***This article was accepted for publication in December 2023 and will be published in the Journal of Business Law.**

Derivative Actions and LLPs: The Need for Reform

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Abstract

This article examines the means by which a derivative action can be brought on behalf of a limited liability partnership (LLP) through an analysis of the recent judicial decisions that pave the way for further reforms to extend the statutory regime under the Companies Act 2006 to include LLPs.

Introduction

A key issue that has garnered significant attention recently is whether the statutory derivative action, enshrined in the Companies Act 2006 (CA 2006), is applicable to limited liability partnerships (LLPs). As it is well known, a derivative action is a mechanism by which a member of a company, usually a minority shareholder, is able to initiate legal proceedings on behalf of the company to remedy any wrongdoings caused to the company.[1] With the

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[1] Arad Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007), p.1.

introduction of the CA 2006, derivative actions have been placed on a statutory footing for the very first time, aiming to abolish the common law principles for companies.[2] Traditionally, the law of derivative actions for companies were governed and regulated by the *Foss v Harbottle*[3] rule, which had as its main effect to bar disgruntled members from initiating such actions. This is because the policy behind *Foss* has long supported that the suitable body to initiate litigation proceedings on behalf of the company is the majority of shareholders at a general meeting, reinforcing the idea of the "majority rule".[4]

The strictness of the rule became apparent as minority shareholders were generally not able to bring an action on behalf of the company unless the claim fell under the "fraud on the minority" exception.[5] This exception required members to prove that the wrong caused to the company amounted to a "fraud"[6] and that the wrongdoers were actually in "control" of the company.[7] Due to the ambiguities and uncertainties surrounding the meaning of "fraud" and "control",[8] this made it difficult for members of the company to obtain justice through the use of derivative

[2] Companies Act 2006 ss.260-264.

[3] *Foss v Harbottle* (1843) 2 Hare 461.

[4] K.W. Wedderburn, "Shareholders' Rights and the Rule in Foss v Harbottle" (1957) 15 C.L.J 194, 197-198.

[5] *Edwards v Halliwell* [1950] 2 All ER 1064 at 1066-1069, *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 at 264.

[6] *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2 at 12, *Burland v Earle* [1902] AC 83 at 93, *Pavlides v Jensen* [1956] 2 All ER 518; [1956] Ch 565 at 572, *Daniels v Daniels* [1978] Ch 406 at 414.

[7] *Russell v Wakefield Waterworks Co* (1875) LR 20 Eq 474 at 482, *Burland v Earle* [1902] AC 83 at 93, *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 at 219.

[8] K.W. Wedderburn, "Derivative Actions and Foss v Harbottle" (1981) 44 M.L.R 202, 205-207; A.J. Boyle, *Minority Shareholders' Remedies* (CUP, 2002), pp.27-29; Reisberg, *Derivative Actions and Corporate Governance*, pp.90-94.

actions. As a result, the failure of the *Foss* rule to provide an effective remedy for minority shareholders led the UK Parliament to re-examine the common law derivative procedure by introducing a statutory regime under Part 11 of the CA 2006.[9] The rationale behind this change was largely based upon the recommendations of the Law Commission to simplify, modernise and improve the accessibility of the law on derivative actions by placing it on a statutory footing.[10]

However, while the purpose of the statutory derivative action was to abolish the *Foss* rule and its complexities, this was not achieved in practice. Recent judicial decisions have confirmed that the common law derivative action has not been wholly replaced as it has managed to survive the enactment of the CA 2006, and therefore any actions that do not fall within the ambit of the statutory regime will fall under the umbrella of the common law principles.[11] Although with the introduction of the CA 2006 the common law derivative action has been abolished for companies, this has not been the case for LLPs and therefore any actions made

[9] ss 260-264.

[10] Law Commission, *Shareholder Remedies: Report* (1997), Law Com. No.246, Cm.3769, para. 6.15.

[11] It is worth noting that the common law derivative action has managed to survive the enactment of the statutory regime under the CA 2006 and thus it is still applicable for claims involving LLPs, multiple derivative actions, and overseas companies. For LLPs, see *Harris Microfusion 2003-2 LLP* [2016] EWCA Civ 1212; [2017] C.P. Rep. 15, *Homes of England Ltd v Nick Sellman (Holdings) Ltd* [2020] EWHC 936 (Ch); [2020] B.C.C 607. For multiple derivative actions, see *Universal Project Management Services Ltd v Fort Gilkicker Ltd and others* [2013] EWHC 348 (Ch); [2013] Ch 551, *Abouraya v Sigmund* [2014] EWHC 277 (Ch); [2015] B.C.C 503; David Kershaw, "The rule in Foss v Harbottle is dead: long live the rule in Foss v Harbottle" (2015) 3 J.B.L 274, 275. For overseas companies, see Daniel Lightman, "Two aspects of the statutory derivative claim" (2011) 1 Lloyd's Maritime and Commercial Law Quarterly 142.

by members of an LLP will fall under the common law rule in *Foss* and not under the statutory regime.

This article takes the view that while the application of the common law derivative action to LLPs could be regarded as a powerful mechanism allowing a member of an LLP to bring a derivative action on behalf of the LLP, in reality, such an action will only be allowed in exceptional circumstances as the courts will be asked to revert back to the limited scope of the exceptions applicable to the *Foss* rule. Given the notorious difficulty of satisfying the rule in *Foss* and its exceptions, a member of an LLP seeking permission to continue a derivative action will find it difficult to proceed with such an action. Therefore, if LLPs were also recognised under the CA 2006, this would have avoided the continuing existence and applicability of the common law derivative action which could undermine the effectiveness of the statutory remedy to provide a powerful mechanism to do justice by preventing a wrong going without redress.

It is worth noting that no previous study has embarked on an enquiry to conduct a thorough analysis of the applicability of the law on derivative actions to LLPs. As a result, this article, addressing a gap in the current academic literature, aims to examine the means by which a derivative action can be brought on behalf of an LLP through an analysis of the recent judicial decisions that pave the way for further reforms to extend the statutory regime under the CA 2006 to include LLPs.

The article is structured as follows. First, it starts its analysis by examining the current application of the law on derivative actions to LLPs by looking at the key rationale behind the restrictive approach of the Government to apply the statutory regime to LLPs. Second, it

examines the key decisions which have shed light on the issue, with particular emphasis on *Homes of England v Nick Sellman (Holdings) Ltd*,[12] as this is the first case that provided detailed elaborations on the correct test applicable for LLPs. Third, it looks on the applicability of the unfair prejudice remedy to LLPs through sections 994 to 996 of the CA 2006, as compared to the statutory derivative regime of the CA 2006. Fourth, the article puts forward a proposal for legislative changes to apply the statutory derivative regime to LLPs. Finally, it provides concluding remarks.

The applicability of derivative actions to LLPs

The applicability of the statutory derivative action under the CA 2006 to LLPs has been subject to considerable debate in the UK. Indeed, one of the key questions the courts have been asked to address recently, is whether a member of an LLP has the legal standing to initiate a derivative action on behalf of an LLP.[13] Considering the statutory interpretation of section 260 of the CA 2006, the answer is negative, as this section provides that Part 11 of the CA 2006 only applies to proceedings initiated by "a member of a company – (a) in respect of a cause of action vested in the company, and (b) seeking relief on behalf of the company". As section 1 of the CA 2006 provides, "company" means a company formed and registered under the CA 2006. Since an LLP is a body corporate which is registered under the Limited Liability Partnerships Act 2000 (LLP Act 2000),[14] it is apparent that an LLP does not fall within the definition provided under section 1 of the CA 2006 and therefore Part 11 is not extended to allow members of an LLP to bring a derivative action on behalf of an LLP. Even though the word "member" under section

[12] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* [2020] EWHC 936 (Ch); [2020] B.C.C 607.

