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Client Memorandum

Privy Council Judicial Committee Permits Shareholder's Direct Claim Against Cayman Islands Company for Allegedly Invalid Dilution of Shareholding to Proceed to Trial

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Introduction

In the recent decision of ***Tianrui v China Shanshui***[1] the Judicial Committee of the Privy Council overturned the Cayman Islands Court of Appeal and upheld the ruling of Mr. Justice Segal at first instance, in which Mr. Justice Segal dismissed a Cayman Island's company's application to strike-out a shareholder's direct action against the company for an allegedly unlawful and invalid dilution of the shareholder's shares in the company.

Two important points emerge from the proceedings before the Privy Council: (i) like shareholders in many other common law jurisdictions, shareholders in Cayman Islands companies can have direct and enforceable rights of action against the company if the company unlawfully dilutes that shareholder's shares; and (ii) the necessity for Plaintiffs to draft clear and precise pleadings.

Background

The salient facts of *Tianrui* were:- (i) Tianrui held 28.16% of the shares in China Shanshui Cement Group Ltd ("China Shanshui"), a Cayman Islands exempted company; (ii) Tianrui's shareholding gave it *"negative control"* over China Shanshui; (iii) China Shanshui issued convertible bonds in August and September 2018; (iv) in October 2018, conversion of the bonds was accelerated and China Shanshui agreed the allotment of 888,980,352 new shares to the bondholders in exchange for some of the bonds; (v) at an adjourned annual general meeting and an extraordinary general meeting of China Shanshui at the end of October 2018, the shareholders passed a resolution mandating the directors to allot and issue 1,067,830,759 shares; (vi) the new shares were issued the same day; (vii) Tianrui's shareholding was, therefore, diluted from 28.16% to 21.85%, thereby removing its negative control over China Shanshui.

Tianrui brought an action before the Cayman Islands Court alleging, *inter alia*, that the issue of the bonds and the allotment and issue of the new shares were an improper exercise of China Shanshui's power to allot and issue securities. Tianrui alleged that the shares were issued for the purpose of enabling another group of shareholders to control China Shanshui and achieve a dilution of Tianrui's shareholding to under 25% with the result that Tianrui could no longer block special resolutions. Tianrui further alleged that the bond issues and share conversion were concluded in secret, that they were not arm's length transactions and that the subscribers were

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[1] Full name, ***Tianrui (International) Holding Company Ltd (Appellant) v China Shanshui Cement Group Ltd (Respondent) (Cayman Islands)*** **[2024] UKPC 36** (14 November 2024)

connected with China Shanshui's other shareholders. It also alleged that (i) the board of China Shanshui exercised their power to issue the convertible bonds and new shares for an improper purpose and that those transactions were invalid, and (ii) the other shareholders acted for an improper purpose in supporting the resolution at the EGM to grant the mandate to the directors to issue the 1,067,830,759 shares. Tianrui sought declarations from the Cayman Island Court that the exercise by the directors of China Shanshui of the powers (i) to issue the convertible bonds, (ii) to convert the bonds into shares, (iii) to issue the new shares were each not a valid exercise of power.

First Instance

At first instance China Shanshui applied, *inter alia*, to strike-out Tianrui's claim as an abuse of process on the basis that Tianrui did not have standing to sue China Shanshui for what were argued to be essentially claims arising out of breaches by the board of the fiduciary duties they owed to China Shanshui. Justice Segal dismissed China Shanshui's strike-out application and declined to follow an earlier decision of the Grand Court in *Gao v China Biologic Products Holdings Inc*.[2] Justice Segal concluded that a minority shareholder can have a personal claim against the company and that the appropriate remedy was a declaration, binding on the company, that the allotment and issue of the shares was unlawful. He rejected China Shanshui's argument that a shareholder did not have a personal claim because the shareholder could obtain redress by way of derivative action.

