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By

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The Continuing Paradox: A Critique of Minority Shareholder and Derivative Claims Under the Companies Act 2006

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 Derivative actions; Derivative claims; Directors' powers and duties; Minority shareholders

Introduction

“Of the two parts . . . of a paradox, both are often true, and yet, when proved to be true, may continue paradoxical.” Horsley, Bp. Samuel, Sermon 369 (1811).

A continuing paradox underlies statutory codification of minority shareholder derivative claims and directors' duties following the Companies Act 2006 (CA 2006). The most significant changes include codification of directors' duties in plain English, a new duty to promote the company's success, and improved rights to shareholders; but is this more of the same (but different) as the Government asserted,¹ or a seismic shift in shareholders' rights? Will this supposed clarification instead herald an outbreak of increased actions by shareholders willing and now more able to challenge directors' decisions, due to liberalisation of the derivative claim?

The days of the apathetic shareholder are numbered. The growth in the number of cases of shareholder activism in recent years in the United Kingdom reflects the increasing willingness of investors to intervene in the day-to-day control, strategy and management of UK public companies.²

Simplification and modernisation exemplify the “think small first” philosophy fostering business, but the gargantuan Act imposes new expanded duties and codified regimes, whilst aiming to incorporate the old law. This critique examines the extent to which these apparently dissonant themes are reconcilable.

*jpaulsykes@levisolicitors.co.uk. The author expresses thanks to reviewers of previous drafts, especially Charles Stevens of De Montfort University, School of Professional Legal Studies. The law and procedure stated is believed to be up to date to April 2009.

¹ Margaret Hodge, Ministerial Statement (then Minister of State for Industry and the Regions), “Duties of Company Directors: Companies Act 2006” (DTI, June 26, 2007), <http://www.dti.gov.uk/bbf/co-act-2006/index.html> [Accessed January 16, 2010] (issued by DTI, replaced by BERR).

² Alex Kay, Tom Platts, Harsh Kumar, “Shareholder Activism, How it Works” (November 2007) I.F.L.R. 54.

Directors' duties and the range of those owing them are widened. The grounds of derivative claims, formerly restricted by the narrowly applied rule in *Foss v Harbottle*,³ are expanded to include mere negligence and breach of regulatory duties. Notwithstanding objectives of simplicity and assisting business, uncertainty abounds, including fears of increased claims and bureaucracy.

Before specifically addressing derivative claims and directors' duties, it is worth highlighting the behemoth that is the Companies Act 2006, ostensibly enacted to remove red tape, provide flexibility and simplicity for business and the economy.⁴ Whilst never intended to be a consolidating Statute, its protracted evolution through Parliament has produced only a partly-realised leviathan. An example of the paradox is how the Government's "think small first"⁵ mantra has produced reputedly the longest ever Act of Parliament, with 1,300 sections (arranged in 47 Parts), 16 Schedules and a deluge of guidance and statutory instruments.

The then Secretary of State Alistair Darling said:

"This Act will help ensure Britain remains one of the best places in the world to set up and run a business. It makes sure the regulatory burden on business is 'light-touch', promotes shareholder engagement and will help encourage a long-term investment culture in the UK."⁶

The "simplified: company law regime is now governed by:

- the Companies Act 1985;
- the Companies Act 1989;
- the Companies (Audit), Investigations and Community Enterprise Act 2004;
- the Companies Act 2006.

That legislation only deals with companies that are going concerns. Regarding insolvent companies, applicable legislation includes the following:

- the Insolvency Act 1986;
- the Insolvency Act 2000;
- the Enterprise Act 2002;
- the Company Directors Disqualification Act 1986;

³ "The rule in *Foss v Harbottle* (1843) 2 Hare 461 is that in general where a wrong (whether a breach of contract or a tort) is done to a company, only the company may sue for the damage caused to it; a shareholder has no right to bring an action on behalf of the company in order to protect the value of his shares." *George Fischer (Great Britain) Ltd v Multi Construction Ltd* [1995] B.C.C. 310 CA (Civ Div) at 315; [1995] 1 B.C.L.C. 260, per Glidewell L.J.

⁴ "Our reforms rest on four key objectives: Enhancing shareholder engagement and a long-term investment culture; Ensuring better regulation and a Think Small First approach; Making it easier to set up and run a Company and; Providing flexibility for the future." <http://www.dti.gov.uk/bbf/co-law-reform-bill/index.html> [Accessed January 16, 2010].

⁵ "Think Small First", published in 2001 by the Small Business Service (DTI) provides the framework, "to focus first on the needs of small companies. . . there should be an 'integrated approach'".

⁶ Secretary of State Alistair Darling, DTI Press Release, November 9, 2006, <http://www.dti.gov.uk/bbf/co-act-2006/index.html> [Accessed January 16, 2010].

- the two Insolvency Acts of 1994;
- extensive delegated legislation.

There were great expectations of the reforms to;

“Redefine. . . the company for the first time in 150 years. . . create a balance between companies’ rights and responsibilities. . . oblige directors to take responsibility for their companies’ environmental and social impacts, report on these impacts and for all affected communities to have fair rights of redress.”⁷

Also, “[p]roviding flexibility for the future. . . Deregulation. . . to save business up to £250 million a year—including £100 million for small businesses”.⁸ Some cautioned, “estimating direct savings is a very difficult thing to do. . . the costs of familiarisation and compliance are frequently higher than anticipated”.⁹

A company registered before the existing legislation applies is an “existing company”. A “company” is one registered under the new Act.¹⁰ There will therefore be two parallel universes for directors, shareholders, other stakeholders and practitioners to grapple with. Describing this as “simplification” is paradoxical.