[13] *Harris Microfusion 2003-2 LLP* [2016] EWCA Civ 1212; [2017] C.P. Rep. 15, *Homes of England Ltd v Nick Sellman (Holdings) Ltd* [2020] EWHC 936 (Ch); [2020] B.C.C 607.

[14] Limited Liability Partnerships Act 2000 s.2.

260(5) of the CA 2006 has been extended to include a person who is not a member of a company, this does not include members of an LLP as the legal standing has been provided to persons "to whom shares in the company have been transferred or transmitted by operation of law". Therefore, one arguably important omission of section 260 is that no provision was made for LLPs, thus restricting the ambit of derivative actions to proceedings made by members of a company. As a result, claims made by members of an LLP on behalf of an LLP are excluded under the statutory regime.

The rationale behind the restrictive application of the statutory derivative action to LLPs lies on the Government's response in May 2008 to the November 2007 consultation document on the proposed application of the CA 2006 to LLPs.[15] Although it was identified that some provisions extended for companies under the CA 2006 could also be extended for LLPs,[16] the majority of the respondents in the May 2008 consultation document felt that it was "not necessary or desirable" to apply the statutory derivative regime to LLPs.[17] It was argued that since a member of an LLP has already been provided with the means to initiate derivative actions on behalf of the LLP via the Civil Procedure Rules,[18] which have been described to

[15] *Proposals for the Application of the Companies Act 2006 to Limited Liability Partnerships (LLPs): A consultation document* (November 2007, BERR, URN 07/1476); *Government response to the consultation on the proposed application of the Companies Act 2006 to Limited Liability Partnerships* (May 2008, BERR)

[16] *Proposals for the Application of the Companies Act 2006 to Limited Liability Partnerships (LLPs): A consultation document*, para.5.1

[17] *Government response to the consultation on the proposed application of the Companies Act 2006 to Limited Liability Partnerships*, Q18

[18] CPR r.19.14. It is worth noting that the Civil Procedure Rules 1998 have recently been amended by the Civil Procedure (Amendment) Rules 2023 (SI 2023/105, L.3); *Proposals for the Application of the Companies Act*

work "satisfactorily", extending the application of Part 11 of the CA 2006 to LLPs was found to be unnecessary.[19] On the other hand, one respondent to the proposal argued that the application of Part 11 to LLPs "although not essential, was desirable".[20] It was argued that although a member of an LLP has the option to bring a derivative action via the Civil Procedure Rules,[21] "the way in which the principles apply to LLPs is not entirely clear, and that this is an opportunity to set out a statutory scheme and align the law".[22] Despite this argument and in light of the responses received by the majority, the applicability of the statutory regime to LLPs did not gain the imprimatur of the UK Parliament and, hence, did not find its way into legislation.

As explained in the Explanatory Memorandum to Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009, the key reasoning for not applying the statutory derivative action to LLPs related to the fundamental differences that exist between companies and LLPs.[23] This is because an LLP is not technically considered a "company" but rather a

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2006 to Limited Liability Partnerships (LLPs): A consultation document, para.5.8; *Government response to the consultation on the proposed application of the Companies Act 2006 to Limited Liability Partnerships*, Q18.

[19] *Proposals for the Application of the Companies Act 2006 to Limited Liability Partnerships (LLPs): A consultation document*, para.5.9.

[20] *Government response to the consultation on the proposed application of the Companies Act 2006 to Limited Liability Partnerships*, Q18.

[21] CPR r.19.14.

[22] *Government response to the consultation on the proposed application of the Companies Act 2006 to Limited Liability Partnerships*, Q18.

[23] Explanatory Memorandum to The Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009, No.1804, p.10.

"body corporate",[24] which combines both corporate and partnership law principles, with an emphasis distinctly on the former.[25] It is thus a hybrid form mainly governed by company law principles which are often adopted to its particular needs, due to the similarities it shares with a company, such as the separate legal personality and the members' limited liability.[26] It differs fundamentally from companies on the fact that there is no division between the directors and its members, and the internal decision-making machinery is far more flexible than companies.[27] Unlike companies, there is a great autonomy on the part of the members of an LLP to decide on their internal decision-making structures, as their rights and duties are governed by the LLP partnership agreement, which may contain provisions for resolving internal disputes among members.[28] In the absence of an LLP agreement, default provisions are also applied under Regulation 7 of the Limited Liability Partnership Regulations 2001,[29] which allow "ordinary matters connected with the business of the LLP" to be decided by the majority of the members.[30] This autonomy allows members of an LLP to resolve internal disputes that may arise among the members and the LLP, and address any wrongdoings without the need for a statutory intervention. It was thus acknowledged that there would be "little benefit" in applying

[24] Limited Liability Partnerships Act 2000 s.1(2).

[25] Geoffrey Morse and Thomas Braithwaite, *Partnership & LLP Law*, 9th edn (OUP, 2020), pp.317, 325.

[26] Limited Liability Partnerships Act 2000 ss.1(2) and 1(3); Morse and Braithwaite, *Partnership & LLP Law*, pp. 317-318.

[27] John Whittaker and John Machell QC, *The Law of Limited Liability Partnerships*, 5th edn (Bloomsbury Professional, 2021), para.1.5; Elspeth Berry, *Partnership and LLP Law*, 2nd edn (Wildy, Simmonds and Hill Publishing, 2018), p.3.

[28] Limited Liability Partnerships Act 2000 s.5.

[29] Limited Liability Partnerships Regulations 2001 (SI 2001/1090).

[30] Limited Liability Partnerships Regulations 2001 reg.7(6).

the statutory derivative regime to LLPs.[31] As LLP agreements play an integral part in setting out the duties and responsibilities of the members, the "internal regulation of this nature should continue in this way to allow LLPs flexibility to regulate their own membership and management and the respective duties therein".[32] Therefore, it has been argued that applying the statutory requirements of the CA 2006 to LLPs "would reduce flexibility and add unnecessary complexity and burden on LLPs".[33]

However, a major problem inherent in this argument lies in the idea of the "majority rule", which has long been recognised as an important principle of UK company law under the common law rule in *Foss.* In the context of company law, the majority rule is a device which allows those who hold the majority of the company's shares to control and manage the decision-making procedure of the internal affairs of the company.[34] The idea of this rule derives from the view "that membership of any kind of association involves an obligation to settle disputes within the association and to abide by majority decisions".[35] The rule in *Foss* is an important one in this context, as it has its genesis in partnership law principles which have long recognised that the courts have no jurisdiction to interfere with the internal affairs of the

[31] Explanatory Memorandum to Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009, p.10.

[32] Explanatory Memorandum to Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009, p.10.

[33] Explanatory Memorandum to Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009, p.10.

[34] Wedderburn, "Shareholders' Rights and the Rule in Foss v Harbottle", 197-198.

[35] Derek French, *Mayson, French & Ryan on Company Law* 37th edn (OUP 2021), p.544.

partnership, with the only exception being the dissolution of the partnership.[36] The rationale behind the reluctance of the courts to intervene was based on the fact that the relationship of partners in a partnership is grounded upon the principles of mutual trust and good faith, and therefore any intervention on the part of the courts would not have made the existence of that relationship possible.[37] As a result, the courts were only willing to abdicate "their jurisdiction in favour of the obvious alternative remedy – the majority of the members".[38] The reluctance of the courts was also evidenced in the landmark case of *Carlen v Drury*,[39] where Lord Eldon acknowledged that where an internal remedy to deal with the partnership disputes exists, such as the partnership agreement, it is not appropriate for the courts to have jurisdiction to intervene.[40] As Lord Eldon commented, "this Court is not to be required on every occasion to take the management of every Playhouse and Brewhouse in the Kingdom".[41] It is only where "the means of redress, provided by the parties themselves in the articles, are not effectual, this court will interfere".[42]

In the context of an LLP, a key issue pertaining to the idea of the majority rule is the fact that it allows the majority of members in an LLP to make important decisions concerning the LLP

[36] Wedderburn, "Shareholders' Rights and the Rule in Foss v Harbottle"; 196, Boyle, *Minority Shareholders' Remedies*, pp.2-5; A.J. Boyle, "The Minority Shareholder in the Nineteenth Century: A Study in Anglo-American Legal History" (1965) 28 M.L.R 317, 318.

