Tianrui v China Shanshui: Privy Council cements the position regarding direct shareholder claims

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In the recent decision of Tianrui (International) Holding Company Ltd v China Shanshui Cement Group Ltd [2024] UKPC 36, the Judicial Committee of the Privy Council (**Privy Council**) confirmed that a shareholder of a Cayman Islands company has a personal claim against a company to challenge the allotment of shares by the board of directors on the basis that the allotment was made for an improper purpose.

The Privy Council's decision is the latest judgment in a spate of litigation between China Shanshui Cement Group Ltd (**China Shanshui**), a Hong Kong listed Cayman Islands company engaged in the cement and construction products industry, and its minority shareholder, Tianrui (International) Holding Company Ltd (**Tianrui**).

Brief factual background

Prior to the share allotment central to this dispute, Tianrui held a 28.16% shareholding in China Shanshui and was the largest single shareholder in the Company. However, in 2018, China Shanshui took a series of steps, including allotting and issuing approximately 1 billion additional shares through convertible bonds to third parties, which had the effect of reducing Tianrui's shareholding percentage in China Shanshui to 21.85%.

China Shanshui maintains that these steps were taken in response to a decision by the Hong Kong Stock Exchange to suspend trading of its shares and eventually delist China Shanshui unless it restored its public float (the shares owned by public investors) to above 25%, as required under the relevant listings rules.

Tianrui, on the other hand, alleges that the shares were issued for an improper purpose. The thrust of Tianrui's argument is that the recipients of the additional shares are parties who are connected with and/or acting in concert with two large shareholders of China Shanshui in order to take over voting control. The practical implication of the dilution of Tianrui's shareholding below 25% is that it lost its 'negative control', being the ability to block special resolutions (which are usually required to change a company's constitutional documents).[1] Leading counsel for Tianrui noted that, were Tianrui's shareholding percentage to not be restored, Tianrui could not prevent a merger of China Shanshui with another company and its shares might be bought out under the merger regime pursuant to section 238 of the Cayman Islands Companies Act.

As a result of the steps described above, Tianrui issued a petition in the Grand Court of the Cayman Islands (**Grand Court**) seeking the winding up of China Shanshui on a just and equitable basis (**Winding Up Proceedings**). Tianrui also issued a separate writ action seeking certain declaratory orders as to the unlawfulness of the directors' exercise of their powers in relation to the issuance of the convertible bonds and their conversion into shares (**Writ Proceedings**).

China Shanshui applied for both the Winding Up Proceedings and the Writ Proceedings to be struck out. The Winding Up Proceedings were struck out by the Grand Court on the grounds that there was an alternative cause of action available to Tianrui, namely a writ of

action. The Cayman Islands Court of Appeal (**CICA**) overturned the decision of the Grand Court and the Privy Council refused leave to appeal. The Winding Up Proceedings therefore remain live.

In the strike-out application in respect of the Writ Proceedings, China Shanshui's position was that the Writ Proceedings were an abuse of process as Tianrui, as an individual shareholder, lacked standing to sue China Shanshui. This was argued on the basis that any alleged breaches by the directors were of duties owed to China Shanshui, rather than to Tianrui as a shareholder.

It is the point of whether Tianrui had standing to bring such a claim that proceeded to the Privy Council, discussed further below.

The Courts below

The Cayman Islands position in respect of direct shareholder claims against companies was, before this case, set out in the 2018 Grand Court decision of Gao v China Biologic.[2] In that decision (which was not subject to an appeal), the Grand Court held that a shareholder did not have standing to sue the company on the basis of an alleged breach of directors' duties in allotting and issuing shares.

The Grand Court reached this conclusion on the basis of the uncontroversial rule that the directors owe their duties not to any individual shareholder, but rather to the company itself (i.e. the same argument made by China Shanshui in its strike-out application). Accordingly, a shareholder is required to advance such a claim as a – usually more complex - derivative action in the name of the company, to ensure compliance with the long established rule in Foss v Harbottle.

However, at first instance in the China Shanshui saga, the Grand Court declined to follow the authority of *Gao*, relying instead on various English and Australian authorities in support of its findings that (i) Tianrui had a personal claim, so could therefore bring the Writ Proceedings, and (ii) in the circumstances, it was appropriate to make a declaration that the allotment and issue of the shares was unlawful.

The first instance decision was appealed by China Shanshui, and was heard by the CICA in mid-2022. The CICA overturned the Grand Court's decision, ultimately reaching the same conclusion as in Gao, that an aggrieved shareholder in these circumstances lacked standing to bring a direct claim and must therefore bring the claim as a derivative action.

The Privy Council's decision

Tianrui appealed the CICA's decision to the Privy Council.

