Offshore Litigation Tools for Local Disputes

British Virgin Island ("BVI") and Cayman Islands companies have been a popular choice of investment vehicle for Hong Kong and Chinese companies and individuals. This article explores the key tools available to members of BVI and Cayman companies in order to protect their investments, which Hong Kong lawyers and their clients should be aware of.

Offshore companies are typically used as holding companies for Hong Kong and PRC companies, which ultimately own immovable assets. These investment structures often involve both multi-national investors and lenders, reflecting the increasing trend of cross-border mergers, acquisitions, partnerships and joint ventures.

During the pre-global financial crisis, such arrangements were often concluded quicker than parties may have liked in order to take full advantage of a particular opportunity or at a time when joint venture parties enjoyed a healthy working relationship. We are now, unfortunately, seeing the end of the honeymoon period in respect of many investments and are witnessing a break down in the relationship between joint venture partners, in some case by reason of fraud committed by one of the parties.

Litigating in the BVI is often seen as an attractive option as proceedings are often brought to trial more expeditiously than in larger onshore centres, while the cost of litigating is comparable to other common law jurisdictions. There is a also a common sensical reason to litigate at the ultimate parent company to ensure that the result of such litigation cascades all the way down the corporate structure sometimes involving protective orders in those other jurisdictions.

1. Minority shareholder protection

Sometimes the majority shareholder, who may well also be a director of the company, takes advantage of its position in an improper or oppressive manner to cause prejudice to the minority shareholders. As in most common law jurisdictions, unfairly prejudiced minority shareholders are protected by the legislative framework in the BVI and Cayman Islands.

BVI – unfair prejudice claims

Section 184I of the BVI Business Companies Act 2004 provides a minority shareholder with refuge to the BVI Courts if he finds himself in a position where his majority shareholding partner(s) are causing prejudice to his rights. This is done by initiating proceedings to rectify the wrong done by the majority shareholder.

Typical examples of minority oppression include:

- Exclusion from management where the minority had a legitimate expectation that they would participate;

- Bad faith or an illegitimate ulterior purpose on the part of the company's directors when carrying out their fiduciary duties.
- Failure to declare dividends and instead arranging for profits to be distributed only to the majority shareholder in another way;
- Diverting business to another company in which the majority shareholder holds an interest;
- Excessive financial distribution to the majority shareholder; and
- Breach of the memorandum and articles of association or a shareholders' agreement.

Another common situation is where there is a breach of a quasi-partnership. This is the superimposition of equitable considerations, which arise at the time of the commencement of the relationship or subsequently, which make it unfair for those conducting the affairs of the company to rely on their strict legal powers under the company's constitution. To establish a quasi-partnership, the claimant must show there was:

- An association formed or continued on the basis of a personal relationship, involving mutual trust and confidence, and each member brought special attributes to the quasi-partnership;
- An agreement or understanding that members shall have equal participation in the conduct of the business; and
- Restrictions upon the transfer of the members' interests in the company so that if confidence is lost, or one member removed from management, he cannot take out his stake and go elsewhere.

The BVI Court has extensive power to make wide-ranging orders in relation to the company. Usual remedies include requiring a majority shareholder to purchase the shares of the minority at market price, or where this is not a suitable remedy, to pay compensation in damages to the minority shareholder.

Where appropriate, the BVI Court will even take steps to regulate the future conduct of the parties as against one another, set aside prejudicial decisions already made by the majority shareholder, make a direction for the rectification of the company's register or, in limited circumstances, appoint a receiver or liquidator for the company. However, the Court will only appoint a liquidator under the just and equitable winding-up grounds if there is no other reasonable remedy available to the shareholder.

It must always be remembered, however, that there is no provision for "no fault divorce." The majority cannot rid itself of unwanted minority and a minority member cannot require the majority to buy out its interest simply because it he is no longer wishes to be a part of the company. Unfair prejudice must therefore be established.

Cayman Islands – just and equitable winding-up petition

There is no equivalent provision to bring unfair prejudice claims in the Cayman Islands, but similar relief is available by way of a just and equitable winding-up petition.

