Feature

KEY POINTS

- The constitutional rights of shareholders must be respected by management when there is a confrontation over what may be in the best interests of the company, even if this means reading the express terms of the company's powers in a broader commercial context.
- This was emphasised in November last year when the Bermuda Supreme Court handed down its Judgment in *Annuity & Life Reassurance Ltd v Kingboard Chemical Holdings Limited* [2015] SC (Bda) 76 Comm, a substantial unfair prejudice claim against a publicly listed company.
- Such claims rarely get close to trial, or are successful, which is why this is one of the few reported decisions of its kind in the Commonwealth.

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The availability of the unfair prejudice remedy for activist shareholders of public companies

This article reviews the decision in *Kingboard*, a key judgment for those concerned with the rise of shareholder activism in relation to publicly listed companies both in the UK and elsewhere. It serves as a useful demonstration of the kind of conduct which could lead to a buy-out order in relation to a public company and how a court may construe the standards of fair dealing in light of a public company's formal constitutional documents. In the words of the court, the majority chose 'to toss [the] rule book aside when a minority shareholder [sought] to enforce the rules …'.

Kingboard provides useful ammunition to activist minority investors of public companies who find themselves in a struggle with management over the way commercial decisions affect the value of their shareholding. Clearly, such shareholders can assert their power through the exercise of their voting rights, particularly with respect to the appointment or removal of directors or the blocking of transactions which require their approval. Yet, the right to vote is of limited effectiveness if it is overridden or by-passed through the exercise of powers by those in control.

In the right circumstances, this can be adequately remedied by an application to the court for the exercise of such powers to be set aside. In other circumstances, the statutory "unfair prejudice" remedy would be appropriate. In broad terms, this gives a court a discretion to grant relief where the affairs of a company are being conducted in a manner unfairly prejudicial to the interests of some part of the members. The available relief is wide-ranging but the most sought after order (and usually the most effective) is one that the company or certain members purchase the shares of other members (ie a "buy-out order").

However, the common law development of that remedy has not been particularly encouraging to activist minority shareholders of public companies. There is no doubt that it has been available to them as a matter of principle, but it is difficult to find many examples of where it has featured in their disputes.

The general approach of the court in *Kingboard*, and its decision, sit comfortably with aspects of the recent UK Supreme Court authority on the exercise of powers by directors for an improper purpose; that is to say, it puts the express written powers and requirements which apply to corporate governance in a broader constitutional or commercial context. Complaints of unfair prejudice very often involve the exercise of specific powers by management in response to shareholder activism.

UNFAIR PREJUDICE CASES AND PUBLIC COMPANIES

The clearest way of succeeding in a claim for unfair prejudice is to establish that there has been a breach of the agreed terms upon which the affairs of the company are to be conducted. The starting point is the written constitution of the company, whether recorded in the articles or in collateral agreements. By contrast with private companies, the management of a public company is subject to more regulatory law or codes of practice so these too can be relied upon to show misconduct.

Having said that, a breach of the constitutional, statutory or regulatory requirements will not, by itself, entitle a petitioner to a remedy: the conduct must also be both prejudicial and unfair. Even conduct which is capable of being a breach of the directors' fiduciary duties will not amount to unfair prejudice if there is no loss (and therefore no prejudice): see for example *Rock (Nominees) Ltd v RCO Holdings plc (in liq.)* [2004] B.C.C. 466. Similarly, a breach of listing rules or a City Code, without more, will not be enough: see for example, *Re Astec (BSR) plc* [1998] 2 B.C.L.C. 556.

The impediments to relief (particularly, that of a buy-out order) tend to be based on the very nature of a publicly listed company, namely:

- the ability of a disgruntled shareholder to sell his shares as a means of avoiding the prejudice about which he complains (unless there are extraordinary circumstances in which there is an illiquid market);
- the court's concern that there be certainty in promoting the orderly trading of shares on stock markets;
- the availability of alternative protection or relief from the regulatory environment in which publicly listed companies operate;
- the reluctance of the law to import equitable constraints based on the "reason-

> able expectations" into the relationship that shareholders of public companies have with each other or with their management. Unlike private companies, there is usually a considerable amount of information available on the structure, history and operations of public companies at the time members acquire their shares. This tends to leave very little scope for relying upon unwritten understandings and puts shareholders on notice of the potentially prejudicial aspects of the company's affairs.

