SHERIFF APPEAL COURT

2020 SAC (Civ) 11
GLW-CA6-18

Sheriff Principal M W Lewis
Sheriff Principal C D Turnbull
Appeal Sheriff W H Holligan

OPINION OF THE COURT

delivered by SHERIFF PRINCIPAL C D TURNBULL

in the appeal (presented by written submissions) by

C.J.C. MEDIA (SCOTLAND) LIMITED

Appellant

in the cause

KENNETH SINCLAIR on behalf of C.J.C. MEDIA (SCOTLAND) LIMITED

Pursuer and Respondent

against

GARY CLARK

First Defender

And

CJC MEDIA (UK) LIMITED

Second Defender

Pursuer & Respondent: HarperMacleod LLP
Appellant: Lefevres

3 August 2020

Introduction

[1] This is the opinion of the court to which we have each contributed.

[2] For present purposes the basic facts of this appeal are as follows. Mr Clark and Mr Sinclair are equal shareholders in C.J.C. Media (Scotland) Limited. They were the only directors. In 2013 Mr Sinclair resigned as a director. Having resigned as a director Mr Sinclair set up a company called Tactical Media Limited. In proceedings in the Court of Session (see *C.J.C. Media (Scotland) Limited* v *Sinclair* [2019] CSOH 8) it was held that in establishing and trading this company Mr Sinclair was in breach of his duties as a director of the appellant. He was ordered to pay monies to the appellant. In the current proceedings Mr Sinclair seeks remedies directed principally against Mr Clark. The vehicle to do so is the bringing of derivative proceedings.

[3] Derivative proceedings are brought under section 266 of the Companies Act 2006 ("the 2006 Act"), provision for which is made in Chapter 46 of Schedule 1 to the Act of Sederunt (Sheriff Court Ordinary Cause Rules) 1993.

[4] Section 266 of the 2006 Act is in the following terms:

> "**266 Requirement for leave and notice**
> (1) Derivative proceedings may be raised by a member of a company only with the leave of the court.
> (2) An application for leave must—
> (a) specify the cause of action, and
> (b) summarise the facts on which the derivative proceedings are to be based.
> (3) If it appears to the court that the application and the evidence produced by the applicant in support of it do not disclose a prima facie case for granting it, the court—
> (a) must refuse the application, and
> (b) may make any consequential order it considers appropriate.
> (4) If the application is not refused under subsection (3)—
> (a) the applicant must serve the application on the company,
> (b) the court—
> (i) may make an order requiring evidence to be produced by the company, and
> (ii) may adjourn the proceedings on the application to enable the evidence to be obtained, and
> (c) the company is entitled to take part in the further proceedings on the application.

(5) On hearing the application, the court may —
(a) grant the application on such terms as it thinks fit,
(b) refuse the application, or
(c) adjourn the proceedings on the application and make such order as to further procedure as it thinks fit."

[5] Ordinary cause rule 46.1 ("OCR 46.1") is in the following terms:

"**Leave to raise derivative proceedings**
(1) Where leave of the court is required under section 266(1) (derivative proceedings: requirement for leave and notice) of the Companies Act 2006 (the "2006 Act"), the applicant must lodge, along with the initial writ, a written application in the form of a letter addressed to the sheriff clerk stating the grounds on which leave is sought.
(2) Subject to paragraph (4), an application under paragraph (1) is not to be served on, or intimated to, any party.
(3) The application is to be placed before the sheriff, who shall consider it for the purposes of section 266(3) of the 2006 Act without hearing the applicant.
(4) Service under section 266(4)(a) of the 2006 Act may be given by any of the methods provided for in Chapter 5 (citation, service and intimation) and a certificate of service must be lodged.
(5) If the company wishes to be heard it must, within 21 days after the date of service of the application, lodge written submissions setting out its position in relation to the application.
(6) Subject to section 266(4)(b) of the 2006 Act, the next stage in the proceedings is a hearing at which the applicant and the company may be heard.
(7) The sheriff clerk is to fix the hearing and intimate its date to the applicant and the company.
(8) Where an application under paragraph (1) is granted, a copy of the sheriff's interlocutor must be served on the defender along with the warrant of citation."

