Privy Council Provides Clarification on the Grounds of a Just and Equitable Winding Up for BVI Quasi-Partnerships: *Chu v Lau*

26 October 2020

In a recent decision, *Chu v Lau* [2020] UKPC 24 on appeal from the Court of Appeal of the Eastern Caribbean Supreme Court (British Virgin Islands) (the "**Court of Appeal**"), the Judicial Committee of the Privy Council (the "**Board**") reviewed the law in the British Virgin Islands (the "**BVI**") surrounding a just and equitable winding up where the company in question is a quasi-partnership.

Executive Summary

Upon a review of the case law, and relying heavily on the well-known English authority, *Ebrahimi v Westbourne Galleries Ltd (In re Westbourne Galleries Ltd)* [1973] AC 360 ("**Ebrahimi**"), the Board concluded that an irretrievable breakdown in trust and confidence between the participating members may justify a just and equitable winding up, essentially on the same grounds as would justify the dissolution of a true partnership. Further, the dissolution could be ordered even where both parties were to blame for the breakdown, as the operation of the equitable doctrine of clean hands is expressed in this context by the requirement that the applicant should not have been the sole cause of the breakdown in trust and confidence or of the deadlock.

The Board considered that, while it is well-established that winding up is a shareholders' remedy of last resort, that does not mean that winding up is unavailable to members if they have any other remedy.

On the facts presented to them, the Board concluded that there was a quasi-partnership and that there had been an irretrievable breakdown in trust and confidence between the parties. The Board rejected the contention that there were alternative remedies available to Mr Lau and considered that the Court of Appeal had erred in reversing the decision of the trial judge.

This review of the law is a useful clarification of the factors that the BVI High Court (the "**BVI Court**") will consider when deciding whether to grant a winding up on just and equitable grounds for a quasi-partnership, and confirms the necessary hurdles that a respondent must meet in order to resist such an application.

Background

Chu v Lau concerned two experienced Hong Kong-based businessmen, Mr Lau and Mr Chu who became friends and colleagues, investing in a number of enterprises together. One such investment involved a BVI company called Ocean Sino Ltd ("**OSL**") in which they each owned one of the two issued shares and were the only directors. OSL had a wholly owned subsidiary, PBM Asset Management Ltd ("**PBM**"), a Hong Kong

company of which Mr Lau and Mr Chu were again the only directors. OSL and PBM were the corporate vehicles for a joint venture with a state-owned entity of the People's Republic of China. The joint venture company was Beibu Gulf Ocean Shipping (Group) Ltd ("**Beibu Gulf**").

From early 2014 there was a breakdown in the relationship between Mr Lau and Mr Chu that led to an ultimately abortive attempt to sever their many business relationships by agreement and then to various legal claims and cross-claims, mainly in the Hong Kong courts. In 2015, Mr Lau applied to the BVI Court for the winding up of OSL on the just and equitable ground, alleging (i) an irretrievable breakdown of trust and confidence between him and Mr Chu, and (ii) functional deadlock in the management of OSL (and therefore PBM) both at board and shareholder level.

In 2017 the trial judge, the Hon. Justice Roger Kaye QC, granted the relief sought.

In January 2020, on Mr Chu's appeal, the Court of Appeal unanimously reversed the judgment and discharged the winding up order, holding that that the trial judge had made the following errors:

1. He had wrongly taken into account aspects of the dissension between Mr Lau and Mr Chu which occurred at the Beibu Gulf level, which ought not to be taken into account in assessing whether there was deadlock in OSL.
2. He had failed to concentrate on the question whether OSL was deadlocked at the date of the filing of the application, rather than at the time of the hearing, and thereby failed to take into account evidence that Mr Lau and Mr Chu were able to negotiate and agree matters after May 2015, so that their breakdown in co-operation was not then irretrievable.
3. He had failed to take into account the freedom of Mr Lau to sell his shares in OSL as a means of resolving the deadlock.
4. He had failed to consider alternative remedies reasonably available to Mr Lau, such as a buy-out, before ordering a winding up as a last resort.

