“Of all the situations in which the directors may be called upon to exercise their fiduciary powers ... a battle for control of the company is probably the one in which the proper purpose rule has the most valuable part to play.”[1]

In recent years, where take-private transactions and corporate restructurings have become increasingly common, the actions of directors have come under scrutiny as they push the boundaries of the proper purpose rule.

This article examines, in a practical way, the differing powers, and the remedies available to shareholders who object to a proposed course of action by the directors. By focusing on the circumstances in which a share issue is designed to alter the balance of power among shareholders and drive though a course of action which the directors seek, but existing shareholders can block, the proper purpose rule is brought into sharp relief.

The foundation of the proper purpose rule lies in the fact that a company is in the dichotomy between the powers and responsibilities of company directors and those of the shareholders. Directors are responsible for managing the business and affairs of the company and have the power to issue the shares as a part of that responsibility. In doing so, they must ensure that a proper balance is maintained between the board of directors and the shareholders and confine themselves to the more limited purpose for which their powers exist.

In the U.K., the proper purpose rule has now been codified[2] and provides that a director of a company must only exercise powers for the purposes for which they are conferred.

**Cayman Islands**

Under the laws of the Cayman Islands, directors of a company are under precisely the
same duty. However, unlike the case with the English Companies Act, the Companies Law has not codified the duty to act bona fide in the best interests of the company, which remains in Cayman the predominant and core fiduciary duty owed by directors. To discharge their duty to act in the best interests of the company, directors are required to act to lawfully enhance shareholders’ interests, but not at the expense of creditors’ interests.

The duty to act only for a proper purpose has been identified and specifically recognized by the Grand Court of the Cayman Islands in several cases concerning the breach of fiduciary duties by the directors of a company. The Grand Court has acknowledged that directors of companies owe this duty in Argentine Holdings v. Buenos Aires Hotel,[3] Re Emergent Capital Limited[4] and Re Acorn International Inc.[5]

**Howard Smith**

The leading case on the proper purpose rule for the past 50 years is accepted to be Howard Smith v. Ampol Petroleum.[6] The Privy Council held that the directors, even if acting honestly, could not use their fiduciary powers to issue shares that had the effect of destroying an existing majority or creating a majority, and since the directors’ primary object was to alter the majority shareholding, this was an improper exercise of their powers.

Howard Smith is a paradigm example of how the proper purpose rule operates. The majority of the directors were motivated by the need to bring in capital for the company but the trial judge found that their primary purpose was to dilute the shareholding of one set of companies so that another could proceed with its takeover bid. The primary purpose involved affecting the balance of power in the company and was therefore ruled to be an improper purpose leading to the setting aside of the allotment of shares. The directors’ honest belief could not overcome the fact that the substantial purpose for the issue of shares was an improper one.

The court’s approach to the analysis of the proper purpose rule is two-pronged:

- First, examine what was the substantial or primary purpose for which the directors exercised a fiduciary power; and
Second, ask itself whether the purpose was proper.

On the first question, the Grand Court of the Cayman Islands applied Howard Smith in Re Emergent Capital — a case where a debt/equity swap transaction was authorized to protect the majority’s position of ownership and control to the exclusion of others. Judge Andrew Jones accepted that where a dispute arises about which of two or more purposes was the dominant or substantial one, the court may look at the situation objectively to ascertain whether the purpose relied upon as the dominant one was the true purpose. This meant that if the directors justified their decision to allot shares by the financial condition of the company the court could review the financial situation to determine whether the directors’ assertion was to be believed.

Eclairs

However, the 2015 judgment of the U.K. Supreme Court in Eclairs Group Ltd v. JKX Oil & Gas PLC has seemingly opened the door for a much broader interpretation of the rule in light of the leading judgment given by Lord Jonathan Sumption.

Lords Sumption and Patrick Hodge applied a “but-for” causative test in determining whether the actions of a board will be invalid due to a breach of the proper purpose rule. That is to say, where there are a mixture of proper and improper purposes underlying the board’s decision, the decision will breach the rule if it would not have been taken but for the existence of the improper purpose(s).