On the other hand, there is authority in England and Hong Kong that conduct which risks the listed status of a company itself will justify the granting of relief. Those cases support the notion that a breach of "external" standards, such as listing rules or a City Code, mean that there has been a flouting of the requirement of fair and reasonable conduct: see *Re St Piran Ltd* [1981] 1 W.L.R. 1300 and the Hong Case of *Luck Continent Ltd v Cheng Chee Tock Theodore* [2013] 5 HKC 442. However those cases did not result in orders that the minority's interest be bought out. In *Luck Continent Ltd* the relief was an order that the bye-laws of the public company be amended to comply with listing rules so that the company's listed status could resume.

In the Australian case of *Re Spargos Mining NL* (1990) 3 ACSR 1, the petitioner complained of transactions which, at the expense of the listed company, benefitted other companies in its group and had been carried out by the common directors. Even though the court found that no reasonable board could have entered into the relevant transactions, a buy-out order was not sought. Instead the court made an order appointing an independent and disinterested board of directors to investigate the impugned transactions.

This is not to say that there has been no indication at all prior to *Kingboard* that an unfair prejudice claim could succeed against a publicly listed company and result in a buy-out order. For instance, in the Australian case of *Noble Investments Pty Ltd v Southern Cross Exploration NL* (2008) 69 ACSR 304, where directors of a listed company were alleged to have procured transactions in conflict of their duties, the court refused the defendant's application for summary judgment and found that there was a real prospect of the claim succeeding, including the plaintiff's pursuit of a buy-out order.

It is against this background that we come to the claim in *Kingboard*.

THE FACTS IN *KINGBOARD*

Kingboard Copper Foil Holdings Limited (the "Company") was principally managed in Hong Kong but its commercial activities took place in China. It was a subsidiary of the Kingboard Group, a leading producer of printed circuit boards. The Company was listed on the Singapore Stock Exchange.

The Company was a producer of copper foil and supplied almost all of its product to its Group, and the majority shareholders, at depressed "bulk discount" prices. These were of course "Interested Party Transactions" which could negatively affect the Company's profit margins and thereby prejudice the interests of the investors who had become the Company's minority shareholders. This state of affairs was acknowledged by the Company in its Prospectus which represented that the Company would seek to reduce its dependence on the Group as its main customer. The Listing Rules required that "Interested Party Transactions" be approved by disinterested minority shareholders so this was incorporated into the Company's constitutional documents.

The minority shareholders were given a veto over the Company's ability to trade with its majority shareholders. Practically, this meant that they had been given the power to bring its usual business to an end if they were dissatisfied with the supply arrangements. As the Chief Justice put it, this 'constitutional fetter on [the majority's] controlling powers was the price to be paid for the public investment' enjoyed by the majority shareholders.

For a number of years, the Company sought to comply with these Rules through resolutions passed from time to time in general meetings. However, at a Special General Meeting in April 2011, the minority's veto was exercised for the first time when concerns were raised about how the Company was faring in comparison to the Group and the effect this had on the Company's share value.

As the court ultimately found, the proper response at this point would have been for the controllers of the Group to promptly initiate negotiations with the minority and, in any event, to have regard to the best interests of shareholders as a whole when considering how to respond to the veto. Not only did they not take that course, they voted against the petitioner's resolutions that an independent auditor be appointed to investigate its complaints about pricing.

The Group proposed no alternative means of dealing with the complaints and, instead, took the extraordinary step of having the Company licence its entire business to a British Virgin Islands company which had no apparent experience in the production of copper foil. This licence was known as the "Harvest Licence Agreement". In return, the Company received a fixed annual fee. This essentially transferred the Company's whole business to another entity so that it could continue trading with the Group as its main customer, upon the same terms, despite the veto.

The business continued to do the very thing the veto was directed at stopping. This was beyond the reach of the minority because they obviously had no rights to veto the operations of a separate company. At the same time, no dividends were paid. The majority's interest was served at the expense of the minority. The minority could not exit from this state of affairs, at least not without suffering considerable loss in the market. The Group effectively took the position that this state of affairs had been brought upon the minority by its own conduct as a result of the exercise of the veto.

THE *KINGBOARD* JUDGMENT

The petitioner relied upon two broad areas of complaint; first, that the Company had been trading with the Group on commercially favourable terms to itself which essentially shifted value away from the Company and into the Group without any real steps being taken towards broadening the Company's customer base. Second, the petitioner complained about the Harvest Licence Agreement.