[37] Khurram Raja, "Majority shareholders' control of minority shareholders' use and abuse of power: a judicial treatment (2014) 25 I.C.C.L.R. 162, 166.

[38] Wedderburn, "Shareholders' Rights and the Rule in Foss v Harbottle", 194.

[39] *Carlen v Drury* (1812) V&B 154.

[40] *Carlen v Drury* at 159.

[41] *Carlen v Drury* at 158.

[42] *Carlen v Drury* at 157.

as a whole, such as litigation decisions. By doing so, the majority may abuse their powers to the detriment of the minority members. As ordinary matters connected with the business of the LLP are decided by the majority, this may lead the majority members to exercise their powers in an unfair and unjust manner which may disadvantage the minority members. This poses a significant challenge as the wrongdoing members are usually the controlling majority who are "benefitting themselves at the expense of the [LLP] and using their majority voting power to prevent the [LLP] from taking any actions to remedy the wrong" caused to it.[43] It would thus be unfair to allow the majority to gain control of the decision-making process of the LLP in an unjust manner by preventing the minority to pursue an action on behalf of the LLP to remedy a wrong caused to the LLP. Therefore, in order to balance the majority control, it is important for the law to provide an effective mechanism to achieve justice for minority members in an LLP by redressing any wrongdoings caused due to the exploitation of power by the majority. By not allowing members of an LLP to harvest the benefits of using the statutory derivative regime under the CA 2006, this may prevent the members of an LLP to obtain justice on behalf of the LLP. Confining the right to bring such an action via the statutory route to members of a company, this could eliminate the key purpose and role of the derivative action mechanism to "prevent a wrong going without redress".[44]

In addition to this, it could be argued that the Government's decision to restrict the application of the statutory regime to LLPs have led to the continued existence of two parallel systems –

[43] Whittaker and Machell QC, *The Law of Limited Liability Partnerships*, para.14-37.

[44] *Smith v Croft (No 2)* [1988] Ch 114 at 185; Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007), p.18; *Universal Project Management Services Ltd v Fort Gilkicker Ltd and others* [2013] EWHC 348 (Ch); [2013] Ch 551 at 559 (Briggs J): "a derivative action is merely a procedural device designed to prevent a wrong going without a remedy".

the common law and the statutory derivative action. While the purpose of introducing the statutory derivative action, enshrined in the CA 2006, was to abolish the common law rule in *Foss* and its complexities,[45] it seems that the common law derivative action has managed to survive the enactment of the statutory regime and, thus, it is still applicable to LLPs. Indeed, the principles underlying the rule in *Foss* were applicable to LLPs, for the rule in *Foss* was not just a rule of law of companies but a rule of law applicable to all associations, which can bind themselves by a decision of a simple majority of their members.[46] Notwithstanding the missed opportunity of the Court Appeal in *Cabvision Ltd v Feetum*[47] to clarify the lacuna that exists, Jonathan Parker LJ in his judgment appears to have concluded that, in principle, the common law derivative action is applicable to LLPs. Therefore, although the common law rule has been abolished for companies with the introduction of Part 11 of the CA 2006, its applicability continues to be in effect for LLPs.

This could also be evidenced on the fact that the UK Parliament did not expressly abolish the common law derivative action.[48] As it was established in *Islington London Borough Council v*

[45] Law Commission, *Shareholder Remedies: Consultation Paper* (1996), Law Com. CP. No. 142; Law Commission, *Shareholder Remedies Report*; Andrew Keay and Joan Loughrey, "Something old, something new, something borrowed: an analysis of the new derivative action under the Companies Act 2006" (2008) 124 L.Q.R 469, 469; Andrew Keay and Joan Loughrey, "Derivative proceedings in a brave new world for company management and shareholders" (2010) 3 J.B.L 151, 151-153.

[46] Wedderburn, "Shareholder Rights and the Rule in Foss v Harbottle", 195; Boyle, *Minority Shareholders' Remedies*, p.5; Geoffrey Morse et al, *Palmer's Limited Liability Partnership Law*, 3rd edn (Sweet & Maxwell, 2017).

[47] *Cabvision Ltd v Feetum* [2005] EWCA Civ 1601; [2006] B.C.C 340 at [80].

[48] *Universal Project Management Services Ltd v Fort Gilkicker Ltd and others* [2013] EWHC 348 (Ch), [2013] Ch 551, 564; Kershaw, "The rule in Foss v Harbottle is dead: long live the rule in Foss v Harbottle", 280.

Uckac[49], a statute will only be construed as taking common law and equitable rights if it does so expressly or by necessary implication. While the CA 2006 has introduced a new statutory derivative action, the abolition of the common law derivative action was neither done expressly nor by a necessary implication.[50]

This led *Harris v Microfusion*[51] to confirm the application of the common law derivative action to LLPs, arguing that the rule in *Foss* was not wholly replaced. Therefore, any actions that do not fall within the ambit of the statutory regime, will fall under the umbrella of the common law principles. As a result, this demonstrates that actions such as the ones concerning an LLP, will force the court to fall back upon the general principles of the common law in order to decide whether to allow the continuance of a derivative action.[52]

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[49] *Islington London Borough Council v Uckac* [2006] EWCA Civ 340; [2006] 1 WLR 1303 at [28].

[50] This is in stark contrast to Australia which has expressly abolished the common law derivative action under section 263(3) of the Corporations Act 2001: "The right of a person at general law to bring, or intervene in, proceedings on behalf of a company is abolished". This was also confirmed by Briggs J in *Universal Project Management Services Ltd v Fort Gilkicker Ltd & Ors* [2013] EWHC 348 (Ch); [2013] Ch 551, 564: 'the assertion that the remainder of the common law device was abolished fails because abolition was neither express nor a clear or necessary implication'.

[51] *Harris Microfusion 2003-2 LLP* [2016] EWCA Civ 1212, [2017] C.P. Rep. 15, at [13] (McCombe LJ): "It has been common ground throughout that Ch.1 of Part 11 of the Companies Act 2006 providing for a statutory derivative remedy, does not apply to limited liability partnerships. It is also not challenged that the common law derivative remedy has survived the enactment of the statutory remedy".

[52] David Milman, "A review of developments in partnership law 2017" (2017) 399 Company Law Newsletter 1, 2-3.

The issue has grown in importance in light of *Homes of England v Nick Sellman (Holdings) Ltd*[53] where Zacaroli J confirmed for the very first time that the correct test applicable for LLPs in relation to derivative actions is the one found under the common law in *Foss*, and not the one applicable for companies under section 263 of the CA 2006. Due to the immense importance of this case, this article aims to examine its facts and the reasoning behind reaching the decision. As the derivative proceedings in this case were conducted under the purview of the Civil Procedure Rules 1998,[54] it is imperative to note that certain provisions of the Civil Procedure Rules 1998 have recently been amended by the Civil Procedure (Amendment) Rules 2023 (CPR). Therefore, for the purposes of this article, references to the Civil Procedure Rules 1998 will be made in accordance with the amended CPR, as it is crucial to align the discussion with the current rules that govern the procedural aspects relevant to the law on derivative actions.

Homes of England v Nick Sellman (Holdings) Ltd: the correct test for LLPs

This case involves an appeal brought against the decision of HHJ Saunders to grant permission to a member of an LLP under section 261 of the CA 2006 to continue with the derivative action. The case concerns a limited liability partnership, Bromham Road Development LLP, incorporated to hold the freehold of a property situated in Bedford, England. The LLP had two members, Homes of England (HoE) and Nick Sellman (Holdings) Ltd (Holdings), each of them being a 50% partner of the LLP. The property had been financed by way of a commercial loan from Wellesley Finance plc and a loan from HoE. The commercial loan had its expiration date on 14th January 2018, with a penalty interest charge in case of a failure to repay the loan within

[53] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* [2020] EWHC 936 (Ch), [2020] BCC 607.

