CURRENT ISSUES IN JOINT VENTURES

1. What is a "Joint Venture"?

1.1. A "joint venture" is not a legal term of art; but may be defined, broadly, as a business arrangement under which two or more parties agree to pool resources for common purpose. Joint ventures may be unincorporated (i.e. governed by principles of partnership or contract law) or incorporated, i.e. conducted through a joint venture vehicle such as a company or LLP.

1.2. This paper considers three current issues in the context of incorporated joint ventures.

2. Can a nominee director act in the interests of his nominator?

2.1. This is an issue which arises surprisingly frequently. The terms of a joint venture (whether set out in a JVCo's articles or shareholders' agreement) often give the shareholders the right to nominate directors to the JVCo's board. Once the shareholders have exercised these rights of nomination, can their nominees act in their interests? In my experience, the assumption made by shareholders is that they can. That, however, is a dangerous assumption.

2.2. It is a cardinal principle that a director's duties are owed *to his company*. Directors do not, in general, owe duties directly to shareholders: ***Percival v Wright*** [1902] 2 Ch 421. Further, directors nominated by a particular shareholder does not, of itself, affect the nature or extent of the director's duties. The fact that a particular shareholder nominates the director does not, in itself, create duties owed by the director to the nominator: ***Re Neath Rugby Ltd (No. 2)*** [2009] 2 BCLC 427.

2.3. Therefore, the real issue is the extent to which shareholders may relax the general duties owed to the JVCo. There are three director's duties which must be considered here. These are (i) the duty to avoid conflicts of interest; (ii) the duty to exercise independent judgment; and (iii) the duty to act in good faith and in the interests of the JVCo.

2.4. First, the issue of whether a nominee director can act in the interests of his nominator rather than the JVCo becomes a problem in circumstances where the interests of the nominator and JVCo diverge. In these circumstances, the nominee director may well face allegations that he has breached his duty to avoid conflicts.

2.5. In my view, however, a robust approach may be taken to the relaxation of this duty. It is established that shareholders may authorise a director's conflict of interest by ordinary resolution: ***Hogg v Cramphorn*** [1967] 1 Ch 254. If shareholders can authorise conflicts by ordinary majority, it follows that they can, by special majority, include provisions in a JVCo's articles of association permitting a nominee director to act in circumstances where he facts a situational conflict as between (i) his duties to the JVCo and (ii) his duties to, or interests in, the shareholder who nominated him.

2.6. It is sometimes argued that if shareholders include in a company's articles of association provisions authorising a director's conflict of interest which go beyond the authorisation of conflicts permitted under model articles (in Hong Kong, the relevant model articles being prescribed in Schedules 1 and 2 of the Companies (Model Articles) Notice (Cap. 622H)) (the "**Model Articles**"), such provisions are void. This is because, so it is argued, such provisions involve, as a matter of substance, an attempt to exempt a director from liability for breach of duty, contrary to statutory provisions rendering such exemptions void (see s 468 of the Companies Ordinance (Cap. 622).

2.7. In my view, however, this argument is wrong. The reasoning in ***Movitex v Bulfield*** [1988] BCLC 104 remains sound. It is, in principle, open to shareholders to narrow the director's duty to avoid conflicts of interest as much as they want. This does not involve an exemption from breach of duty; rather, the point is that the duty does not arise in the first place.

2.8. The second duty is the duty to exercise independent judgment. If a nominee director follows directions given to him by his nominator, it is hard to see how he can be described as fulfilling this duty.

2.9. Again, however, this duty may be limited by provisions in the JVCo's constitution. Under the Model Articles, the directors' management powers are subject to any directions given to them by shareholders by special majority. Plainly, once the shareholders give such a direction, the directors' duty to exercise independent judgment has no application: directors who receive such a direction must comply. If directors do not approve of the shareholders' direction, their only option is to resign.

2.10. Given that, under the model articles, the directors' duty to exercise independent judgment is expressly limited by directions given to the board by special majority, it must follow that the shareholders may, by the same special majority, include provisions in the JVCo's articles of association obliging nominee directors to act on the instructions of the nominator.

2.11. It is the third of the directors' duties referred to at paragraph 2.3, namely, the duty to act in good faith and in the interests of the JVCo, which is the most problematic. This is the core duty of loyalty owed by a fiduciary to his principal. In ***Southern Counties Fresh Foods Ltd*** [2008] EWHC 2810. Warren J expressed doubt as to whether this core duty of loyalty could be abrogated, even with the unanimous agreement of shareholders.

2.12. I share the doubts expressed in ***Southern Counties***. If a director is not required to act in good faith or in the interests of his company, it is hard to see how he can be described as a director at all. In my view, there is little doubt that, if shareholders amended a JVCo's articles so as to include provisions which purported to permit a nominee director to act in the interests of his nominator and contrary to the interests of the JVCo, a court would treat such provisions as invalid, either on the basis that it was outside the power of shareholders to amend the statutory contract of membership in that way or, alternatively, on the basis that the provisions exempted the nominee from liability, contrary to s 468.

