Oppression of minorities v majority right

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Mr Ebrahimi *(Ebrahimi v Westbourne Galleries* [1973]), a co-founding partner, must have had the shock of his life when in 1969 his long standing partner orchestrated a shareholders' General Meeting ending with his removal as a director of the company they had incorporated together some years before. Since 1945 their shared business interests of selling expensive rugs had passed through an unincorporated partnership. The subsequent incorporation 12 years later would not have surely pointed to such an awful falling out since the original idea was merely to use the corporate formulation as a tool of tax mitigation. For quite some time the seamless passing from partnership to company had gone off without a hitch making the introduction of Mr Nazar's son as third shareholder an innocuous occurrence and something that met with Mr Ebrahimi's blessing given that he consented to the boy being made a director and, along with the lad's father, transferred to him some of his shares. He conceivably would have had no notion that he had become a minority and had unwittingly elevated Messrs Nazar to majority status. One shareholders' ordinary resolution later the penny must have dropped and the hapless Mr Ebrahimi was out of a job. Luckily for him however, England's House of Lords, representing the highest court in the land at the time, regarded the company not as a joint stock company per se but as a quasi-partnership in which all of the partners would play an active managerial role. Their lordships reasoned that the legitimate rights of the majority shareholders in General Meeting had, given the facts and circumstances, been exercised legitimately but expressed unconscionably. Consequently, overturning the Court of Appeal, they ordered the imposition of a restraining conscience on Messrs Nazar in order that the gallery's business be wound up. The company thereby was not allowed to continue with Mr Ebrahami shut out, but had to return to him and his estranged partners their share capital and profits.

Not all shareholders[1] across the British Commonwealth have been quite so fortunate. Some, perhaps even many, have learned the hard way that justice under the model of English company law and by derivation the corporate law of Cyprus, still begins with the immortal phrase: 'caveat emptor'. For the coming together of subscribers to form an association for an economic purpose do so first and foremost under the principles of contract and acquire the quite specific legal rights that flow therefrom. Each and every shareholder must understand the dominance of those rights, together with the superior statutory provisions contained in 'CAP113 – Companies', otherwise they can lead to surprising unintended outcomes. Indeed whilst these legal rights and statutory provisions are adjudged by the courts within a context of contractual good faith these legal rights are superior in force. Many foreign shareholders of Cyprus companies manifestly have no idea what they are in for, even insomuch as being frozen out almost

indefinitely from participation in a company's management and by the same token the receipt of dividend. Be of no doubt, the award in *Westbourne Galleries* was an exception that proved the rule. Getting there would have been very traumatic for Mr Ebrahimi necessitating appeal after appeal, not mention legal fees.

For Cyprus' practitioners of corporate services, the analogy will not be lost because their clients too tend to be driven and orientated by tax planning. Where this is espoused with the widely used and worded 'blue print' Memorandum and Articles of Association (M&A) that have no provision for the unintended consequences of the Majority Rule Principle as it is known, the stage is set, establishing a contingent financial loss or a surprising disappointment, from the outset. So it arguably behoves professional fiduciaries where appropriate to draw up, at the 'Know Your Client' phase, a detailed memorandum of the shareholders' intentions that covers and explains these legal fundamentals.

The precise orientation of such a 'memo' might look to the regulation CAP113 s285 for its inspiration. Said s285 states that upon a voluntary winding up, a company's share capital or membership interest would be distributed to shareholders 'according to their rights and interests in the company'. The message then is clear. A shareholder must focus on the 'end game' or his exit. Any realisation of his financial interest could legitimately be deferred for a very long time, where the majority will it to be so, since most 'shelf-companies' possess perpetual succession[2]. Furthermore, without appropriate consideration and modification of the M&A, the minority member has no right to hold office as a director and therefore the majority could decide as circumstances dictate, not only who receives remuneration, but the quantum thereto. All of this is unquestionably licit making it clear that the time to catch these things is at birth.

Foss v Harbottle

It is certainly not the case that the law affords no protection for minorities from majority tyranny, as there are some reassuring exceptions that are worth looking at which act as a check on any departures from contractual understanding and the attendant good faith[3]. The leading English precedent of *Foss v Harbottle [1843]* is seminal. Decided long ago before the first Joint Stocks Companies Act 1844 when companies were unincorporated trading trusts or unlimited partnerships, it emphatically confirmed the '*lex non scripta*' principle that the will of a company is in the hands of the majority vote in a General Meeting, duly convened and held. So the minority cannot ordinarily compel a company to take legal action to seek redress against a miscreant director or a third party. However, over time the courts declared some important exceptions to the rule. These are where they can show the directors have acted *ultra vires* or illegally; or where a simple majority vote is insufficient as per the Articles or CAP113; or where the directors have through action or omission committed a '*Fraud on the company*' and they, the perpetrators, remain in control.

