Important Abu Dhabi Judgment on Distribution of Profits in an LLC and Public Policy

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The judgment confirmed that the nullification of the sale and purchase agreement/side agreement shall have effect from the date of the court judgment and not from the date of the agreement (i.e. the nullification will not be applied retroactively). Accordingly, the foreign shareholder shall be entitled to the profit in accordance with his actual shareholding (reflected in the side agreement) if the UAE shareholder is only acting as service agent/sponsor. The foreign shareholder's entitlement to the profit (before the judgment) is guaranteed even if a court declares that the side agreement is in violation of the UAE Company law and public policy. In summary, the rights set out in the side agreement, such as the distribution of profit, are protected notwithstanding that the side agreement is void.

Al Tamimi & Company successfully defended the Defendants before the Abu Dhabi courts.

Legal Background – Ownership requirement in LLCs

Each company established under the Companies Law must at all times have 51% of its shares registered in the name of a UAE citizen ('citizen' being interpreted to include UAE individuals and corporate entities owned 100% by UAE individuals). A foreign investor, whether an individual or a corporation, is permitted to be registered as the shareholder of up to 49% of the shares in a company. This is pursuant to Articles 22 and 230 of the old Companies Law 1984 (similar to articles 10 and 79 of the new UAE Companies Law).

In the UAE, it is common for agreements (sponsorship/nominee arrangements) to be entered into between foreign entities or individuals on the one hand and UAE national shareholders on the other hand which, in effect, state that the beneficial and/or economic interest in shares legally held by the UAE shareholder belongs to the foreign party and that the economic interest of the UAE shareholder in the company is restricted to an agreed annual fee.

Factual Background

The background of the case is complex and relates to a family company, but essentially in 1989 the Claimants (the UAE party) and the Defendants (the non-UAE party) set up a company with an equity split of 51-49 respectively. In 2004, the Company was performing badly and the Claimants wanted to sell their shares to the Defendants. The parties therefore entered into an SPA in 2004 by which the Claimant would sell their shares to the Defendants for AED 5 million, exit the Company, but remain a partner (a silent partner to satisfy the legal requirements for the Company), in return for receiving an annual sponsorship fee of AED 150,000.

The sale was not registered with the Notary Public, nor was it on the company's registrar or the commercial register. Following the sale, the Claimants gave a Power of Attorney for management without referencing the SPA. After two years, the Company's business improved and the Claimants brought an action against the Defendants to invalidate the sale of the shares.

The Court of First Instance

The Claimants filed an action against the Defendants seeking the nullification of the SPA on the basis that the sale was not shown on the Company's revenue and the shares were sold at less than their market price. The Claimants claimed, amongst other things, for:

- the invalidation of the SPA and the cancellation of the power of attorney that was granted to effect the sale;
- payment of the Claimant's share of the Company's profits and revenues since the date of the sale of the shares to date; and
- the reinstatement of the Claimants as partners in the Company (as opposed to silent partners).

The Court of First Instance appointed an expert who concluded in his report that the sale of the shares was concluded upon the request and satisfaction of the Claimants. The Defendants were found to have fulfilled their obligations and the action was dismissed. The Claimants had not provided any proof that they were deceived.

The Claimants appealed the decision.

The Court of Appeal and the Cassation court

The Claimants appealed in Appeal 114 of 2011, but the appeal was dismissed. The Claimants appealed and the Court of Cassation overturned the Court of Appeal's ruling and returned the case to the Court of Appeal for a decision by a different panel.

The Court of Appeal (on remand)

The Court of Appeal held that the sale was contrary to public policy for not meeting the requirements of 22 and 230 of the old Companies Law (Article 10 and 79 of the new Companies Law). The SPA was therefore declared void. The Court ordered that pursuant to Article 274 of the Civil Code, the two contracting parties were to be restored to the positions they were in before the contract was made, and if that is not possible, compensation was to be ordered.

A three-man expert committee was appointed to review the case documents and, based on the committee's findings, the Court of Appeal ordered the pre-sale contract status quo be restored by keeping the Claimants as partners and ordering a set-off between the amount received by the Claimants as a result of the sale and their entitlements to the Company's profits from 2004 to date. This resulted in the Claimants being entitled to receive more than AED 20 million.

The Court of Cassation

The Defendants appealed the decision.

The first point they raised was that the Court of Appeal was wrong to base its decision on the MoA and find that the Claimants were entitled to 51% of the Company shares, since the MoA was a dummy contract, the true one being the SPA (the side agreement) which accurately set out the relationship between the parties and recorded the fact that the Claimants were only license sponsors, not actual partners. The SPA could not have been registered and lodged on the commercial register as the Companies Law did not allow it. The Claimants were kept as nominal partners in the Company so that the Defendants' could benefit from the Claimants' license.

The Court of Cassation dismissed this argument. It found that the existence or otherwise of a dummy agreement is a question of fact for the trial judge and not a matter that could be reviewed by the Court of Cassation (see Court of Cassation judgment in Appeals 198,200/2012). The sale contract had been declared an absolute nullity by final court ruling, and so all of its terms and conditions (including those relating to sponsorship and the annual fee) were null and void.

The second, third and fourth arguments raised by the Defendants were also dismissed. However the last argument raised by the Defendants was that the Court of Appeal had been wrong to find that the Claimant was entitled to the profit on account of their status as partners with a 51% shareholding interest because the decision of the Court of Appeal had been declaratory in nature, and so only applied to future profit and not the profit from 2004 to the date of judgment. This is an exception to the general principle that the parties should be restored to the positions they occupied prior to the contract. Furthermore, the Claimants had been aware since 2004 that the SPA was contrary to public policy, and yet had maintained their role as service agents for the annual fee.

The Court of Cassation agreed that the Court of Appeal had been wrong to award the Claimant the profit from 2004. Whilst the general principle was that following the invalidation of a sale contract the parties should be restored to their positions before the contract had been made, this is subject to certain exceptions, such as either or both contracting parties having acted in bad faith at the time of making the contract. In this case the Claimants had knowingly and voluntarily participated in the violation of the Companies Law which led to the agreement being invalidated, and they could not benefit from their wrongful conduct. The Defendants were therefore only liable to pay profits from the date of the Court of Appeal (remand) judgment, not from 2004 (the date of the SPA).

The matter was then referred back to the previously appointed experts for a recalculation of profit based on the above. The Cassation Court's final decision (recorded in a later judgment) ordered the Claimants to return the sale price received when the shares were sold (approximately AED 5 million), in addition to the service agent fees paid in the period from 2004 until 2015.

The importance of this judgment

The Court of Cassation judgment is important in that it addresses key issues concerning service agents who attempt to claim profits of a company despite not being an active shareholder. Notwithstanding that the sale of the UAE national's shares was not effective (because it was not registered in the company's records and in the Commercial Register, and that the sale reduced the shares belonging to UAE nationals in the company to below 51%, the court ruled in favour of the foreign shareholder) the Court held that a UAE-national shareholder who knowingly sells his shares in violation of the UAE Companies law and public policy will not have the right to claim a profit if he had served as a service agent (and not as an active shareholder). The striking result in this case is that whilst the Claimants had tried to renege on the agreement and sue for the profit from 2004 onwards, because they had knowingly participated in violating public policy the end result was that not only were they not awarded this profit, but the Claimants were ordered to return the purchase price for their shares and the annual fee that they had received for over a decade.