

## Practice questions for chapter 23 – Shareholders' remedies

### Essay question

'The statutory derivative claim, introduced under the Companies Act 2006, provides a welcome form of protection for minority shareholders, who have lacked sufficient protection due to the Rule in *Foss v Harbottle*.'

Discuss.

### Introduction

- The law provides a number of remedies to disgruntled shareholders. One of the oldest remedies was the derivative action which was created as an exception to the rule established in the landmark case of *Foss v Harbottle*. However, the rules relating to the derivative action have been heavily criticized. Accordingly, the 2006 Act abolished the derivative action and created a new statutory derivative claim. This essay will analyze both the original common law derivative action and the statutory claim introduced by the Companies Act 2006.

### The rule in *Foss v Harbottle*

- Briefly explain the three principles that form the Rule in *Foss v Harbottle*, (hereinafter referred to as the Rule) namely the proper claimant principle, the internal management principle and the irregularity principle. Also state that the courts created the Rule out of a desire to avoid becoming involved in the internal business matters. The classic floodgates argument is also an often-cited justification for the Rule's existence.
- However, the Rule cannot be absolute. Were the Rule absolute, wrongs committed by the directors or the majority shareholders would rarely be subject to litigation. Accordingly, in limited situations, the courts would allow members to bring actions of a company's behalf (this was known as a 'derivative action,' as the action derived from a right belonging to the company). Accordingly, a number of exceptions to the Rule were created, namely:
  1. Where the act complained of was illegal or ultra vires
  2. Where the act complained of infringed the personal rights of a member
  3. Where the act complained of could only be done or sanctioned by the passing of a special resolution, and
  4. Where the act complained of constituted a fraud on the minority.
- While the existence of, and justifications behind, the Rule itself are not open to significant criticism, there is little doubt that the operation of the Rule and its exceptions came in for significant criticism. The Law Commission identified four major problems.<sup>1</sup>
  1. The Rule and its exceptions are a creation of case law, much of which was created many years ago.

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<sup>1</sup> Law Commission, *Shareholder Remedies* (Law Com CP 142, 1996) [14.1 – 14.4].

2. An member who wishes to bring an action to recover damages where the company suffers loss due to a breach of the directors' fiduciary duties will need to establish that the wrongdoers have control of the company. However, what constitutes 'control' is not clear.
  3. An member who wishes to bring an action to recover damages where the company suffers loss due to the negligence of a director will need to show that the negligence confers a benefit on the controlling shareholders, or that the failure of the other directors to bring an action constitutes a fraud on the minority.
  4. A member who wishes to bring a derivative action will need to establish standing by showing that he has a prima facie case. The potential exists for these standing hearings to become mini-trials which will further increase the already high cost of litigation.
- Accordingly, the Law Commission, along with a number of respondents to the consultation paper and the Company Law Review Steering Group, recommended that a new derivative action be created. The result was the creation of the 'statutory derivative claim,' the details of which can be found in the Companies Act 2006, Pt 11.

### **The statutory derivative claim**

- The first thing to note is that Part 11 of the 2006 Act does not abolish the Rule in *Foss v Harbottle* and the Rule itself and its justifications retain much of their force. However, the common law derivative action has been abolished and a member can only bring an action on behalf of the company in accordance with the rules relating to the new statutory derivative claim.
- Discuss the operation of the statutory derivative claim, focusing in particular on the differences that exist between the common law derivative action and the statutory derivative claim. Notable differences include:
  1. The rules relating to the derivative action can be found in a mass of common law, which adversely affected the accessibility and clarity of derivative actions. The derivative claim is on a statutory footing, which provides a number of advantages. Having the derivative claim and the unfair prejudice remedy in a single statute means that the 2006 Act provides a more complete source of shareholders' remedies. It will better alert shareholders, directors and other interested parties to the existence of the remedy. The disadvantage of placing the remedy in statute is that alteration of the remedy will require amending the 2006 Act, and amending legislation is rarely a quick and simple process.
  2. Under the common law, negligence could only form the basis of a derivative action if the wrongdoer gained some form of benefit from the negligent act. This limitation has not been preserved in the 2006 Act and derivative claims can be brought for any negligent act. This reform has caused fears that derivative claims will increase sharply.
  3. A common law derivative action could be based on an act/omission by a director or a member. A statutory derivative claim can only be based on the acts/omissions of a director (including former directors and shadow directors).
  4. Permission from the court was required to continue a derivative action, and this requirement is preserved for derivative claims. However, the 2006 Act provides guidance on what factors are relevant when determining whether or not to grant permission. Such guidance did not exist under the common law.
- One final point is worth noting. With the creation of the unfair prejudice remedy, derivative actions/claims are much less common and it could be argued that the shareholder remedy is of little significance in practice.