[54] Civil Procedure Rules 1998 (No. 3132, L.17).

14 days. HoE had negotiated new financing to repay the LLP's commercial loan, requesting Holdings on 22nd January 2018 to execute the documentation to enable the refinancing to take place. However, Holdings did not execute the documents until 20th February 2018. As a result of the delay, the LLP was asked to pay a penalty charge on the commercial loan, which resulted in the reduction on the amount the LLP could afford to repay the HoE's loan. Initially, HoE brought a direct claim against Holdings, arguing that, by not executing the documentation promptly, Holdings had breached certain duties it owed towards the LLP. However, in its defence, Holdings asserted that HoE was not legally entitled to bring a claim for the losses incurred, as it was the LLP who suffered the loss not the HoE, and therefore only the LLP had the right to initiate legal proceedings against Holdings. This argument was based on the fact that any losses suffered by HoE were irrecoverable as reflective loss. As a result, HoE amended its claim to include a derivative action brought on behalf of the LLP for the same amount.

The principal question raised by Zacaroli J on the appeal was whether the test applicable in considering whether to grant permission to a member of an LLP to continue with a derivative action was that contained in section 263 or the one at common law.[55] In reaching its decision, Zacaroli J embarked on an enquiry to examine the current law applicable to companies in relation to derivative actions by identifying which parts of the companies' legislation have also been applied to LLPs. As already mentioned above, the law on derivative actions applicable to companies can be found under Chapter 1 of Part 11 of the CA 2006, particularly under sections 260 to 264. With the introduction of the statutory derivative action, the court has been provided with the jurisdiction to decide on whether permission must be granted to continue with a derivative action, by applying the test applicable for companies under section 263 of the CA

[55] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* at [2].

2006. Section 263 contains the substantive criteria the court must consider when determining the continuance of the derivative action. In the context of LLPs, although section 15 of the LLP Act 2000 allows regulations to be made specifying which parts of the CA 2006 apply to LLPs, it is clear from the relevant regulations, referred to as Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009, that sections 260 to 264 do not apply to LLPs.

Notwithstanding this, HoE raised the novel argument that section 263 applies to LLPs by virtue of the CPR rule 19.17.[56] Although, as stated above, section 260 of the CA 2006 is only applicable for companies within the meaning of section 1 of the CA 2006, it has been argued that rules 19.14 and 19.17 of the CPR allow for a derivative action to be brought in respect of other bodies corporate, and this could include the LLPs. Indeed, the wording "other body corporate" in CPR could clearly include an LLP as,[57] according to section 1 of the LLP Act 2000, an LLP is regarded as a body corporate with its own legal personality distinct from its members. Therefore, the procedure that a member of an LLP will follow for such claims is governed by CPR and according to the rule 19.17(4), this would entail adopting the same procedures applicable to companies under sections 261, 262 and 264 of the CA 2006 as if the LLP were a company. In overturning the decision of HHJ Saunders, Zacaroli J determined conclusively that the correct test applicable for LLPs in relation to derivative actions is the one found under the common law regime, thus rejecting the argument made by HoE that the same test for companies, as laid down in section 263, is also applicable to LLPs.[58] Zacaroli J supported his decision by drawing upon the following key reasons.

[56] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* at [29].

[57] Whittaker and Machell, *The Law of Limited Liability Partnerships*, para.14.38.

[58] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* at [H5].

First, although it was submitted by HoE that section 263 applies to LLPs by virtue of CPR rule 19.17, Zacaroli J clarified that the main weakness of this argument is that HoE failed to acknowledge that rule 19.17 is only applicable to the procedures set out in sections 261, 262 and 264, and that no references are made with regard to section 263. As it was pointed out by Zacaroli J, "the omission of section 263 appears to be deliberate".[59] This was supported by the fact that, in comparison to the provisions of CPR rules 19.14 to 19.20 that deal purely with procedural matters, "section 263, on the other hand, makes a substantive change to the test to be applied in considering an application for permission".[60] Therefore, "its application to LLPs would itself be a substantive change, and one that is not apt to be brought about by provisions of the CPR concerned with matters of pure procedure".[61] Indeed, section 263 made a substantive change to the law applicable for companies in relation to derivative actions, by replacing the common law rule in *Foss* with a statutory regime under the CA 2006. Therefore, had the UK Parliament intended also to replace the rule applicable for LLPs, it would not have done so via the procedural provisions in the CPR but via the statutory regime. This conclusion was also supported by the fact that "section 260 is also omitted from the provisions applied by CPR [rule 19.17] to LLPs",[62] which is itself a substantive provision that has abolished the application of the common law rule in *Foss* in respect of companies. Zacaroli J thus argued that

[59] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* at [30].

[60] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* at [31].

[61] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* at [31].

[62] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* at [32].

"failure to apply section 260 to LLPs (and thus the failure to abolish the common law position for LLPs) demonstrates that it was not the intention of the drafter of CPR [rule 19.17] that the position in relation to LLPs should mirror that in relation to companies".[63]

It would thus "be surprising if CPR [rule 19.17] was intended to apply the new statutory test under section 263 to LLPs but not in a way which rendered it the exclusive test".[64] As a result, the common law rule in *Foss* has managed to survive the enactment of the CA 2006 and thus it is still applicable to LLPs. This argument was further supported by the differences that exist between the court forms which,[65] although previously annexed to the Practice Direction of CPR Part 19C,[66] are now available online via the HM Courts and Tribunals website. Particularly, the form in respect of companies includes a statement that the factors the court should consider are those laid down in section 263,[67] whereas the form in respect of other bodies corporate, such as LLPs, do not include such a statement.[68] The distinction between the two forms made it apparent that the drafter of CPR rule 19.17 had not intended to treat LLPs in the same way as companies in relation to the substantive aspect of the procedure, but only from a procedural perspective. Additional support for this conclusion was also drawn by Whittaker and Machell QC in their book titled *The Law of Limited Liability Partnerships*, where it was stated that:

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[63] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* at [32].

[64] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* at [32].

[65] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* at [33].

[66] This has now been replaced by the "Practice Direction 19A – Derivative claims".

[67] https://www.gov.uk/government/publications/notice-in-relation-to-a-derivative-claim-involving-a-company-form-n535

[68] https://www.gov.uk/government/publications/notice-in-relation-to-a-derivative-claim-involving-a-body-corporate-that-is-not-a-company-or-a-trade-union-form-n536

"The adoption for LLPs (and other non-company bodies corporates) by CPR, [rule 19.17] of the procedure for permission applications set out in CA 2006, sections 261, 262 and 264 appears not to include the adoption of the requirements set out in section 263 for deciding the substance of the application in the case of a company. In the case of a permission application by members of an LLP, therefore, it will be the pre-2006 Act, judge-made criteria and principles which will be relevant".[69]

Second, HoE argued that even if section 263 did not apply to LLPs via CPR rule 19.17, section 261, on the other hand, does apply to LLPs. As HoE stated, this is because section 261 provides the court with a broad and unfettered discretion to apply the statutory test laid down in section 263 when granting or refusing permission to continue the derivative action.[70] Particularly, section 261(4) provides that:

"On hearing the application, the court may – (a) give permission (or leave) to continue the claim on such terms as it thinks fit, (b) refuse permission (or leave) and dismiss the claim, or (c) adjourn the proceedings on the application and give such directions as it thinks fit".

Zacaroli J rejected this argument, holding that section 261(4) is merely procedural in nature which "says nothing about the test which the court is to apply in determining whether to give permission".[71] Indeed, the wording used in section 261(4) sets out what orders the court could

[69] Whittaker and Machell QC, *The Law of Limited Liability Partnerships*, para.14-41.