[6] The procedure to be followed in derivative proceedings in the sheriff court was commented upon by the Inner House in *ICU (Europe) Ltd* v *Ibrahim* 2016 SLT 1182 at paragraphs [2] – [4]:

"[2] The procedure which should be followed in terms of s.266 and OCR 46.1 is clear. A written application must be lodged, addressed to the sheriff clerk, specifying the cause of action, and summarising the facts upon which the proceedings are to be based. At that stage the application is not to be served upon any party. It is then placed before a sheriff for consideration without a hearing. If the court considers that a *prima facie* case is not disclosed, it must refuse the application. If the application is not refused on such a basis, the alternative is not that the application is granted. Rather the application is

> effectively deemed to merit further consideration. At this point the applicant must serve the application on "the company" (s. 266(4)(a)) by which is clearly meant the company of which the applicant is a member and in protection of the interests of which the application has been made. At the same time, the sheriff may order the production of certain evidence, and may adjourn proceedings for that purpose. Moreover, from now on the company "is entitled to take part in further proceedings upon the application" (s. 266(4)(c)). On hearing the application the court may grant, refuse, or adjourn the application, with orders for further procedure.
>
> [3] If there were any doubt that this is the procedure to be followed in terms of s. 266, it is removed on consideration of s. 268 which makes provision for the circumstances in which the court must refuse an application or in respect of the matters which the court must take into account in reaching its decision. These include matters of fact which would be likely to be in the exclusive knowledge of the company — see e.g. s. 268(2)(d) and (e) . Ordinary Cause Rule 46.1 also clearly envisages that after service of intimation in terms of s. 266(4) (i.e. where the court has determined that there appears to be a *prima facie* case) the company may be heard on the application on giving due notice to that effect (OCR 46.1(5)) and the next stage will be a hearing at which both the applicant and the company may be heard (OCR 46.1(6)). The hearing is to be notified to the applicant and the company (OCR 46.1(7)).
>
> [4] It is noteworthy that at no stage in this process is there any entitlement for the potential defenders in the proposed derivative action to be heard. That is what one would expect, since there is no action at this stage, and the only live issue is one between the company and the members who are making the application. The only provision for notice to the defender is once an application has been granted (OCR 46.1(8)). However, once an action has been raised, it would be open to the defender to challenge the competency of the action on the basis that leave had not been granted, which is effectively what happened here in due course."

[7] The procedure set out by OCR 46.1 envisages five different stages. First, presentation of an initial writ and a letter addressed to the sheriff clerk stating the grounds on which leave is sought (see OCR 46.1(1)). This stage facilitates compliance with the requirements of section 266(2) of the 2006 Act.

[8] Second, the application is placed before the sheriff who is to consider it for the purposes of section 266(3) of the 2006 Act, without hearing the applicant (see OCR 46.1(3)).

If, at this stage, it appears to the sheriff that the application and the evidence produced by the applicant in support of it do not disclose a *prima facie* case for granting it, the sheriff must refuse the application (see section 266(3)(a) of the 2006 Act).

[9] Third, if the sheriff is satisfied that the application and the evidence produced by the applicant in support of it disclose a *prima facie* case for granting it, service on the company is ordered (in terms of OCR 46.1(4)) (see section 266(4) of the 2006 Act).

[10] Fourth, if the company wishes to be heard it must, within 21 days after the date of service of the application, lodge written submissions setting out its position in relation to the application (see OCR 46.1(5)). Thereafter, a hearing is fixed at which the applicant and the company may be heard (see OCR 46.1(6) and (7)).

[11] Fifth, at (or after) the hearing of the application, the sheriff may grant the application on such terms as he or she thinks fit; refuse the application; or adjourn the proceedings on the application and make such order as to further procedure as he or she thinks fit (see section 266(5) of the 2006 Act). OCR 46.1(8) applies where the application is granted. A copy of the sheriff's interlocutor must be served on the defender along with the warrant of citation.

[12] The terms of the court's interlocutor of 23 January 2018 are worth setting out in full:

> "The Sheriff, having considered the foregoing initial writ and the pursuer's letter dated 19th January 2018, Grants the pursuer leave to raise derivative proceedings in terms of Section 266(1) of the Companies Act 2006; Appoints the company, should it wish to be heard, within 21 days after the date of service of the application, to lodge written submissions setting out its position in relation to the application; thereafter, having considered the pursuer's motion, number 7/1 of process, and being satisfied in terms of Section 15(E)(2)(a), Section 15(E)(2)(b) and Section 15(E)(2)(c) of the Debtors (Scotland) Act 1987, Grants same and in terms thereof, Grants warrant for inhibition on the dependence of the action in terms of Section 15(E)(1) of the aforementioned Act; Assigns the 14th February 2018 at 2pm within the commercial court within the Sheriff Court House, 1 Carlton Place, Glasgow as a hearing in terms of Section 15(K) of the aforementioned act; Appoints the agent for the pursuer to intimate said hearing to the defenders by Officer of Court on a period of notice of 48

