The Dubai Courts Approach when Dealing with De Facto Companies

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In a recent Dubai Court of Cassation decision (Property Appeal 454 of 2015, dated 13 April 2016), the court highlighted that in the absence of an agreement between shareholders that sets out the sharing of losses (and profits), the courts will treat the company as a 'de facto' company. In the event there is an agreement but it is silent on losses/profits, the trial court has the discretion to interpret a contract and determine the parties' intent by establishing its objects and terms in light of the circumstances surrounding its formation. The courts will not consider an incorrect description of the parties' agreement.

Introduction

In a recent Dubai Court of Cassation decision (Property Appeal 454 of 2015, dated 13 April 2016), the court highlighted that in the absence of an agreement between shareholders that sets out the sharing of losses (and profits), the courts will treat the company as a 'de facto' company. In the event there is an agreement but it is silent on losses/profits, the trial court has the discretion to interpret a contract and determine the parties' intent by establishing its objects and terms in light of the circumstances surrounding its formation. The courts will not consider an incorrect description of the parties' agreement.

A de facto company is a company which operates as if it were a corporation although it has not completed the legal steps to become incorporated (i.e. is not yet a 'de jure' company) but nevertheless continues to function. As a result of the absence of express provisions on the sharing of profits and losses, this inevitably leads to disputes in the event the de facto company fails or succeeds.

The existence or otherwise of a de facto company between persons that have expressed an intent to participate in risk-bearing activities is for the trial judge to determine based on the circumstances of the case and the evidence presented to the courts.

Summary of the Facts

The Claimant entered into an agreement with the Defendant for the latter to purchase a plot of land that was to be partitioned, subdivided and sold to third parties with the Claimant acquiring a joint share in ownership of a company (expressed as a percentage of the total price of the plot) as well as a share of the profits from the sale. The Claimant advanced finance to the Defendant to purchase the plot.

The Defendant failed to comply with its obligation to furnish proof of purchase of the plot and failed to register the Claimant's joint share. The Defendant failed to provide proof that the plot had been partitioned, subdivided and offered for sale. The Claimant filed its dispute with the Centre for Amicable Settlement of Disputes ("CASD") and requested the contract be rescinded and the return of the purchase price.

The Defendant argued that the matter was premature because the parties' relationship involves a

de facto company which the Claimant has not sought to liquidate. The Claimant, as a partner in the company, may not bring an action to claim his share of the capital before liquidation proceedings are commenced.

The dispute was not settled at CASD and subsequently was referred to the Court of First Instance. On 26 February 2015, the Court of First Instance held in favour of the Claimant and ordered the Defendant to refund the Claimant the purchase price plus 9% interest from the date of the action (9 April 2013) until paid. The Court held that the Memorandum of Association was in fact an investment contract.

On 27 August 2015 the Defendant appealed the decision, but the Court of Appeal upheld the Court of First Instance judgment. The court took the view that the contract was an investment contract rather than a de facto company's Memorandum of Association, because the document did not have a loss sharing provision.

The Defendant appealed on 21 September 2015 to the Cassation Court which overturned the Court of Appeal's ruling.

The Court of Cassation

The Court of Cassation held that it was well established that where a Memorandum of Association only provides a profit sharing ratio, that ratio also applies to loss unless the parties intended not to share corporate risk and to share profits only but not losses (Article 659 of the Civil Transactions law):

"There is a presumption that the profit-sharing ratio is also the loss-sharing ratio. The fact that there is no contractual provision concerning loss sharing does not of itself indicate that the contract is not a Memorandum of Association."

In addition, the criterion when interpreting contracts is the intention of the parties and the meaning of the words used, and not the form. The existence or otherwise of a de facto company between persons that have expressed an intent to participate in risk-bearing activities (where each partner assumes a share of the risk by sharing in profit and loss) is for the trial judge to determine based on the circumstances of the case and the evidence and presumptions on the record if there is scope for interpretation of the contract.

The enquiry must be into the common intention of the contracting parties, without stopping at the literal meaning of the words, and taking guidance from the nature of the transaction and the necessary element of trust and confidence that should exist between the contracting parties in accordance with the current custom in transactions.

In the absence of an agreement between shareholders that sets out the sharing of losses (and profits), the courts will treat the company as a de facto company. In the event there is an agreement but it is silent on losses/profits, the trial court has the discretion to interpret a contract and determine the parties' intent by establishing its objects and terms in light of the circumstances surrounding its formation.

In this case, the argument of the claimant that the Memorandum of Association is an Investment Contract was refuted and it was concluded that the parties had agreed to create a de facto company that included a profit-sharing ratio but was silent on the lost-sharing. The Claimant, as a partner in the company, may not bring an action to claim his share of the capital before liquidation proceedings are commenced.

The claim was accordingly premature and was dismissed.

Conclusion

The Court of Cassation's judgment is important because it clarifies the circumstances in which the courts will interfere to characterize a de facto company. This can have important consequences for parties to a joint venture when these arrangements have not been duly incorporated. This case helps investors to define their position by setting out the necessary elements which form their common intention.