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Developments in the Jersey law on unfair prejudice

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Introduction

The Royal Court has recently clarified its approach to applications made pursuant to Articles 141 to 143 of the Companies (Jersey) law 1991. These Articles comprise the statutory unfair prejudice regime in Jersey which can be deployed by a minority shareholder to preserve and protect its rights and position. Article 141 states that:

"A member of a company may apply to the court for an order under Article 143 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 of some part of its members (including at least the member) or that an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial."

Article 143(2)(c) says that if the court is satisfied that an application under Article 141 is well-founded it may: *"authorise civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct"*.

The facts

This case involved a Jersey company called Wharf Land Investments (Jersey) Limited (the **"Company"**). The Company was a special purpose vehicle which was to be utilised for the purchase of a substantial piece of real estate in the United Kingdom (the **"Site"**). It was initially wholly-owned by an English holding company (**"HoldCo"**), which in turn was owned by a property investor. JTC Management Limited (**"JTC"**) provided the directors and company administration services to the Company.

Funds to purchase the Site were acquired from a number of investors, one of whom, Prestigic, obtained a 2.84% shareholding in the Company as part of the terms of its investment. The Site was purchased in 2006. The subsequent development of the Site proved to be complex. In the course of 2007 and 2008, the Company authorised payments (the **"Payments"**) totalling in excess of £1.5m. There was no apparent justification for the Payments. They were made for corporate finance services, which were not recorded by the Company as having been received. They were also made in contravention of certain statements made to investors in the information memorandum provided to them in advance of their investment.

In evidence, JTC said that the Payments were made in good faith relying on implicit representations from HoldCo. In contrast, Prestigic alleged that, in authorising the Payments, the directors acted in breach of their duties to the Company, *inter alia*, to exercise the appropriate level of care and skill.

Prestigic sought an order under Article 143(2)(c) authorising it to bring proceedings against JTC in the name of the Company, seeking an inquiry as to the money lost through the alleged breaches of duty, and the repayment by JTC of any sums so lost.

Shareholder ratification

Following commencement of Prestigic's action, an EGM of the Company was convened. This EGM was convened because, under Jersey law, where a minority shareholder action is brought either pursuant to Articles 141-143 of the Companies (Jersey) Law 1991 or to the common law, and where the Plaintiff seeks as its remedy to be allowed to bring an action on behalf of a company, the views of any independent shareholders on the probity of the litigation should be ascertained in the course of the proceedings (see *Pacific Investments -v- Christensen & Others* [1995] JLR 250).

Various resolutions were proposed at the EGM, which sought shareholder sanction for the following propositions: (i) that the Company should oppose Prestigic's application; (ii) that the Payments were authorised and made properly in the best interests of the Company; (iii) that the reliance by the directors on the implicit representations of HoldCo was appropriate and in the best interests of the Company; and (iv) that the acts of the directors at the relevant time were all in the best interests of the Company.

All of the resolutions were passed by the shareholders with overwhelming support (ranging from 78.75% to 83.58%).

Counsel for Prestigic asserted that the shareholders voted in this way on the basis of commercial considerations. In other words, they sought to reject the litigation because it would potentially be time-consuming, costly and a distraction from the more important matter of making the development of the Site successful and profitable. The court accepted that there was evidence that this was the case. The court also accepted that, absent proper explanation by HoldCo, the Payments were prejudicial. However, the court remained concerned to establish that the actions complained of were not only prejudicial but *"unfairly"* prejudicial in circumstances where the overwhelming majority of shareholders had rejected the concept of legal proceedings.

The Law

The court summarised the applicable legal principles as follows. The statutory unfair prejudice regime in Jersey bore substantive similarity to the equivalent statutory regime in England and Wales in force at the time it entered the statute book (sections 459 and 461 of the Companies Act 1985). English authorities decided under that statute were therefore to be considered persuasive, but not binding, in Jersey [1].Jersey procedure in seeking relief is, however, substantially different. Therefore, whilst the applicable legal principles may be reflective of English law, the relevant procedure will not necessarily be so.

One of the cases cited and applied was the English Court of Appeal decision of *Grace -v- Biagioli, Titanium Electrode Products Ltd. Re* [2006] BCC 85 which drew heavily on Lord Hoffman's judgement in the House of Lords decision in *O'Neill -v- Phillips* [1999] 1 WLR 1092. From this it was determined by the Jersey court that:

- unfairness should be considered objectively, but not in a vacuum. It should be considered against the corporate structure and legal matrix underpinning a company, which would inform and identify the rights and obligations of shareholders;
- strict legal rights may be moderated by equity when insistence on those rights might be considered unconscionable. Such temperance is, however, to be determined by established equitable principles not by *"some indefinite notion of fairness"*;
- therefore unfairness either derives from a breach of the rules of a company or in using those rules in a manner which is contrary to good faith;
- it is not enough merely to show that the relationship between the parties has irretrievably broken down. There has to be some further evidence of prejudicial behaviour;
- the parameters of the statutory unfair prejudice regime should at all times be considered by reference to core corporate principles: internal management, the legal bargain between shareholders, majority rule, the locus of the company alone (subject to exceptions) to conduct the company's affairs and the doctrine of fraud on a minority.

