RW Blears

Fundamentals: Share class rights (and how to vary them)

In our latest 'Fundamentals' explanatory guide, Monty Halliday and George Tack focus on share class rights and the considerations and restrictions to bear in mind when one seeks to vary such rights.

What are class rights?

A company having a share capital may have different classes of share, with different rights attaching to each class. Class rights are typically contained in the company's articles of association and commonly include voting rights, dividend rights and rights to capital on a winding up. Other documents may also set out the rights attaching to shares, such as any shareholders' resolution approving the allotment of shares or varying the rights attaching to shares or any shareholders' agreement.

The concept of "class rights" can sometimes be construed much more widely to include additional rights conferred on a person in their capacity as a shareholder but not attached to a class of share distinguishable from others in respect of voting, dividend, or capital rights.[1] As such, although a company's articles and public documents may refer to only one class of share, the company may have additional classes of shares where specific rights attach to a distinct group or to a particular shareholder. Clearly the opposite is true, and a class of shares will not be created by simply giving a different name to a sub-group of shares with identical rights to others. It is the rights of the shares, not the name, which matters.

A company's constitutional documents (or sometimes a separate contract such as a shareholders' agreement) may stipulate that certain matters require the consent of the holders of a particular class of share. In this way, those shareholders have a class right of veto over such matters. Alternatively, investors may seek the inclusion of weighted voting rights in respect of such matters.

What constitutes a variation of class rights?

There is little guidance in the Companies Act 2006 (the "**Act**") as to what constitutes a variation of class rights. The courts have interpreted a variation of class rights in narrow terms and distinguished a variation which affects the rights of the holders of a particular class of shares from a variation which merely affects the enjoyment of those rights.[2] If the proposal does not affect the rights but just affects their enjoyment then there will be no variation.

For example, the issue of a new class of shares which rank ahead of one existing share class but behind another class of share does not constitute a variation of class rights; the change affects the value of the rights of the holders of the existing classes of share (and therefore their enjoyment), but not the actual rights.[3]

Similarly, the dilution of voting rights of preference shareholders by issuing new shares to the holders of ordinary shares does not constitute a variation of class rights since the underlying rights of preference shareholders has not been altered.[4]

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[1] Cumbrian Newspapers Group Ltd v Cumberland & Westmorland Herald Newspaper & Printing Co Ltd [1987] Ch.1

[2] White v Bristol Aeroplane Co [1953] Ch. 65

[3] Hodge v James Howell & Co [1958] The Times, December 13

[4] White v Bristol Aeroplane Co; Re John Smiths Tadcaster Brewery Co Ltd [1953] Ch.308

In contrast, the insertion of drag along rights into a company's articles would constitute a variation of class rights because it affects the shareholders' right to continue to hold shares.

In light of the Courts' narrow interpretation of what constitutes a variation of class rights, companies often include specific matters in their articles for what constitutes a variation of rights. As such, a company's articles (and any other relevant documents) should always be checked carefully if any changes to those rights are proposed. If there any provisions in the company's articles for the variation of class rights, these must be complied with in order to be effective (instead of following the statutory procedure as set out below).

How do investors seek to protect class rights?

Under the Act, rights attaching to a class of share may only be varied in accordance with the articles (if such provisions are included) or with the consent of the shareholders in accordance with the Act.

The recent decision in *DnaNudge v Ventura Capital*[5] illustrates the potential for conflict in a company's articles regarding variation of class rights.

The case concerned two provisions, at odds, within the articles of a MedTech company, which were amended following the issue of preference shares to two new investors in the company. The provisions in question stated the following:

- That an investor majority could authorise the conversion of preference shares into ordinary shares by sending written notice to the company.

- That any variation of class rights required the consent in writing of the holders of more than 75% of the shares of that class.

Relying on the former, the holders of ordinary shares (who together represented an investor majority as defined in the articles) served notice to convert the preference shares into ordinary shares. The holders of preference shares claimed the ordinary shareholders had no authority to effect the conversion because no consent had been obtained from them to vary the class rights under the articles.

The High Court held that the ambiguity created by the conflicting provisions could only be resolved by reading the investor majority conversion mechanism as being subject to obtaining class consent from the preference shareholders. Since no such consent had been obtained, the variation was declared void and of no effect.

The Court of Appeal upheld this decision but commented obiter that, had there been no inconsistency, the variation would not have been unfair for the purposes of section 633 of the Act, even though the preference shareholders would still have suffered from the conversion. In this instance, the variation of class rights would have followed the provisions of the articles that both parties had agreed to.

To safeguard class rights, investors should be alert for any potential conflict between provisions in a company's articles and specify how any such conflict should be resolved. Conversion mechanisms should be drafted in unambiguous terms that clearly specify the intersection with class consent rights.

[5] DnaNudge Ltd, Re [2023] EWHC 437 (Ch)

Where the articles do not contain a variation of class rights provision, any variation of class rights must be in accordance with section 630 of the Act, which requires (i) the consent in writing from the holders of at least three-quarters of that share class and (ii) a special resolution passed at a separate meeting of the holders of that class sanctioning the variation.

Under section 633 of the Act, minority shareholders who together hold not less than 15% of the issued shares of the class in question may object to a variation of class rights by applying to court within 21 days of the relevant authorisation being obtained.

An alternative route to that offered by section 633 is a petition by a company member (under section 994 of the Act) that the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of some parts of its members. Unlike section 633, the procedure under section 994 provides a means for investors who do not meet the 15% threshold to protect their class rights.

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