Grounds for a just and equitable winding-up include:

- Management deadlock;
- Loss of confidence in management due to a lack of probity in their conduct. This may include conduct carried out in respect of other related companies to that which is sought to be wound-up;
- Need for the affairs of the company to be investigated;
- Quasi-partnership in place and the shareholder's legitimate expectations were breached; and
- Loss of a company's substratum. (The Cayman Islands Grand Court has deviated from English and BVI law in establishing a new test. It uses a viability test, rather than the traditional one of impossibility.)

As an alternative to a winding-up order, the Court can make an order:

- Regulating the future conduct of the company's affairs;
- Enjoining the company from doing certain acts or requiring the company to do certain acts;
- Authorising civil proceedings to be brought in the name and on behalf of the company by the petitioner; and
- Providing for the purchase of the shares of any members of the company by other members or by the company itself.

2. Third party disclosure orders

Generally, the right to company-related information in offshore jurisdictions is very limited, unless specifically provided for in companies' constitutions or by way of shareholder agreements. For example, directors and members registers are not publicly available, and shareholders do not have an automatic right to company information such as its accounts.

In certain circumstances, however, Norwich Pharmacal Orders can be used to gain critical information necessary to properly bring an action, which the offshore jurisdictions' strict confidentiality provisions would otherwise prevent.

A Norwich Pharmacal Order is simply an order of the Court for disclosure of information from an innocent third party who is somehow mixed-up in a wrongdoing through no fault of their own. Typical third parties will include banks or registered agents of BVI or Cayman incorporated companies.

Such orders are commonly used in fraud cases where the ability to gain access to bank account statements and documents used by the fraudster to transfer funds is critical to tracing the use of monies improperly taken. The information gained will enable determination of how the funds in question were used, whether there are assets available for potential recovery, and if other persons might be involved.

Norwich Pharmacal Orders are often accompanied by a gagging order preventing the third party from communicating anything regarding the disclosure order to the wrongdoer or any third parties. This makes it a discrete weapon in the arsenal of a claimant.

3. Stand-alone freezing injunctions

The BVI offers an effective framework to preserve assets of a company by granting an injunction freezing the assets or preventing the wrongdoers from further prejudicial action.

Prior to 2010, freezing injunctions in the BVI were only available as ancillary relief and a substantive cause of action against the respondent was required. This approach was overturned by the BVI High Court in Black Swan Investment I.S.A. v Harvest View Limited. The Court held that it could grant a stand-alone freezing injunction in support of foreign proceedings where the respondent was within the in personam jurisdiction of the BVI Court. This means that a party can commence litigation in Hong Kong, for example, whilst taking comfort in the knowledge that it has obtained a freezing injunction in the BVI to protect the fruits of any litigation pending judgment in Hong Kong.

However, at present the position in the Cayman Islands is different. While the Grand Court initially adopted the Black Swan formula in allowing a freestanding order in Gillies-Smith v Smith, it has subsequently held that previous Court of Appeal decisions in the Cayman jurisdiction provided “no room for a Black Swan type jurisdiction in the Cayman Islands”. This decision is currently under appeal and it is expected to go all the way to the Privy Council for ultimate determination of the issue. The development of this area of law in the Caymans will be closely watched.

4. Corporate governance

Battles for control over the Hong Kong or PRC level companies under offshore holding companies are becoming more commonplace as conflicts arise and relationships break down. An effective means of resolving a dispute in these circumstances is through taking control of a group’s structure from the top down.

Amendments to a company’s or group’s corporate structure are another way to effect changes from the BVI holding company to the subsidiaries in Hong Kong or the PRC.

By using legitimate means such as replacing directors or making changes to the company’s constitution, wrongdoers can be ousted and those in control can then influence, if not dictate, the disputes occurring at the Hong Kong or PRC level.

While additional proceedings may still be necessary in order to recover misappropriated funds or assets or damages from wayward directors, gaining control of the companies involved will prevent further wrongs from being perpetrated in the meantime.

Conclusion

The popularity of offshore companies in Hong Kong and the PRC will ensure that litigation continues to be a growing area. Offshore jurisdictions offer numerous methods to resolve conflicts involving Hong Kong and PRC companies where the top holding company is incorporated in an offshore jurisdiction.

The courts have many tools in its belt such as stand-alone freezing orders, winding-up orders, and third-party disclosure orders, as well as relief to minority members who have suffered at the hands of the majority. Hong Kong lawyers should be familiar with the various methods available

so that they can best assist their clients when issues arise.

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