Can the Common Understanding Amongst the First Generation Partners Pass on to the Second Generation?

Introduction

It is not uncommon, in a family context, for a quasi-partnership to arise among the older generation and, when shares are passed to children on death or retirement, for the quasi-partnership to be continued by the children. In a quasi-partnership company, members usually enter into association on some kind of common understandings, such as they will all participate in the management of the company. The court will hold the parties to such common understandings, for doing otherwise will be unjust or inequitable.

Authorities

_Brownlow v GH Marshall Ltd_ [2000] 2 BCLC 655 concerns a family company founded by the father, who originally held the majority shares of the company. After his death, his daughter, the petitioner, and two of her siblings became the only shareholders. Relationship among them deteriorated and the petitioner was excluded from management. She therefore brought a petition under s.459 of the Companies Act 1985 and sought an order for the company to purchase her shares at a fair value. It was alleged that her exclusion was contrary to her legitimate expectation of continued participation in the family business.

The Judge found that before the father’s death, the second generation grew into greater and greater involvement in the employment and management in the company, and it was always envisaged in the family that each member would participate in varying degrees in management and in the company’s success or failure. The Judge considered that there was a family expectation, growing over the years, that each of the children would, so far as possible and so far as personal circumstances allowed, be brought into the management of the affairs of the company. Accordingly, the Judge made a buy-out order.

The same principle was applied in _Fisher v Cadman_ [2005] EWHC 377 (Ch). Cadman Developments Limited (“CDL”) was set up by the father in 1961 as the vehicle for his building and property development business. He had two sons, Cedric and Rodney, and one daughter, Mrs. Fisher. Cedric and Rodney both worked as directors in CDL. In 1969, they also set up another building and property development company of their own, called Cadman Homes Ltd (“CHL”). The two companies entered into transactions with each other over the years.
After the father’s death, the shares in CDL were passed to the three children in roughly equal share. The relationship between Mrs. Fisher and her brothers turned sour. Mrs. Fisher took out a petition under s.459 of the Companies Act 1985, alleging that the affairs of CDL had been conducted in a manner unfairly prejudicial to her interests.

The court found that after the death of their father, Cedric and Rodney introduced into CDL’s accounts provisions relating to remuneration for themselves as directors, which was contrary to previous understanding that they should not receive any remuneration as directors. The two brothers also denied Mrs. Fisher any reasonable means to inform herself about what had happened in relation to CDL’s affairs. Moreover, they caused CDL to make a payment of £70,000 to CHL when the amount due was of only £9,236.

The Judge recognized that Mrs. Fisher was never involved in the management of CDL and did not herself provide capital for the company, but was given or inherited her shareholding in it from her parents. Nevertheless, the Judge held at paragraph 89 that:

“the relationship between Mrs. Fisher and [her brothers] was one in which equitable considerations going beyond the simple terms of CDL’s articles of association applied as constraints upon the way in which [the brothers] could behave in relation to the company and Mrs. Fisher…. The company had started life as a clear quasi-partnership and it was effectively continued on the same basis, after the death of the older generation, as a small family company in which the family relationship would be important alongside the relationship defined in the articles of association. Its affairs were dealt with on a very informal basis throughout, indicating a common understanding on all sides that the articles of association did not represent the complete and exhaustive statement of how the relationship between the members and the members and management should be conducted.”

The Judge therefore held that in paying themselves excessive directors’ remuneration and removal of economic value from CDL to CHL, the two brothers disregarded the interests of Mrs. Fisher and their conduct qualify as unfairly prejudicial to the interests of Mrs. Fisher. Accordingly, the Judge made an order requiring that Mrs. Fisher’s interests in CDL be bought out at a fair value.

Yung Kee

In Re Yung Kee [2012] HKEC 1480, Harris J was also not hesitant to hold that it was possible for a common understanding which came into existence among the older generation to continue to bind the subsequent generations.

Yung Kee Holdings Limited ("Yung Kee") was incorporated in the BVI. It is a holding company of another BVI company, Long Yau, which in turn operates two Hong Kong
subsidiaries carrying on business exclusively in Hong Kong. The restaurant business was started by the late Kam Shui Fai (“Kam Senior”). After the death of Kam Senior, Kwan Sing and Kwan Lai became shareholders of Yung Kee, each holding directly or indirectly 45% of the shares, with the remaining 10% being held by their sister, Kelly. However, Kelly claimed that she had gifted away her 10% shares to Kwan Lai, which made Kwan Lai effectively the majority shareholder.

The two brothers later fell out and Kwan Sing brought proceedings in the Hong Kong court seeking an order that Kwan Lai buy him out on the ground that the affairs of Yung Kee were being carried on in a manner which was unfairly prejudicial to him, pursuant to s.168A of the then Companies Ordinance. In the alternative, he sought an order that the Company be wound up on the just and equitable ground under s.327(3)(c).

At first instance, Harris J found that it has always been Kam Senior’s intention to have Kwan Sing and Kwan Lai to succeed him and continue to run the family business with equal rights and power. This was also the understanding of other family members. Thus, when Kwan Lai took steps to control Yung Kee, Harris J considered that inconsistent with their long established practices and lack of regard for Kwan Sing’s reasonable expectation.

On appeal, the Court of Appeal agreed that a previous course of dealings between two parties before they became shareholders or their predecessors in title can be relevant to the subsistence of a quasi-partnership after they became shareholders. However, the Court of Appeal found that there was insufficient evidence to support the finding that there was such a mutual understanding.

Further, CA also criticized Harris J’s approach in determining the fairness of the conduct of Kwan Lai by reference to the legitimate expectation of Kwan Sing. The correct approach, according to CA, requires the examination of whether Kwan Sing can pray in aid of any equity to restrain the exercise of Kwan Lai’s majority voting power to appoint an additional director in the board of Yung Kee. If such equity could not be identified, it matters not that Kwan Sing’s expectation was upset and that the trust and confidence between the brothers had been destroyed. As there was insufficient evidence suggesting a mutual understanding between Kwan Sing and Kwan Lai that they had to vote in unison whenever there was any difference, Kwan Lai was entitled to exercise his voting rights without any restraint.

When the case finally reached the Court of Final Appeal, the court was unanimous in finding that there was a mutual understanding between the brothers that each is entitled to fully participate in the running of the business and to be properly consulted. But such understanding has been breached by Kwan Lai, as “he consciously took steps to control
Yung Kee and then exercised that control without proper regard to previous understandings”. A winding-up order was accordingly made.

**Conclusion**

The above cases have clearly demonstrated that in a family context, a quasi-partnership can “pass down” a generation. However, one should also bear in mind that the second generation is always entitled to seek to revive strict adherence to the Articles of Association, thereby bringing the quasi-partnership to an end.