Overview

The “simple high level guidance” issued by the DTI¹¹ contended that the new statutory duties are “essentially the same” as the common law, whilst also representing a cultural change in the way that directors carry out their duties.¹²

This begs the question: if statutory codification equates to simplification, why is such a preponderance of explanation, clarification and guidance required?¹³ Various aspects of CA 2006, including s.260¹⁴ do capture a cultural change; the conflict is that formerly, the “best interests” of a company were often

⁷ Sarah McCarthy-Fry MP and Baroness Thornton letter, *Financial Times*, May 10, 2006.

⁸ DTI website, May 3, 2006, <http://www.dti.gov.uk/files37956> [Accessed January 16, 2010].

⁹ G. Peel et al., “Directors’ Duties and the Company Law Reform Bill” (2006) *Einstein Network* 1750.

¹⁰ CA 2006 s.1.

¹¹ “Duties of Company Directors: Companies Act 2006” (DTI, June 26, 2007), <http://www.dti.gov.uk/bbf/co-act-2006/index.html> [Accessed January 16, 2010].

¹² “Duties of Company Directors: Companies Act 2006” (DTI, June 26, 2007), <http://www.dti.gov.uk/bbf/co-act-2006/index.html> [Accessed January 16, 2010].

¹³ “Despite the recent comment and guidance, there remains considerable uncertainty about the meaning of certain aspects of the new law and its practical implications.” Clifford Chance, Corporate Update, “Directors’ Duties and Derivative Actions” (Special Client Briefing September 2007).

¹⁴ CA 2006 s.260:

- “(2) A derivative claim may only be brought
- (a) under this Chapter, or
 - (b) in pursuance of an order of the court in proceedings under section 994 (proceedings for protection of members against unfair prejudice).

regarded as inimical to the concerns of society at large.¹⁵ That definition has now been replaced by “success”, namely whatever is in the interests of the shareholders.¹⁶

A director must “have regard” to a series of potentially conflicting factors in promoting the success of the company for the benefit of its members (CA 2006 s.172).¹⁷ What constitutes “success” is not specified, as to whether this might be the profitability of the company for its members, long term increase in value, or other considerations. The new approach is intended to be complementary; however there is an inherent tension, which should be embraced in reconciling the paradoxical claims made by the Act’s proponents.

Inevitably, the many interdependent new provisions will influence how the courts balance competing demands and claims brought by shareholders under the new legislation. The Government’s desire to introduce a statutory statement of directors’ duties derives largely from the findings of the independent Company Law Review Steering Group in their successive reports.¹⁸ Arising out of their 2001 *Final Report*, the new duties are “based on” the existing duties,¹⁹ and regard should be had to the “corresponding” law when applying the new duties²⁰ CA 2006 s.170(4). However, during debates on this aspect, the Government conceded that the duty to promote the company’s success was a “radical” change to the status quo.

- (3) . . .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 by a director of the company.”

¹⁵ *Smith & Fawcett Ltd, Re* [1942] Ch. 304. Directors must act in good faith in the “best interests” of the company, (company’s present and future members).

¹⁶ Lord Goldsmith, *Hansard*, HL Vol.678, cols GC255–6 (February 6, 2006):

“What is success? The starting point is that it is essentially for the members of the company to define the objective they wish to achieve. Success means what the members collectively want the company to achieve. For a commercial company, success will usually mean long-term increase in value.”

¹⁷ CA 2006 s.172:

“(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –

- (a) the likely consequences of any decision in the long term,
- (b) the interests of the company’s employees,
- (c) the need to foster the company’s business relationships with suppliers, customers and others,
- (d) the impact of the company’s operations on the community and the environment,
- (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
- (f) the need to act fairly as between members of the company.”

¹⁸ Company Law Review Steering Group, *Modern Company Law for a Competitive Economy; The Strategic Framework* (February 1999), URN 99/654; *Developing The Framework* (March 2000), URN 00/656; *Completing The Structure* (July 2001), URN 01/942; and the *Final Report*, URN 01/943.

¹⁹ CA 2006 s.170(3).

²⁰ CA 2006 s.170(4).

Numerous new developments affect the potential exposure of directors to claims from disaffected shareholders, including under CA 2006 s.172.²¹ The perception of such increased exposure to litigation may have wide-ranging effects, from the willingness of individuals to accept appointment as directors, to the likely impact on directors' and officers' insurance (D&OI).

The enhanced business review²² for quoted companies, and corporate social responsibility (CSR) enshrined in CA 2006 s.172, are evolving concepts. Ministers contended that codifying directors' duties reflects a common sense approach, developing CSR. These objectives are laudable, but concerns remain whether the Government underestimated the impact of litigation to enforce shareholders' rights and the possible opening of floodgates to derivative claims, perhaps pursued by aggrieved individuals, pressure groups, hedge funds, or others with a less than conventional concern with the "best interests" of the company:

"Deep-pocketed hedge funds could be encouraged to take action to apply pressure on company boards to implement the sorts of strategy required to produce the high returns their investors demand. Shareholder pressure groups concerned about the environment might exploit the wider duties described in CA 2006 to force companies to act in a more socially or environmentally responsible way."²³

Particularly in private limited companies, there is no ready market for sale or transfer of shares; the articles restrict the transferability of shares due to the close interdependence and active participation of the shareholders. The courts have recognised this with the development of case law based on the specific issue of close companies that may be analogous to quasi-partnerships. This background explains the interface between equitable concepts of fidelity, fiduciary duties and reasonable expectations, otherwise absent in the contractarian or proprietary relationship between members, which are governed primarily by the articles.

The entitlement to bring a derivative claim has been interpreted restrictively, hence cases are relatively rare. The balancing exercise necessary between upholding the autonomy of the company through majority rule, and ensuring that individual members are not treated unfairly or their rights abused is a universal issue, inviting a variety of approaches.

Unfair prejudice petitions

Improving redress for shareholders was a primary objective of CA 2006, by putting derivative claims on a statutory footing. Previously however,

²¹ See fn.17, above, for text of CA 2006 s.172.