Mr Lau then appealed to the Privy Council. The Board set out the legal position before considering each of the Court of Appeal's points in turn.

Legal Position

The Board first set out the legal position regarding a just and equitable winding up. The Board found that a just and equitable winding up may be ordered where the company's members have fallen out in two related but distinct situations. First, where the winding up is to resolve a functional deadlock; this is where the inability of members to co-operate in the management of the company's affairs leads to an inability of the company to function at board or shareholder level.

The second instance is where a company is a corporate quasi-partnership and an irretrievable breakdown in trust and confidence between the participating members may justify a just and equitable winding up, essentially on the same grounds as would justify the dissolution of a true partnership. The Board looked to *Pease v Herwitt* (1862) 31 Beav 22 and *Atwood v Maude* (1868) LR 3 Ch App 369, to confirm that a dissolution of a partnership might be ordered even where both parties were to blame for the breakdown in mutual trust and confidence.

The Board considered that an important distinction is that where there is a functional deadlock, the winding up may be ordered regardless of whether the company is in a quasi-partnership. By contrast, where the company is in fact a quasi-partnership, then a breakdown of trust and confidence may justify a winding up even where there may not be a complete functional deadlock.

In the first scenario, winding up is a remedy for paralysis, in the latter winding up is the response of equity to a state of affairs between individuals who agreed to work together on the basis of mutual trust and confidence where that trust and confidence has completely gone.

The Board also referred to *Ebrahimi* and upheld the principle that an applicant for a just and equitable winding up is not barred from their remedy merely because the breakdown or deadlock upon which they rely has been caused to some extent by their own fault.

Looking at the Beibu Gulf Level when Assessing Deadlock

It is well-established that, where there is a corporate quasi-partnership what matters is the relationship between the quasi-partners, and the extent to which the necessary basis of trust and confidence has evaporated. On the facts, the Board considered that there was considerable evidence of

a breakdown of trust and confidence between Mr Lau and Mr Chu and that this manifested itself to a substantial extent in their activities in connection with Beibu Gulf, of which they were both directors.

In the Board's view, the three indicators of a quasi-partnership set out in Lord Wilberforce's test in *Ebrahimi* do not represent necessary elements, in that the absence of one or more was not fatal to the trial judge's finding that OSL was a quasi-partnership and that the management of OSL included the management of the affairs of its wholly owned subsidiary PBM.

The first criticism of the trial judge by the Court of Appeal was therefore mistaken.

Failure to Assess Deadlock and Breakdown of Trust and Confidence as at the Date of Filing the Application

The Board considered that this criticism was unwarranted for three reasons: first, there is no rule that a just and equitable application for winding-up must be justified solely by reference to the position as at the date of the filing of the application; second, in any event the trial judge found that there was both deadlock and an irretrievable breakdown of trust and confidence by May 2015, when the application was filed; and, third, there was ample evidence about matters which occurred thereafter from which the judge could conclude, as he did, that, rather than demonstrating continued co-operation between the two men, they just made matters worse.

Mr Lau's Freedom to Sell His Shares

There was no restriction in the company's articles of association which restricted Mr Lau's ability to sell his shares, and the Court of Appeal had considered that this provided a mechanism for resolving the deadlock. The Board's view was that this might be an answer in a case based on purely functional deadlock i.e. that a member could extract himself by a sale of his shares, but that would only be the case where the members could do so on fair terms.

