Protecting minority investments in UAE companies

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Background

Over the past two decades, the United Arab Emirates ("UAE") has acquired a richly deserved reputation as a dynamic business environment for investment, and a great place to buy, or to establish, a business.

The UAE offers real advantages to foreign investors. It remains a substantially taxfree country, which is the hub of a region experiencing rapid population growth and infrastructure development. Any business can hire and employ skilled and unskilled workers from all around the world. The UAE has outstanding physical infrastructure vital to business (e.g. airports, ports and roads). Its residents enjoy an enviable lifestyle, with all the amenities sought after by expatriates (schools, sporting facilities, retail and hospitality).

However, any new investor to the UAE soon learns that its legal infrastructure has not kept pace with the modern physical infrastructure and amenities. Although the UAE offers an appetising menu of free zone options where foreign investors can enjoy secure and full ownership of their businesses and operate within advanced legal frameworks, many active businesses can be carried on only outside the boundaries of the free zone licensing systems; so many business opportunities in the country are accessible only by engaging with the mainstream UAE legal and business licensing system, outside the enclaves of the free zones.

Challenges for the Foreign Investors

The mainstream legal system in the UAE presents the foreign investor with some challenges.

The first challenge is the Commercial Companies Law 2015 ("the Companies Law"). Article 10 of this law imposes foreign investment restrictions and dictates that mainstream companies can be established or can operate only if UAE national shareholders hold at least 51% of the shares. Nationals of other Gulf Co-operation Council ("GCC") countries do have expanded investment privileges, but investors with nationalities outside the GCC need to find an Emirati national or company to participate as a majority joint venture partner.

Moreover, businesses licensed to operate in the UAE must generally be conducted through a local company formed under the UAE Companies Law. For the most part, offshore and free zone companies cannot obtain UAE business licences, even it their shareholders are wholly Emirati. There are some business activities which are open to be conducted by branches of foreign corporations, but these avenues are limited and usually they are not tax efficient.

Sometimes, foreign investors look for local partners who are true partners in every sense of the word, in the sense that they share the profits and losses of the business and likewise shoulder part of the financial and operational load of the business. However, in many cases, all the risk and benefit of the business goes back to the foreign investor, and the local Emirati national is involved for compliance reasons only, with the local partner receiving a negotiated annual return.

So, a recurrent question from inbound investors is "How can I protect my investment as a minority shareholder?" To answer this question, we must explain some aspects of the Companies Law.

The UAE Companies Law

The existing Companies Law came in to force late in 2015 and replaced the old 1984 law. It is fair to say that there were high expectations in the business community for the 2015 law, which had a long gestation period, beginning in 2004. Expectations were further elevated as government spokesmen predicted, from time to time throughout this long period of gestation, that the 2015 law would likely liberalise the 49% limit on foreign investment.

However, in general the expectations surrounding the revised law were not met, either with respect to the liberalisation of foreign investment rules or the modernisation of the UAE Companies Law to bring it in line with similarly developed economies. Salient differences between the UAE Companies Law and their international counterparts are explained below.

Forms of Corporate Vehicles Available to Investors

With limited exceptions, the only companies which can operate UAE businesses “on the ground” are those incorporated under the UAE Companies law. And no such company can be established or can operate without Emirati majority participation.

Most foreign investors utilise a corporate vehicle known as the “limited liability company” (“LLC”).

Another form of entity, namely the private joint stock company, is also an option, in theory, but this type of company is not suited to joint ventures because there is a relatively heavy handed and prescriptive regulatory regime surrounding joint stock companies. For example, the Ministry of the Economy favours its own template Articles of Association and also must approve the agenda for any shareholder meeting. Any changes to the Articles effectively have to be approved by the Ministry, and in practice this leaves limited scope to customise the Articles.

LLC’s are more flexible and the shareholders have some room to tailor-make their own Memorandum of Association (“MOA”) subject to the terms which UAE public notaries will allow to be included at the time notaries review the MOA. So this type of entity is the corporate form most suited to closely held enterprises.

In practical terms, no MOA can be constituted or amended without the approval of the UAE public notaries, who act as “gatekeepers” to ensure that the provisions of the Companies Law are followed. However, when viewed through the eyes of observers with experience in Western and offshore jurisdictions, the LLC vehicle in the UAE is an alien legal vehicle which works quite differently from its common law counterparts. This creates some difficulties for minority shareholders; although, in some cases, the differences can work to the minority’s advantage.