²² For inclusion in the annual directors' report (CA 2006 s.417) to provide information to members and help them assess the performance of the directors in fulfilling their duty to promote the success of the company.

²³ Partick Beale, "Directors Beware?" (2007) 157 N.L.J. 1033.

a disgruntled shareholder had three potential courses of court action; the common law derivative claim, the unfair prejudice petition,²⁴ and the winding-up on just and equitable grounds.²⁵ It will be instructive to see the new statutory derivative action combining with these differing—but potentially complementary—provisions, and indeed with the new statutory codification of director’s duties, and how the court balances the competing considerations.

“Unfairly prejudicial conduct” is a concept that avoided accommodating the strictures of the derivative action, covering a wider sweep of conduct than the narrowly defined “fraud on the minority” or “oppression”, and s.459 was intended to have a broader application.²⁶ Excluding a minority shareholder from management in a quasi-partnership company may constitute unfairly prejudicial conduct sufficient to justify a winding up on grounds of unfair prejudice.²⁷ The development of CA 1985 s.459 had already lowered the threshold, “enabling the court in an appropriate case to outflank the rule in *Foss v Harbottle* was one of the purposes of the section”.²⁸

However, derivative claims were very limited, arising in narrow circumstances, where something was taken from the company, for example, directors could arrange for ratification of a secret profit by a simple majority, further militating against claims progressing. Lord Hodgson contended at the final committee stage of the House of Lords that the existence of s.459 was another reason why the codification of derivative claims was unnecessary:

“[T]here is already a working method whereby aggrieved shareholders can exercise their rights. If this codification goes ahead, the Bill should not muddy the waters with such a reference to Section 459, which is a stand-alone procedure unrelated to derivative claims.”²⁹

The prevalence of CA 2006 s.994 “unfair prejudice” in relation to quasi-partnership companies rather than listed companies is likely to continue. This is due to informal arrangements common in “close companies” giving rise to the legitimate expectations of the shareholders for their participation in the management of the company. In listed companies however, the court’s approach will usually be that the “legitimate expectations” of members are

²⁴ CA 1985 s.459 (originally s.210 of CA 1948) now CA 2006 s.994 permits a shareholder to petition the court on the basis that his interests have been unfairly prejudiced in the conduct of the company’s affairs due to, e.g. breach of: the articles of association, the shareholders’ agreement (SHA), or fiduciary duties by directors, and exclusion from the running of the company in small quasi-partnership companies. The court has wide discretion to grant such relief as it deems fit, commonly an order that the petitioner’s shares are purchased for “fair value”, which may include a premium on the actual value of the shares as recompense to the petitioner for the wrongdoing.

²⁵ IA 1986 s.122(g) provides that any shareholder may apply to have a company wound up on just and equitable grounds including in quasi-partnerships, involving the shareholder’s right to manage the company—*Ebrahimi v Westbourne Galleries Ltd* [1973] A.C. 360 HL; [1972] 2 W.L.R. 1289; [1972] 2 All E.R. 492. The sole remedy here of winding up is draconian, available only in specific circumstances.

²⁶ *R&H Electric Ltd v Haden Bill Electrical Ltd* [1995] B.C.C. 958 Ch D; [1995] 2 B.C.L.C. 280.

²⁷ *Cumana Ltd, Re* [1986] B.C.L.C. 430 CA (Civ Div).

²⁸ *Saul D Harrison & Sons Plc, Re* [1994] B.C.C. 475; [1995] 1 B.C.L.C. 14, per Hoffinan LJ.

²⁹ Lord Hodgson of Astley Abbots, *Hansard*, HL Vol.679, col.GC3 (February 27, 2006).

limited to compliance with the memorandum and articles, and that the shareholders are not tied in, but may sell their shares as they wish.³⁰

Background

As recommended by the Law Commission, the statutory derivative claim replaces that arising in common law, thereby providing for development by the courts of a coherent legal framework arising exclusively out of CA 2006 Pt 11. The Government contended that there was no great paradigm-shift and there should be no increase in derivative actions,³¹ avoiding, “opening a Pandora’s box to every disenchanted individual in the country”³² whilst ensuring that shareholders could bring legitimate claims.³³ Business should not be inhibited by unmeritorious or speculative claims.³⁴

The derivative action was a tried and tested procedure, the “proper plaintiff rule” ensuring that the claim was pursued on behalf of and any damages awarded to the company, rather than the individual shareholder. Furthermore, the claimant, whilst not benefiting from any award of compensation, would not only have to fund their own claim (on behalf of the company) from the outset, but would also be exposed to the serious risk of being ordered to pay the opponents’ costs.³⁵

The Government sought to allay fears about directors being exposed to frivolous or vexatious claims, by enhancing the court’s supervisory function and underlining the directors’ primary duty as the promotion of the success of the company for the benefit of the members as a whole.³⁶

Directors’ duties

Before examining the scope of the new derivative claim in detail, it is essential to review the other element of what was colourfully described as a “double whammy” against directors.³⁷ Hitherto, directors’ duties were set out in 250 years of accumulated case law with, “considerable confusion amongst directors. . . three quarters thought that directors’ duties were difficult to understand”.³⁸ Now, for the first time there is a statutory code to which directors must turn in considering their duties.

³⁰ *Astec (BSR) Plc, Re* [1999] B.C.C. 59; [1998] 2 B.C.L.C. 556.

³¹ Lord Hodgson of Astley Abbots, *Hansard*, HL Vol.679, col.GC4-5 (February 27, 2006).

³² Lord Sharman, *Hansard*, HL Vol.681, col.885 (May 9, 2006).

³³ Lord Hodgson of Astley Abbots, *Hansard*, HL Vol.679, col.GC4-5 (February 27, 2006).