3. Protecting Nominee Directors

3.1. Given that any provision in a JVCo's articles disapplying the duty of directors to act in the best interests of the JVCo is likely to be treated by a court as invalid, is there anything else which shareholders can do to protect their nominee directors?

3.2. One possibility would be for shareholders to include appropriate provisions in an agreement to which the JVCo is <u>not</u> a party. Shareholders could agree, for example, that they will not sue or cause the JVCo to sue in respect of any actions taken by nominee directors on the instructions of the nominator.

3.3. It is suggested that covenants of this kind would at least protect shareholders and their nominee directors against the risk of unfair prejudice proceedings. This is because the essence of the unfair prejudice jurisdiction is breach of the shareholders' bargain. It is difficult to see how a shareholder could establish unfair prejudice in circumstances where he had agreed that another shareholder's nominee directors could act in the interests of that other shareholder.

3.4. However, mutual covenants of this kind between shareholders would not protect nominee directors from claims brought by an office-holder on behalf of the JVCo itself in the event that the JVCo entered insolvency proceedings; nor would they protect nominee directors against claims brought by any new shareholders who had not given such covenants.

4. Terminating a joint venture: expelling a shareholder

4.1. This is another issue which commonly arises. Two or more shareholders commence business through a JVCo. After a period of cooperation, the shareholders fall out due to disputes as to the future direction of the business. One shareholder wants to boot out the other and continue to venture under his sole control. Is this possible?

4.2. If the existing terms of the joint venture give one shareholder (A) the right to expropriate the shares held by another (B), then A is, in principle, entitled to enforce the terms of that bargain and expropriate B. Note, however, that a court is likely to construe expropriation provisions strictly against the party seeking to rely on them.

4.3. This shows the sense in planning ahead. At the commencement of the joint venture, careful thought should be given to the inclusion of provisions in the JVCo's articles or a shareholders' agreement which enable to one shareholder to acquire another's shares. If provisions of this kind are included in the JVCo's articles on incorporation (or, alternatively, the shareholders, acting unanimously, adopt such articles), there is no unfairness if a shareholder subsequently relies on such provisions to expropriate another shareholder.

4.4. If, however, expropriation provisions are not included in a company's articles on incorporation, it is very difficult for majority shareholders to amend articles so as to include those provisions.

4.5. The powers of the majority to amend a company's articles are subject to limits most recently considered by the English Court of Appeal in ***Charterhouse Capital Ltd*** [2015] BCC 574. In my view, the Court's decision in that case signalled a more relaxed approach to amendments to a company's articles: it will now be harder for minorities to challenge amendments. Nonetheless, the Court held that if the amendment in question involved the unwarranted appropriation by the majority of benefits for themselves, this would be outside the power of the majority and the amendment would be invalid.

4.6. In my view, even applying the more relaxed ***Charterhouse*** test, a court is likely to conclude that the introduction of provisions into a JVCo's articles so as to enable one shareholder (A) to expropriate another (B) is invalid, at least in the absence of exceptional circumstances justifying B's removal. Plainly, the fact that A and B have different views about the future direction of the JVCo's business would not justify the introduction of provisions enabling A to remove B.

5. Terminating the venture: other possibilities

5.1. Given the risks of challenge to the introduction of expropriation provisions into a JVCo's articles, shareholders who wish to bring a joint venture to an end may need to consider other options. Some of the main ones which I have encountered are briefly summarised below.

5.2. First, a shareholder could consider whether to terminate the joint venture by seeking to wind up the JVCo on the just and equitable ground. It is now clear that the court's jurisdiction to wind up on this ground is broader than the jurisdiction to grant relief for unfair prejudice: ***Re Neath Rugby Ltd*** [2010] BCC 597. Deadlock between joint venturers or a loss of substratum may justify a winding up.

5.3. Alternatively, if a shareholder (A) controls the JVCo's board (and there are no contractual restraints in any agreement preventing him from doing so), he could procure the JVCo to sell its business and assets to a vehicle wholly-owned by him, thereby leaving the JVCo as a cash shell. This aggressive 'self-help' solution may, however, to lead to allegations that A's nominee directors have acted in breach of duty in acting for improper purposes and/or acting contrary to the JVCo's interests.

5.4. Finally, while it would be unethical to advise majority shareholders to behave badly in order to provoke the minority into presenting an unfair prejudice petition, it is worth observing that majorities often <u>benefit</u> from the presentation of such a petition. This is because the usual relief granted on a petition is an order that the majority buy out the minority. The presentation of a petition therefore affords the majority a means of removing the minority. It is for this reason that my own experience of advising majorities has been that they are often distinctly cheerful at the news that their improper conduct may provoke the minority to petition against them.

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