

## Chapter 15

### Members' Remedies

Here, basic guidance to the end-of-chapter questions will be provided.

**1. Define the following terms:**

- **no reflective loss principle;**
- **representative action;**
- **group litigation order;**
- **derivative claim;**
- **proper claimant principle;**
- **irregularity principle;**
- **quasi-partnership.**

Term	Definition
no reflective loss principle	A member cannot sue a person for losses sustained if those losses are reflective of losses sustained by the company and which could be recovered by the company
representative action	A member (or members) who has sustained losses due to the actions of another can commence proceedings on behalf of himself and other wronged members
group litigation order	A legal action involving multiple claims arising from the same issues of act or law, whereby affected persons can opt into the action. Their names will be entered into 'group register' and their claims heard by a single court. If the action succeeds, the judgment will bind all those on the group register
derivative claim	A claim brought by a member in respect of a cause of action vested in the company, seeking relief on behalf of the company
proper claimant principle	The principle that where the company is wronged, the company is the proper claimant and therefore the person in whom the cause of action is vested
irregularity principle	Where an irregularity is committed, an aggrieved member cannot commence proceedings where the irregularity is one that can be ratified by a simple majority of the members
quasi-partnership	A company involving one or more of the following elements: <ul style="list-style-type: none"> <li>• as association formed or continued on the basis of a personal relationship involving mutual confidence;</li> <li>• an agreement or understanding that all, or some, of the members shall participate in the conduct of the business;</li> <li>• a restriction upon the transfer of the members' interest in the company</li> </ul>

**2. State whether each of the following statements is true or false and, if false, explain why:**

- where an unlawful act causes loss to both the company and a member, the general rule is that both may commence actions against the perpetrator of the act;
- where the company has been wronged, the members can usually bring a claim on behalf of the company;
- the common law derivative action has been abolished;
- a derivative claim can be brought in relation to a cause of action that occurred before the derivative claimant became a member;
- the court will refuse permission to continue a derivative claim where the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company;
- section 994 allows a person to bring a claim where the company's affairs have been conducted in a manner that is unfair or prejudicial to his interest as a member;
- criminal conduct can amount to unfairly prejudicial conduct;
- the most common remedy awarded under s 996 is a share purchase order;
- a member cannot bring both a s 994 petition and a winding up petition.

- **Where an unlawful act causes loss to both the company and a member, the general rule is that both may commence actions against the perpetrator of the act:** This statement is true.
- **Where the company has been wronged, the members can usually bring a claim on behalf of the company:** This statement is false. The members are generally prohibited from bringing a claim on behalf of the company and can only do so where statute provides (via the derivative claim procedure).
- **The common law derivative action has been abolished:** This statement is false. Whilst the statutory derivative claim largely replaces the common law derivative action, there are instances where the statutory claim will not apply and so the common law derivative action will continue to exist.
- **A derivative claim can be brought in relation to a cause of action that occurred before the derivative claimant became a member:** This statement is true.
- **The court will refuse permission to continue a derivative claim where the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company:** This statement is false. This is a factor that the court must take into account, but it will not automatically result in permission being refused.
- **Section 994 allows a person to bring a claim where the company's affairs have been conducted in a manner that is unfair or prejudicial to his interest as a member:** This statement is false. In order for an unfair prejudice petition to succeed, the conduct complained of must be both unfair and prejudicial.
- **Criminal conduct can amount to unfairly prejudicial conduct:** This statement is true.
- **The most common remedy awarded under s 996 is a share purchase order:** This statement is true.
- **A member cannot bring both a s 994 petition and a winding up petition:** This statement is false. A member can bring both petitions, but a Practice Direction states

that a winding-up petition should only accompany an unfair petition if winding up is the relief that the petitioner prefers or it is considered that it is the only relief to which he is entitled.