Having been incorporated in Bermuda, the Company was subject to the Bermuda companies legislation, including the relevant unfair prejudice provisions. Those provisions were substantially similar to the old English provisions which were contained in the English 1948 legislation.

The court found that the first area of complaint was not proved at trial but had little difficulty in finding that the Harvest Licence Agreement amounted to unfairly prejudicial conduct. In doing so, the court reinforced the following important principles:

- majority shareholders are given considerable latitude to exercise their own business judgment in managing companies so long as they abide by the rules upon which minority shareholders relied when they purchased their shares;
- the unfair prejudice remedy cannot be deployed as a means of obtaining judicial relief in respect of "commercially unfavourable outcomes" alone, especially in relation to a publically listed company;
- a breach of contractual rights or a misuse of powers conferred by a listed company's constitution (including any listing rules) would need to be proved if the alleged unfair prejudice was to be of sufficient gravity to justify a winding up on the just and equitable ground. There must be some fundamental breach of the express or implied terms upon which an aggrieved shareholder made his investment.

The court agreed with comments made by the New Zealand Court of Appeal in *Latimer Holdings v Sea Holdings Ltd* [2004] NZCA 226 that the activities of listed companies with tradeable shares are not beyond the reach of the unfair prejudice provisions – the tradeability of their shares just means different considerations may apply to them.

The court concluded that where a listed company is run in a way which seeks to subvert the effect of the rules put in place to protect minority shareholders, and actual prejudice results, there must be relief available under the unfair prejudice provisions – otherwise minority shareholders in solvent listed companies would effectively be deprived of any remedy.

The veto power was directed to the inequality of the relative position of the minority and a means by which it could prevent the majority from effectively transacting with itself on unduly favourable terms. This went to the 'bread and butter of the Company's business activities' and meant, as a practical matter, that the majority had to be prepared to persuade the minority each year that the sales to the Group were commercially acceptable.

On this basis, the court found that the use of the licence arrangement for a prolonged period was unacceptably unfair. It allowed trading to continue in a manner which favoured the majority and put the minority in a worse position.

INTERESTING ASPECTS OF THE COURT'S APPROACH

If one were to justify the Chief Justice's decision on the basis that there had been a breach of the formal terms governing the shareholders' relationship, then this could be done by reference to the principle that terms may be implied into bye-laws in order to lend them business efficacy.

Put another way, and although not deployed as a means of analysis, the Chief Justice's conclusion is consistent with the dictum of Lord Hoffmann in *O'Neill v Phillips* [1999] 1 W.L.R. 1092 at 1101 to the effect that cases of unfair prejudice may arise in circumstances analogous to "contractual frustration"; in his Lordship's words:

> '[t]he unfairness may arise not from what the parties have positively agreed but from a majority using its legal powers to maintain the association in circumstances to which the minority can reasonably say it did not agree … It is well recognised that in such a case there would be power to wind up the company on the just and equitable ground.'

The approach of the Chief Justice also resonates with the recent Supreme Court decision in *Eclairs Group Ltd v JKX Oil & Gas plc* [2015] UKSC 71 which was handed down shortly afterwards in December in relation to a different, albeit related, kind of complaint, namely, that directors had exercised their constitutional powers for an improper purpose. Like *Kingboard*, that case concerned steps taken by the Board of a public company to curtail the constitutional rights of a large minority shareholder for what it believed to be the "best interests of the company".

The shareholder in that case was regarded as a "corporate raider" and the dispute was whether the Board's power to impose restrictions on the shareholder under the articles was subject to the "proper purpose" rule or whether it could be exercised in what the directors bona fide believed to be the best interests of the company. The restrictions were a serious interference with the financial and constitutional rights of a shareholder and an interference with the proper operation of the market in its shares. Ultimately, the court found that 'such a draconian power [must] be circumscribed by something more than the directors' duty to act in the company's interest as they may in good faith perceive it'. The Supreme Court allowed the appeal and held that the power had been exercised for an improper purpose.

At para 29 of the Judgment, Lord Sumption recorded the 'formidable dissent' of Briggs LJ in the Court of Appeal and quoted the following passage from his judgment:

> 'Furthermore, I consider it important that the court should uphold the proper purpose principle in relation to the exercise of fiduciary powers by directors, all the more so where the power is capable of affecting, or interfering with, the constitutional balance between shareholders and directors, and between particular groups of shareholders.'

