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Shareholder disputes – the duty to negotiate with shareholders

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Minority shareholders angry with the conduct of their company have limited rights of redress other than to sell their shares for whatever price they can get. One of the few weapons at their disposal is the minority oppression action which empowers the Court to issue buy-out orders (at a price set by the Court) where the minority has been unfairly prejudiced by the majority. This power is contained in Section 111 of the *Bermuda Companies Act, 1981* and its English equivalent is Section 994 of the *English Companies Act, 2006.*

There are few instances of successful minority oppression actions even against private companies. Against listed companies, the number of successful petitions drops to zero.

This is why the 2015 first instance decision in *Annuity Re -v- Kingboard* [2015] SC (Bda) 76 Comm created a stir. It was the first known case anywhere of a minority oppression petition succeeding against a listed company. The Bermuda Supreme Court (Bermuda's first instance court) had ordered that minority shareholders could sell their shares at a price to be set by the Bermuda Courts rather than the market price on the exchange. More importantly, the Bermuda Supreme Court had ruled that a company had a duty to negotiate with its minority shareholders about operational issues which impacted the minority.

Legal commentators were right to suggest that the decision represented a potential shift in power dynamics. Activist investors were invited to sharpen their spreadsheets:

"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."[1]

This shift in power dynamics has however proved a false dawn. The Bermuda Court of Appeal has overturned the decision in *Kingboard* and reasserted traditional notions of a company's relationship with shareholders.

The Decisions

Kingboard concerned a vertically integrated group of companies. One of those companies, Kingboard Copper Foil Holdings Limited ("the Company"), a company domiciled in Bermuda but whose operations were in China, produced copper foil which was sold predominately to group companies. The Company was listed on the Singapore Stock Exchange ("the SGX"), but the majority of the shares were held by those group companies.

The ownership and operational structure created an inherent and admitted conflict of interest: it was in the interests of the group companies for the foil to be sold cheaply to them even if this was at the expense of the Company. The minority

[1] Butterworths Journal of International Banking and Finance Law, Issue 3, March 2016.

shareholders, who had bought their shares on the SGX, believed that the Company was indeed selling the foil too cheaply for this reason. They claimed that, as a result, group companies were doing well, but the Company was doing badly.

The minority had various remedies open to them – they could have complained to the SGX; they could have brought a minority oppression action in Bermuda on the issue. Instead, they took action themselves using powers granted to minorities under the SGX rules. Under SGX rules, shareholders must approve all 'interested party transactions' and only non-interested shareholders can vote. This meant the minority had a veto under the SGX rules on such arrangements. The minority exercised this veto which threatened the Company's survival. Having exercised the nuclear button, the minority waited for the Company to open negotiations.

The Company's response was perhaps unexpected. The Company licensed its entire operation to a third party for a monthly fee. The licensee then continued the copper foil production, including the sales to the group companies. The license was designed as a temporary measure – it was terminable on a month's notice. The Company then invited the minority to remove the veto and waited for the minority shareholders to surrender.

Instead, the minority issued the minority oppression petition and sought a buy-out of their shares.

Despite seeking a buy-out of their entire shareholding, the petitioners increased their purchases of shares in the Company after filing the petition. The petitioner argued that there was nothing wrong in doing so: it was a way to finance the litigation by increasing the potential damages award. The Chief Justice ultimately ruled that this was not permissible. It was abusive for the petitioner to claim for shares which had been purchased after the filing of the petition.

The petition itself alleged that (a) the Company had been selling its copper foil too cheaply prior to the veto; (b) the new license arrangement was a sham designed to bypass the veto.

At first instance, the Chief Justice dismissed the first ground. He ruled that the Company had not been selling its copper foil too cheaply and that the pricing had been at arms-length. In regards to the second ground, he ruled that the license arrangement was a genuine and commercial response to the veto.

However, the Chief Justice nevertheless concluded that the license was oppressive and the petition should succeed. He ruled that the license arrangement had improperly bypassed the veto, not least because the Company had failed to open negotiations with the minority, and that the minority had been prejudiced since the licensing arrangement was far less profitable than producing copper foil. The Chief Justice was particularly critical of the Company for not seeking a solution to the impasse via negotiations with the minority shareholders.

In last month's decision, *Kingboard v Annuity Re* [2017] CA (BDA) 3 Civ, Bermuda's Court of Appeal unanimously allowed the appeal. The Court of Appeal ruled that the license arrangement had not caused prejudice and was not oppressive. It had not caused prejudice because the alternative to the license was the cessation of production, which would have been worse for all shareholders and that was the proper comparison. The Company had not acted oppressively by failing to negotiate, because there was no duty to negotiate.

The Court of Appeal also dismissed the petitioner's cross appeal on the post-petition share purchases, ruling that the Chief Justice had been right to disallow claims for damages which had been self-inflicted.

Conclusion

The first instance decision in *Kingboard* gave activist investors a new weapon in their limited arsenal: companies were potentially under a duty to negotiate with minority shareholders when deciding issues which impacted the minority more than the majority. Since decisions often impact shareholders differently, particularly with vertically integrated groups of companies, this duty would often arise. The duty was potentially a difficult one to navigate: if the negotiations failed, the minority could seek a buy-out on the basis that the Company had failed to negotiate in good faith.

The Court of Appeal decision has removed this potential weapon. While the Court of Appeal refused to rule out the possibility of such a duty arising in other cases, it pointed out the difficulties inherent in the creation of such a duty, not least the difficulty of proving that negotiations would have led anywhere.

In short, minority shareholders are in the position they have always been in – passengers, not active participants.

Jeffrey Elkinson and Ben Adamson, Directors in Conyers Dill & Pearman, led by William Wong SC of the Hong Kong Bar, represented the Company and the majority shareholders with the assistance of Norman Hau in the Conyers' Hong Kong office.

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