The Court’s approach – Side Agreements and their enforceability

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A recent judgment handed down by the Federal Supreme Court demonstrates a unique position on the issue of side agreements and the removal of a partner in a company. The judgment sheds light on the validity and enforceability of side agreements in the context of a 49/51 UAE limited liability company. The judgment also addressed a very important issue on whether the majority shareholder can request the court to remove any of his partners/shareholders and the grounds for such request. The case is discussed in detail below.

Background

A dispute arose in relation to a limited liability company in Abu Dhabi between a UAE shareholder (owning 51 % of the shares), an Omani shareholder (owning 24 % of the shares) and a US company (owning 25 %). An action was filed by the UAE shareholder requesting confirmation of its entitlement to 51 % of the profits according to the shareholder’s agreement. The UAE shareholder also requested the court to issue judgment for the withdrawal of the Omani shareholder on the basis that the Omani shareholder had not been cooperative and caused loss to the company as a result of his lack of cooperation. The Omani shareholder argued that the partners in the company signed a side agreement and entered into an arrangement whereby the UAE partner would own 37.5 % of the shares, the Omani partner would also have 37.5 % and 25% was owned by the US Company.

Court of First Instance

The matter progressed before the Court of First Instance and the court issued judgment in favour of the UAE partner on the basis of the official documents (the Memorandum of Association) which confirmed that he was the owner of 51% of the shares of the company. The court however rejected the request of the UAE partner to expel the Omani partner.

Federal Court of Appeal

Both the UAE and Omani partners appealed further against the judgment and the Court of Appeal rejected both appeals and upheld the lower judgment.

Federal Supreme Court

Both parties appealed further to the Federal Supreme Court. The Federal Supreme Court ruling highlighted two important issues:

- Side agreements

The general principle in UAE Evidence law is that a written contract can only be contradicted by written evidence, except where the opponent waives his right to documentary evidence or where there is an agreement to defraud the law. When the fraud exception to the general principle applies, the party against whom the fraud was made can use all means of evidence including testimony of witnesses to prove that the official agreement is not genuine vis-à-vis the side agreement.

- Withdrawal of the Omani shareholder

The UAE shareholder requested the court to dismiss the Omani shareholder as a result of the losses he caused the company to incur. The Court of First Instance refused to accept the UAE shareholder's request on the basis of articles 37, 47 and 63 of the Commercial Companies Code. These articles mandate that a numerical majority is required and in these circumstances, only one shareholder out of three requested the dismissal. This was followed by the Court of Appeal however this was reversed by the Federal Supreme Court (as discussed below).

Federal Supreme Court

The Federal Supreme Court decided that what is legally required is the majority of shares rather than a majority of the partners and accordingly a shareholder owning a majority of the shares could request the court to dismiss a partner based on sufficient reasons to justify the request. As the UAE shareholder owned 51% of the shares he could request the dismissal of the Omani entity on the basis of the following articles:

Article 677 of the civil code provides:

(1) It shall be permissible for a majority of the partners to apply for a judicial order dismissing any partner if they adduce serious reasons justifying the dismissal.

(2) It shall likewise be permissible for any partner to apply for a judicial order that he cease to be a partner in the company if the company is of defined duration, and he provides reasonable grounds for such application.

(3) In both of the foregoing events the provisions of Article 675 (2) shall apply to the share of the dismissed or withdrawing partner, and such share shall be assessed in accordance with its value on the date the claim was brought.

Article 675 (2) provides that 'it shall likewise be permissible for an agreement to be made to continue the company as between the remainder of the partners if one of them dies or is placed under a legal restriction or becomes bankrupt or withdraws, and in those events such partner or his heirs shall be entitled only to his share in the assets of the company…'
In light of the above, the Federal Supreme Court overruled the Court of Appeal judgment and remanded the case again to the Court of Appeal to look into the appeal and consider the directions of the Supreme Court.

The Court of Appeal

Upon re-trial, the Court of Appeal gave the Omani shareholder the opportunity to call witnesses to prove his side agreement. However, the case was dismissed for lack of evidence confirming ownership of the UAE partner for 51% of the shares. The court also dismissed the appeal filed by the UAE partner to remove the Omani partner on the basis of lack of evidence to support such request.

Both parties appealed again to the Supreme Court. The Omani shareholder argued that it has submitted sufficient evidence to establish the side agreement but argued that the Court of Appeal neglected this issue. The UAE shareholder filed its appeal insisting on its request to remove the Omani shareholder.

Federal Supreme Court

The Federal Supreme Court confirmed that the Court of Appeal neglected to look at evidence confirming the Omani's shareholding. The Court of Appeal did not address the side agreement which contains a clause (Article 20 of the contract) Article 20 of the side agreement states that "Each of the parties acknowledges that they hold shares equally in the company." The profits and losses of the firm were distributed equally under Clause 20. This is in addition to various other documents which prove that the profits and losses were distributed equally between the two companies and not based on the official 51/49% shareholding of the UAE Company.

The Federal Supreme Court, however, rejected the appeal filed by the UAE shareholder on the basis that there was no evidence to support its request to remove the Omani shareholder.

The Supreme Court therefore overruled the Court of Appeal judgment for the second time and returned the case back for retrial to look into the documents and arguments raised by the Omani shareholder in support of the side agreement.

As a result of this judgment the request of the UAE partner to expel the Omani partner became final and the only issue that remained to be addressed by the Court of Appeal was the issue of the side agreement as argued by the Omani partner.

The Court of Appeal Judgment –upon retrial

As a result, the Court of Appeal heard the case again (for the third time) in order to decide whether or not there are sufficient documents to establish the existence of the side agreement/arrangement as argued by the Omani partner. Upon reviewing all the documents submitted by the Omani partner, the court concluded that there is sufficient evidence to establish the existence of the side agreement between the parties (and that the shares have been distributed on the basis of 37.5% to the UAE and Omani partners and 25% to the US Company).

Comment

In this case, it was clear that the shareholders of the company could continue the company's business on the basis of the side agreement. In the event that one of the parties wanted to dissolve the company, a separate court judgment would be needed to dissolve the company on the basis that the company lacked the required legal corporate structure as the UAE partner's shares had been declared to be less than 51%, however the partners may need to decide whether or not their interest are better served by living with the side agreement and continue with the company or dissolve it.