## Conclusion

- There is little doubt that the derivative action was desperately in need of reform. Whilst the justification behind the Rule in *Foss v Harbottle* is still valid, the exceptions to it crafted by the courts were complex and did not fulfil their intended function.
- By placing the derivative claim in statute, it is hoped that the remedy will become clearer and will gain more prominence. Some of the limitations of the common law derivative action have been removed and it remains to be seen whether or not this will make derivative claims under statute more common than they were under the common law.

## Problem question

Helen, Tom and Joseph have, for ten years, run a small, but successful partnership. They decide to incorporate the business and a new company (JME Ltd) is created and the business is transferred to the new company. Helen, Tom and Joseph become directors and each take 300 shares in the company. A further 200 shares are issued and allotted to Dave, a local businessman. The Articles of JME Ltd provide that (i) no director can be removed without his or her prior consent, (ii) each director is to receive a salary of £150,000 per year, and (iii) any shareholder who wishes to sell his shares must first offer them to the directors.

After incorporation the company was successful but no dividends were paid as all the profits were ploughed back into the company, the directors drawing only their salaries of £150,000 each year.

Six months ago, Joseph had an argument with Tom and Helen over matters of business policy. After this argument, Tom and Helen made all the business decisions in advance and outvoted Joseph at all the directors' meetings. Joseph initially complained but has now lost interest and ceased attending meetings.

A month ago, Tom and Helen voted to remove Joseph as a director at a general meeting and to distribute the profits by increasing the directors' salaries to £300,000 per annum.

Discuss whether or not JME Ltd has been run in a manner that is unfairly prejudicial, or whether any conduct has taken place that would justify winding up the company.

## Introduction

- Remember that if a question asks you to focus on a specific area or areas of the law that you do so. Even though the facts of this problem involve other shareholder remedies (notably enforcing the constitution), only focus on the unfair prejudice remedy and the petition to wind up the company.
- How you structure the answer is up to you. You may wish to discuss the unfair prejudice remedy first and then discuss the winding up remedy. Here, I have chosen to focus on the key events and then discuss whether or not those events give rise to a remedy.

## Failure to pay dividends

- It is likely that Dave has purchased shares in JME Ltd on the basis that he will receive a return on his investment through the payment of a dividend. Accordingly, he is likely to feel aggrieved that, despite the company operating successfully, he has not received a dividend. The question is does the failure to pay the members a dividend entitle them to a remedy.

- In our case, Dave has two possible avenues of complaint, namely (i) that the failure to pay a dividend amounts to unfairly prejudicial conduct, and/or (ii) that the failure to pay a dividend is grounds to wind up the company.