Court of Appeal

The Court of Appeal allowed China Shanshui's appeal against Justice Segal's refusal to strike-out the claim. The Court of Appeal held that an aggrieved shareholder had no personal right of action against the company for the diminution of his voting power caused by an issue of shares in breach of fiduciary duty owed to the company. The Court of Appeal reasoned that the central question was whether a minority shareholder had standing to sue the company in which it held shares. The Court of Appeal decided that (i) it was trite law that directors owe their fiduciary duties to the company which appoints them and not its shareholders and (ii) damage suffered as a result of a breach of fiduciary duty by the directors is damage to the company and not to a shareholder whose voting power has been diminished by the issue of the new shares.

Privy Council

It is clear from the Privy Council's decision that their Lordships had no hesitation in (i) allowing Tianrui's appeal, (ii) overturning the decision of the Court of Appeal, (iii) making clear that the earlier first instance decision of the Grand Court in *Gao* was wrongly decided, and (iv) reinstating the order of Justice Segal dismissing China Shanshui's strike-out application.

At para. [3] the Judicial Committee stated:

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[2] 2018 (2) CILR 591

It has long been held in cases of high authority, by the Board, the UK Supreme Court, the High Court of Australia and other appellate courts, that in these circumstances proceedings may be brought by shareholders personally, rather than by derivative action on behalf of the company, to challenge such allotments, notwithstanding that the duty of directors to exercise their powers of allotting shares for proper purposes is owed not to shareholders personally but to the company alone. Although it has never previously been doubted that shareholders personally have standing to bring proceedings in these circumstances, the juridical basis for their standing has not been decided, and barely discussed, in most cases. In the present case, the Court of Appeal, reversing decision of the first instance judge, held that the claimant shareholders had no personal standing to bring the present claim.[3]

At para. [43] the Judicial Committee observed:

The issue at the heart of this appeal, namely the juridical basis of the individual shareholder's standing to bring proceedings to challenge the directors' exercise of a power for improper purpose, arose also in those cases. Given that in each case the shareholder's rights were directly affected by the relevant improper decision, they were obvious cases for intervention by the courts, but there still needs to be a proper legal basis - in short, a cause of action. As we discuss later in this judgment, we consider that, as an intrinsic feature of the contract constituted by the memorandum and articles of association, it is implicit that when exercising their powers on behalf of the company the directors will exercise them in accordance with their fiduciary duties, including the duty to exercise powers only for a proper purpose.

The Judicial Committee found at paras [69] – [76]

The power to issue shares is conferred upon CSCGL by its memorandum of association, but the power to cause the company to allot and issue shares is conferred upon the directors, acting as fiduciaries, by the articles of association. The power is therefore necessarily a fiduciary power and must therefore only be exercised for proper purposes. The proper purposes for the exercise of the power to allot and issue shares include the raising of new capital where that is genuinely considered by the directors to be in the best interests of the company, but there can be other legitimate purposes. No part of those proper purposes includes deliberately altering the balance of power between shareholders. …

The conferment upon the directors of that fiduciary power to allot and issue shares is an important part of the contract between shareholders and the company, constituted by its memorandum and articles: see sections 12 and 25 of the Companies Act (para 31 above). The inevitable consequence of the conferral of a power upon fiduciaries is that it

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[3] The "cases of high authority" to which the Judicial Committee were referring include, *Hindle v John Cotton Ltd* (1919) 56 Sc LR 625; *Eclairs Group Ltd v JKX Oil & Gas plc* [2015] UKSC 71; *Fraser v Whalley* (1864) 2 H & M 10; *Punt v Symons & Co Ltd* [1903] 2 Ch 506; *Piercy v S Mills & Co Ltd* [1920] 1 Ch 77; *Hogg v Cramphorn Ltd* [1967] Ch 254; *Bamford v Bamford* [1970] Ch 212; *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821; *In re Sherborne Park Residents Co Ltd* [1987] BCLC 82; *Residues Treatment & Trading Co Ltd v Southern Resources Ltd* (1988) 6 ACLC 1160; *Ngurli Ltd v McCann* (1953) 90 CLR 425