Governance of LLC’s

LLC’s have governance rules comparable to a partnership. However, they do possess the important attributes of a separate legal identity and perpetual succession and LLC’s extend limited liability to their shareholders.

The founders of an LLC have the option to establish a governance framework where a general manager is appointed under the MOA, and that individual so appointed reports directly to the shareholders (often referred to as “the partners”) or, if preferred, an advisory committee representing the shareholders. Alternatively, the incorporators can choose a governance structure more like the common law model, under which a Board of Directors is the zenith, with an Executive Manager reporting to the Board and the Board elected by shareholders. Under the old 1984 law, there was a limit of five Board members for LLC’s; but this has now been abolished.

Some foreign investors use the “general manager” model of governance to their own advantage by entrenching their own rights under the MOA to appoint or dismiss the general manager from time to time. However, even if a general manager or Board governance model is specified in the company’s MOA it is still necessary under the Companies Law for some important corporate actions to be authorised by the shareholders as a whole, which can give majority shareholders significant leverage over the minority.

Minority Shareholder Remedies

There are major differences between the approach under the UAE legal framework to shareholder remedies and the approach in common law jurisdictions.

Most of the common law jurisdictions grant minority shareholders legal remedies where there is oppressive or unreasonable conduct on the part of the majority. Essentially, this provides a remedy for abuse of power even where the exercise of power by the majority is strictly within the “black letter” of the company’s Articles of Association.

Under English law (and the similar companies laws operating in the Dubai International Financial Centre and in the Abu Dhabi Global Market financial free zone) any shareholder has a legal remedy where the affairs of the company are being conducted in a manner which is “unfairly prejudicial” to them. Where the shareholder establishes that this has occurred, under common law rules the Court has a wide range of powers and remedies which can be invoked to give minority shareholders redress against wrongful conduct by controlling shareholders.

The UAE Companies Law does not confer any specific remedy tailored for the minority shareholder to hold the controlling shareholders to account in a direct fashion. However, Article 84 does give shareholders the right to sue “managers” (but not the controlling shareholders) for losses arising to the shareholders from any “fraudulent acts”, “improper use of powers” or “gross error”. A “manager” will include both an individual sitting on the Board in a non-executive capacity and a general manager with executive functions and authority. The direct liability of these individuals to shareholders cannot be excluded by the company’s MOA or by contract.

Because the right to claim damages can be exercised by “shareholders” directly as well as the LLC company itself, any minority shareholder can bring a direct claim without navigating the maze of restrictions on shareholder claims imposed under the statutory derivative action rules which operate in common law countries. Therefore an aggrieved minority shareholder will have direct legal redress against directors/ management – if not the majority shareholders.

The Role of the UAE Courts

One hidden problem with this UAE regime is to be found in the limits on the powers of the UAE Courts, which were established on the Egyptian model. These powers differ from, and are narrower than, those which can be exercised by Courts in common law jurisdictions. In the mainstream UAE Court system, it is rarely feasible to resolve serious commercial and business disputes in“real time”. As a rule, urgent interim orders will not be made by UAE Courts except in a few restricted scenarios (e.g. asset freezing orders and orders to prevent debtors fleeing the jurisdiction).

For example, if an individual were to be appointed to the Board or to the position of CEO in a UAE company, in breach of a shareholder agreement, it is not possible to obtain an urgentorder declaring the appointment to have been invalid; or to secure a Court order restraining the appointment from taking effect or the appointee from taking office or from entering transactions on behalf of the company. This is not because the shareholder agreement is not legally binding; rather, it is because the UAE Courts are generally are not empowered or willing to grant interim or urgent orders but require a longer legal process ending with trial and judgement. Shareholder agreements are legally enforceable and they do subject the parties to legal exposure for damages, but the reality is that accountability may not be obtained rapidly, and when it does it will come in the form of a financial damages award.

In most situations, it is necessary to proceed through a full litigation process to trial. Even if the minority shareholder succeeds, the outcome of the trial will usually be a judgment awarding damages for any financial loss which the minority shareholder can substantiate, a year or more after the disputed appointment. But in the meantime, the governance and management of the business will have altered and shifted in the way the majority shareholders dictated.