The court then considered whether it was appropriate to distinguish between: (i) proceedings for unfairly prejudicial mismanagement of a company's affairs; and (ii) proceedings in relation to breaches of duty and/or misconduct. The assertion by Counsel for the Company was that only the former fell within the ambit of the statutory unfair prejudice regime. The latter fell within the ambit of the common law derivative action (known as the exception to the *"rule in* *__Foss -v- Harbottle__"*[2]). It was the assertion of Counsel for the Company that Prestigic's complaints amounted to assertions of misconduct and, thus, that Prestigic had advanced its case on the wrong footing.

The distinction is a subtle one and one might conceive of overlap between the two areas. However, they serve different functions. Shortly stated, the Court, applying a line of English authority, held as follows:

- the distinction does not lie in the act or omission complained of, but in what relief is being sought. Therefore, conceivably the same act or omission could give rise to either approach depending on how the complaint is structured;
- the common law derivative action regime exists to provide a remedy for misconduct. The essence of the complaint is, therefore, that the act or omission is *unlawful*. If an act or omission is unlawful (for example fraud or breach of duty) then it will have a remedy available *per se* under the law which will redress the position. It is that remedy which is being invoked on behalf of the company by the shareholder. The shareholder may have suffered some loss or damage, but that loss or damage arises indirectly through loss or damage caused to the company by the unlawful behaviour;
- by contrast, the statutory unfair prejudice regime exists to bring an end to mismanagement. The essence of this regime is not the *unlawfulness* of the conduct in question, (although it may be unlawful) but its prejudicial effect on the complainant. The remedy will be tailored by the complainant according to its circumstances. A remedy sought might, for example, be for the shareholder to be bought out by the company. In this case it is not necessary to prove any *unlawfulness*, but there is the burden of proving unfair prejudice.

Counsel for Prestigic maintained that the complaint was one of mismanagement and not misconduct and, therefore, that it was right to adopt the unfair prejudice rule. Counsel for Prestigic also acknowledged that if he was wrong, and the complaint did amount to misconduct, he would not be able to establish the necessary conditions to invoke the exception to the *"rule in Foss -v- Harbottle"*. The directors of the Company (who were in control of the Company) had not improperly prevented it from bringing proceedings. They were also not alleged to have acted dishonestly or in bad faith, and had received overwhelming support and ratification from the vast majority of shareholders, all of whom were independent of the directors (neither the directors or JTC owned any shares in the Company)[3]. In that sense, Prestigic's case hung largely on whether it could be advanced as mismanagement and therefore invoke the statutory unfair prejudice remedy.

The court disagreed with Prestigic. There were grounds for legitimate complaints, but those complaints were of misconduct and not mismanagement. It was therefore held to be an abuse of process for Prestigic *"...to attempt to circumvent the rule in Foss -v- Harbottle, the exceptions to which it did not seek to argue it came within, by the use of an Article 141 application"*. In relation to the alleged misconduct, the requirement to ascertain the views of the other shareholders had been properly undertaken, and the majority had resolved that it was not in the interests of the Company to pursue the litigation.

The court considered the fact that some of the shareholders had voted at the EGM on the basis of purely commercial considersations. It contemplated what was fair in the circumstances, and questioned whether it should itself take a view on the commercial interests of the Company and seek to impose that view (to the extent it was different) on the majority. It concluded that it should not. It concluded that:

- the minority shareholders had signed up to the principle of majority rule and there was nothing unfair in this rule being applied: *"This is a case in which the articles of the Company do reflect the understandings upon which the shareholders are associated and accordingly the view of the majority should prevail"*;
- therefore, the rule in *Foss -v- Harbottle* applied. Prestigic could not invoke any exception to that rule, and was therefore bound by the decision (supported by the majority of shareholders) not to bring proceedings.

Conclusion

The court did not consider questions of who might constitute a *"proper plaintiff"* in proceedings brought on behalf of a company under the common law derivative action route (although it seems likely that it will be a plaintiff who is capable of selflessly representing the interests of the Company and its general body of shareholders, and not acting for its own private purposes). This question will, therefore, have to wait until another day. This decision does, however, make it clear that if a minority shareholder has grievances, which it proposes to advance in litigation, careful thought must be given before choosing the procedural path to be trodden. It acts as useful guidance as to when the statutory unfair prejudice regime, embodied in Articles 141-143 of the Companies (Jersey) Law 1991, will apply.

It should be noted that the common law derivative action route is rarely applied in Jersey. We are not aware that it has ever been successfully applied in relation to a public company. It has, as far as we are aware, only been applied once in England, in the much critised decision of *Prudential Assurance -v- Newman* [1982] 1 Ch 204. If, therefore, the complaint is one of misconduct as opposed to mismanagement, a minority shareholder should carefully craft its case before embarking on proceedings.

Notes

[1] As Jersey develops its own body of law in this area, those authorities decided by the Jersey Courts will take precedence over English authorities to the extent that there is a clash.

[2] The *"rule in Foss -v- Harbottle"* is the rule that only a company may sue for losses caused to that company. An *"exception"* to this rule (giving rise to a derivative action whereby the shareholders can bring a claim on behalf of the company) will apply only if certain conditions are met. The shareholder must establish that those in control of the company are guilty of equitable fraud (e.g. dishonesty or bad faith) and wrongly preventing the company's claim from being brought. This is known as a *"fraud on the minority"*. The *"rule in Foss -v- Harbottle"* has been developed through case law, rather than statute, and has been applied in Jersey to prevent inappropriate derivative claims on a number of occasions - most notably in *Khan -v- Leisure Enterprises* [1997] JLR 313.

[3] Ratification is not possible where it would allow the majority to oppress the minority - *Cook -v- Deeks* [1916] 1 AC 554.

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