At para 30, consistent with the approach taken in *Kingboard*, Lord Sumption remarked that '[a]scertaining the purpose of a power where the instrument is

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silent depends on an inference from the mischief of the provision conferring it, which is itself deduced from its express terms, from an analysis of their effect, and from the court's understanding of the business context'.

As to the implicit assertion (which featured in both cases) that the actions of a shareholder may justify the dramatic response of the company, Lord Sumption further observed that 'the limitation of the power to its proper purpose derives from its fiduciary character. If its exercise would otherwise be an abuse, it cannot be an answer to say that the person against whom it is directed had only himself to blame': see para 39 of the judgment.

It is interesting to contrast the approach of these recent decisions with the much earlier decision in *CAS (Nominees) Ltd v Nottingham Forest FC plc* [2002] 1 BCLC 613 where the public company's subsidiary was the owner of a football club. Like *Kingboard*, the public company had been floated in order to raise capital. Sometime after the floating of the shares, the company structured a transaction whereby the controlling interest in its subsidiary was procured for a single new investor in order to raise new capital for the club. The central issue was whether the amount and terms of the new investment justified the loss of overall control suffered by the existing shareholders in the company. Those who were originally the controlling shareholders claimed that this was unfairly prejudicial because it was designed as a way of avoiding the need for the new investment to proceed by way of a subscription for the company's shares. Such a subscription would have needed approval at a general meeting and, had it been put to the meeting, would have been defeated by the minority's vote. In a sense this was akin to *Kingboard* because it was a situation in which the minority had a "veto" over the way the controllers wished to conduct the company's affairs.

The complaint was that the board acted for an ulterior purpose, namely, to by-pass the legal and quasi-legal protection given to shareholders by the company's articles of association and the Companies Act 1985 in order to permit the investor to acquire control of the assets of the company. The court framed the issue as being whether '… the means adopted to secure [the transaction] were an improper (and in s 459 terms unfair) evasion of obstacles laid in their path by statute'.

The court held that, given a genuine desire to raise capital, the company's powers could not be regarded as being exercised for a purpose foreign to their proper ambit. It refused to construe an "anti-avoidance provision" which limited the Board's ability to deprive the shareholders of their right to block the transaction. By contrast, in *Kingboard* it did not matter what the Board might have genuinely regarded as being in the company's interests (or even what was actually in the company's interests so far as the pricing issue was concerned); the constitutional "right to block" had been subverted without a process of engagement with the minority shareholders. This was unfair regardless of it being achieved through the Board's power of general management. It was not a question of having to find an express limitation on that power.

The approach in *Kingboard* (and to an extent, *Eclairs Group Ltd*) requires those in control of a company to be more respectful of the constitutional rights of shareholders when there is a confrontation over what may be in the best interests of the company. This is the case even if this means reading the express terms of the company's powers in a broader commercial context.

These decisions were able to reach that conclusion without needing to descend into the quagmire of whether the management were correct in their assessment of the company's commercial interests. From the point of view of commercial certainty, this makes considerable sense because those constitutional rights, or regulatory safeguards, are often the subject of complex negotiation at the time shareholders make their investment or at least they may feature in a decision to acquire shares.

Sometimes it is inadequate to say to those shareholders that they should leave the company if they do not like it – often they did not join a company with the intention of leaving as soon as they felt aggrieved. However, equally, a balance must be struck so that management can fulfil its role and not be confronted by an activist minority which can hold the company's affairs as its hostage.

CONCLUDING REMARKS

The controlling shareholders in *Kingboard* took the intransigent and adversarial view that they could ignore the minority's interests because this was justified by the dramatic implications of the veto on the Company's business. Yet the implications of the veto derived from the very thing the minority complained about, and the very thing to which the power to veto was directed, namely, that the Company had the Group as its main customer.

If nothing else, *Kingboard* provides encouragement to sophisticated, activist investors who are looking for a means of further shifting the balance of power in their direction, particularly those professionally engaged in the investment business. The case also serves as welcome guidance for management as to how to navigate its way through disputes with such investors while also protecting the company's business. It will be interesting to see whether activist shareholders, and management, will discern a greater willingness from the courts to assist shareholders of public companies and how this will affect their dialogue when the balancing of constitutional rights is at stake. ■

Bibliography

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Further Reading:

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- Discretionary decision making in a commercial context [2013] 4 JIBFL 195.
- LexisPSL: Corporate: Shareholder activism practice notes.