[70] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* at [35].

[71] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* at [37]

make with regard to the continuation of the derivative action, rather than which test the court could choose to use when determining if permission is to be granted.

Third, having established that the correct test applicable for LLPs is the common law test in *Foss*, Zacaroli J held that the common law test was not satisfied on the facts of the case and therefore permission to continue the derivative action was refused. This is because, on the facts of the case, HoE was unable to demonstrate that its claim fell within the true exception to the *Foss* rule, namely the "fraud on the minority" exception. In reaching his decision, Zacaroli J applied the test adopted in *Abouraya v Sigmund*[72] which requires to establish either (a) cases of actual fraud, ie deliberate and dishonest breaches of duty or (b) in the absence of actual fraud, whether the alleged wrongdoing resulted in loss to the LLP and personal gain by the alleged wrongdoers. While Zacaroli J accepted that Holding's actions caused financial loss to the members of the LLP,[73] there had been no allegations of dishonest breach of duty[74] nor any sufficient allegations that Holdings acquired a personal benefit at the expense of the LLP.[75]

The decision in *Homes of England* is a welcome one, as it clarifies the correct test applicable for LLPs in relation to derivative actions. It would be anomalous, and open to a serious question, if the CPR rule 19.17 were able to apply sections of the CA 2006 which are only applicable to companies. As stated by Whittaker and Machell QC, whilst sections 261, 262 and 264 of the CA 2006 apply to LLPs, sections 260 and 263 "are neither directly applied to LLPs by the LLP Regulations 2009 nor mentioned in the CPR as applicable to non-company bodies

[72] *Abouraya v Sigmund* [2014] EWHC 277 (Ch), [2015] BCC 503 at [18], [25].

[73] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* at [47].

[74] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* at [48].

[75] *Homes of England Ltd v Nick Sellman (Holdings) Ltd* at [50], [52].

corporate".[76] The decision in *Homes of England* was thus correct in its application of the common law rule, as both sections 260 and 263 consistently refer to "the company" and not to any other body corporate, such as the LLP. In addition to this, as one of the key criteria laid down in section 263 requires the court to consider whether "a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim", applying the test under section 263 would have been problematic, given that section 172 does not apply to members of an LLP.

It could therefore be argued that, while the continued existence of the common law rule in *Foss* could be regarded as a powerful tool to remedy wrongdoings caused to the LLP, the case of *Homes of England* highlights the notorious difficulties in applying the *Foss* rule and its exceptions as well as the different results that might be reached when using the *Foss* rule as compared to the statutory regime. Particularly, with the introduction of the statutory derivative action, one of the significant changes that have been made was the inclusion of negligence in the types of breaches for which a derivative action may be brought.[77] Traditionally, mere negligence was not recognised as "fraud" under the fraud on the minority exception, unless it was proved that the wrongdoers have benefited from their negligence.[78] The inclusion of negligence under the statutory regime is thus significant in the sense that there is no longer a requirement to establish benefit on the part of the wrongdoers for their negligence, thus allowing more flexibility to the members to initiate derivative actions.[79] The difficulties of the

[76] Whittaker and Machell, *The Law of Limited Liability Partnerships*, para.14.41.

[77] Reisberg, *Derivative Actions and Corporate Governance*, p.136.

[78] *Pavlides v Jensen* [1956] 2 All ER 518; [1956] Ch 565 at 572, *Daniels v Daniels* [1978] Ch 406.

[79] Reisberg, *Derivative Actions and Corporate Governance*, p.136.

"fraud on the minority" exception have also been highlighted in *Harris v Microfusion* where it has also been accepted that in order to bring a derivative action, a member of an LLP must

"show that the alleged wrongdoing has caused harm to the LLP or company in question and that the alleged wrongdoer has benefited from the alleged wrongdoing. It was not sufficient to simply allege that there had been a breach of fiduciary duty or an abuse/misuse of power in order to rely on the [fraud on the minority] exception".[80]

Drawing upon the analysis above, it is evident that there is some "divergence" between the derivative action that can be brought on behalf of a company and the action that can be brought on behalf of the LLP.[81] This leads to the conclusion that LLPs are subject to the more restrictive approach of the common law rule in *Foss* as compared to the statutory regime applicable for companies. It is therefore regrettable that the statutory regime, enshrined in the CA 2006, has not been extended to members of an LLP. It is not surprising that the Law Commission adopted the view that the *Foss* rule and its exceptions are "inflexible and outmoded".[82] In the opinion of the Law Commission, there were four major problems that urged the need for a statutory reform. First, the rule in *Foss* "cannot be found in rules of court, but only in case law, much of it decided many years ago".[83] Indeed, it was acknowledged that in order to gain a proper understanding of the rule in *Foss*, it is required to examine a variety of reported cases that have

[80] *Harris Microfusion 2003-2 LLP* [2016] EWCA Civ 1212, [2017] C.P. Rep. 15 at [H4].

[81] Whittaker and Machell QC, *The Law of Limited Liability Partnerships*, para.14-41.

[82] Law Commission, *Shareholder Remedies: Consultation Paper*, para.14.1.

[83] Law Commission, *Shareholder Remedies: Consultation Paper*, para.14.2, Law Commission, *Shareholder Remedies: Report*, para.6.4.

been decided over a period of 150 years.[84] This makes the law "virtually inaccessible", except to the lawyers who are experts in this field.[85] Second, in order for a derivative action to be brought by a member of a company to recover damages suffered by the company, there is a need to prove that the wrongdoers are in control of the company,[86] otherwise no such actions are allowed to be taken which led wrongs remain unredressed. This is the so-called "wrongdoer control" requirement,[87] which has caused much controversy due to the uncertainties surrounding the meaning of "control".[88] Although the Law Commission noted that the requirement was "not restricted to situations where wrongdoers have voting control…its applicability outside these circumstances is in doubt".[89] Third, it is not possible for a member of a company to bring a derivative action by reason of a mere negligence on the part of the wrongdoer, unless the member is able to prove that the wrongdoer conferred a benefit from his negligence or that the failure of the other company directors to bring such an action constitutes a fraud on the minority.[90] Fourth, another key weakness that lies on the rule in *Foss* is that "the standing of the member to bring a derivative action has to be established as a preliminary issue by evidence which shows a prima facie case on the merits".[91]

Given the notorious difficulty in satisfying the common law rule and its exceptions, this may prevent members of an LLP to achieve justice by using an effective mechanism to remedy

[84] Law Commission, *Shareholder Remedies: Report*, para.1.4.

[85] Law Commission, *Shareholder Remedies: Consultation Paper*, para.4.35.

[86] Law Commission, *Shareholder Remedies: Consultation Paper*, para.14.2.

[87] *Russell v Wakefield Waterworks Co* (1875) LR 20 Eq 474 at 482.

[88] Law Commission, *Shareholder Remedies: Consultation Paper*, para.14.2.

[89] Law Commission, *Shareholder Remedies: Consultation Paper*, para.14.2.

[90] Law Commission, *Shareholder Remedies: Consultation Paper*, para.14.3.

[91] Law Commission, *Shareholder Remedies: Consultation Paper*, para.14.4.

wrongdoings caused to the LLP. Even though a member of an LLP has been provided with the means to initiate derivative actions via the common law rule in *Foss*, this does not justify in principle why the statutory regime should not be extended for LLPs. There is thus an urgent need for a further reform in this area of law, aiming to extend the statutory regime under the CA 2006 to LLPs. Similar calls for reforms have also been raised to amend sections of the CA 2006 to pave the way for multiple derivative actions to use the statutory regime.[92] It might thus be worth amending the CA 2006 to incorporate provisions for LLPs, thus avoiding having two parallel systems dealing with the law on derivative actions. The extension of locus standi to members of an LLP via the statutory regime under the CA 2006 is predicated on the overarching imperative of doing justice, by providing an effective mechanism to remedy the wrongs caused to the LLPs.