³⁴ Lord Hodgson of Astley Abbots, *Hansard*, HL Vol.679, col.GC6 (February 27, 2006).

³⁵ HC Official Report, *SC D (Company Law Reform Bill)*, col.665 (July 13, 2006).

³⁶ Lord Goldsmith, *Hansard*, HL Vol.678, cols GC255-6 (February 6, 2006). See text at fn.16.

³⁷ Lord Hodgson of Astley Abbots, *Hansard*, col.GC2 (February 27, 2006): “In Part 10, directors’ duties are widened, while Part 11 makes it easier for shareholders to commence actions against directors. There is concern.”

³⁸ Patricia Hewitt speech, July 5, 2002, Cambridge Faculty of Law, <http://www.guardian.co.uk/business/2002/jul/05/politics.economicpolicy1> [Accessed January 28, 2010].

Pursuant to CA 2006 s.172 a duty is imposed on directors to promote the success of the company and to “have regard” to an array of considerations.³⁹ The purported failure of directors to take such factors in to account, or give them appropriate weight, could afford shareholder activists the means to object to directors’ decisions. This could constitute a derivative claim being, “used to seek judicial review, in effect, of a commercial decision of management”.⁴⁰

A director must act in good faith and “have regard” to a series of six potentially conflicting factors in promoting the success of the company for the benefit of its members as a whole.

Factors in CA 2006 s.172⁴¹ include the long-term consequences of the decision, interests of employees, relationships with others,⁴² community and environmental impact, reputation for high standards of business conduct and fairness between members. Although this echoes s.309 of CA 1985, specifically in relation to employees, the prospect of such stakeholders enforcing rights under CA 2006 s.172 is, if anything, diluted and the reforms are only superficial changes in the presentation of directors’ duties, whilst the wording of the Act allows directors to pay:

“[L]ip service to the factors listed in s172. . .the requirement to consider these additional six factors will make very little difference to how boards make decisions.”⁴³

Enlightened shareholder value

The expansion of the simple duty to act in the best interests of the company is a concept known as “enlightened shareholder value” (ESV)⁴⁴ which, viewed from certain perspectives, constitutes a further dramatic development.⁴⁵ Further complications surround ESV: in discharging the duty to promote the success of the company, a director must (so far as reasonably practicable) “have regard” to all of these Pt 10 Ch.2 factors in every decision, even if a factor is plainly irrelevant and if it would be outweighed by other matters. This list is not exhaustive, but illustrative of areas reflecting expected responsible business behaviour.

³⁹ See fn.17, above, for text of CA 2006 s.172.

⁴⁰ B. Hannigan, “The Derivative Claim—An Invitation to Litigate?” in *The Companies Act 2006—A Commentary* (London: Butterworths, 2007), Ch.4, para.4.13.

⁴¹ See fn.17, above, for text of CA 2006 s.172.

⁴² In June 2007 at the Tesco AGM, shareholders demanded a resolution under CA 1985 s.376 (broadly replicated by CA 2006 s.338) regarding the working practices of some of their foreign clothes manufacturers; Alex Kay, Tom Platts, Harsh Kumar, “Shareholder Activism, How it Works” (November 2007) I.F.L.R. 54.

⁴³ Daniel Attenborough, “Recent developments in Australian corporate law and their implications for directors’ duties: lessons to be learned from the UK perspective” 18(9) I.C.C.L.R. 207, 318.

⁴⁴ Company Law Reform White Paper, March 2005.

⁴⁵ “[T]he ESV approach is not dependent upon any change in the ultimate objective of companies, shareholder wealth maximisation”; *Modern Company Law for a Competitive Economy: The Strategic Framework*, URN 99/654 (February 1999), para.5.1.17.

There is no effective guidance on what “have regard to” means, or how a director can properly “have regard” to something without a suitably comprehensive investigation. It could be argued that no director can consider the relevance of a matter without actually having “regard to” it. There are rafts of matters enacted, to which regard must be had by a director in reaching a decision. Directors must:

- act in accordance with the company’s constitution and use their powers for the purpose for which they are conferred (s.171);
- simultaneously have regard to the interests of creditors where insolvency threatens (s.172.3);
- exercise independent judgment (s.173);
- act with reasonable care, skill and diligence. The standard is the higher of the skill actually possessed, or that objectively expected of such a director (s.174);
- avoid conflicts of interest and conflicts of duty (s.175);
- not accept benefits from third parties in circumstances where there might be a conflict of interest or duty (s.176);
- disclose their interest in any proposed transaction or arrangement (s.175).

The Government claimed the Act, “simply codifies the existing common law obligations of company directors”⁴⁶ whilst simultaneously contending, “ESV marks a radical, historic and vital cultural change in the way our companies conduct their business”.⁴⁷ As a Shadow Minister for Corporate Governance wryly noted, “please take your pick of interpretations. . . such confusion cannot be good for business”.⁴⁸

Codification

Although concise, constituting a simple and readily accessible guide for directors, the new general duties also remarkably incorporate the equivalent common law duties. The civil consequences of breach are the same as at common law.⁴⁹ The new duties therefore encompass the full body of relevant English case law. This could detract from the *raison d’être* for codifying directors’ duties, extending the paradox: if the statutory duties are not self-standing, the scope of directors’ duties is in fact neither clarified nor made more accessible.⁵⁰

⁴⁶ “Duties of Company Directors: Companies Act 2006” (DTI, June 26, 2007), <http://www.dti.gov.uk/bbf/co-act-2006/index.html> [Accessed January 16, 2010].

⁴⁷ “Duties of Company Directors: Companies Act 2006” (DTI, June 26, 2007), <http://www.dti.gov.uk/bbf/co-act-2006/index.html> [Accessed January 16, 2010].

⁴⁸ Jonathon Djanogly MP, January 2, 2008, <http://www.companylawforum.co.uk> [Accessed January 16, 2010].

