

A departure from the majority rule: Unfair prejudice in the Companies Ordinance (Cap. 622)

(Relevant to PBE Paper IV — Business Law and Taxation)

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**All section numbers mentioned herein refer to the Companies Ordinance (Cap. 622)*

Introduction

It is not uncommon for law students to encounter a question on minority shareholders' rights. A typical story might involve a group of minority shareholders experiencing a conflict with the majority. In such a situation, the latter would have effective control of the board of directors and at the same time consistently and indiscriminately vote in favour of themselves at the general meeting. For this reason, minority shareholders would usually be deprived of dividends, remuneration and profits, and would also be excluded from the management. Students will usually be asked to offer a solution to such a conflict and to explain the legal principles behind their proposed solution. The student's initial perspective on this problem tends to be sharp and clear: The Themis would offer help to David against the evil Goliath. While our faith in justice is beyond doubt, such a perspective will immediately encounter a contradiction with another equally cherished principle — the majority rule. This article will try to explain the legal principles behind this apparent dilemma.

The Majority Rule

The majority rule is the cornerstone of corporate administration. To put it simply, this principle means that the decisions of the members of the company are made by the majority¹. The majority rule is reflected in the mechanism for decision-making, both at the general meeting and on the board. However, the majority rule can potentially be abused to the detriment of the minority. The law provides certain redresses to remedy such situations. The underlying reason for this is that minority members are subject to control by the majority within the corporate mechanism, thus they can only rely on the specific legal remedies to resolve their grievances.

The Appropriate Action

The law provides two main categories of remedies to address the problem. The remedies available are: (i) derivative action; and (ii) unfair prejudice remedy. The two methods are similar in the sense that both of them are

¹ *North West Transportation Co Ltd v Beatty* [1887] 12 App Cas

applicable to a situation in which the corporate administration was under the control of the wrongdoers, and thus the internal mechanism failed to resolve the problem on its own. However, the choice for the most appropriate action shall depend on whether the wrong is done to the company or to the members personally. When a corporate right is infringed, then a member can only seek for redress by a derivative action on behalf of the company. If a personal right is infringed, then the member may pursue an action of unfair prejudice. The infringement on a corporate right tends to be easier to conceive (e.g. illegal conduct, fraud on the company), whereas the events amounting to an unfair prejudice are more complicated. We shall focus on the latter.

Statutory Protections

Under s. 724(1), a member of a company may apply to the court for a remedy if the company's affairs are conducted in a manner unfairly prejudicial to the interests of the members generally, or of one or more members.

This section offers a formal statutory protection to the minority. This means that it may be possible for a minority, which supposes itself to be overwhelmed within the corporate mechanism, to overturn a decision against their interests. This is, in substance, a departure from the majority rule principle.

The interests of members mainly include their financial interests in the real value of their shares as well as their entitlement to the profits². In fact, however, the word "interests" implies that section 724(1) is not limited solely to conduct affecting strict legal rights. A member may have many different types of interest, which will usually be financial, but interests are not necessarily limited to this type³.

The Threshold

The power of a company shall be exercised either by the members in a general meeting or by the board of directors. These bodies make their decisions according to the majority rule. Usually, the court has no jurisdiction to interfere with the internal management of a company acting within its own powers⁴.

Therefore, a petitioner can only make a successful application under s. 724 if he can prove that the relevant conduct is unfairly prejudicial as stated in the ordinance. Both elements, including unfairness and prejudice, must coexist. Conduct may be deemed unfair but not necessarily prejudicial. For a successful application, it is not sufficient for the alleged conduct to satisfy only one of these tests⁵.

² *SFC v Mandarin Resources Corp Ltd* [1999] HKEC 688

³ *Jaber v Science & Information Technology Ltd* [1992] BCLC 764

⁴ *Burland v Earle* [1902] AC 83

⁵ *Re Saul D Harrison & Sons plc* [1995] 1 BCLC 14

Unfairness and Prejudice

Like its predecessor, s. 724 does not define what would constitute unfairly prejudicial conduct.

