CHANCERY BAR

SHAREHOLDERS' DISPUTES
WHAT USE CAN BE MADE OF "GOOD FAITH" AS A SWORD OR A SHIELD?

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NOTES

INTRODUCTION

(i) Is it a ground for relief in favour of the minority that the majority have failed to act in good faith?
(ii) Can the majority exculpate itself by establishing that it acted in good faith?
(iii) Can the minority lose its entitlement to relief if it fails to act in good faith?

"In the case of [the UK unfair prejudice remedy in ss. 994-996 Companies Act 2006], 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 carried 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 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.'

:*O'Neill v Phillips* [1999] 1 W.L.R. 1092, per Lord Hoffmann

REMEDIES IN SHAREHOLDER DISPUTES

UK

- unfair prejudice: ss. 994-996 CA

"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 some part of its members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial."

If the above circumstances are established, the court "may make such order as it thinks fit for giving relief in respect of the matters complained of".

- winding-up on just and equitable basis: s. 122(1)(g) IA

"(1): a company may be wound up by the court if—

"(g): the court is of the opinion that it is just and equitable that the company should be wound up."

- the two statutory remedies for the protection of minority shareholders remedies (i.e. unfair prejudice and winding up) are merely parallel remedies and need to be considered independently - grounds for relief under one remedy are not necessarily either a necessary or a sufficient condition for relief under the other, as Stanley Burnton L.J. explained in *Hawkes v Cuddy* [2009] 2 B.C.L.C. 427

- derivative claim: a shareholder may with the permission of the Court under Pt 11 (ss.260–269) of the 2006 Act bring proceedings for the benefit of the company to redress a wrong done to the company by its directors, as defined in s.260(1)
    - The new statutory code is clearly based on the existing law and practice in relation to the derivative claim, i.e. under the judge- made "fraud on the minority" exception to the rule in *Foss v Harbottle*. There was a "fraud on the minority" where (a) the directors abused their powers, intentionally or unintentionally, fraudulently or negligently, in a manner which benefited themselves at the expense of the company, and (b) the wrongdoers used their control over the company so as to stifle improperly a claim by the company. The court exercised a wide discretion in permitting a derivative claim,

which it would exercise having regard to all the circumstances, including the availability of other remedies, and to ensure that the claim was pursued in good faith for the benefit of the company.

- but the common law lives on even in the UK: *Re Fort Gilkicker* [2013] BCC 365; *Abouraya v. Sigmund* [2014] EWHC 277 (Ch): derivative claims which do not fall within s. 260(1), i.e. claims brought by a shareholder for the benefit of a subsidiary of a company in which he is a shareholder, or claims for the benefit of foreign companies, fall outside s. 260(1) but can still be brought at common law

- "fraud on the minority" other than derivative claims: alteration to the articles of association, and possibly a wider principle – the test traditionally applied in equity is that the majority must exercise their voting rights to change the articles "**bona fide for the benefit of the company as a whole**": per Lindley M.R. in *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch. 656 at 671.

Cayman Islands

- winding-up on just and equitable basis: s. 92(e) CICL but now with "UK unfair prejudice" remedies: s. 95(3) CICL

"92. A company may be wound up by the Court if- …

(e) the Court is of opinion that it is just and equitable that the company should be wound up"

"95. (1) Upon hearing the winding up petition the Court may-

(a) dismiss the petition;

(b) adjourn the hearing conditionally or unconditionally;

(c) make a provisional order; or

(d) any other order that it thinks fit, …

(3) If the petition is presented by members of the company as contributories on the ground that it is just and equitable that the company should be wound up, the Court shall have jurisdiction to make the following orders, as an alternative to a winding-up order, namely-

(a) an order regulating the conduct of the company's affairs in the future;

(b) an order requiring the company to refrain from doing or continuing an act complained of by the petitioner or to do an act which the petitioner has complained it has omitted to do;

(c) an order authorising civil proceedings to be brought in the name and on behalf of the company by the petitioner on such terms as the Court may direct; or

(d) an order providing for the purchase of the shares of any members of the company by other members or by the company itself and, in the case of a purchase by the company itself, a reduction of the company's capital accordingly."

Thus, once the Cayman court has found that it is just and equitable to wind up the company, it has a wide jurisdiction as to what order to make in the alternative or in addition to making a winding up order, the section conferring in effect the same wide powers as an English court has upon making a finding of unfair prejudice: see *Camulos Partners Offshore Ltd, Re*, Court of Appeal of the Cayman Islands, (2010) (1) CILR 303.

- derivative claim: common law
- "fraud on the minority" : common law

DISTINGUISH "GOOD FAITH" FROM FIDUCIARY RELATIONSHIPS

A duty of good faith must be distinguished from duties owed in a **fiduciary** relationship. A duty of good faith may well be owed between shareholders, e.g. because they have expressly so provided in a written shareholders' agreement or arguably because it is a "quasi-partnership", but it does not follow that they are in a fiduciary relationship. A duty of good faith may be relatively undemanding: it is in general a subjective duty: what is critical is that the duty-ower behaves honestly. The best example of the undemanding nature of the duty is indeed the famous case of *Re Westbourne Galleries* [1974] AC 360 (HL) where it was held that relief should be granted notwithstanding the fact the majority had acted in good faith in the interests of the business. But a fiduciary relationship, in contrast, will generally impose stringent duties, principally the duty not to place oneself in a position of conflict of interest[1]. Relationships between shareholders are very rarely fiduciary.