⁴⁹ CA 2006 s.178.

⁵⁰ G. Peel et al., “Directors’ Duties and the Company Law Reform Bill” (2006) *Einstein Network* 1750.

Practically however, codification does provide some assistance to directors, expressed in accessible terms indicating factors to weigh up and where further consideration should be given.

There are also benefits from drafting the Act in this way, avoiding the same conduct otherwise being subject to similar but slightly differing statutory and common law duties. Hence, links between the statutory duties and their common-law embodiments maintain the flexibility of judicial interpretation, thus avoiding interpretation of directors' duties becoming a matter purely of statutory construction.

Whilst these objectives are admirable, they are not straightforward. In practice, company directors are already selected by the members for their ability to balance many factors in fulfilling their role. The most likely effect of these provisions, coupled with Pt 11 of the Act relating to derivative claims, is to invite increased litigation against company directors, for example, on the grounds that a party has suffered loss because one of the six factors was not properly taken into account.

The duties are not definitive; they are an indication of areas for consideration. The concern is however, irrespective of inconsistencies inevitable in laborious efforts at "simplification", litigation may (at least temporarily) be boosted against directors, on the basis that they have not sufficiently "had regard to" the various factors.

Balancing exercise

A balancing exercise will doubtless be required, but this is open to continuing uncertainty. Conflicts will have to be resolved in accordance with the director's judgment, exercising reasonable skill and care in good faith.

The Government has asserted that its amendments "put beyond doubt" that the director's duty to "have regard" to certain factors:

"[I]s subject to the overriding duty to act in the way he considers, in good faith would be most likely to promote the success of the company for the benefit of its members as a whole."⁵¹

However, this is not what the Act says, and the Act gives little genuine practical guidance.

What exactly does the s.172 "success of the company" mean in practice?⁵² For example, what "success" is a company director required to promote in the following situations: on payment of a dividend; where he is director of a parent or subsidiary company; where the company has no objects; on deciding valuation criteria in transactions between connected companies; in a takeover, or a solvent winding up?

⁵¹ "Duties of Company Directors: Companies Act 2006" (DTI, June 26, 2007), <http://www.dti.gov.uk/bbf/co-act-2006/index.html> [Accessed January 16, 2010].

⁵² See fn.17, above, for text of CA 2006 s.172.

On the one hand, CA 2006 suggests that, since the duty under s.170(3) was derived from common law, common-law principles should be used to interpret the duty. Conversely, the wording of the new duty is clearly different, and so arguably a different concept, which should be interpreted in a different way.

CA 2006 derivative claim

Uncertainty which exists regarding the newly codified directors' duties will inevitably be exacerbated by reform of the derivative claim. At common law, the derivative claim was a procedure developed by the courts as an exception to the rule in *Foss v Harbottle*.⁵³ Under the Act, the relatively tried and tested "fraud on the minority" and "control of the wrongdoer" concepts have now been jettisoned in favour of a general discretion for the court to decide whether to allow an application to proceed at an obligatory initial "leave" stage. Breach of almost any duty or "mere negligence" is potentially actionable, and statutory codification of directors' duties expands the scope for derivative claims.

The duty to promote the success of the company,⁵⁴ the duty to avoid conflict (CA 2006 s.175), and the potentially very broad obligation not to accept benefits from third parties (CA 2006 s.176) all extend the scope for derivative claims.

The rationale for extending derivative claims to "mere negligence" was expounded by the Law Commission on the basis that although shareholders inevitably take the risk that directors may make mistakes, this did not extend to directors ignoring or acting in breach of their duties.⁵⁵ Negligence, to be actionable, no longer has to be self-serving.⁵⁶

Inclusion of "default" within CA 2006 s.260(3)⁵⁷ envisages alleged breaches of statutory duties founding derivative claims, for example transactions with directors where the approval of members is required.⁵⁸

The radical change is that under the Act, "fraud" by a director (or an approximation) is no longer a prerequisite; all that is required to gain a foot in the door is a "mere" breach of duty, trust or negligence—actual or proposed.

Shadow directors

The claim may be brought against the director concerned, or against another, or both, providing it arises out of the act or omission of the director. Thus, claims arising out of a director's negligence, if implemented through or with the assistance of a third party, such as the company's auditor, could be pursued

⁵³ *Foss v Harbottle* 67 E.R. 189 Ch D; (1843) 2 Hare 461.

⁵⁴ See fn.17, above, for text of CA 2006 s.172.

⁵⁵ Law Commission Shareholder Remedies (1997), Law Com.No.246, para.6.41.

⁵⁶ *Palvades v Jensen* [1956] Ch. 565 Ch D; [1956] 3 W.L.R. 224; [1956] 2 All E.R. 518.

⁵⁷ See fn.14, above, for text of CA 2006 s.260.

⁵⁸ CA 2006 Ch.10 Pt 4.

by an aggrieved member against the accomplice. This constitutes another extension to the derivative claim, where the third party has participated in the director's breach of duty by providing knowing assistance, or has knowingly received property, in breach of trust.

The duties owed by directors are also owed by former directors and "shadow directors"; someone, "in accordance with whose directions or instructions the Board is accustomed to act".⁵⁹ Although there are relatively few authorities, a shadow director is one who exercises, "real influence over the majority of board members"⁶⁰ although this does not have to extend to subservience.⁶¹

*Ultraframe (UK) Ltd v Fielding*⁶² provides that generally a shadow director owes no duties, unless for example a special responsibility was assumed regarding a particular asset. This is a duty imposed by the common law or a fiduciary duty arising out of a particular asset. However, under CA 2006, all duties owed by a director can apply to a shadow director. The practicalities remain unpredictable, given the absence of authorities, but it is axiomatic that liquidators will look for someone to sue when a company collapses.