**3. 'The statutory derivative claim provides a much more useful remedy than the common law derivative action.' Discuss the validity of this quote.**

## **Introduction**

- Every essay should begin with a succinct introduction that demonstrates that you understand the essay question. Briefly explain what the essay is about and set out what the essay will discuss and how it will be structured.
- This essay requires you to compare and contrast the statutory derivative claim with the common law derivative action.

## **Comparing the derivative claim to the derivative action**

- Focus on the differences between the derivative claim and the derivative action and discuss the practical effects of these differences bearing in mind the quote in the essay question. The key differences to focus on include the following.
- The grounds for a derivative claim are wider than those of a derivative action. For example, negligence was only a ground for a derivative action where the wrongdoer gained some benefit from the negligent act. This limitation does not apply to the derivative claim and any act of negligence can form the basis of a derivative claim.
- A derivative action could arise based on the actions of a member. A derivative claim, however, can only be based on the act or omission of a director (including former directors and shadow directors). A derivative claim can be brought against a third party, but only where the third party is in some way connected to the director's wrongful act or omission.
- The derivative claim only applies to companies registered under the CA 2006. Accordingly, other claims involving other companies (e.g. claims involving foreign companies) are subject to the common law derivative action.
- A statutory derivative claim cannot be brought in relation to a multiple derivative action (discussed at 15.2.1.2), and so such actions continue to be subject to the common law rules.
- Perhaps the most notable difference is that the statutory derivative claim is subject to statutory rules requiring the claim to obtain permission to continue from the court. Discuss the extent to which the requirement of obtaining permission to continue limits the effectiveness of the derivative claim.

## **Conclusion**

- Every essay should end with a conclusion. Briefly summarise the main points/arguments and, if possible, come to a conclusion regarding the essay topic (i.e. which of the opposing views has the stronger arguments).

4. Stanley, Sophie and Kim are the directors of Dragon Goods Ltd ('DG'), a company that manufactures tools that are then sold by Dragon Tools Ltd (another company in the Dragon Group). The company has issued 1,000 shares as follows:
- 500 shares are held by Dragon plc (DG's parent company);
  - each of the three directors holds 100 shares;
  - 200 shares are held by Dominic, a local businessman whose firm is one of DG's principal suppliers.

DG has adopted the model articles, but has added a provision stating that each director is to receive a salary of £150,000 per year. The articles also provide that 'the business of Dragon Goods Ltd is the manufacture of tools.' For the last few years, DG has not paid a dividend as the profits made by the company are used to pay the directors' salaries. This has angered Dominic, but DG's directors assure him that, if profits increase, a dividend will be paid.

For a few months, Sophie and Kim have been trying to persuade Stanley that DG should diversify its business into providing electrical components for consumer products. Stanley disagrees stating that 'the company should stick to what is it good at.' At a board meeting, an argument ensued in relation to DG's future direction, which led to Stanley falling out with Sophie and Kim. Since then, Sophie and Kim have outvoted Stanley at all directors' meetings and have sought to make all the business decisions themselves. As a result, DG began manufacturing electrical components. Since this meeting, Stanley has stopped attending board meetings.

At the most recent board meeting, in Stanley's absence, Sophie and Kim voted to remove Stanley as a director and he was subsequently informed of this. This meeting also noted that, as a result of DG diversifying into electrical components, DG's profits had improved in recent months and so Sophie and Kim proposed that their salaries should be increased to £200,000. The directors of Dragon plc agreed and so the articles of DG were amended to provide that Sophie and Kim would receive an annual salary of £200,000.

Dominic and Stanley are angry at the way events have unfolded, and seek your advice as to whether Sophie, Kim or DG have engaged in any breaches of the law and, if so, what remedies (if any) are available.

#### **Lack of a dividend payment**

- The first issue to discuss is the lack of a dividend payment, despite the fact that the company has been profitable. Generally, a member has no right to a dividend (unless the articles provide otherwise, which is not the case here).
- However, the courts have held that a non-payment of dividends or the payment of low dividends is, depending on the facts, capable of amounting to unfairly prejudicial conduct – see the case of *Re McCarthy Surfacing Ltd*.