[1] But NB cases where the content of the duties owed in a fiduciary relationship is held to be fact-sensitive and may in particular be affected by what shareholders have agreed between themselves: e.g. the whole judgment of Mason J. in *Hospital Products Ltd v United States Surgical Corp* (1984) 156 C.L.R. 41, cited in part by Patten J. in *Halton International Inc (Holding) SARL v*

The relationship between partners, for example, is a fiduciary one, and partners owe each other a duty of the utmost good faith, and it is reciprocal: *Lindley & Banks on Partnership* (19th ed.) Ch. 16, paras. 16-01, 16-05. These principles are reflected in the approach taken by the courts in the context of the statutory remedies. A very good example is the case of *Blackmore v Richardson* [2006] B.C.C. 276.

The most important relationship within the context of a company which is undoubtedly fiduciary is the relationship between the company and its directors, including de facto and shadow directors. But NB: the fiduciary duty is as a general rule owed to the company NOT individual shareholders –

- save in special situations, e.g.
    - *Smith v. Ampol* [1974] AC 821, i.e. where the fiduciary duty of the director is one in which the company itself has no real interest
    - *Coleman v. Myers* [1977] 2 NZLR 225, i.e. where directors enter into direct dealings with shareholders in circumstances where they assume a fiduciary responsibility to the shareholders in question
- subject to the availability of a derivative claim

And if the aggrieved shareholder can establish that his grievance arises out of a breach by the directors of their duties as such, then this is a ground for relief under the statutory remedies: per Hoffmann LJ (as he then was) in *Saul D Harrison, Re* [1995] 1 B.C.L.C. 14 at 17–18.

And it is thought that the same principles would prevail under ss. 92(e) and 95(3) CICL, i.e. the Cayman Islands just and equitable winding up remedy. But NB an interesting decision in the BVI where it has been held that this ground for winding up does not extend beyond small private companies and quasi-partnerships and does not apply to hedge funds whose membership is restricted to professional investors: *Citco Global Custody v Y2K Finance Inc*, unreported, September 18, 2009 Eastern

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Kaddoura [2006] 1 B.C.L.C. 78, has been influential in England (see e.g. *Ross River v Waveley Commercial Ltd* [2013] EWCA Civ 910) as well as in Australia: see e.g. the company director cases of *Streeter v Western Areas Exploration (No.2)* [2011] WASCA 17; *Links Golf Tasmania v Sattler* [2012] F.C.A. 634.

Caribbean Supreme Court, Bannister QC J. at [24]. In such companies established on a purely commercial basis, the learned judge held that the remedy for the wrongdoing on the part of directors belonged to the company and it would be a breach of the rule in *Foss v Harbottle* for a minority shareholder to be granted a winding up order on this basis. Of course, there would be no breach of that rule if the wrongdoing directors were in control of the company and could improperly stifle proceedings by the company, in which case presumably the obstacle to a winding up order would not arise.

FIDUCIARY RELATIONSHIPS BETWEEN SHAREHOLDERS

In special and rare situations, a fiduciary relationship may be held to exist between shareholders.
This stems in part[2] from the deep-rooted judicial reluctance to allow fiduciary principles, which are flexible, to intrude upon and render uncertain commercial transactions and relationships.

> "I agree with the observation of Bramwell L.J. in *New Zealand and Australian Land Co v Watson* 7 Q.B.D. 374 at 382, when he said that he would be very sorry to see the intricacies and doctrines connected with trusts introduced into commercial transactions."
>
> per the Divisional Court in *Henry v Hammond* [1913] 2 K.B. 515 at 521

But, just as in certain special circumstances equity regards directors as having assumed fiduciary responsibilities towards shareholders (as in *Coleman v. Myers*, see above) as opposed to the company, so in certain special circumstances equity regards shareholders as having assumed fiduciary responsibilities to other shareholders.
Murad v. Al Saraj [2004] EWHC 1235 (Ch) is believed to be the first UK case where such a state of affairs has been held to exist. The Court of Appeal in *Ross River v. Waveley Commercial Ltd* [2013] EWCA Civ 910 (C.A.)[3] approved the following summary of that case:

> 'In *Murad v Al Saraj*, the claimants successfully argued that the defendant owed them fiduciary duties in connection with a joint venture to acquire a hotel. The fiduciary duties were held to arise because the parties were in the position of joint venturers, the relationship was one of trust and confidence, the defendant had taken on a number of responsibilities in connection with the joint venture, in some respects acting as the claimants' agent, the claimants had no relevant experience, they had no knowledge of

[2] It also stems of course from the general rule that shares are property whose owners can use selfishly.
[3] The Court of Appeal has further commented on *Murad* in *Crossco (No.4) v Jolan* [2012] 2 All E.R. 754.

