

This time it's personal: Grand Court of the Cayman Islands recognises minority shareholder rights

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The Grand Court of the Cayman Islands recently handed down an important decision on the right of minority shareholders to object to an issue of shares which has the effect of diluting their position in a company. The Honourable Mr Justice Segal held that, contrary to the earlier decision of Mr Justice Kawaley in the matter of *Gao v China Biologic Products Holdings, Inc.* (unreported, FSD 157/2018, 10 December 2018 ("**Gao**")), a minority shareholder does have standing to bring a personal claim against the company in respect of such a share issue, and is not necessarily limited to bringing a derivative claim.

Background

Tianrui (International) Holding Company Limited v China Shanshui Cement Group Limited (unreported, FSD 161/2018, 6 April 2018) concerns a long running takeover battle for a significant cement producer in the People's Republic of China. The cement producer (the "**Company**") is the subject of a winding up petition and the defendant in a related proceeding. Both proceedings were brought by a significant shareholder in the Company (the "**Petitioner**"). The Company is the subject of a winding up petition on the just and equitable ground (the "**Petition proceeding**"). It is also the defendant in a related proceeding in which the Petitioner alleges that the Company's decision to issue a significant number of convertible bonds and then convert them to shares constituted an improper exercise of the director's powers (the "**Writ proceeding**").

In August and September 2018 the Company issued over \$500 million in convertible bonds to a number of subscribers, which were subsequently converted to shares in October 2018. The issue of the convertible bonds was not disclosed to shareholders or the market until after the Company had entered into the relevant subscription agreements. The shares that were issued to give effect to the conversion were equivalent to approximately 24% of the total shares previously on issue. The Petitioner argues that these transactions were entered into for an

improper purpose, and are the result of the controllers of the Company (the Petitioner's rivals in the takeover battle) attempting to cement their control by diluting the Petitioner's holding in the company. In particular, the Petitioner argues that the effect of the share issue was to dilute its shareholding in the Company from approximately 28%, at which point it had the power to block special resolutions of the Company, to approximately 21% at which it would not.

In August 2019 the Company filed summonses to either stay one or both of the Writ proceeding and Petition proceeding, or to strike out one or both of the Writ proceeding and the Petition proceeding on a number of bases^[1]. One of the grounds on which the Company sought to strike out the Writ proceeding was that, as a minority shareholder and for the reasons explained in *Gao*, the Petitioner did not have standing to bring a claim regarding the dilutive share issue. The Company contended that, as the claim properly related to breaches by the board of the fiduciary duties they owed to the Company, the proper plaintiff was the Company itself and the Petitioner could only have brought a derivative claim.

On 6 April 2020 the Honourable Justice Segal handed down a decision in respect of both the Petition proceeding and the Writ proceeding.

The Decision – Does a shareholder have a personal right to sue?

Mr Justice Segal identified the question he was required to determine as:

Can a shareholder bring a personal claim against the company where the directors allot shares for the improper purpose of diluting the shareholding of a minority shareholder from above to below 25% where it is alleged that the directors were acting in concert (and were part of a conspiracy with) the majority shareholders in order to achieve that dilution?

Justice Segal considered there was also a related question:

Can the majority shareholders ratify the allotment and the breach in such circumstances and if they can do so, does ratification preclude the shareholders' personal claim?

In *Gao*, a minority shareholder (Mr Gao) had brought a writ action against a company in respect of the exercise by its board of directors of the power to allot and issue shares. The Honourable Mr Justice Kawaley struck out the writ on the basis that individual minority shareholders have no standing to pursue personal claims against a company for an improperly motivated allotment of shares which dilutes their voting rights. In reaching this decision, Kawaley J rejected the suggestion that a shareholder had a personal right of action arising from the improper issue of shares, concluding that to the extent any authorities could be read as supporting the existence of such a right, they were distinguishable or ought not be applied as the relevant statements were *obiter dicta*.

In reviewing the earlier decision of Kawaley J, the Honourable Mr Justice Segal undertook a

detailed consideration of the relevant authorities and concluded that authoritative dicta in the cases and principle supported the view that the Petitioner had standing to bring its claim against the Company in a personal capacity; see *Re Sherborne Park Residents Co* [1987] BCLC 82, *Howard Smith v Ampol* [1974] AC 821, *Residues Treatment and Trading Co Ltd v Southern Resources* [1988] 6 ACLC 1160 ("**Residues**"), *Peskin v Anderson* [2001] 1 BCLC 372 and *Eclairs Group Ltd v JKC Oil and Gas plc* [2016] 3 All ER 641.

While his Lordship was hesitant to disagree with the decision of Mr Justice Kawaley in *Gao*, he ultimately accepted the existence of a shareholder's enforceable personal right, pointing in particular to the compelling and persuasive reasoning found in *In re Sherbourne Park* and *Peskin*, the significance of which had been dismissed in *Gao*. In particular, he noted that:

1. In *Gao*, Mr Justice Kawaley considered the key question to be whether minority shareholders have direct claims against the directors, and applied the (correct) principle that, absent special circumstances, directors owe their duties to the company, not to individual shareholders. However, the real question in that case and again here, was not whether and when directors owe duties directly to shareholders, but whether the Petitioner could bring a claim against the Company itself (as distinct from its directors) arising from breach of the statutory contract between the Company and the shareholder.
2. It is well understood that improper conduct of directors of a company is only voidable where it is not ultra vires (in which case it would be void). As such, the directors' conduct constitutes an act of the company itself unless and until the act is set aside. Accordingly, once the power has been improperly exercised, the company is in breach of the articles (and its statutory contract with its shareholders). On this basis, the Company's decision to issue shares gave rise to a personal right to bring a claim against the Company for its conduct.
3. This position was *a fortiori* where the shareholders who have suffered from the improper allotment have control rights, including negative control rights (such as the Petitioner's ability to block special resolutions), which would be affected by the allotment.
4. On the question of ratification of the decision to issue the convertible bonds, Justice Segal held that it follows from the characterisation of the claim as being based on a personal right of the shareholder that, as a matter of principle, ratification by the majority of shareholders was not available. This was on the basis that ratification only relates to causes of action brought by the company. Even if ratification were available on principle, his Lordship held that it was strongly arguable that it would not apply in cases of a fraud on the minority coming within the exception to the rule in *Foss v Harbottle*, as this case was (as the Petitioner's claim is that the share allotment was part of a conspiracy involving both the company's directors and its majority shareholders).

Relevance of decision

This decision protects the position of minority shareholders who may be disadvantaged by an improper share allotment by making clear that they have standing to sue the company in their personal capacity and are not limited to bringing a derivative claim on behalf of a company against its directors in search of relief.

[1] In circumstances where the Company had previously sought to strike out the Petition proceeding as an abuse of process. The Court of Appeal's judgment in respect of the reinstatement of the Petition is *In the matter of China Shanshui Cement Group Limited* [2019] (1) CILR 481.

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