No Different Classes of Shares

An LLC cannot issue different classes of shares, nor permit particular shares to carry differential voting rights. Article 95 of the Companies Law is prescriptive on the question of voting rights, and states that every shareholder shall have the right to attend a general meeting and that every shareholder shall have a number of votes equal to the number of shares held or represented by such shareholder.

As an LLC cannot be established with special classes of shares or weighted voting rights, the majority shareholders will inevitably have the voting power to carry any general meeting. Irrevocable powers of attorney granted in favour of minority shareholders are not the answer, because public notaries in the UAE do not recognise powers of attorney as being irrevocable, and will allow any existing power of attorney to be revoked.

How Can Minority Shareholders Protect their Investment?

Although the minority shareholder has no foolproof way of being assured majority voting power in an LLC, it is possible to add “super majority” provisions to the MOA to give minority shareholders a veto right, but it is not possible to give the minority a positive power to override the majority. So, it is open to the minority shareholder to formulate and include in the MOA a list of “reserved matters” which would have to be carried by sufficient large majorities to give the minority shareholder credible veto rights. For example, a resolution to sell fixed assets could require a 60% majority, so a 49% shareholder can block the transaction.

Although the UAE Companies Law requires all shares to be equal in value and have equal voting rights, an interesting provision can be used by minority shareholders to adjust profit shares (i.e. dividend entitlements).

Article 29 permits shareholders to write into the MOA a profit share distribution regime which is not proportionate to the number of shares held by each shareholder. However, it is not permissible to deprive a partner from the right to participate in the profits at all. Dubai notaries will, in practice, approve 80%/20% splits i.e. 80% going to the minority (49%) foreign investor and 20% going to the majority (51%) UAE shareholder.

Mandatory Rights of Pre-emption

Another inflexible aspect of operating within the framework of an LLC company is that Article 80 of the UAE Companies Law grants every shareholders a statutory right of pre-emption where any other shareholder wishes to transfer their shares. Article 80 provides absolutely no flexibility for cases where one of the shareholders in restructuring wishes to transfer to an affiliated party, or where one shareholder wishes to transfer to another shareholder. The pre-emption process still applies, unless waived by every shareholder.

This legal requirement also has a surprising practical impact, which flows from the reality that no share transfer can be completed legally without public notarisation. In the UAE, the public notaries are vigilant to guard against any shareholder trying to circumvent rights of pre-emption. Therefore it is uniform public notarial practice in the UAE to require every single shareholder in any LLC to attend before the public notary at the time of the share transfer (in person or by notarised power of attorney) and agree to the transfer in the presence of the notary – even if those other shareholders are not even parties to the transaction and have waived their rights in writing.

The result is that just one shareholder can frustrate any share transaction by refusing to cooperate and attend before the notary. Even if a minority shareholder has a binding contract which requires the local national shareholder to transfer the 51% shareholding to another UAE national, in practice it is not feasible to force the issue unless the minority investor can somehow induce the majority shareholder to cooperate because, as explained earlier, UAE Courts have no power to make urgent orders to resolve such an impasse by compelling the co-operation of the recalcitrant shareholder. A full litigation process to trial and financial damages award is the only alternative to a negotiated compromise.

For these reasons, call options and put options are not really workable in practice in relation to shares in LLC entities, and private equity investors rarely operate within the framework of mainstream UAE companies.

Takeaways for the Minority Investor

How can a minority investor protect their investment?

1. Pay attention to the terms of company's MOA. This is a vital document which will be the first point of reference in the event of any disagreement. Any governmental authority, bank or third party will place much more weight on the provisions of the MOA than on the terms of any shareholder agreements. It is best to have both a carefully framed MOA and a shareholders agreement in place to protect your rights, as there will be limitations as to what you can write into the MOA, due to local notarial practices. Nevertheless, even allowing for the constraints of UAE notary practice, you can protect yourself under the MOA in critical areas such as "distribution of profits" and "appointment of the CEO".
2. If you cannot select the general manager unilaterally, make sure that you have a Board seat because it can give you access to confidential information. Also, where Boards are in place, they control the appointment of key signatories (e.g. bank accounts and labour visa processes).
3. Last, and most important of all, choose your local partner with care. This is the most important rule, as the best business relationships are those where lawyers are involved at the outset, but never consulted again. If it is not essential to find a local partner to share the burden of funding the business or developing the business on the ground, you should consider as a partner a firm which has a business model based on facilitating foreign investment, because their business reputation depends upon serving the wishes of their foreign clientele, making conflict unlikely.