SELBORNE CHAMBERS

Compound Photonics Group Limited: A Discussion in "Good Faith"

© 2023 Ian Clarke KC, Selborne Chambers. All rights reserved.

In Compound Photonics Group Limited [2022] EWCA Civ 1371, the Court of Appeal considered the meaning and effect of an express good faith clause in a shareholders' agreement, the argument arising in the context of a section 994 petition. In doing so, it gave valuable guidance on how to approach such clauses in commercial contracts as a whole. This article aims to explore some of that guidance.

The (much simplified) relevant facts

Compound Photonics Group Limited was the vehicle for the intended development and commercialisation of certain academic research by a Dr Sachs. As perhaps befitted the academic research behind the underlying product, Dr Sachs was the CEO with day-to-day control of both companies. As one of the investors put it, he was "the jockey they were backing." Mr Faulkner was an independent financial adviser and a "Founder Director" and chairman.

The story is not unusual. Substantial investment was required. External investors provided it and held 97.5% of the issued shares. In 2016, there was a disagreement. Dr Sachs was left under no illusions that he either had to resign or he would be removed under the procedure prescribed in the Companies Act 2006; the Judge concluded that he was presented with a fait accompli and that he had little option but to go. And go he did. Shortly after, Mr Faulkner followed suit. The minority shareholders petitioned under section 994, claiming to have been unfairly prejudiced by the investors when Dr Sachs and Mr Faulkner respectively were forced to resign from office and thereby excluded from any continuing role in the management of the Company.

The terms of the 2013 shareholders' agreement and articles

Clause 4.2 of the shareholders' agreement contained a provision that each shareholder undertook to the other and the Company

THE JUDGMENT CAN BE ACCESSED HERE → http://www.bailii.org/ew/cases/EWCA/Civ/2022/1371.html

that "[they] will at all times act in good faith in all dealings with the other Shareholders and with the Company in relation to matters contained in this agreement".

A number of other clauses required the exercise of rights and powers to ensure that the Business was conducted in accordance with good business practice and on sound commercial and profit-making principles. Clause 7 made provision in relation to the Board including for a quorum to "include (insofar as they each remain a director) [Dr Sachs], [Mr Faulkner] and, if more than one has been appointed, an Investor Director." Importantly, further provisions governed what could and could not be decided in the absence of agreement by Dr Sachs and Mr Faulkner. Clause 21 provided obligations for the shareholders to exercise their powers and their voting rights in a manner consistent with the shareholders' agreement. Clause 23 provided that nothing in that agreement created a partnership (and it was common ground for the purposes of the 994 petition that the Company was not a quasi-partnership) and clause 25 contained an entire agreement clause.

It is unnecessary to set out the terms of the articles in any great detail; they reflected the shareholders' agreement and article 15 provided for the vacation of the office of a director upon a board resolution to remove the same.

The above (necessarily) limited review of the constitutional documentation does not do justice to that which was said in support of the minority shareholders' arguments. Their case focused on the meaning of clause 4.2 (the good faith provision), arguing that it required adherence to a "bargain" inherent in the 2013 shareholders' agreement and articles, namely that Dr Sachs and Mr Faulkner would be "entrenched" as directors would hold the balance of power on the board of the Company; they also argued that the 2013 shareholders' agreement formed part of the constitution of the Company for the purposes of the directors' duties under section 171(a) of the Companies Act 2006, with the consequence that the directors that voted to remove Dr Sachs and Mr Faulkner were in breach of their duties to act in accordance with the Company's constitution.

The trial judge agreed with the minority shareholders' arguments.

The issues on appeal

Snowden LJ (with whom the other members of the Court agreed) considered that the trial judge was correct, in principle, to approach matters on the basis that, in the absence of any suggestion that the Company was a quasi-partnership or that there were other grounds for the imposition of equitable constraints upon the actions of the members, the question of whether that amounted to unfairly prejudicial conduct within the meaning of section 994 turned upon whether such conduct breached the terms upon which the members had agreed that the affairs of the Company should be conducted, i.e. the 2013 Articles on the 2013 shareholders' agreement: see paragraph [142].

To that end, the majority of his findings of unfair prejudice depended upon his interpretation of the content of the obligation of good faith in clause 4.2 of the 2013 shareholders' agreement. The Judge concluded that the expression "good faith" necessarily imported all of the "minimum standards" of good faith identified in Unwin v Bond [2020] EWHC 1768 (Comm). These standards included, in addition to a requirement that the investors should act

honestly, a requirement of "fidelity to the bargain", a requirement of "fair and open dealing" and a requirement "to have regard to the interests" of the minority shareholders: [143].

A particularly important point is the identity of the "bargain" to which the parties were required to have fidelity. The trial judge's conclusion was that it was embodied in the 2013 constitution of the Company, namely the articles of association and the shareholders' agreement, and that, come what may, it provided that the management of the Company was to be conducted by a board in which Dr Sachs and Dr Faulkner were entrenched, held the balance of power and were able to make certain decisions with which the investors could not interfere.

The investors' appeal was principally on the basis that the trial judge interpreted the "good faith" clause in the shareholders' agreement far too widely; it did not mean that they had given up the right to remove Dr Sachs and Mr Faulkner or take control of a company in which they were very substantial investors and majority shareholders and it did not impose on them duties of procedural fairness which required them to take into account the interests of the minority shareholders when deciding how to exercise their rights to vote as the majority.