The applicability of the unfair prejudice remedy to LLPs

Of particular note is the applicability of the unfair prejudice remedy under sections 994 to 996 of the CA 2006 to LLPs, provided the members of the LLPs have not excluded the remedy by a unanimous written agreement.[93] This has the effect of allowing a member of an LLP to petition to the court on the ground that the affairs of the LLP are being or have been conducted

[92] Pearlie Koh, "Derivative actions 'once removed'" (2010) 2 J.B.L 101; James Bailey and Jan Mugerwa, "Multiple derivative actions in company law: can you or can't you?" (2013) 34 Company Lawyer 302; Tag Cheng-Han, "Multiple derivative actions" (2013) 129 L.Q.R 337; Arad Reisberg and D.D. Prentice, "Multiple derivative actions" (2009) 125 L.Q.R 209; S.H. Goo, "Multiple Derivative Action and Common Law Derivative Action Revisited: A Tale of Two Jurisdictions" (2010) 10 Journal of Corporate Law Studies 255; Andrew Keay, "Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006" (2016) 16 Journal of Corporate Law Studies 39.

[93] Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009, (SI 2009/1804), regs 48-49.

in a manner that is unfairly prejudicial to the interests of the members generally or some of its members or that an actual or proposed act or omission of the LLP is or would be so prejudicial.

The applicability of the unfair prejudice remedy was firstly introduced by the Limited Liability Partnerships Regulations 2001,[94] in which substantial parts of companies' legislation applied to LLPs with necessary modifications to reflect the differences between a company and an LLP.[95] This continued with the introduction of the Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009,[96] as there was a need to update the regulations to apply the provisions of the CA 2006. The purpose of these regulations is "to ensure that an LLP, as a body corporate, will be subject to similar requirements to those made of companies".[97] As it was stated, "because the internal structure of an LLP is not prescribed that of a company, it has been necessary to modify existing corporate legislation in its application to LLPs",[98] without the need to undertake any fundamental changes to company law as the modifications that have been made to companies' legislation were only in relation to LLPs.[99]

Although the applicability of the unfair prejudice remedy to LLPs had not been greeted by universal acclaim,[100] it was proposed by the consultation paper issued in September 1998 that

[94] Limited Liability Partnerships Regulations 2001 (SI 2001/1090).

[95] HL Deb 16 March 2001 Vol 623 CC 1127-40 at 1127 (Lord McIntosh of Haringey).

[96] Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009, regs 48-49.

[97] HL Deb 16 March 2001 Vol 623 CC 1127-40 at 1128 (Lord McIntosh of Haringey).

[98] HL Deb 16 March 2001 Vol 623 CC 1127-40 at 1128 (Lord McIntosh of Haringey).

[99] HL Deb 16 March 2001 Vol 623 CC 1127-40 at 1128 (Lord McIntosh of Haringey).

[100] "Consultees expressed considerable opposition to this, in particular because it was seen to be an unreasonable threat to the smooth running of the organization that one disgruntled member might be able to make an

the unfair prejudicial remedy should be applied to LLPs, with an option for the members to exclude the remedy by an LLP agreement.[101] Regrettably, no attempt was made to sufficiently explain the rationale which underlay the proposal. This was followed by the consultation paper issued in February 2000,[102] in which views were sought on the applicability of the unfair prejudice remedy to LLPs and its exclusion by an LLP agreement. Consultees to the proposal opposed applying the unfair prejudice remedy to LLPs, as "it was seen to be an unreasonable threat to the smooth running of the organisation that one disgruntled member might be able to make an application to the courts".[103] In addition, referring to the suggestion to exclude the unfair prejudice remedy by an LLP agreement, it was commented that

"it would not be appropriate to give a member such a right and then provide for it to be subject to exclusion by agreement between the members, since such a provision would not provide protection against a powerful majority".[104]

application to the courts": *Limited Liability Partnerships Regulatory: Default Provisions Governing Relationships Between Members: A Consultation Paper*, (February 2000, DTI, URN 00/617), para.29.

[101] *Limited Liability Partnerships: Draft Bill: A consultation document*, (September 1998, DTI, URN 98/874); Katherine Reece Thomas and Christopher L. Ryan, "Section 459, public policy and freedom of contract: Part 2" (2001) 22 Company Lawyer 198, 203.

[102] *Limited Liability Partnerships Regulatory: Default Provisions Governing Relationships Between Members: A Consultation Paper*, paras.29-34.

[103] *Limited Liability Partnerships Regulatory: Default Provisions Governing Relationships Between Members: A Consultation Paper*, para.29.

[104] *Limited Liability Partnerships Regulatory: Default Provisions Governing Relationships Between Members: A Consultation Paper*, para.31.

Concerns have therefore been raised with regard to the exclusion of the unfair prejudice remedy by an LLP agreement, as by excluding the remedy, this may act as a detriment to minority members who will be left with no effective mechanism to use against the majority members. This is similar to the view adopted by Morse and Braithwaite who argued that where members of an LLP are provided with an alternative mechanism to resolve their internal disputes, which is similar to the one that could be addressed via the unfair prejudice remedy, then it would be convenient to allow for the unfair prejudice remedy to be excluded. However,

"where the remedy is excluded without some alternative mechanism being in place, the LLP runs the risk that the court will accede to a disgruntled member's application to wind it up on the just and equitable basis, there being no alternative viable mechanism for redress".[105]

It is thus not surprising that the underlying issue raised in the February 2000 consultation paper was the imposition of some form of mandatory buy-out for minority members regardless of what may be contained in the LLP agreement. This is because in a partnership, minority partners are in a better position to recover their financial interests by forcing the dissolution of the partnership, as compared to a minority member of an LLP who is more closely akin to a minority shareholder in a limited company rather than to a partner in a partnership. Therefore, a minority member of an LLP is more likely to "be exposed to the risk of the majority depriving him of any financial returns from the business carried on by the LLP and of any effective participation in management".[106]

[105] Morse and Braithwaite, *Partnership & LLP Law*, p.376.

[106] *Limited Liability Partnerships Regulatory: Default Provisions Governing Relationships Between Members: A Consultation Paper*, para.32.

Considering the complexities of the unfair prejudice remedy, it has been suggested that allowing LLP members to deal with matters concerning the protection of minority interests through the LLP agreement, rather than through a judicial procedure, may be more appropriate.[107] This is because members of an LLP are in a different position to the members of a company who do not often "consider the implications and consequences of the constitution they adopt".[108] This is in comparison to the LLP, as its members are "more likely to have come to an express agreement on how the LLP should be run and their respective rights and duties".[109]

In the published response to the February 2000 consultation paper, although there was a "lukewarm reception" to the proposal with regard to the applicability of the unfair prejudice remedy to LLPs, it was decided that the remedy will be applied and can be excluded by an LLP agreement.[110] It was stated that

[107] *Limited Liability Partnerships Regulatory: Default Provisions Governing Relationships Between Members: A Consultation Paper*, para.33.

[108] *Limited Liability Partnerships Regulatory: Default Provisions Governing Relationships Between Members: A Consultation Paper*, para.33.

[109] *Limited Liability Partnerships Regulatory: Default Provisions Governing Relationships Between Members: A Consultation Paper*, para.33.

[110] *Summary of Responses* (May 2000, DTI, URN 00/865), pp.11-12.

"this will put members of an LLP on a broadly equivalent footing with directors of a company, but taking account of the need to strike a balance between minority protection and freedom for members of an LLP to decide the internal relationship between themselves".[111]

This opened the door for the legislators to apply the unfair prejudice remedy to LLPs via the Limited Liability Partnerships Regulations 2001, which has later been modified to adopt the changes implemented under the CA 2006 to apply the remedy under sections 994 to 996 via the now Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009.