> hours and thereafter; further, Grants warrant to cite the defenders by serving upon them a copy of the Writ and Warrant on a period of notice of twenty one days and Ordains them, if they intend to defend the action or make any claim, to lodge a notice of intention to defend with the Sheriff Clerk at Sheriff Court House, 1 Carlton Place, P.O. Box 23, Glasgow within the said period of notice after such service."

[13] The action came before this court in relation to the sheriff's interlocutor of 20 December 2019 finding the appellant liable (i) to pay all expenses incurred and to be incurred by the respondent in respect of or in connection with these derivative proceedings, on an agent and client, client paying basis so far as those expenses are incurred up to and including the diet of proof before answer allowed; and (ii) to indemnify the respondent against all awards of expenses made against him in the said proceedings up until the said hearing, unless and to the extent that the Court otherwise orders, on an application by the appellant in these proceedings prior to the said hearing. The sheriff reserved to the appellant the right to apply in these proceedings for an order as aforesaid in the event of a material change in circumstances; and to the respondent the right to apply in this action for a similar order in respect of subsequent stages of the derivative proceedings. The sheriff granted permission to appeal against the interlocutor of 20 December 2019.

[14] Parties were agreed that the appeal would proceed by written submissions, standing the Covid-19 pandemic. Although the appellant made passing reference to the interlocutor of 23 January 2018 in their Note of Argument, neither party fully addressed the issue as to (a) whether the interlocutor of 23 January 2018 was incompetent; (b) if so, the effect on subsequent procedure; and (c) what orders the court should make. We invited parties to make submissions on these issues.

Submissions on competency

[15] The pursuer and respondent maintained that, whilst the sheriff had departed from the procedure outlined in OCR 46, the interlocutor of 23 January 2018 was competent. He drew attention to the fact that the present proceedings are a commercial action and the provisions of OCR 40 consequently apply. OCR 40.3(1) permits the sheriff to make such order as he or she thought fit for the progress of the case insofar as not inconsistent with the other provisions of Chapter 40 of the Ordinary Cause Rules. The pursuer and respondent argues that such flexibility was essential in the context of derivative proceedings in the sheriff court. To construe the provisions otherwise would have the effect of seriously undermining the administration of justice and the efficacy of derivative proceedings. The pursuer and respondent observed that in granting leave in *ICU (Europe) Ltd* the Inner House did not adhere strictly to the statutory process or to OCR 46. The company was not a party to the Inner House appeal. The decision of the Inner House in *ICU (Europe) Ltd* demonstrated that there is sufficient flexibility in the procedure for a pragmatic approach to be taken.

[16] The appellant submitted that the interlocutor of 23 January 2018 was not competent because the sheriff had no power to grant leave at the stage he purportedly did. Further the requirement for the court to grant leave represented an essential control on use of derivative proceedings by minority shareholders to prevent abuse of the procedure. The procedure set out in the 2006 Act is required in order to ensure that the company is heard and that the court is fully informed as to the circumstances of the case before leave is granted. The sanction of the court for the proceedings, granted in accordance with the prescribed procedure, is an essential requirement of initiating such proceedings. The statutory procedure was not followed in the present case in that the sheriff granted leave to bring

proceedings when the application was received by the court; before the application had been served on the company; and without giving the company the opportunity to be heard on the application. Given that these specific steps of procedure are required by statute, it followed that the sheriff had no power to grant leave on 23 January 2018 and that the purported grant of leave was incompetent.

Discussion - competency

[17] In a question of competency, the fact that the action was a commercial one, governed by the provisions of Chapter 40 of the Ordinary Cause Rules, is immaterial. It will be noted that whilst the procedure envisaged by what we have referred to as the first and second stages of the process was followed, the procedure required by section 266 of the 2006 Act and OCR 46.1 was then departed from. Most notably, the company was deprived of its statutory right to take part in the proceedings (see section 266(4)(c) of the 2006 Act) by way of the lodging of written submissions (see OCR 46.1(5) and being heard at a hearing (see OCR 46.1(6)) prior to the application being granted. The interlocutor of 23 January 2018 is an incompetent one.