> the arrangements made by the defendant with third parties and they entrusted the defendant with extensive discretion to act in relation to venture which affected the claimants' interests. The judge ordered that the defendant should account for the entirety of his profits from the joint venture even though that remedy gave to the claimants significantly more than they would have obtained pursuant to an award for damages for deceit, to which they were also entitled.'

But *see Re Coroin Ltd* [2012] EWHC 2343 (Ch)[4].

GOOD FAITH – AT COMMON LAW

- Emphatically no duty of good faith is as a general rule owed between shareholders: shares are property which can be used and enjoyed by their ("wicked capitalist"!) owners in their own selfish interests: see *Coroin* above, the latest in a very long line of cases affirming this principle.
- Further, in contract law, whilst an express duty of good faith is increasingly common-place and enforceable, no duty of good faith will be implied or recognised save in special cases, the most important of which for present purposes (because company law has developed seamlessly from partnership law) is the relationship of partnership.

WHAT DOES "GOOD FAITH" MEAN?

Mullins v. Laughton [2003] Ch. 250 was a partnership case which illustrates very well what failing to act in "good faith" means.

> ". ..**Bullying, seeking to trap and intentionally taking by surprise with a view to shock, in hope of obtaining an advantage for the co-partners and a disadvantage for the partner concerned, must, in my view, amount to a breach of good faith**."

See further *F&C Alternative Investments Holdings Ltd v Barthelemy* [2012] Ch. 613 at [252]–[259].

HAS A DUTY OF GOOD FAITH BEEN INTRODUCED IN THE STATUTORY REMEDIES BY THE CONCEPT OF THE "QUASI-PARTNERSHIP"?

The leading UK cases on the scope of the statutory remedies and the relevance of the concept of a "quasi-partnership" are well-known. Perhaps the most influential is the speech of Lord Wilberforce in *Re Westbourne*

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[4] See also per Patten J. in *Halton International Inc (Holding) SARL v Kaddoura* [2006] 1 B.C.L.C. 78

Galleries [1974] AC 360 (HL). He held that partnership principles of good faith and fair dealing may be applicable in some companies, labelled a "quasi-partnership".

In *O'Neill v. Phillips* [1999] 1 WLR 1092 (HL) Lord Hoffmann held that the same principles applied to the statutory unfair prejudice remedy. But he added the gloss that, where the "quasi-partnership" principles were engaged, the court applied only settled and traditional equitable principles, not general notions of fairness. In particular, he held that a mere breakdown of the relationship of trust and confidence, the main sign of a "quasi-partnership", did not establish a ground for relief under the unfair prejudice remedy, and he doubted whether it was a ground for winding up.

It is clear that the above cases do not establish that shareholders in a "quasi-partnership" stand in a fiduciary relationship to one another.

But do they establish a *general* duty of good faith?

There is a recent UK decision which is relevant but is problematic:

Boughtwood v. Oak Investment Partners Ltd. [2010] 2 BCLC 459 (C.A.).

In *Crawley v Short* (2009) 76 A.C.S.R. 286 at [113], the *Boughtwood* case (above) was treated by the New South Wales Court of Appeal as authority for the proposition that "[e]specially in a closely held corporation there will even be a duty on a non director not to act unconscionably to his or her fellow shareholders"— The court also held at [108]:

> ". . . If the Court considers that the corporate entity is sufficiently closely held to be akin to a partnership it may consider that it is appropriate to hold that the directors have the same obligations to their co-members as a partner would have had . . ."

Sed quaere

See also *Clemens v. Clemens* [1976] 2 All E.R. 268, and *Sunlink International Holdings Ltd v Wong Shu Wing* [2010] 5 H.K.L.R.D. 653,

F&C Alternative Investments Holdings Ltd. [2012] Ch. 613.

A SHORT DIGRESSION – "FRAUD ON THE MINORITY"

In the context of the alteration of the articles of association, it is well established that the majority owe a duty to exercise their voting rights "bona fide for the benefit of the company as a whole": *Allen v. Gold Reefs* [1900] 1 Ch 656; recently applied in *Citco v. Pussers* [2007] BCC 205 (P.C.) and even more recently in a case involving an alteration to the terms of notes issued by a company, *Azevedo v. Imcopa Importacao* [2014] 1 BCLC 72 (C.A.).

AN EVEN SHORTER DIGRESSION – THE DERIVATIVE CLAIM

The "good faith" of the minority shareholder seeking to pursue a derivative claim is integral to his right to sue at both common law and under the UK statutory regime. The claimant has to show that he is acting in good faith in the interests of the company.

- *Barrett v. Duckett* [1995] 1 BCLC 243
- UK CA s. 263(3)(a)

CONCLUSIONS

In summary:

(1) There is no general implied duty of good faith at common law, although express duties of good faith will of course be given effect to.
(2) A duty of good faith must be distinguished from a fiduciary duty – they are far from the same things.
(3) A duty of good faith may be held to be owed in "quasi-partnerships" in the context of the statutory remedies for relief for the oppression of minority shareholders.
(4) But it is not necessarily a demanding duty in practice.