

UPDATE

Issuing shares for a 'proper purpose'

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BVI Court of Appeal interprets the '*proper purpose*' test set out in section 121 of the BVI Business Companies Act, 2003 in relation to the issue of shares by the director of a BVI company

The Eastern Caribbean Court of Appeal (**CoA**) recently considered section 121 of the BVI Business Companies Act, 2003 (**BCA**) in *Independent Asset Management Company Limited v Swiss Forfaiting Ltd* (BVIHCMA2016/0034, 24 November 2017). This case provides a helpful reminder as to the proper purposes for which directors can and cannot issue new shares.

The BVI Business Companies Act

Section 45 of the BCA provides that:

'Subject to this Act and to the memorandum and articles, shares in a company may be issued, and options to acquire shares in a company granted, at such times, to such persons, for such consideration and on such terms as the directors may determine.'

And section 121 provides that:

'A director shall exercise his powers as a director for a proper purpose and shall not act, or agree to the company acting, in a manner that contravenes this Act or the memorandum or articles of the company.'

Section 121 of the BCA is one of several checks and balances in the BCA, which protects shareholders from abuse or breach of duty by directors, including in exercising powers to issue new shares.

Background

Swiss Forfaiting Ltd (the **Fund**) was a BVI company set up as an investment fund. As is relatively common for such funds, it had two share classes.

- Class A shares held all the voting rights, but no entitlement to any profits of the Fund (the **voting shares**).
- Class B shares carried no voting rights, but shared in the Fund's profits and in its assets on a winding-up.

The facts of this case are complicated, but can be summarised shortly as follows:

The Fund was set up by two individuals, Mr I (a wealthy investor) and Mr C (an investment expert). It had a corporate director, CTS Management Limited (the **Fund's Director**), which was not affiliated with either Mr I or Mr C.

Mr I beneficially owned the majority of the Fund's Class B shares. Mr C controlled the Fund's investments through two companies:

- Independent Asset Management Company Limited (**IAM**) which was a Hong Kong company and acted as the Fund's Investment Manager. All of the Fund's voting shares were held by IAM. In turn, the majority of IAM's shares were beneficially owned by Mr C.

- Another of Mr C's companies, SFC Swiss Forfeiting Company Ltd (**SFC**), acted as IAM's agent.

Adversely impacted by the global recession, the Fund performed poorly and ultimately decided to suspend redemptions and liquidate its investments. By this time, the relationship between Mr I and Mr C had deteriorated and the atmosphere was *pregnant with the possibility of litigation*.

The Swiss Litigation

Mr C's company, SFC, held approximately €8m on trust for the Fund, which the Fund was eager to recover (primarily for the benefit of its Class B shareholders, including Mr I). However, SFC also asserted a potential claim against the Fund for €4.3m in unpaid management fees.

The Fund had a problem. It wanted to commence litigation against SFC to recover the €8m, but knew that if it did so, Mr C might cause IAM to use its voting shares to replace the Fund's Director and ultimately cause the Fund to discontinue any such claim.

In 2014, when contemplating this litigation, the Fund discovered that IAM had been dissolved since late 2011 and that, notwithstanding its dissolution, IAM had not transferred the Fund's voting shares to anyone else.

The Plan

A few months later, the Fund's Director drew up a plan to deal with the impasse. One aspect of the plan was for the Fund to issue new voting shares, *'in order to ensure that control of the fund is not lost'*.

Ultimately, the plan was put into effect and the Fund's Director caused the Fund to issue new voting shares (the **New Shares**) to a third party (the **July Issuance**). The New Shares were then transferred to a company controlled by Mr I, called Sunimar Private Ltd (**Sunimar**). As a result, IAM's voting rights were diluted from 100% to 16.67%.

On the same day, the Fund commenced proceedings against SFC in Switzerland seeking to recover the money held by it on trust for the Fund.

Upon becoming aware of the Swiss Litigation, Mr C restored IAM to the Register of Companies in Hong Kong. Under Hong Kong law, upon restoration, IAM was deemed to have existed continuously, as if it had not been dissolved, and so still held 100 voting shares in the Fund (and this was not disputed in the BVI proceedings). Shortly thereafter, IAM raised proceedings against the Fund in the BVI (the **BVI Proceedings**).

The Dispute

In the BVI Proceedings IAM alleged that, as a shareholder of the Fund, it had been prejudiced by the actions of the Fund's Director. IAM sought orders under Sections 184I and/or 184B of the BCA declaring that the July Issuance was unfairly prejudicial and/or in breach of the BCA and setting it aside. However, IAM did not include Sunimar (which held the New Shares) as a party to those claims.

IAM's principal assertion on the s.184B claim was that, in issuing the New Shares, the Fund's Director had exercised its powers for an improper purpose and that therefore the July Issuance was in breach of Section 121 of the BCA.

At first instance, the Commercial Court disagreed with that assertion. Furthermore, the Court noted that even if its conclusion was wrong, it could still not rescind the July Issuance as Sunimar was not a party to the claim.

The Appeal

IAM appealed against this decision. It argued that:

- the Court should have held that the only purpose of the July Issuance was to dilute IAM's control of the voting rights in the Fund;
- this did not amount to a proper purpose; and
- accordingly the Fund's Director's exercise of power to cause the July Issuance breached the BCA and should be reversed by the Court.

For its part, the Fund argued, *inter alia*, that the Fund's Director issued the New Shares to prevent IAM from influencing the Swiss Litigation to the detriment of the Fund and that this was a proper purpose in terms of the BCA.

The CoA's Decision

The CoA analysed the definition of *proper purpose*, as set out at section 121 of the BCA.

It noted that the foundation of the *proper purpose* rule lies in the fact that a company is divided into two basic organs, the board of directors and the shareholders. Directors are responsible for managing the business and affairs of the company and have the power to issue shares as part of that responsibility. In doing so, they must ensure that a proper balance is maintained between the two organs of the company.

Specifically, the CoA held, this means that directors:

should not issue additional shares in such a way as to affect the balance of power in the company or influence in any way the outcome of shareholders' resolutions, even if this results in additional capital or other benefits for the company.

In the present case, the CoA rejected the Fund's submission that, notwithstanding that the substantial purpose of the July Issuance was to create a new majority with controlling power, the fact that this was done to protect the company as a whole overrode any improper purpose of creating a new majority, such that the July Issuance would thereby be rendered proper.

Rather, it held that the basic rule is:

The directors' purpose, however noble, should not be used to affect the balance of power in the company. If it is used in this way, it is an improper use of the power and is liable to be set aside.

However, the CoA held that it could not grant orders setting aside the July Issuance and rectifying the share register, because Sunimar had not been a party to this claim.

Comments

This case is a helpful reminder that a BVI company's directors should not seek to control the outcome of shareholder decisions by issuing new shares and changing the balance of power amongst the shareholders. It illustrates that even where directors are acting with honest intent or altruistic motives, a decision to issue shares for an improper purpose cannot be 'saved' by such honest intentions.

This case also illustrates that directors should exercise great care when deciding whether to issue new shares, or indeed exercising any of their other powers, especially where litigation is contemplated. A prudent director may wish to seek independent legal advice before making such decisions.

Finally, this case illustrates that, when contemplating litigation, it is important to ensure that a claimant and its advisors focus on the relief that will ultimately be sought, and ensure that all necessary defendants are made parties to the claim.

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