Oppression of minorities

Another form of protection from majority domination is in CAP113 itself (s202). It amounts to wrongful oppression of minorities' financial interests and contractual rights. Guidance may be found in Lord Wilberforce's comments in *Elder v Elder and Watson Ltd [1952]* to wit:

> "the essence of the matter appears to be that the [majority]conduct complained of should at the lowest involve a visible departure from the standards of fair dealing, and violation of the conditions of fair play on which every shareholder who entrusts money to a company is entitled to rely."

From the commentaries however it is clear that s202's standard of transgression is very high. It is designed to prevent the majority will from committing manifest wrongdoing of the unjust, harsh or tyrannical kind. As a remedy it is an alternative to the 'just and equitable' provision utilised in *Westbourne Galleries* which is found in s211. If a petitioner was successful, it would probably require a company or its majority to buy the minorities' shares at a price to be determined by the court which could be either '*paripassu*' or subject to a minority discount. This could be regarded as encouraging news, but on the downside when this provision was applicable in the UK between 1948 and 1980, only two recorded cases came 'before the bench'. Commentators and protagonists for reform said that the difficulty in proving 'oppressive' when weighed against the risks of litigation was an enormous disincentive. The point they won leading eventually to a rewording of British law. The lowering of the benchmark from 'oppressive' to 'unfairly prejudicial' however was never adopted in Cyprus.

The duties of directors

As well as the built-in protections arising under common law and CAP113 s202 and s211, a minority shareholder can look to the directors to act with reasonable care and skill and in accordance with their fiduciary duties (honestly and loyally) to a company. But here again one is struck by the fact that rather than rely on others to act honourably which they invariably do, if it is so important, far better to be a director oneself or to nominate a professional alternate director or trustee in one's stead i.e. guaranteed representation on the board. At least this underpins access to the full information that is found in a company's books and records.

These fiduciary duties themselves fall into four categories:

1. to act in good faith in the best interests of the company as a whole;
2. to exercise powers for a proper purpose;
3. to avoid conflicts of interest; and
4. not to make personal profit that in equity ought to belong to the company.

Yet, comforting as they are, these duties are not without a sting in the tale. As a starter, the courts prefer not to interfere on the question of good faith, intervening only where no reasonable director could have believed that a course of action was in the best interests of a company. Next, there are legal authorities confirming that where an improper purpose is merely ancillary to a legitimate purpose, the decision could be legitimised by an ordinary resolution of the shareholders. Lastly, where a director finds himself in a position where his interest conflicts with those of his company this might be tenable as long as the conflict is approved by either the disinterested directors in accordance with the Articles or again an ordinary resolution of the shareholders in General Meeting. One last point to add is that common law, in seeking to foster equality of opportunity, allows the majority to approve negligent acts of directors as long as they are not fraudulent.

In other words these duties offer minority shareholders a degree of protection. However the overarching theme is that the legal system prefers to let private parties sort matters out among themselves and ratify acts as much as practicable privately as a means of settling disputes quickly and cleanly without the court's involvement.

Understanding minorities' remedies

So where does this bring us? The first point is that the remedies under s202 and s211 are only available in very specific and extreme circumstances and any action thereon could be expensive and risky.

There is clearly a potential dichotomy between shareholders' legal rights and the court's power to apply equitable principles when petitioned by minorities. In addition, these rights within the context of an association that is a company are always supposed to be carried on '*bona fides*' i.e. in good faith. There is a presumption that directors act bona fides to their company.

Wherever there is dualism there may also be Plato's moral hand discerned. Perhaps this dualism could be likened to two related separately moving objects, one greater and senior (legal rights) and the other lesser and junior (shareholder value). All is well until they stop moving harmoniously in parallel. Should they collide or fail to keep up one with another, it is justice that must bring them back into a cooperating and complimentary synthesis. The result reached may not be to everyone's liking but it is a sincere and conscientious attempt to reach a unifying compromise of the legal principles of company law and equity. It explains and justifies why the minority are right in conscious to look for honourable and honest stewards of their capital while the majority has the right to ratify the:

1. allotment of shares for an improper purpose;
2. failure to disclose an interest in a contract;
3. making of a secret profit that the company could not have followed through on; and
4. failure to work with skill and care as long as it is not fraudulent.

Within this framework then a petitioner could move under s211 to wind a private company up because the specific legal rights and obligations were no longer in harmony with the ancillary role of producing a reasonable investment return and/or managerial involvement.

The searching quality of the dialectic though does not seem so fitting in the case of s202 which seems to be impervious to the dialectic's finesse. Instead this provision seems to hold shades of Jean-Baptiste Colbert's quote that 'the art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing'[4]. Somewhere along the line a point is reached where a judge would say enough is enough. If the majority keep ratifying the incompetence of their preferred board in the end it is going make the goose hiss and that is where it becomes oppressive.

Fraud on the company

That being said there is also the alternative for minorities that does not result in winding up or the necessity to buy back the capital of the dissenting minority. This remedy would return misappropriated property to a company. It may involve tracing procedures or claims against the company's insurers as a means of restoring corporate property to its rightful home. In other words all shareholders would indirectly benefit.