In this case, Mr Lau's ability to sell his shares was purely theoretical and little if any evidence had been provided at the trial about the possibility. The Board's view was that it was most unlikely that the experienced trial judge would have been unaware of the lack of any restriction on sale and the fact that it was ignored both by the parties and the judge was more consistent with the fact that Mr Lau's freedom to sell was purely theoretical. That being so, the point did not provide a basis for the Court of Appeal to have departed from the judge's finding of functional deadlock

Alternative Remedy

So far as an alternative remedy is concerned, the Board considered that, while it is well-established that winding up is a shareholders' remedy of last resort, that does not mean that winding up is necessarily unavailable to members if they have another remedy. Rather, Section 167(3) of the Insolvency Act 2003 sets out a three stage analysis to be carried out by the court upon an application for a just and equitable winding up:

(i) Is the applicant entitled to some relief?
(ii) If so, would a winding-up be just and equitable if there were no other remedy available?
(iii) If so, has the applicant unreasonably failed to pursue some other available remedy instead of seeking winding-up?

The Board noted that the legal burden of proof is on the applicant for stages one and two, but that it shifts to the respondent for stage three. The Court of Appeal had therefore erred in taking the view that it was for Mr Lau to demonstrate that there was no alternative remedy reasonably available to him. The legal onus on this issue lies with the respondent to the application.

The Board endorsed the trial judge's conclusion that the prospect of a sale by Mr Lau was not a realistic available remedy; despite there being no restriction in the articles of association of OSL against dealings by each member with their shareholding, an incoming third party purchaser of Mr Lau's shares would face various disincentives to paying full value. Mr Lau would not therefore be able to sell his shares on fair terms.

An order for the sale of Mr Lau's shareholding would have required proceedings based on, and proof of, unfair prejudice, and the Board agreed with the trial judge's reason why it was not unreasonable for Mr Lau to avoid such proceedings; namely, it was not unreasonable for Mr Lau to confine himself to seeking a winding-up, mainly because of the risk that it would increase the range of litigation already afoot between the parties and would be both speculative and expensive, by comparison with a winding-up application. The Board added that unfair prejudice in the management of a company is a different allegation from either deadlock or breakdown of trust and confidence and it is not to be assumed that an applicant who can prove the latter will equally be able to prove the former.

Additional Points

The Board also looked at additional points raised by Mr Chu in the proceedings. The Board determined that a just and equitable winding-up is a statutory remedy, albeit of an essentially equitable nature. The clean hands doctrine finds appropriate expression in this context by the requirement, as expressed in *Ebrahimi*, that the applicant should not have been the sole cause of the breakdown in trust and confidence or of the deadlock. The Board further determined that the notion of a share split at the PBM or Beibu Gulf level does not appear on its face to be as suitable as a winding-up of OSL. It would not achieve a clean break between Mr Lau and Mr Chu, and it would not (if operated at the Beibu Gulf level) do anything about those assets of PBM consisting of its claims in relation to its loan to Beibu Gulf, or its claims against Mr Chu for misfeasance and breach of fiduciary duty which would better be investigated and (if thought fit) pursued by a liquidator.

Conclusion

The Board concluded that there was a quasi-partnership and that there had been an irretrievable breakdown in trust and confidence between the parties. The Board rejected the suggestion that that there was a ready remedy for the deadlock by means of a sale by Mr Lau of his shares or that there was an available alternative remedy available to Mr Lau. The Board therefore overturned the order of the Court of Appeal and restored the order of the trial judge.

In so doing, the Board commented that this was an unusual case in which the Court of Appeal took it upon itself to overturn an essentially factual decision followed by the exercise of discretion of the trial judge. It depended upon the judge having made relevant errors of law, taken into account inadmissible matters, ignored relevant matters and exercised his discretion on a flawed basis. The argument before the Board had demonstrated that all the Court of Appeal's criticisms of the judge were ill-founded.

The Board's review of the law, and its analysis of the two types of breakdown case provides useful clarification of the factors which the Court will consider when deciding whether to grant a winding up on just and equitable grounds. Since the jurisdiction to wind up a BVI company on the just and equitable ground closely follows the similar jurisdiction in the UK, which dates back to the mid-19th Century, the decision is likely to be of interest not only to BVI legal practitioners dealing with shareholder disputes but also to UK practitioners and to those around the common-law world in the many jurisdictions which have broadly followed the same model.

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