[18] Having reached that conclusion, the additional arguments advanced by the pursuer and respondent which pertain to it fall to be considered. The pursuer and respondent contends that the interlocutor could have been appealed at the time by the company or by either of the defenders. It was not. Further, the interlocutor of 23 January 2018 is a procedural interlocutor which has been acted on by all parties and has formed the basis of these proceedings. The pursuer and respondent contends that the interlocutor is final by implication and not open to review by this court, notwithstanding the terms of section 116(2)

of the Courts Reform (Scotland) Act 2014. The pursuer proceeded in good faith upon the interlocutor of 23 January 2018 and neither the company nor the defenders have sought to challenge that interlocutor at any time; whether by lodging answers as the company was entitled to do, or by seeking to appeal. It would be unconscionable and an affront to procedural fairness if the interlocutor of 23 January 2018 was now open for review.

[19] Questions of competency are *pars judicis*. In the course of considering the written submissions made relative to the appeal the court identified the issue of competency set out above. The fact that the point was not raised by one of the parties is immaterial. The attempt by the pursuer and respondent to categorise the interlocutor of 23 January 2018 as a procedural one is misconceived. The procedure to be followed is laid down by statute. The grant of leave is an essential pre-requisite for derivative proceedings; it is not a procedural nicety. The subsidiary arguments advanced on behalf of the pursuer and respondent are without merit.

Submissions on retrospective leave

[20] The pursuer and respondent invites the court to grant leave of new on the basis that the materials and submissions on the merits already before the court plainly demonstrate that it would be appropriate to do so having regard to section 268 of the 2006 Act. That is especially so given the stage the action has reached. The pursuer and respondent does not accept that the appellant had ceased to trade.

[21] The arguments for the appellant against the retrospective grant of leave can be summarised as follows. A director seeking to promote the success of the company would not seek to raise or continue the present proceedings. The appellant says that it is not trading and has no intention of resuming trading. In terms of section 172(1)(f) of the

2006 Act there is a duty to act fairly as between members of the company. The members of the company are Mr Sinclair and Mr Clark only. A disinterested director would not pursue the current proceedings. The appellant was, in reality, a "quasi-partnership" with each of Mr Sinclair and Mr Clark owning an equal share of the company. When Mr Sinclair set up Tactical Media Limited he did so in direct competition with the business of the appellant and was successful in diverting the pharmacy contract from the appellant to Tactical Media Limited. Proceedings in the Court of Session have determined that, in so doing, Mr Sinclair breached his duty as a director of the appellant. The behaviour of Mr Sinclair in setting up Tactical Media Limited resulted in a substantial loss of business to the appellant.

[22] The appellant's argument leads to the conclusion that Mr Sinclair could resign as a director whilst still remaining a member of the appellant and continue to compete for the same business through the medium of Tactical Media Limited. It was not fair to require Mr Clark to continue the business of the appellant for the benefit of Mr Sinclair, leaving Mr Sinclair free to pursue his interests. A disinterested director, having regard to the nature of the business, would conclude that it was fair as between Mr Sinclair and Mr Clark that the appellant ceased trading and for both Mr Sinclair and Mr Clark to be free to compete with their new businesses. There are significant risks that the litigation will fail either in whole or in part. It is a matter of evidence that the appellant's total accumulated profit post-2013 is likely to be a few thousand pounds at most. It is highly unlikely the appellant will ever see any significant recovery from the present action. If any monies were recovered, Mr Sinclair would be entitled to deduct his expenses before remitting them to the appellant. The net result is that unless the action is entirely successful the result may be the insolvency of the appellant. Furthermore, Mr Sinclair's conduct in pursuing the interests of Tactical Media

Limited do not suggest that he wished the appellant's business well or that he was concerned about the success of the appellant's business.

[23] In terms of section 268(2)(e) of the 2006 Act the appellant has decided not to raise proceedings. That is consistent with the appellant's submission as to the conduct of a disinterested director in relation to the pursuit of these proceedings. So far as section 268(2)(f) of the 2006 Act is concerned, Mr Sinclair has not taken any steps to either wind up the appellant or to recover the value of his share in the appellant's business. As the business is not trading that is the only way in which its value could be realised. Mr Sinclair would be entitled to bring a petition under section 994 of the 2006 Act on the grounds that the appellant was being managed in a manner unfairly prejudicial to him. That has not been done. It is an alternative remedy that is open to Mr Sinclair. In substance, the present situation arises from the breakdown of the relationship between Mr Sinclair and Mr Clark.

