Client Alert.

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If it be done, let it be done quickly…

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The recent case of Canterbury Travel[1] tells the story of a fractious board and a majority shareholder who seeks to seize control of the company to the exclusion of a founder director. Does this sound familiar to you? The case concerns a travel industry company, but the subject matter is arguably more common in the technology and life science sectors which are notoriously dogged by clashes between investors and founders.

This article looks at the entrenchment of founders and the strength of the tools with which investors may seek to uproot them.

DIRECTORSHIP

Investors may be surprised at how difficult it can be to remove a founder director. Absent bespoke constitutional documents, a director cannot be removed from office by the other members of the board; indeed he/she can only be removed by shareholders' resolution. Moreover, in contrast to other general meetings: the director has the right to make representations to the company's shareholders in which he may object to his proposed removal; and the statutory written resolution procedure, which may have otherwise avoided the need to convene such a meeting, may not be used.

Although the procedure may be cumbersome, Canterbury Travel affirms the strength of the statutory process. In this case the founder sought an injunction to prevent his removal. The application was rejected, the court noting that, though the applicant had the prospect of potential compensation under a claim for unfair prejudice[2], he did not have a right to be kept permanently in office.

An issue may arise, however, where the constitutional documents confer an express right on the founder to appoint a nominee director (in a like manner to which investors are commonly granted similar rights). Such entrenched rights can be problematic as case law indicates that, depending on their drafting, such rights may be incapable of removal or amendment without his/her consent. Where such rights are nevertheless commercially agreed, it is prudent for the company to incorporate safe guards (such as minimum required shareholdings) in their drafting to prevent the abuse of this power.

EMPLOYMENT RIGHTS

Although a founder's status as a director and as an employee may in principle be distinguishable, his/her involuntary removal from office as a director may constitute constructive dismissal even in the absence of express termination.

Such dismissal may be wrongful or unfair: it can give rise to a founder's contractual claim for damages for salary and benefits in respect of any period of notice (subject to deduction for mitigating factors) and potential statutory claims

[1] Re: Canterbury Travel (London) Ltd, Collins v Collins and another [2010] All ER (D) 133.
[2] Section 944 (1) Companies Act 2006.

(currently capped at £65,300 for a compensatory award and £11,400 basic award) for unfair dismissal. Exposure to such liabilities can be mitigated by ensuring that the company has the contractual power in the contract to remove the director from office and that a fair procedure is followed, though the latter may not always be practicable. More generally, it is important to note that payments for loss of office as a director (as distinct from legal entitlements in connection with the termination of his/her employment or the compromise of bona fide employment claims) are prohibited absent shareholder approval[3]. This may restrict the ability of the company to offer golden parachute payments to founders.

In addition to the potential financial costs as may arise from the unlawful termination of a founder's employment, investors should note that a breach of contract renders the restrictive covenants under the terms of his/her employment unenforceable. An investor may, however, still have some protection in this area if covenants were given directly by the founders under applicable shareholders and/or investment agreements.

EQUITY INTERESTS

Founders commonly hold equity interests represented by a mix of shares and options. These may be at risk of forfeiture in the event that he/she ceases to be engaged by the company (often referred to as a "good/bad leaver" provision).

The terms of most option schemes will provide for the lapse (without payment) in whole or in part of those founder options outstanding on the date on which the founder ceases to be engaged by the company.

Unlike options (which are, in essence, contractual), a share is an asset in its own right and may not simply lapse. Typically, a good/bad leaver provision will provide that some or all of a founder's shares will be offered for sale (often at the lower of market value or original purchase price where the shares are unvested or the founder is a "bad leaver" (such as when dismissed for cause)). Such a sale of founder shares can, however, be problematic: *Firstly*, where the sale is to be made to the company, the company must be able to finance the purchase from its distributable profits (which may be difficult for a loss-making R&D company, for example) or from the proceeds of a new issue of share (which may require investors to advance further funds). *Secondly*, the validity of good/bad leaver provisions can be subject to challenge, particularly when unilaterally introduced to a company's constitutional documents without the founder's consent.

Investors should be wary of the limitations of good/bad leaver provisions and the potential prospect of needing to invest further to secure the removal of founder equity interests.

Founders should be cautious of the need to distinguish equity received in their capacity as originators and inventors from other equity incentivisation arrangements which may be linked to their continuing engagement by the company (and at risk if such engagement may cease).

UNFAIR PREJUDICE

A founder shareholder who finds himself/herself excluded from the affairs of the company may seek to bring a claim for unfair prejudice. In essence, such a claim requires that the founder demonstrate that the company's affairs are being conducted in a manner which is unfairly prejudicial to its (or some of its) shareholders. A common assertion is that the company was run as a quasi-partnership between a small number of people who have since taken steps to exclude the founder.

[3] Sections 215-222, Companies Act 2006.

In practice, claims for unfair prejudice can be costly to both pursue and defend. Further, as the court warned in Canterbury Travels, bad business judgement is not in itself the proper subject matter of compensation by way of unfair prejudice proceedings. Invariably the substance of such a claim will depend on contested facts, thus limiting the scope for either party to obtain summary judgement.

Investors should also note that although the claim may be brought principally against the company, it is not uncommon for a court to rule that the claimant's interests be bought out by the other shareholders (as may include the investor).

CONCLUSIONS

To investors, the case of Canterbury Travel provides welcome reassurance as to the predominance of the right of majority shareholders to select the company's directors and evidences the unwillingess of the court to intervene when it would result in the "continuation of a business relationship between two people who could not get on". As is apparent, however, the removal of a founder director may entail a bitter battle and a cost which the investor may ultimately be called upon to finance.

To founders, the case serves as a reminder of the need to protect the value of their contribution as originators and inventors in a manner severable from their management/employment position.

That investors and founders in some companies will fall into dispute is inevitable – the key is to minimise the potential damage to the parties by establishing a clear basis at the outset of the relationship for the apportionment of rights which accommodate potential changes in a founder's position. Ultimately, where the withdrawal of a founder's active participation in management is unavoidable, if it is to be done, let it be done quickly and fairly to mitigate damage to the company.

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