The Privy Council analysed a number of cases in England and Australia, starting with the foundational company law case of Foss v Harbottle.[3] This (in)famous decision led to what is today known as the rule in Foss v Harbottle, comprising two key tenets: first, the 'proper plaintiff principle' stipulates that a company, not its shareholder, is the proper plaintiff to sue when harm has been caused to the company. Second, the 'majority rule principle' stipulates that the will of the majority of shareholders typically prevails in the administration of the company's affairs unless there is a fraud on the minority.

The Privy Council considered this rule, as well as the myriad cases following from it. The Privy Council also further extensively considered cases in which other common law courts have considered shareholders' personal rights enforceable by personal (direct) actions.

Having reviewed the various authorities, the Privy Council noted that the courts of England and Australia, applying law 'not materially different to'[4] the law of the Cayman Islands, have repeatedly recognised a shareholder's personal action to challenge the validity of an allotment of shares made by directors for an improper purpose. The Privy Council stated that both *Gao* and the CICA's decision below (which relied on *Gao*) were wrongly decided, such that Cayman Islands law should and does recognise the right of a shareholder whose shareholding is diluted by an improper allotment of shares to bring a personal claim against the company to challenge that allotment.

The Privy Council's reasoning for this included the - seemingly logical - argument that, as a shareholder, one is entitled to a bundle of rights including the right to vote and thereby participate in the exercise of the shareholders' collective power to control the company's affairs. The Privy Council noted that this 'active power' is 'critically dependent upon'[5] the shareholder's relative proportional holding. As such, dilution of that holding by an allotment of shares may alter the balance of power between shareholders.

Against this backdrop, and whilst accepting that allotments of shares may be made for valid and legitimate purposes (noting China Shanshui's position), the Privy Council expressly recognised that the cause of action is based on an implied term in the contract between China Shanshui and Tianrui that the directors would exercise their powers to allot and issue shares in accordance with their fiduciary duties (that is to say, not for an improper purpose). This is a constraint implied by the law of equity (fairness) as inherent in the relationship between the shareholder and the company.

On this basis, the Privy Council held that the CICA had erred in allowing the Writ Proceedings to be struck out on the grounds of lack of standing, and allowed Tianrui's appeal. In doing so, the Privy Council also held the following:

1. the size of the shareholding is irrelevant;

2. the company also having a cause of action against the directors in connection with the issuance of the convertible bonds and consequent share allocation and issuance is irrelevant (the two claims are not mutually exclusive);

3. the exercise of the directors' power to allot and issue shares is only voidable, rather than void. It follows that a challenge may be ineffective against a *bona fide* purchaser for value of the issued shares who does not have notice of the impropriety. Here, Tianrui allege that the relevant directors and shareholders all had notice of the alleged conspiracy to assume control of China Shanshui and remove Tianrui's "negative control"; and

4. the ability of shareholders to ratify the decisions of a company is constrained by minority oppression principles. For example, a breach constituted by the directors having the improper purpose of assisting an existing majority to oppress a minority could not be ratified by the majority, without itself falling foul of the constraint against minority oppression.

Impact of this decision

This decision is of significance to shareholders in Cayman Islands companies because it reiterates the circumstances in which a shareholder can avoid a derivative action, which can be more complicated, time consuming and expensive to bring, and advance a direct claim in its own name. The ability to bring a direct action also provides an alternative option to the more 'nuclear option' of winding up the company.

Whilst the Privy Council's decision was limited to the issue of an improper allotment of shares (being the facts before it in this instance), there is a prospect that similar considerations may be applied to other claims involving actions taken by directors in breach of fiduciary

duty and/or in violation of the terms of the company's constitutional documents which infringe upon a shareholder's rights.

Similarly, this decision serves to bolster the position of minority shareholders in the Cayman Islands and potentially other common law jurisdictions where there are limited statutory protections available to them. The Cayman Islands' lack of a statutory unfair prejudice remedy like the one found in English, Guernsey and Jersey company law, respectively, means that minority shareholders are reliant on the protections afforded to them at common law. Decisions such as the one in Tianrui v China Shanshui are the building blocks of a robust and effective system by which minority shareholders can protect their rights.

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[1] The appeal proceeded in the Courts below and in the Privy Council on the basis that Tianrui's averments as to the improper purpose of the share allotment and issuance were true; however, this remains an issue to be determined as a matter of fact in the next chapters of this saga.

[2] Gao v China Biologic Products Holdings, Inc. [2018] (2) CILR 591.

[3] Foss v Harbottle (1843) 2 Hare 461.

[4] Tianrui (International) Holding Company Ltd v China Shanshui Cement Group Ltd [2024] UKPC 36 at para 65.

[5] Tianrui (International) Holding Company Ltd v China Shanshui Cement Group Ltd [2024] UKPC 36 at para 68.

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