Given the various extensions in directors' duties and liabilities, and widening of the class of persons covered, practical questions arise regarding the majority shareholder's vulnerability. If money was invested in a property speculation, will the majority shareholder be susceptible to being treated by the court as a shadow director? Did they approve or decline funding? Private funders and possibly venture capitalists could therefore fall in to the trap of becoming "shadow directors". What would happen to them on insolvency? This is tempered by such funders commonly requiring a directorship. Following *Deverell*,⁶³ per Morritt J., a "nod and a wink" can amount to an "instruction". A management consultant,⁶⁴ a parent company,⁶⁵ and a "stakeholder"⁶⁶ have all been held to be shadow directors. A bank could be a shadow director, although as yet there has been no reported example.⁶⁷

Notwithstanding the list of matters which must be taken into account by directors, their discretion is very broad. Superficially it may seem that the new statutory derivative claim is an "invitation to litigate",⁶⁸ but it is by no means clear that derivative claims will become more common as a forum for disaffected members to expose contentious decisions to public and judicial scrutiny. The expanded grounds and the widened criteria, encompassing

⁵⁹ See now CA 2006 s.170(5), the same "puppet master" equivalent definition in insolvency under IA 1986 s.251, and Company Directors Disqualification Act 1986 s.22(5).

⁶⁰ *Unisoft Group Ltd (No.3), Re* [1994] B.C.C. 766 Ch D; [1994] 1 B.C.L.C. 609. In *Lord v Sinai Securities Ltd* [2004] EWHC 1764 (Ch); [2004] B.C.C. 986 this was, "at least a consistent majority".

⁶¹ *Secretary of State for Trade and Industry v Deverell* [2001] Ch. 340 CA (Civ Div); [2000] 2 W.L.R. 907.

⁶² *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch); [2006] F.S.R. 17.

⁶³ *Deverell* [2001] Ch. 340 CA (Civ Div).

⁶⁴ *Tasiban Ltd (No.3), Re* [1991] B.C.C. 435; [1991] B.C.L.C. 792 Ch D.

⁶⁵ *Hydrodam (Corby) Ltd, Re* [1994] B.C.C. 161; [1994] 2 B.C.L.C. 180 Ch D.

⁶⁶ *Deverell* [2001] Ch. 340 CA (Civ Div).

⁶⁷ *PFTZM Ltd, Re* [1995] B.C.C. 280; [1995] 2 B.C.L.C. 354 Ch D.

⁶⁸ B. Hannigan, "The Derivative Claim—An Invitation to Litigate?" in *The Companies Act 2006—A Commentary* (London: Butterworths, 2007), Ch.4, para.4.13.

the “double whammy”,⁶⁹ must be examined in the context of the new court procedures, and the inherent system of judicial supervision, to gain an appreciation of how these new provisions may be controlled.

CA 2006 procedure

The Act introduces a new two-stage procedure for a claimant to obtain leave to pursue a derivative action.⁷⁰ First an ex parte application is made to court for consideration of the shareholder’s evidence only; the claim should be struck out if a prima facie case is not established, and the court can make an appropriate order for costs.⁷¹ If the claim survives, prior to commencement of the substantive action, the second stage of the filtering process is consideration by the court of the company’s evidence. The court is accordingly given control of the action at an early stage, by way of special procedural discipline and judicial “case management”.⁷²

The written evidence in support of the application for permission to proceed is made pursuant to CPR r.19.9A(2).⁷³ There has been criticism as to the lack of scrutiny exercised by the courts in allowing derivative claims to proceed at this initial stage, supported by inadequate written evidence, due to reluctance to suppress such claims:

“Obliged to decide the issue on inadequate evidence, the Courts have been much too willing to permit the continuation of derivative claims in circumstances that are far from exceptional,”⁷⁴

resulting in companies being deprived of the protection otherwise provided by the rule in *Foss v Harbottle*. However, elsewhere the courts have insisted that permission is not automatically granted, and judicial control must be effective at all stages of the derivative proceedings.⁷⁵

There were attempts to impose a precondition that before seeking to commence derivative proceedings a shareholder must give a minimum of 28-days’ prior notice, citing the grounds relied on in support, to afford the company the chance to correct the position.⁷⁶ Similarly, an amendment to the Bill was proposed whereby a derivative claim could only be brought if the directors had refused to commence proceedings.⁷⁷

However, the Government’s aim was to prevent any diversion that would be entailed in effectively allowing introduction of the “wrongdoer control” test, which may cause delay and frustrate a legitimate claim.⁷⁸ CA 2006 s.263(3)

⁶⁹ Lord Hodgson of Astley Abbots, *Hansard*, col.GC2 (February 27, 2006), quoted above at fn.37.

⁷⁰ Civil Procedure Rules 1998 (SI 1998/3132) r.19.9.

⁷¹ CA 2006 s.261(2).

⁷² Civil Procedure Rules 1998 (SI 1998/3132) r.19.9.

⁷³ Civil Procedure Rules 1998 (SI 1998/3132) r.19.9.

⁷⁴ Reed, “Derivative Claims: The Application for Permission to Continue” (2000) 21 Co. Law 156.

⁷⁵ *Portfolios of Distinction Ltd v Laird* [2004] EWHC 2071 (Ch); [2004] 2 B.C.L.C. 741.

⁷⁶ Law Commission Consultation Paper No.142 (1996), para.16.15.

⁷⁷ HC Official Report, *SC D (Company Law Reform Bill)*, cols 660,672 (July 13, 2006).

⁷⁸ *Hansard*, HL Vol.679, cols GC7–8 (February 27, 2006).

referred to under “Court permission” below, was preferred as the mechanism by which the court would be able to exercise control in giving consideration to a wide variety of matters, including whether the company had refused to bring proceedings. Rather than imposing specific thresholds it was preferred that the courts should have the opportunity to gradually develop case law over a period of time,⁷⁹ under CPR r.19.9(4).