A good illustration of the applicability of the unfairly prejudice remedy to LLPs is *Eaton v Caulfield*.[112] This case involves the expulsion of Eaton from the LLP by another member, Caulfield, due to an ongoing dispute between them that broke down their relationship. As a result, Eaton claimed that his wrongful expulsion from the LLP amounted to unfair prejudice under section 994 of the CA 2006 which was applicable to LLPs via the Limited Liability Partnerships Regulations 2001. A crucial aspect of this case was that there was no written LLP agreement between the members to provide an express power to expel a member from the LLP. As stated in regulation 8 of the Limited Liability Partnerships Regulations 2001, LLP members cannot expel other members unless a power to expel has been conferred by an express agreement. This led the court to conclude that the petition for unfair prejudice was well

[111] *Summary of Responses*, p.12; HL Deb 16 March 2001 Vol 623 CC 1127-40 at 1133 (Lord Goodhart): "We welcome the fact that after some uncertainty about the matter, Section 459 is to be applied to LLPs by the regulations".

[112] *Eaton v Caulfield* [2011] EWHC 173; [2011] BCC 386.

founded, as Eaton's exclusion from the LLP "was one of the clearest examples of conduct which equity regarded as unfair prejudice".[113]

This case is an important one, as it sheds light on the critical need to implement effective mechanisms to redress wrongdoings where there is an absence of an LLP agreement. Even though an LLP agreement may exist, LLPs tend to "routinely" exclude the operation of the unfair prejudice remedy.[114] This is because members of the LLP "are unlikely to want to give individual members an opportunity to attempt to go behind the terms of the [LLP] agreement by asserting unfair prejudice".[115] As a result, minority members of an LLP are likely to be exposed to the potential abuses of power by the majority members. It is thus not surprising that the option to exclude the unfair prejudice remedy by a unanimous agreement has led to a "dearth of litigation" in this area of law,[116] with only a few cases having dealt with the issue.[117] The result of this is that members of the LLPs will be left with no means to initiate actions against wrongdoers. Therefore, by implementing effective mechanisms for redress, this will safeguard the interests of the LLP and its members and uphold the principles of fairness and justice within the LLP.

Proposed Legislative Changes

[113] *Eaton v Caulfield* at [66].

[114] Whittaker and Machell QC, *The Law of Limited Liability Partnerships*, para.32.14.

[115] Whittaker and Machell QC, *The Law of Limited Liability Partnerships*, para.32.14.

[116] David Milman, "Resolution of internal disputes within solvent business organisations: the legal options" (2012) 314 Company Law Newsletter 1, 5.

[117] *F&C Alternative Investments (Holdings) Ltd v Barthelmy* [2011] EWHC 1731 (Ch), [2012] Ch 613.

In light of the above analysis, this article argues that the need for a legislative reform in this area of law is necessary, which prompts the proposal to apply the statutory derivative regime under the CA 2006 to LLPs. As a result of the challenges faced by the courts when applying the common law rule in *Foss* and its "fraud on the minority" exception, it is evident that a legislative amendment of the statutory regime to include LLPs is required, which may mitigate the complexities and uncertainties surrounding the common law rule that have been reiterated in a number of cases. As Milman pointed out:

"This need to revert to the discredited common law is an unfortunate position for the law to be in—it would make much more sense if Pt 11 of the Companies Act 2006 were to be applied to LLPs".[118]

The proposal to extend the statutory regime to LLPs lies on the overarching imperative of doing justice to minority members of an LLP, allowing them to seek for an effective remedy that could redress any wrongdoings caused to the LLP by the majority members. Although this article proposes a legislative reform to apply the statutory regime to LLPs, it acknowledges that the proposal presents both advantages and potential drawbacks. On the positive side, implementing the statutory regime applicable for companies under sections 260 to 264 of the CA 2006 could create a consistent legal framework, as it will align LLPs with the derivative action process used for companies, along the same line it was done with the unfair prejudice remedy. This could lead to a uniformity of the criteria the courts should consider when determining whether permission for derivative actions should be allowed for both LLPs and companies. As both the judiciary and the legal professionals are already familiar with the

[118] Milman, "A review of developments in partnership law 2017", 3.

statutory derivative action criteria applicable for companies, adopting a similar legal framework for LLPs could help to reduce uncertainties in the applicability of the law on derivative actions to LLPs.

In addition, not abolishing the common law derivative action for LLPs could lead to unjust results due to the difficulties in addressing the complexities and uncertainties of the common law rule in *Foss* and its requirements under the "fraud on the minority" exception. As the policy behind *Foss* was to bar minority shareholders from initiating a derivative action, by applying the statutory regime to LLPs, this could provide a better avenue for redress and access to justice for members of an LLP. It is thus evident that the common law derivative action applicable for LLPs has posed significant challenges for minority members seeking to initiate derivative actions on behalf of the LLP. Applying the statutory regime to LLPs will reduce reliance on cases which have been decided over a period of 150 years and which are, in practice, outmoded and inaccessible. There is therefore a need for a more modern and accessible criteria for LLPs, along the same lines with companies, when seeking relief via the derivative action route.

As LLPs continue to gain prominence in the modern commercial world with their numbers dramatically increasing,[119] having a legal framework which is modern and accessible to the current business needs may help enhance the credibility of LLPs as a viable business model. The proposal to apply the statutory regime to LLPs could thus streamline the process and remove unnecessary barriers by providing a better access to derivative actions which could bolster the effectiveness of such actions to do justice to LLPs. This sits well with the derivative

[119] As of March 2023, there have been 52,627 registered LLPs (https://www.gov.uk/government/statistics/companies-register-activities-statistical-release-2022-to-2023/companies-register-activities-2022-to-2023).

action's traditional raison d'être, which is to "prevent a wrong going without redress".[120] Therefore, by not applying the statutory regime to LLPs, this would dismiss the effectiveness of derivative actions to provide justice for minority members of LLPs.

On the other hand, while the proposal has its potential advantages, it also has its drawbacks. As it has already been mentioned above, one of the primary concerns is that, although LLPs share similar characteristics with companies, they have fundamentally different structures and governance mechanisms. The current statutory regime as it is, cannot be directly applicable to LLPs as it contains provisions that have been exclusively designed with the corporate structure in mind. For example, in comparison to the directors of companies,[121] it has been decided in *F&C Alternative Investments (Holdings) v Barthelemy*[122] that members of an LLP do not automatically owe fiduciary duties to the LLP. In determining the existence of a fiduciary obligation to the LLP, it is necessary to "look at the specific roles and responsibilities arising in the particular context in question", as well as whether the member is in direct control over the affairs or property of the LLP.[123] Therefore, the position of members of an LLP is not analogous to the directors of a company, as the existence of members' duties must "be assessed having regard to the specific context created by the factual background and the contractual framework constituted by [the LLP Agreement]".[124] However, since section 6 of the LLP Act 2000 provides that every member of an LLP is an agent of the LLP, the court may accept that members, when they are acting as agents of the LLP, may owe fiduciary duties to the LLP.

[120] *Smith v Croft (No 2)* [1988] Ch 114 at 185; Reisberg, *Derivative Actions and Corporate Governance*, p.18.

[121] Companies Act 2006 ss 171-177.

[122] *F&C Alternative Investments (Holdings) Ltd v Barthelmy* [2011] EWHC 1731 (Ch), [2012] Ch 613.

[123] *F&C Alternative Investments (Holdings) Ltd v Barthelmy* at [218].

[124] *F&C Alternative Investments (Holdings) Ltd v Barthelmy* at [245].

This, of course, will depend upon the specific circumstances of the case looking upon the structure of the LLP and any agreement entered into between the members and the LLP. To eliminate this problem, it is vital to carefully draft the statutory derivative regime to acknowledge the unique nature of the LLPs and the distinction that exists between company directors and members of an LLP.

Considering the above, this article proposes the following key legislative changes, aiming to extend the applicability of the statutory regime under the CA 2006 to LLPs. The proposal does not aim to re-draft the existing statutory regime enshrined in the CA 2006, but rather to suggest the creation of an amended version of the statutory regime which will be enshrined under a new version of the Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009, along the same lines with the unfair prejudice remedy.