- Remember to go through the process to establish if unfairly prejudicial conduct has occurred. This involves discussing (i) does the lack of a dividend payment affect Dominic's interests as a member; (ii) is the lack of a dividend payment unfair, and; (iii) is the lack of a dividend payment prejudicial.
- Do not ignore discussing remedies. If Dominic does bring an unfair prejudice petition and it succeeds, the likely action will be Dragon plc or the directors to purchase Dominic's shares.

### **Stanley's exclusion from management**

- Prior to his removal from office, Stanley was effectively excluded from management by Sophie and Kim. Two remedies are of relevance here, namely an unfair prejudice petition and a winding-up petition. Note that it is possible for Stanley to bring both petitions, but the courts have issued a Practice Direction stating that a winding up petition should only accompany an unfair prejudice petition if winding up of the company is the relief which the petitioner prefers or it is the only relief to which he is entitled.

#### *Unfair prejudice petition*

- Most unfair prejudice petitions involve a member being excluded from management. The question that arises is whether this can be regarded as conduct that unfairly prejudices the interests of a member.
- This will depend upon the type of company in question. In many companies (especially larger companies), the members will have no expectation to manage and so exclusion from management will not unfairly prejudice their interests as a member (*Re Blue Arrow plc*).
- Conversely, in a quasi-partnership company, the members will likely have a legitimate expectation that they will be involved in management, and so exclusion from management could unfairly prejudice their interests as a member (*Re Ghyll Beck Driving Range Ltd*).
- We are not told enough about DG to determine if it is a quasi-partnership or not, so discuss both outcomes.

#### *Winding-up petition*

- A company can be wound up where the court is of the opinion that it is just and equitable to do so (IA 1986, s 122(1)(g)). The courts have held that, in a quasi-partnership company, exclusion from management can justify winding up (*Ebrahimi v Westbourne Galleries Ltd*).

### **Stanley's removal from office**

- Stanley has purportedly been removed from office by Sophie and Kim. The first issue is whether Sophie and Kim have the power to do this. It is common for companies to amend their articles to provide that a director must vacate office if the other directors

so require. However, such a provision is not in the model articles, and so Sophie and Kim have no power to remove Stanley.

- Stanley could be removed by an ordinary resolution (CA 2006, s 168), so if Sophie and Kim could convince Dragon that Stanley should be removed, the s 168 removal procedure could be used. But there is no indication that this procedure was used.
- Accordingly, Stanley's removal is not valid as Sophie and Kim had no power to remove him.

### **The move into manufacturing electrical components**

- DG's articles provide that its business is the manufacture of tools. This objects clause is binding on the company and if the company wishes to diversify into the manufacture of electrical components, the objects clause should be amended or removed.
- By not doing this, the company is acting *ultra vires*. Note that any contracts entered into to manufacture electrical components will not be rendered void, due to s 39 of the CA 2006 (discussed at 6.2.2).
- However, s 171(a) places a duty on the directors to act in accordance with the company's constitution. By causing DG to breach the objects clause, it can be argued that the directors have breached this duty.
- The duties of a director are owed to the company, so DG is the proper claimant here. However, it is highly unlikely that Sophie and Kim will cause DG to commence proceedings against themselves. Stanley or Dominic could commence a derivative claim against Sophie and Kim as breach of duty is a ground for a derivative claim (CA 2006, s 260(3)).

### **Amendment of the articles**

- Sophie and Kim have proposed that the articles should be amended to increase their salaries. An amendment of the articles requires a special resolution (i.e. a majority of not less than 75%). If Dragon plc, Sophie and Kim vote for the amendment, that will only form a majority of 70%. Accordingly, they will need to convince Stanley or Dominic to support the amendment, which seems unlikely.
- Accordingly, the amendment to the articles is not valid, as it likely does not have the requisite support.