Court permission

Pursuant to CA 2006 s.261, the court considers solely the written evidence lodged by the claimant. CA 2006 s.263 sets out what the court must take in to account, subs.(3) is a novel way of expressing whether permission will be refused, introducing a new range of matters at (a)–(f). There are countervailing pressures on the one hand emancipating the derivative claim, whilst otherwise introducing a new range of fetters:

- (a) good faith;
- (b) importance in continuing the claim attached under s.172⁸⁰;
- (c) act/omission yet to occur and likely to be: (i) authorised before; or (ii) ratified after;
- (d) where already occurred, whether likely to be ratified;
- (e) whether the company has decided not to pursue the claim;
- (f) cause of action could be pursued by a member in own name.

Good faith: section 263(3)(a)

As noted by Hannigan, “the vulture hedge fund and the opportunistic shareholder may have difficulty in meeting this good faith requirement”.⁸¹ There will inevitably be significant interplay between the various subsections in examining whether the shareholder is acting in good faith, in the interests of promoting the success of the company, and what the views of independent shareholders may be.⁸²

The Australian experience indicates that the courts may consider two sides of the same coin in examining “good faith”, first enquiring as to the claimant’s genuine belief that there are good grounds for complaint, and secondly whether the claimant has a selfish interest in bringing the action that would constitute an abuse of process.⁸³

⁷⁹ *Hansard*, HL Vol.679, col.GC22 (February 27, 2006).

⁸⁰ See fn.17, above, for text of CA 2006 s.172.

⁸¹ B. Hannigan, “The Derivative Claim—An Invitation to Litigate?” in *The Companies Act 2006—A Commentary* (London: Butterworths, 2007), Ch.4, para.4.69.

⁸² Payne, “‘Clean Hands’ in Derivative Actions” (2002) C.L.J. 76, 81.

⁸³ Ramsay and Saunders, “Litigation by Shareholders and Directors: An Empirical Study of the Australian Statutory Derivative Action” (2006) 6 J.C.L.S. 397, 427, 442–433.

Section 263(3)(b)

Similarly, under CA 2006 s.263(3)(b), leave must be refused if a person acting in accordance with s.172 would not pursue the claim.⁸⁴

The cumulative effect of CA 2006 s.263 is that the court must have regard to the various combinations of interest within the company, in particular the views of independent members ((4)), “the company” ((3)(e)), and independent directors ((3)(b)).

However, as referred to under “Unfair prejudice petitions” above, the CA 1985 s.495 route has been favoured by aggrieved minority shareholders, in preference to the common law derivative claim, which had become, and notwithstanding the new statutory procedure, may remain reduced to:

“[A]lmost a legal footnote. . . Nothing. . . would suggest any change in that position and the fundamental attraction of CA 2006, s994—a personal remedy for the Claimant—remains an overwhelming justification for taking that route rather than bringing a derivative claim.”⁸⁵

Now that the derivative claim has been put on to a statutory footing, the courts may be less willing to blur the distinction with personal remedies. On the one hand, petitioners under CA 2006 s.994 seeking a personal remedy, whose complaints are based on breaches of fiduciary duty by directors, or where a remedy is being pursued on behalf of the company, may be redirected to the new statutory mechanism for bringing a derivative claim, and required to satisfy the two stage qualifying criteria, including the non-exclusive factors to be considered under CA 2006 s.263.

Conversely, the courts may wish to prevent extension of the derivative claim, and instead encourage shareholders to pursue claims on a personal basis under CA 2006 s.994. This stance may prevail in the average OMB (owner-managed business) dispute or quasi-partnership company, but if such complainants were excluded from the derivative claim jurisdiction to be dealt with instead solely via personal remedies, that could render the new statutory derivative action otiose.

There has been no clear indication as to how the courts will resolve these issues, and for example in *Clark v Cutland*⁸⁶ a petitioner was entitled to an indemnity order under CA 1985 s.461 where the relief sought was for the good of the company.⁸⁷ However, elsewhere the claimant has been refused leave to proceed with a derivative claim on the basis that the situation was equivalent to dissolution of a partnership.⁸⁸ This inherent paradox remains key to practically reconciling such conflicting themes.

⁸⁴ See fn.17, above, for text of CA 2006 s.172.

⁸⁵ B. Hannigan, “The Derivative Claim—An Invitation to Litigate?” in *The Companies Act 2006—A Commentary* (London: Butterworths, 2007), Ch.4, para.4.80.

⁸⁶ *Clark v Cutland* [2003] EWCA Civ 810; [2003] 2 B.C.L.C. 393 at 406.

⁸⁷ Payne, “Shareholder’s Remedies Reassessed” (2004) 67 M.L.R. 500; Payne, “Sections 459–461 Companies Act 1985 in Flux: The Future of Shareholder Protection” (2005) C.L.J. 647.

⁸⁸ *Mumbray v Lapper* [2005] EWHC 1152 (Ch); [2005] B.C.C. 990.

Views of members: section 263(4)

Where ratification or authorisation has not taken place, and there has been no decision by the company declining to pursue the derivative claim, a further hurdle is consideration of the views of the independent shareholders.⁸⁹ If shareholders unconnected with the director in breach were against proceedings continuing, considerable weight should be afforded to their independent opinions.⁹⁰ How this class of independent shareholders whose views would be so influential is to be established remains unclear, particularly in widely held companies, as does the means by which soundings of their opinions would be taken, or evidence obtained.⁹¹ These radical provisions need to be examined whether advising minority shareholder, or directors.