#### *Unfairly prejudicial conduct*

- Here, it needs to be discussed whether non-payment or low payment of dividends can amount to unfairly prejudicial conduct under the Companies Act 2006, s 994. The conduct must unfairly prejudice the member's interests as a member, so you may need to discuss what the interests of the members are. Clearly, receiving a dividend is a substantial interest of the members. Accordingly, the focus of the discussion should be on whether the non-payment of dividends can be unfairly prejudicial.
- It should first be noted that, as a general rule, the members of a company do not have a right to a dividend and, as regards quasi-partnership companies, the payment of a dividend will not normally amount to a legitimate expectation.<sup>2</sup>
- The courts have stated, on several occasions, that the non-payment of dividends or the low payment of dividends is capable of amounting to unfairly prejudicial conduct. However, it will depend upon the facts of the case. In many cases, the non-payment of a dividend will not normally amount to unfairly prejudicial conduct. As Peter Gibson J stated in *Re Sam Weller & Sons Ltd*:<sup>3</sup>

I do not intend to suggest that a shareholder who does not receive an income from the company except by way of dividend is always entitled to complain whenever the company is controlled by persons who do derive an income from the company and when profits are not fully distributed by way of dividend. I have no doubt that the court will view with great caution allegations of unfair prejudice on this ground.

- However, Peter Gibson J refused to allow a strike out application that contended that the non-payment of dividends could amount to unfairly prejudicial conduct. In other cases, the courts have overtly stated that the non-payment or low payment of dividends can amount to unfairly prejudicial conduct.<sup>4</sup> The question is when will such conduct amount to unfairly prejudicial conduct. In *Re a Company (No 004415 of 1996)*,<sup>5</sup> the directors (who were also members) paid themselves an exorbitant salary, but refused to pay out dividends, even though the company was financially healthy. A minority shareholder (who was not a director) alleged that this conduct was unfairly prejudicial and the court agreed that such conduct would be unfairly prejudicial to members who were not directors.
- Were the court to feel that Helen, Tom and Joseph are paying themselves an exorbitant remuneration, then, given that Dave's only source of return is the payment of dividends, the court might very well be convinced that the failure to pay a dividend is unfairly prejudicial to Dave's interests as a member.

#### *Just and equitable winding up*

- Can the non-payment or low payment of dividend justify winding up a company? A member has the power, under the Insolvency Act 1986, s 122, to petition the court for an order winding up a

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<sup>2</sup> *Irvine v Irvine (No 1)* [2006] EWHC 406 (Ch); [2007] 1 BCLC 349.

<sup>3</sup> [1990] Ch 682 (Ch).

<sup>4</sup> See e.g. *Re a Company (No 00370 of 1987)* [1988] 1 WLR 1068 (Ch); *Re a Company (No 004415 of 1996)* [1997] 1 BCLC 479 (Ch).

<sup>5</sup> [1997] 1 BCLC 479 (Ch).

company on several grounds. The relevant ground in our problem is that it is just and equitable to wind the company up.<sup>6</sup>

- In *Re a Company (No 00370 of 1987)*,<sup>7</sup> Harman J stated that a failure to pay dividends could provide a sufficient justification for winding up a company on just and equitable grounds. However, in subsequent cases, the courts have stated that a winding up order will not be granted where other less drastic remedies (notably a share purchase order following a finding of unfairly prejudicial conduct) are available.<sup>8</sup> This is backed up by Insolvency Act 1986, s 125(2) which provides that the court will not order a winding up where an alternative remedy is available and the petitioner is acting unreasonably in seeking winding up as opposed to the alternative remedy. In such cases, the winding up application will likely be struck out.
- Accordingly, if Dave were to petition the court to have the company wound up, the petition would likely fail.