must be exercised for proper purposes … Where such a power is conferred by the articles upon fiduciaries, this constraint upon its exercise is as much a part of that corporate contract as if it had been spelt out word for word in the articles. It is a term of the corporate contract that, if the exercise of the power to allot and issue new shares by the directors as agents for the company is to be valid and binding as between the individual shareholder and the company, it should comply with all conditions necessary to make it a proper exercise. These include compliance with the directors' fiduciary duty owed to the company. This is a constraint implied by law as inherent in the relationship between the shareholder and the company.

It is not, of course, any part of the corporate contract that a shareholder's holding will not be diluted, or that nothing will be done by the directors which alters the balance of power between shareholders. The Board may for example perfectly legitimately decide to issue shares for proper business purposes to new shareholders and that issue, while diluting all existing shareholders' holdings in equal proportions, incidentally alters the balance of power by depriving a shareholder or group of majority control, or of negative control. But it is part of the corporate contract that, if this is to happen, it is done only by a proper exercise of the power, ie one that is exercised bona fide for the benefit of the company as a whole and exercised for the purposes for which the power was conferred. This will necessarily exclude, for example, an allotment and issue of shares which is deliberately aimed at altering the balance of power between shareholders, so as to advance the power of one (or one group) at the expense of another.

This is, in the Board's view, the basis of the shareholder's right to bring an action against the company to challenge an improper exercise of the directors' power to allot and issue shares. It is implicit in the contract constituted by the articles of association that the company's power to allot and issue new shares, delegated by the articles to the directors, will be exercised properly, which is to say by the directors on behalf of the company in accordance with their fiduciary duties. The harmful consequence to the shareholder is the alteration (adverse to him) in the balance of power between the company's shareholders and the particular harm which that does to the value of the rights embedded in his shares. It is an actionable harm because the impropriety in the exercise of the power contravenes the corporate contract binding him and the company, even though the relevant fiduciary duty breached by the directors is not owed to him.

…

… What gives the shareholder that right is the corporate contract binding between the shareholder and the company, in which this right not to have his say in the company adversely affected by an improper exercise of the power is embedded.

… Although the action is founded upon the fact of the commission of a breach of fiduciary duty by the directors, the cause of action is that the contract between the shareholder and the company contains the implied term that, in exercising the power to allot and issue shares, the directors as the company's agents will do so in accordance with their fiduciary duties.

In the Board's view this term falls to be implied into the contract between the shareholder and the company and between the shareholders inter se and it arises out of the nature of the contractual constitution of the company. It is a term which is implied as *a result of the nature of the contract and the relationship thereby created between the parties to that contract. …*

Conclusion

The Privy Council's decision should be welcomed for (i) setting out and explaining the juridical basis for a shareholder's personal action against a company in the case of an unlawful or invalid dilution of shares; (ii) correcting the aberrant decisions of the Court of Appeal in *Tianrui* and at first instance in *Gao*; and, (iii) putting Cayman Islands Law relating to shareholder's rights to challenge dilution of their shares in line with similar shareholder rights to be found in other Commonwealth jurisdictions.

It was noteworthy that during the course of the hearing Lord Leggatt observed *"I sympathize with your difficulty Mr. Smith*[4] *because the case against you has not been formulated with any kind of precision or analytical clarity and therefore you're having to deal with various attempts by the court to formulate a clear basis for the claim."*[5] This provides a salutary reminder that plaintiffs are always well-advised to plead their cases with precision and clarity, if they wish to try to minimize costly and protracted interlocutory skirmishes which take "pleading points" or objections based on standing.

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[4] Leading Counsel appearing for the Respondent

[5] Morning session, Part 3 of 3, 55:50-56.04