Discussion – retrospective leave

[24] Having concluded that the interlocutor of 23 January 2018 is incompetent the issue is what then should be done. Whether the court could grant leave retrospectively was raised, but not decided, in *ICU (Europe) Limited*. The matter was more fully considered in *Wilton UK Limited* v *Shuttleworth* [2018] Bus LR 258. In that case the court concluded that it did have jurisdiction to grant leave retrospectively. Parties were in agreement that if the interlocutor of 23 January 2018 was held to be incompetent it was none the less open to this court to grant leave to bring the derivative proceedings retrospectively. We shall proceed upon the basis that the court does have jurisdiction to grant leave. We have taken account of the materials placed before the court and submissions on the merits made on behalf of the appellant and on behalf of the pursuer and respondent.

[25] Section 268 of the 2006 Act sets out the test to be applied as to the granting of leave:-

> "(1) The court must refuse leave to raise derivative proceedings on an application under section 267 if satisfied –
>
> (a) that a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to raise or continue the proceedings (as the case may be)…
>
> (2) In considering whether to grant leave to raise derivative proceedings on an application under section 267, the court must take into account, in particular –
>
> (a) whether the member is acting in good faith in seeking to raise or continue the proceedings (as the case may be),
>
> (b) the importance that a person acts in accordance with section 172… would attach to raising or continuing them (as the case may be),
>
> …
>
> (e) whether the company has decided not to raise proceedings in respect of the same cause of action or to persist in the proceedings (as the case may be)
>
> (f) whether the cause of action is one which the member could pursue in his own right rather than on behalf of the company."

[26] Leaving aside the question as to whether or not the appellant is still trading, it appears that there is certain common ground between the parties. Until 2013, both Mr Clark and Mr Sinclair were directors of the appellant; there appear to be no other directors. Each had an equal share holding. In 2013, whilst still a member of the appellant, Mr Sinclair set up Tactical Media Limited in direct competition with the appellant. In so doing it has been determined judicially that he breached his duty as a director of the appellant. He has been ordered to pay money to the appellant. Indeed, it would appear that these funds may be the only funds available to the appellant in satisfying the indemnity for expenses made in favour of Mr Sinclair which gave rise to this appeal. Mr Sinclair and Mr Clark were in what was described as a quasi-partnership together. Both Mr Clark and Mr Sinclair appear to have established new companies to undertake similar business to that of the appellant.

[27] These proceedings have been in dependence for some time now and it might be said that they should be allowed to continue on that ground alone. However, it appears to us

that, had the correct procedure been adopted at the outset, there would have been a very real issue as to whether Mr Sinclair was entitled to the grant of leave to raise derivative proceedings. We are not persuaded that when one considers all the features of this matter that this is a suitable case for a grant of leave. Put shortly, the commercial reality is that this was a business in which each of the two directors and members had an equal share and an equal say. It is plain that by 2013 the relationship was irrevocably damaged and, in effect, each director went on to pursue other, albeit similar, commercial interests. In setting up and operating Tactical Media Limited, Mr Sinclair was in breach of his duties to the appellant. It had adverse consequences for the appellant. The grant of leave to one of the members, coupled with an order for indemnity for expenses, is to privilege one of the two members at the expense of the other; it creates an unfairness and an imbalance.

[28] In terms of section 268 of the 2006 Act, the court must refuse leave to raise derivative proceedings if it is satisfied that a person acting in accordance with section 172 of that Act (the duty to promote the success of the company) would not seek to raise or continue the proceedings (as the case may be). In the whole circumstances, we have reached the conclusion that a disinterested director would not seek to raise (or continue) these proceedings. We have had regard to whether Mr Sinclair was acting in good faith in seeking to raise the proceedings. We are not satisfied that he was, particularly when one considers the decision reached in the Outer House (see paragraph [2] above). The appellant decided not to raise proceedings in respect of the same cause of action. Whilst Mr Sinclair could not pursue the proceedings in his own right, rather than on behalf of the company, we have regard also to the fact that it remains open to him to commence proceedings in terms of section 994 of the 2006 Act. We shall refuse the motion of the pursuer and respondent to grant leave retrospectively.

Disposal

[29] We shall allow the appeal; recall the sheriff's interlocutor of 20 December 2019; and dismiss the action. We shall reserve the question of expenses (in relation to both the appeal and the proceedings generally) meantime and invite parties to make submissions thereon within 14 days.