There is a hard and fast rule that possession of the board room is nine tenths of the law. The board often have at their disposal the power to pay themselves more or less, declare or pass a dividend, divest or invest, act *'bona fides'* or *'mala fides'*, sue in a company's name, etc.. Minorities simply do not have these powers or, if they do, they have to pass first through the tortuous process of convincing a judge that their petition qualifies as 'Fraud on the Company'.

These then are the three options as one surveys the scene of legal possibilities set against the commercial realities of winning or losing an action. A minority member may be confident he has a strong case because he is hissing loudly, but if his action fails, the cost of litigation could wipe him out. So on the whole petitioners come forward because they have little alternative or poor legal advice. Looking back over the legal authorities not even the learned judges of the courts of appeal have always agreed with one another as to what should be the outcome. In the case of *Re Lee Behrens & Co Ltd [1932]* the judge sitting alone confused the issue of corporate capacity (*ultra vires*) with the abuse of powers by directors. His mistake was incorporated into several cases before it was cleared up 40 years later!

Remedies: professional commentary

The 'just and equitable' winding up (s211) has been clarified by Lord Wilberforce in *Westbourne Galleries* where he gave three pointers in these words:

> 'It would be impossible, and wholly undesirable, to define the circumstances in which these considerations [just and equitable winding up] arise. Certainly the fact that a company is a small one, or a private company is not enough…The superimposition of equitable considerations requires something more, which typically may include one, or probably more, of the following elements:
>
> 1. an association formed or continued on the basis of a personal relationship, involving mutual confidence – this element will often be found where a pre-existing partnership has been converted into a limited company;
> 2. an agreement, or understanding, that all, or some (for there may be sleeping partners), of the shareholders shall participate in the conduct of the business;
> 3. restriction upon the transfer of the members' interest in the company – so that if confidence is lost, or one member is removed from management, he cannot take out his stake and go elsewhere.'

The meaning of oppression (s202) involves wrongdoing and Lord Wilberforce again gave his explanation above in *Elder v Elder and Watson Ltd [1952]*. Nevertheless, the point at which a minority can declare enough is enough is exacting.

Turning to the last possibility of *'Fraud on the Company'* Stephan Griffin LLB[5] lists three separate categories of this kind, namely:

1. an intentional misappropriation of corporate assets;
2. a negligent misappropriation of corporate assets; and
3. unfair advantage.

Final remarks

My aim here has been to bring attention to an aspect of current practice rather than critique the legal framework which is tried and tested and to my mind possesses the requisite level of legal certainty.

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Furthermore, I would go on to say that a commendable feature of justice under English legal principles, as adopted in Cyprus, is its built-in flexibility and reluctance to interfere where it has no business poking its nose. But this does come at a price requiring clients to bone up on the facts and to do their homework first.

Relying on other commendable principles such as the equitable restraint of legal rights or general fairness or the remedies outlined may not be sufficient when it comes to the crunch.

The memorandum I proposed may positively lead to an increase in bespoke M&A that incorporate fixed terms before winding up, weighted voting, capped remuneration, share restrictions, the right to board representation, specific objects; and finally, a Maitland Trust[6] as successor in the event of an 'intervention call' because of deadlock. It may also stand as a better alternative for the popular shareholder agreements that can be costly and complicate intractable situations further.

Of course in the vast majority of cases companies work without these things founded upon mutual respect and trust. This success tends to be about the coming together of capital risk takers and managerial entrepreneurs in a spirit of free enterprise and endeavour. Indeed for some commentators, the 19th century's Joint Stock Companies Acts of 1844 and 1855 are credited with unleashing great enterprise and prosperity across America and the Empire when for the first time investors' liability was limited, a company's objects, directors and shareholders became a matter of public record and it was no longer necessary to obtain the consent of all shareholders in order to sue a third party in the company's name. Capital flowing into companies increased. Railways, towns and roads were built, land was farmed and mines were dug giving commerce and industry a 'shot in the arm' aided and abetted by the certainties of the new joint stock company and the rule of law.

Something similar might be happening today as illustrated by Cyprus' significant position as a conduit of capital in and out of former Soviet Union. The professional classes of Cyprus have been playing a dynamic role in contributing to this transition. Steadily improving standards of fiduciary services along the lines I have outlined would go hand in hand with the imminent law to licence fiduciaries. With the right knowledge and good application, notwithstanding a rather outdated yet efficacious 1948 British companies' law, Cyprus as a financial services centre has the means to continue to punch above her weight.

END NOTES:

1. *In this article shareholder and member are used one and the same.*
2. *This means they possess the potential for eternal life.*
3. *This good faith has been assumed into company law from partnership law.*
4. *Colbert was an able 17th century finances minister of the French royal court of Louis XIV, although not even he managed to curtail his master's profligacy on account of the costs of war.*
5. *Company Law Fundamental Principles – Pitman Publishing.*
6. *A Maitland Trust is written on terms that take on the legal ownership of the shares of a company with a mandate for professional trustees to wind up the company over a fixed period. The trustees are appointed only upon a formal 'intervention call'.*