### Joseph's exclusion from management

- Despite being a director, Joseph has been excluded from management and is eventually removed from office by Tom and Helen. Initially, it might be thought that, as we are concerned with shareholders' remedies, being excluded from management would not warrant a remedy, but many cases concerning the unfair prejudice remedy relate to a member being excluded from management.
- The reason for this is that the unfair prejudice remedy seeks to protect a member's interests, and a member's interests are wider than his rights. However, in many companies, a member will have no interest in managing the company, nor will he have an expectation of doing so. In such companies, the members will have no interests outside those found in the company's constitution.<sup>9</sup>
- However, in certain types of company, the members' expectations may extend beyond those rights and interests found in the constitution. Such companies are known as 'quasi-partnership companies.' The House of Lords in *Ebrahimi v Westbourne Galleries Ltd*<sup>10</sup> stated that a company would be a quasi-partnership if it displayed all, or some of the following characteristics:
  1. The company is an association formed on the basis of mutual trust and confidence – although we are not told this, the fact that Helen, Tom and Joseph have worked together in partnership for ten years would indicate that there will be a relationship of trust and confidence between Helen, Tom and Joseph.
  2. There will be an agreement that some, or all, of the members will be involved in management. This agreement need to be in writing and the members may simply have informally agreed that they would all be involved in management. Certainly, JME Ltd would appear to have been formed on the basis that Helen, Tom and Joseph would all be involved in management.
  3. The shares of the company will not be freely marketable.
- Given the above, it is likely that JME Ltd will be classified as a quasi-partnership and so the interests of the members will not only include their rights but also any legitimate expectations of the parties and any agreements that may exist between them.

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<sup>6</sup> Insolvency Act 1986, s 122(1)(g).

<sup>7</sup> [1988] 1 WLR 1068 (Ch).

<sup>8</sup> See e.g. *Re Sam Weller & Sons Ltd* [1990] Ch 682 (Ch); *Re a Company (No 004415 of 1996)* [1997] 1 BCLC 479 (Ch).

<sup>9</sup> *Re Blue Arrow plc* [1987] BCLC 585 (Ch).

<sup>10</sup> [1973] AC 360 (HL).

- In many quasi-partnership companies, the members will expect to be involved in the management of the company and, if they are excluded from doing so, this can amount to unfair prejudice.<sup>11</sup> This expectation may derive from an explicit right contained in the company's constitution, but it often derives from an informal agreement between the members that is never put into writing.
- In excluding Joseph from management (and eventually removing him from office), it is therefore likely that Helen and Tom have acted in a manner that is unfairly prejudicial.

### Increase in remuneration

- There is little doubt that the payment of excessive remuneration can amount to unfairly prejudicial conduct. In *Re Cumana Ltd*,<sup>12</sup> the company's share capital was held by two directors, Bolton and Lewis, with Lewis holding one-third and Bolton holding the remaining two-thirds. Bolton engaged in a number of schemes to financially improve his position, one of which was getting the company to pay him, over a 14-month period, remuneration totaling £356,000. The court found this to be excessive and held that Bolton had acted in a manner that was unfairly prejudicial to Lewis' interests.
- Dave might argue that Helen, Tom and Joseph are paying themselves excessive salaries and, in doing so, they are unfairly prejudicing Dave's interests as the excessive remuneration might affect the level of dividends that Dave might receive (although, as we have seen, Dave has not received a dividend).
- Of course, this argument is dependent upon the remuneration actually being excessive and this will depend on many factors (e.g. the company's revenue, how much profit the company makes etc). It could be argued that for a newly created company to pay its directors £150,000 would appear to be excessive. If this is accepted, a doubling of their remuneration to £300,000 would certainly be excessive.

### Remedies

- It would appear likely that the affairs of JME Ltd have been run in a manner that is unfairly prejudicial. Although the court has considerable remedial flexibility in s 994 cases, the most common remedy ordered by the courts is a share purchase order, stating that the petitioner's shares are to be bought by the other members of the company or the company itself. It is likely therefore that the court would order Helen and Tom, or JME Ltd, to purchase Joseph's and Dave's shares.
- Winding up the company is not an available remedy under s 994 but, as we have seen, it is available under the Insolvency Act 1986, s 122. However, winding up will not be ordered where a share purchase order would provide an appropriate remedy. Winding up should be viewed as a remedy of last resort.

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<sup>11</sup> See e.g. *Re Ghyll Beck Driving Range* [1993] BCLC 1126 (Ch).

<sup>12</sup> [1986] BCLC 430 (CA).