The Court of Appeal's analysis

The general approach to interpreting express clauses of good faith

Unsurprisingly, the starting point is to construe the contract, just like any other – "an express clause in a contract requiring a party to act in "good faith" must take its meaning from the context in which it is used": [147].

Secondly (and this may explain where the trial judge initially fell into error) cases from other areas of law or commerce, which turned upon their own particular facts, may be of limited value and must be treated with considerable caution. The starting point was a requirement of honesty but, as Auld LJ observed in Street v Derbyshire Unemployed Workers' Centre [2004] EWCA Civ 964 at [41], "Shorn of context, the words "in good faith" have a core meaning of honesty. Introduce context, and it calls for further elaboration….. Terms to be found in many statutory and common-law contexts and because they are necessarily conditioned by their context, it is dangerous to apply judicial attempts at definition in one context to that of another."

Against this analysis, aside from the irreducible obligation to act honestly, the Court declined to deduce any number of further "minimum standards" of conduct that a defendant must be taken to have agreed to comply with simply because there was a "good faith" clause in a contract.

Fidelity to the bargain and the consideration of interests

Similarly, the failure to address context tainted the Judge's decision that the investors were required to act with "fidelity to the bargain" and have regard to the interests of the minority shareholders as well as their own.

The Court of Appeal reviewed the origins of these concepts, recognising they were influence by decisions from the USA and Australia where "they have been applied in other areas of law and commerce not involving changes to the constitutional structure of the company".

Consistent with the requirement to consider context, the Court also analysed the underlying circumstances of the American

and Australian authorities cited in the English decisions in order to put the nature and scope of the duty under consideration into its proper context. It identified a number of points relating to the concepts of fidelity to the bargain and the requirement to have regard to the interests of the other contracting party.

First, these concepts originated in a commentary on US contract law and were adopted and developed in New South Wales, Australia in the context of imposing terms requiring good faith and the performance of contracts as a matter of general law and not in the context of the interpretation of individually negotiated contracts. As such, the desire to give a requirement of good faith a single, clearly understood meaning was entirely understandable but there was no such basis for automatically adopting such a formulaic meaning in English law where the parties to it individually negotiated a provision to act in good faith; there was no presumption that the parties should automatically be presumed to have intended to incorporate obligations of fidelity to the bargain and the consideration of the other parties' interests.

Secondly, the concept of having regard to the interests of the other contracting parties has largely been developed and applied in cases concerning business decisions which are capable of adversely affecting or even depriving the other parties of the commercial benefit expected to be enjoyed under the contract.

Thirdly, although judges have on occasions used the expression "the spirit of the contract" in the context of a good faith clause, it is not an open invitation to interpret such a clause as imposing additional substantive obligations or any restrictions on action outside the other terms of the contract: [205]. "That must especially be so where… the contract in question is professionally and comprehensively drafted and contains an entire agreement clause": [205].

Accordingly (and in summary), in the case under consideration, the structure of a limited company and the relationship and interests of its members were held to provide a very different backdrop to that of an ordinary commercial contract; in general meeting, there is no requirement to consult with the other shareholders nor is there any general requirement that they should take into account the interests of others when deciding how to vote – votes attached to shares of proprietary rights, which may be exercised as the holders see fit: [199]. In doing so, they do not ordinarily deprive the other shareholders of the benefit of the statutory contract, i.e. their shares. If these well-known principles of company law are intended to be changed, they must be done so expressly, clearly and directly with further consequences (e.g. as to consultation between the parties) being spelt out – especially in a professionally drafted agreement: [201]

Is dishonesty or bad faith required for any breach of a good faith clause?

The Court of Appeal held that the authorities did not support a requirement of dishonesty, citing Yam Seng Pte Ltd v International Trade Corp Ltd [2013] 1 All ER (Comm) 1321 and the dicta of Leggatt J at [138] of that decision where he observed:-

"not all bad faith conduct would necessarily be described as dishonest. Other epithets which might be used to describe such conduct include "improper", "commercially unacceptable" or "unconscionable"."

Accordingly, the Court of Appeal concluded

that a duty of good faith could be breached by "bad faith conduct" which could include conduct which would not necessarily be described as dishonest. Whether it went that far depended on – you've guessed it – the context.

So what?

The discussion in Compound Photonics allows the following propositions to be stated: –

First, in relation to an express duty of good faith, it can only be understood upon a proper construction based on its context, applying ordinary principles of construction. The exercise is case-specific and authorities based upon different facts – particularly those drawing upon foreign law – must be approached with caution.

Secondly, the only "core" duty is one to act honestly, assessed in a subjective sense in light of what the defendant actually knew albeit applying an objective standard. Everything else is contextual, including a duty not to act in a way that might fall short of dishonesty (e.g. conduct which is commercially unacceptable to reasonable and honest people). In circumstances where there are additional, contextual duties, dishonesty is not a requirement.

Thirdly, the relevance and scope of "fidelity to the parties' bargain" remains opaque and clearly may gain more traction in cases in which there is not such a clear statutory starting point. It is not, however, carte blanche for additional obligations to be imposed, certainly in professionally drawn agreements.

This article is a shortened version of a paper and seminar presented by Ian Clarke and Sarah Walker.

Those who might wish to hear the full presentation should contact Gemma Cselko gemma.cselko@selbornechambers.co.uk for details.

IAN CLARKE KC

THE JUDGMENT CAN BE ACCESSED HERE → http://www.bailii.org/ew/cases/EWCA/Civ/2022/1371.html