Where there is a power struggle between different groups of shareholders, Lord Sumption held that the directors should not issue additional shares in such a way as to affect the balance of power in the company or influence in any way the outcome of shareholders’ resolutions, even if this results in additional capital or other benefits to the company. The restriction is not written into the company’s articles and, accordingly, equity imposes on the directors the additional requirement that the shares must be issued for a proper purpose.

The rule that the fiduciary powers of directors may be exercised only for the purposes for which they were conferred is one of the main means by which equity enforces the proper conduct of directors. It is also fundamental to the constitutional distinction between the respective domains of the board and the shareholders.[7]
The Supreme Court's decision makes clear that the proper purpose rule is omnipresent and should be closely contemplated whenever a board is exercising the powers conferred upon it, particularly the issuance of new shares.

Uncertainty

However, the impact of Eclairs was muted by the fact that Lords Jonathan Mance, Anthony Clarke and David Neuberger reserved their position on what the proper causative test should be, given the absence of detailed submissions on this point during the hearings. Lord Mance said that "but for" causation offers a single, simple test, which it might be possible or even preferable to substitute for references to the principal or primary purpose test but (along with a majority of the court) expressly left this important question undecided.

Therefore the decision arguably raises more difficulties than it solves in relation to determining proper purpose in more complex corporate disputes where the directors do not have a unified or clear purpose. As the Supreme Court declined to comment decisively on the correct test, and also emphasized the importance of assessing the subjective intentions of each director, there will inevitably be continuing argument on the matter.

To date, there has been no Cayman Islands decision which has considered or applied the "but for" causation test. It may be that the courts in this jurisdiction will continue to apply the "substantial or primary purpose" test in Howard Smith until a judgment of sufficient weight and clarity is given in relation to Eclairs.

Remedies

The general consequences of a breach of fiduciary duty, such as the proper purpose duty, are summarized in Palmer's Company Law[8]:

- injunctions and declarations (generally only when the breach is still threatened);

- common law damages or equitable compensation where the company has suffered loss;
• restoration of the company’s property, following a declaration that the property is held by the director on constructive trust for the company; an account of profits made by the director; or rescission of a contract where the director failed to disclose an interest.

The primary remedy for a breach of the proper purpose duty would be to set aside the transaction or resolution passed by the directors for an improper purpose. Where the directors have allotted shares in breach of the proper purpose duty, the courts have declared the allotment invalid and ordered the rectification of the share register as seen in Howard Smith and Re: Emergent Capital.

**British Virgin Islands**

Interestingly, in 2016, the Court of Appeal in the British Virgin Islands considered Eclairs in *Independent Asset Management Company Limited v. Swiss Forfaiting Limited*. Section 121 of the BVI Business Companies Act contains a similar statutory duty for directors to act for a proper purpose. In considering whether an issue of shares was for an improper purpose, the court applied the causation test set out in Howard Smith and did not expressly apply (or consider the appropriateness of) the “but for” methodology advanced by Lord Mance in Eclairs. Nonetheless, the court found that the issue of shares was for an improper purpose, stating that “the directors’ purpose, however noble, should not be used to affect the balance of power in the company” and having found that was the ‘substantial’ purpose, it did not matter that the directors were influenced by other motives and reasons that benefited the company as a whole or its remaining shareholder.

In a very recent decision in Antow Holdings Limited (September 2018), the Court of Appeal declined to apply the “but for” test, opting again for the ‘substantial purpose’ test from Howard Smith. Pereira CJ however noted that the “but for” test as suggested by Lord Sumption was one to be considered when the directors are motivated by multiple purposes. She ruled that it was clear that there was one purpose only and that purpose was improper.

**Conclusion**

Despite the ongoing uncertainty regarding the impact of Eclairs on the established test, it is clear that the proper purpose rule will continue to operate as a useful legal safeguard for shareholders faced with a hostile share issue designed to alter the balance of power in a company.
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[1] Lord Sumption in Eclairs Group Ltd v. JKX Oil & Gas plc [2015] UKSC 71 at paragraph 37

[2] Section 171 (b) of the Companies Act 2006

[3] [1997] CILR 90, 104

[4] [2011] (2) CILR 329 at 349


[7] Lord Sumption in Eclairs Group Ltd v. JKX Oil & Gas plc [2015] UKSC 71 at paragraph 37

[8] (Rev. ed, January 2017) at 8.3303