This could be achieved by amending section 260 to allow members of an LLP to initiate derivative actions on behalf of the LLP. For example, section 260(1) should be revised by replacing the term "company" with "LLP". The section will thus be amended to apply "to proceedings in England and Wales or Northern Ireland by a member of an LLP – (a) in respect of a cause of action vested in the LLP, and (b) seeking relief on behalf of the LLP". By doing so, a member of an LLP will be conferred with the locus standi to bring a derivative action on behalf of an LLP, as compared to the common law rule where the policy behind *Foss* was to prevent members from initiating such actions.

With regard to section 260(3), this could be adjusted by replacing the term "director" with "member". In addition, this section should preserve its original wording with regard to the causes of action, as this will broaden the type of breaches in which a member of an LLP may

be able to pursue a derivative action, as compared to the common law which follows a restrictive approach. Derivative actions for LLPs will thus be allowed to be brought "in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust". This article takes the view that this will also be in alignment with the wording used under section 1157 of the CA 2006, which is also applicable to LLPs via regulation 77 of the Limited Liability Partnerships (Application of Companies Act 2006) Regulations 2009. This section allows the courts to provide relief to a member of an LLP, wholly or in part, from liability arising due to "negligence, default, breach of duty, or breach of trust", provided the member have "acted honestly and reasonably" and ought, in all the circumstances of the case, "fairly be excused" from liability. The fact that section 1157 uses the same wording as with section 260(3) of the statutory regime, this supports the view that there is a need for a uniformity which requires to adopt the causes of action along the same lines with the directors of companies. There is no persuasive reason why the same wording of the statutory regime is used under section 1157 for relief of liability, but not when seeking to find liability. In addition, by preserving its original text, a member of an LLP will no longer be required to show "fraud on the minority" and "wrongdoer control". The inclusion of "negligence" will also allow a member of an LLP to initiate a derivative action without the need to prove that the wrongdoers have benefited from their negligence.

This article also suggests following the same approach adopted for companies under section 260(4). This will allow incoming members of the LLP to initiate derivative actions on behalf of the LLP for a cause of action that arose before or after the person seeking to initiate a derivative action becomes a member of the LLP. Although this may raise significant concerns as to whether such a provision will open the floodgates of litigation for LLPs, the evidence so far suggests that this is not the case, as the claims made for companies via the statutory regime

have not been dramatically increased.[125] It would be unfair not to allow incoming members to initiate such actions, considering the fact that membership of an LLP brings with it various rights and duties which binds all members on various internal matters concerning the LLP.[126] Using the words of Lord Grabiner when referring to the applicability of that section to companies:

"Once you buy shares, you are party to a changing contract and you derive all the benefits and rights associated with that contact. The fact that you arrive later than earlier on the scene should not in principle deprive you of the entitlement of that contractual bargain".[127]

This view seems to be supported by Milman when he argued that incoming members

"tend to get the benefit of successful management actions, and quite naturally, will suffer from past mistakes that affect the company adversely – therefore they have a legitimate right in principle to initiate derivative proceedings".[128]

As an incoming member of an LLP may be directly affected by decisions or actions occurred before becoming a member, by allowing that member to initiate derivative actions for causes

[125] David Milman, "Litigating internal disputes within companies: a summary of recent UK jurisprudence" (2023) 433 Company Law Newsletter 1, 2; Keay, "Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006", 41.

[126] Limited Liability Partnerships Act 2000 s.5(1).

[127] HL Deb 27 February 2006, vol 679, col GC13.

[128] David Milman, "The Company Law Reform Bill: statutory derivative claims and the future of shareholder protection" (2006) 13 Company Law Newsletter 1, 2.

of action that occurred before or after joining the LLP, this will empower new members to protect the LLP who will be afforded with an effective mechanism to address any past wrongdoings which may have otherwise remained unredressed.

With regard to sections 261, 262 and 264, as they are already applicable to LLPs via the CPR, it is only required to amend the term "company" with "LLP". This will allow the applicability of the procedural provisions enshrined in the CA 2006 to LLPs via the new proposed statutory regime.

This is in stark contrast with section 263 which contains substantive provisions that have been designed exclusively for companies. Although this article does not aim to embark on an enquiry to suggest a detailed structure of how section 263 should be amended, one of the key changes that need to be done is to remove any references to section 172, which is the duty for directors to promote the success of the company. Since the directors' duties under the CA 2006 do not directly apply to members of an LLP, it will make no sense to have that duty in place for LLPs. The provision should be replaced using a broader and more flexible approach that acknowledges the unique nature of LLPs. For example, the duty under "section 172" may be replaced with "the duty of good faith", a duty which is found to apply to members of an LLP. The proposed change will allow flexibility for the courts to provide guidelines on what "acting in good faith" means within the context of LLPs. This would also entail adopting the "hypothetical director"[129] test applicable for companies but in a modified version that could be

[129] *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch), [2009] 1 B.C.L.C 1. It is worth noting that the "hypothetical director" test also reflects the common law approach followed in *Airey v Cordell* [2006] EWHC 2728 (Ch) at [66], where it was held that the appropriate test for permission to continue with the derivative action was "the view of the hypothetical independent board of directors".

adjusted to consider the particular needs of the LLPs. For example, the test could be rephrased as the "hypothetical member" test which will ask the courts, when determining whether or not permission to continue the derivative action will be granted, to consider "what an independent and impartial" member would do in the particular circumstances of the case.[130]

In addition, as the concepts of authorisation and ratification are not applicable to LLPs, it is prudent to replace those concepts with tailored-made concepts that could be adopted to the needs of LLPs. Since the liability of a member of an LLP can be excluded by an LLP agreement or relieved by the court,[131] this article suggests amending section 263 to provide provisions for the courts to consider whether the cause of action arises from an act or omission, that is yet to occur or has already occurred, has been excluded or authorised by an LLP agreement via a unanimous agreement. The proposed legislative change will provide the courts with tailored-made requirements to consider whether to permit the continuance of a derivative action on behalf of an LLP. By doing so, this will provide a striking balance between safeguarding the autonomy and flexibility of LLPs with the need to provide an effective mechanism to remedy wrongdoings caused to the LLPs.

Conclusion

Undoubtedly, a legislative reform to modernise the accessibility of the law on derivative actions to LLPs is necessary, which leads the article to propose the amendment of the statutory derivative action under the CA 2006 to include LLPs. Using the words of Lord Reid, this article

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[130] Whittaker and Machell QC, *The Law of Limited Liability Partnerships*, para.14-43.

[131] Morse and Braithwaite, *Partnership & LLP Law*, p.372.

takes the view that "the law…shall be just and move with the times".[132] As LLPs have an important role to play within the modern commercial world, it is essential to ensure that they are afforded with the right means to protect themselves against any abuse of powers by the majority members. Although the proposed legislative changes should be considered with caution, this does not eliminate the importance of modernising the current law applicable for LLPs by consolidating the law on derivative actions into a statute, along the same lines with companies. This will avoid the need to revert to the restrictive approach of the common law rule in *Foss* which has, for so many years, prevented minority members from using the derivative action avenue. In principle, there is no persuasive reason why two parallel systems should exist when there is the option to consolidate the law into one piece. Although it may be argued that a legislative change may open the floodgates of vexatious litigation for LLPs, the evidence so far suggests that this is not the case due to the filtering mechanism implemented under the statutory regime which requires the permission of the courts to proceed with the claim.[133] It is not surprising that much has been written about the applicability of the common law to multiple derivative actions where similar calls for legislative amendments of the statutory regime have been made. As a result, it seems likely that this is not the end of the tunnel for LLPs.

[132] Lord Reid, "The Judge as Law Maker" (1972-1973) 12 Society of Public Teachers of Law 22, 26.

[133] Keay, "Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006", 53-54.