing so is finding a path between diverse and sometimes conflicting interests that affect the company and the people interested in it.

When exercising their powers to manage the business of the company, directors must do so in good faith in the best interests of the company and for no other purpose. In exercising their powers directors must also, however, treat fairly other persons who are affected by them. If shareholders are not treated fairly, the law gives them the remedy to apply to the court for an order that the company's affairs are being conducted in a way that is unfairly prejudicial to the shareholders or a particular group of shareholders.

In order to demonstrate unfair prejudice, a shareholder must be able to show that the effect of the matters complained about was both unfair and caused prejudice to it. It is necessary for these purposes that there is both prejudice and unfairness: an action, such as a rights issue, may cause some damage to the interests of a shareholder or group of shareholders for example, by diluting their interest in the company but that does not justify an action for unfair prejudice unless the action was also unfair. What constitutes unfairness for these purposes is an objective test: would a reasonable observer seeing the consequences of the conduct regard it as prejudicing unfairly the interests of the person making the complaint. Correspondingly, even if there was unfairness, to justify a complaint there must also be some damage to the interests of the person making the complaint.

If the court is satisfied that a complaint about unfair prejudice is well founded, it has power to remedy the problem by making orders which may include regulating how the company carries on its business or requiring that a particular shareholder is bought out.

Some of the most important decisions that directors have to make relate to raising funds for the operation of the company's business: how much does the company need? When does it need it? What is the current financial position of the company? Funding might be raised by borrowing or by issuing shares or any combination of a range of means and the answers to those questions will affect what method is chosen.

Even if the amount of finance that the company needs is settled, the method chosen for raising the money will have different consequences for the company and the shareholders and for different groups of shareholders. Borrowing money, for example, may seem attractive to shareholders because it avoids any dilution of their shareholdings and it may be the quickest way of raising finance but it may not be the best solution for the company if it is more expensive or would result in restrictions on the way it conducts business.

If the directors conclude that the best mechanism for the company for raising finance is an issue of shares they must consider the appropriate form of issue, for example, whether to place the shares with specific shareholders, to make an open offer or to make a rights issue. The Association of British Insurers has indicated that, from the perspective of shareholders it regards rights issues as preferable to non pre-emptive methods of raising share capital because they are more likely to protect against dilution.

In a rights issue, shares are offered to all of a company's shareholders in proportion to their existing holdings. At first glance it is hard to see how making a rights issue could expose a company to an action for unfair prejudice because by the nature of a rights issue the company seems to be treating all shareholders equally.

When considering making a rights issue there are, however, a number of points that directors need to consider and if they fail to consider them properly or make their decisions for the wrong reasons, the company may be exposed to an action for unfair prejudice from one or more groups of shareholders. The linked questions of price and number of shares to issue are particularly important.

The key issue here is that different shareholders may have different concerns and these must be taken into account by the directors if they are to treat all shareholders fairly: the interests of a minority shareholder, for example, are not the same as those of a majority shareholder and directors must even consider the different positions of shareholders who may take up their rights from those that the company suspects will not take up their rights. For different groups the valuation given to shares offered pursuant to a rights issue can have subjective implications.

- if the company as a whole is valued, and the new shares offered at a price which, taken together with the shares already in issue, approximates to that value, this would appear unfair to minority members wishing to subscribe, unless its articles of association permit a sale for a value determined independently disregarding any minority discount; but
- if the shares are offered at a substantial discount to market value, this would appear unfair to those members who are unwilling or unable to subscribe, as the remaining members will be acquiring the rights issue shares at an advantageous price, and those not subscribing in full or in part will suffer a dilution in value and not just a dilution in percentage holding.

If it is known or foreseen that the member or members will or may not have the money or inclination to subscribe, in order to be even-handed and fair between the members or groups of members, the directors must consider what price could and should be paid by those willing and able to subscribe and, correspondingly, how many shares need to be issued to raise the amount required by the company. If the minority shareholders are unable or unwilling to subscribe, but the majority shareholder is so willing, the duty of the directors will ordinarily be to get the best price they can from the shareholder willing to subscribe.

For the purposes of determining the best but also fair price for issuing shares in a rights issue:

- the directors must consider the interests of all groups of shareholders and have regard to the foreseeable range of responses of the different groups of shareholders;
- the directors must be particularly careful to consider the effect of the price of the shares in the rights issue on different groups of shareholders if they, or persons in whom they are interested (for example a shareholder by which they have been nominated), stand to benefit particularly from the rights issue;
- the directors must bear in mind that the value of the rights issue shares offered to the majority in a private company will often be greater than the value of the rights issue shares offered to the minority, reflecting the fact that minority holdings will usually attract a discount;
- the directors can also take into account that in the case of an undercapitalised company in cash flow difficulties, the price must be sufficiently attractive to encourage members to subscribe in the first place; and
- the directors must remember that where there is no market in the shares, the value of the shares will not be readily ascertainable, and will vary according to the size of the different holdings (noting however for the purposes of a rights issue the offer price must be the same for each member).

On a practical level, if they are considering approving a rights issue the directors should:

- make inquiries of all the members in advance of any share offer as to their appetite for subscribing for more shares and any views they may have as to price;
- ensure that members are informed of all options available to them;
- ensure that full records are maintained of the inquiries that are made, including minuting all deliberations of the directors;
- ensure that all declarations of interests are noted in full at all meetings of the directors;
- ensure that the inquiries are conducted impartially, possibly by a third party;

- take appropriate financial and other professional advice in relation to the proposed terms of the rights issue, including appointing independent share valuers if appropriate; and
- depending upon the price of the issue, it may be appropriate for the company to consider providing an exit route in its articles of association for minority members that disregards the discounting effect of the minority holding.

The path that a director has to tread is full of unexpected traps where even procedures like rights issues that by their nature look as though they should be fair turn out to offer all sorts of potential difficulties. With a careful eye on some basic guiding principles and by taking some common-sense practical measures, it should, however, be possible for most of these to be avoided.

## Contacts

A full list of contacts specialising in corporate law can be found here.