Prejudice, as defined by *Re Taiwa Land Investment Co Ltd*⁶ refers to “injury, detriment or damage”. It mainly includes damage to the financial interests of the members, such as devaluation of their shares⁷. Prejudice may also refer to other behaviours that can affect the other members’ interests, like the infringement of their statutory rights or anything stipulated in the articles. Sometimes, prejudice may also be a misapplication of a company’s assets for the benefit of the majority⁸, regardless of its impact on the shares. To put it simply, prejudice means certain acts that hurt the company’s members.

Unfair, as explained by the court in *Re Taiwa Land Investment Co Ltd*, means “not fair, or unjust”. The notions on fairness have been well explained by the court in *O’Neill v Phillips*⁹. Fairness, as stated by Lord Hoffmann in his judgment, includes two limbs. Firstly, the members of a company will not ordinarily be entitled to make a complaint of unfairness unless there has been a violation of the terms (articles or shareholders’ agreement) that they have agreed upon on how the company should be operated. Secondly, only in certain situations, such as where some members breached the terms or they are using the terms in a manner which equity would regard as contrary to good faith, shall the court intervene. In a nutshell, unfairness refers to an act which either departs from the agreed terms or from the terms being abused, and which acts against equity.

Of course, the aforementioned principles only provide the basis for judging the relevant circumstances. We can still sum up certain common situations which have historically been held by the courts as unfairly prejudicial.

- i) Violation of the articles or shareholders’ agreement
- ii) Breach of fiduciary duty
- iii) Excessive remuneration
- iv) Mismanagement and self-enriching practices
- v) Breach of mutual understanding in a quasi-partnership
- vi) Unreasonable exclusion from management
- vii) Insufficient or non-proportional dividend
- viii) Unnecessary alteration of articles

⁶ [1981] HKLR 297

⁷ *Nicholas v Soundcraft* [1993] BCLC 360

⁸ *Re Elgindata Ltd* [1991] BCLC 959

⁹ [1999] 1 WLR 1092

Remedies

Section 725(1) states that the court may make any order that it thinks fit for giving relief. The law gives the court a very wide discretion to do what is considered fair and equitable in order to “put right and cure”¹⁰.

Section 725(2) lists out the specific orders available to the court:

- i) Restraining orders
- ii) Ordering proceedings to be brought in the company’s name
- iii) Appointing receivers or managers
- iv) Regulating orders
- v) Purchase of shares orders
- vi) Damages awarded to members
- vii) Any other orders the court thinks fit.

(including but not limited to the above)

Conclusion

Unfair prejudice, one of the many different topics in company law, has a very influential position in the legal literature, because it represents a departure or exception to the majority rule. It also signifies the possibility of judicial intervention, which may, in certain situations, intervene in a commercial decision made within the corporate mechanism.

The principles on unfair prejudice are also a hot and frequent topic on examinations. Generally speaking, there are two major types of questions related to company law. The first type relates to procedural matters, like the process of incorporation, winding up or the proper procedure in holding a meeting. This type of question requires students to state the necessary steps in order to achieve certain corporate goals. Thus, a good memory and accurate depiction are needed to score good marks. The second type of question usually concerns a series of misbehaviours or liabilities, for example, breach of fiduciary duty or fraudulent trading in winding up. Obviously, unfair prejudice belongs to the latter type of question.

The crux of this type of problem is that students have to spot the possible wrongs done by some of the members, where their actions, at least *prima facie*, were properly done. Students then need to cite the relevant sections and authorities, and apply those principles to point out why some members (most likely the majority) were in fact wrong or acted against the equitable principle. This is no easy task, and it all depends on students’ ability to apply the relevant laws to the given scenario.

¹⁰ *Re Bird Precision Bellows* [1986] Ch 658, 669