It is doubtful whether the *prima facie* test will present a significant hurdle, and the courts are likely to permit most cases to proceed to the second stage. However, the Commonwealth experience of statutory derivative claims is potentially illustrative as to the likely developments in the United Kingdom. Cheffins observed that in Canada the courts would generally permit claims to pass beyond the initial leave stage if the claimant had raised reasonable *prima facie* issues which ought to be addressed, with no determined effort to weed out claims at the preliminary stage.⁹²

If the provisions of CA 2006 s.261(2) are not met (where the claimant's evidence in support does not disclose a *prima facie* case for permission), the action is dismissed without involving the company.

Future conduct

If the court allows the case to pass through the *prima facie* stage, directions will be given for the future conduct of the proceedings,⁹³ including the evidence to be served by the company, and an adjournment, which would also afford the company the opportunity to seek authorisation or ratification of the act complained of, which would then constitute a bar on the matter proceeding further.⁹⁴

The company can always apply to have the case struck out under CPR r.3.4, where there is no reasonable cause of action, the claim is an abuse of process, or there has been a breach of procedure. Yet, due to the court's general discretion, companies defending such claims at the initial leave stage may feel obliged to justify the decision, rather than answering the narrow question of why the complainant should not be granted leave to continue.

⁸⁹ *Hansard*, HL Vol.681, col.888 (May 9, 2006).

⁹⁰ *Smith v Croft (No.2)* [1988] Ch. 114; [1987] 3 All E.R. 909 at 957.

⁹¹ Law Commission Shareholder Remedies (1997), Law Com.No.246, paras 6.88–6.89.

⁹² Cheffins, "Reforming the Derivative Action: The Canadian Experience and British Prospects" [1997] CF.L.R. 227, 244.

⁹³ CA 2006 s.262(4).

⁹⁴ CA 2006 s.263(2)(b),(c).

Ratification

Leave will be refused if the act or omission has *actually* been ratified or authorised by the company, as in either case this operates as a complete bar to the claim proceeding.

This further extends the scope of derivative proceedings, because, “even if there has been no formal ratification, it is not possible for a minority shareholder to bring a common law derivative claim” if the conduct was *capable* of being approved of by the majority of the shareholders.⁹⁵ If the act complained of is capable of ratification or authorisation, proceedings would be adjourned to afford the majority this opportunity.⁹⁶

Any board of directors notified of a derivative claim should examine whether the independent members of the company would ratify the act or omission being challenged. Taking into account who the parties are, the directors may constitute a subcommittee of the board to address the claim.⁹⁷

Under CA 2006 s.263(4) permission to continue a derivative claim must be refused if the court is satisfied that someone acting in accordance with the overriding duty⁹⁸ would not seek to continue the claim. The court will consider the views of disinterested shareholders. There is a delicate balancing act for the court to fulfil its crucial role; claims, “will be struck out if there is no decent basis for them”.⁹⁹

Whilst there may be a risk that consideration of extensive factors could become prolonged, this has not been the case for example in Australia, where applications for leave have generally been disposed of in one or two days.¹⁰⁰

Concerns

CA 2006 is revolutionary in that it is no longer necessary for a member to prove any fraud in bringing a derivative claim, merely negligence, default, breach of duty, or breach of trust (s.260(3)).¹⁰¹ The fetters historically provided by the requirement for a fraud on the minority and wrongdoer control have also been superseded. Furthermore, the rules on ratification and authorisation have been revised such that directors can no longer vote to approve or ratify their own misconduct, although that would have been allowed at common

⁹⁵ V. Joffe et al., *Minority Shareholders: Law, Practice & Procedure*, 3rd edn (Oxford University Press, 2008), p.6, citing *Edwards v Helliwell* [1950] 2 All E.R. 1064, and see *Burland v Earle* [1902] A.C. 83 at 93.

⁹⁶ CA 2006 s.261(3), (4).

⁹⁷ Rosalind Nicolson, “Rights and Wrongs—Shareholders and the Companies Act 2006” (Jan 2008) 2045 *Einstein Network*, Company Law.

⁹⁸ See fn.17, above, for text of CA 2006 s.172.

⁹⁹ *Hansard*, col.841 (May 9, 2006).

¹⁰⁰ Ramsay and Saunders, “Litigation by Shareholders and Directors: An Empirical Study of the Australian Statutory Derivative Action” (2006) 6 J.C.L.S. 397, 427, 442–433.

¹⁰¹ See fn.14, above, for text of CA 2006 s.260.

law.¹⁰² These developments all expand the grounds for bringing a claim, whilst reducing the possibility of authorisation or ratification.

There is the potential for anti-business results, such as the possibly inhibiting effects of expanded directors' duties, coupled with increased availability of the derivative claim and the perceived increasing litigiousness of the consumer rights society and the "compensation culture" impinging on the sanctity of the company's "best interests". The spectre of US-style class actions, exacerbated by contingency fees, and pursuit of investors' rights through litigation is feared; rather than, "discreet market exit. . . derivative actions are merely another mechanism for holding under-performing directors to account".¹⁰³

A contrary view is that activist investors perform an increasingly valuable function, "simply trying to maximise business performance and margins for and on behalf of themselves and other investors".¹⁰⁴ Despite fears that these factors could discourage the appointment of directors in public or private companies, and inhibit the enterprise culture, there is no evidence to support such alarm. However, the impact of the new regime is heightened because, as described under "Shadow directors" above, all new duties owed to the company by directors are also now owed by shadow directors.¹⁰⁵ Shareholders or liquidators can enforce these duties. The scope of the derivative claim has therefore dramatically widened on several fronts simultaneously. Formerly, derivative claims were rare because the criteria were so restrictive, and CPR Pt 19 was a further efficient filter. Nevertheless, initial signs show the courts are not changing their traditional pragmatic approach.

Recent cases

There has been no proliferation of derivative claims, and the courts have not particularly encouraged them.¹⁰⁶ The expedient stance on permission to proceed prevails:

In *Airey v Cordell*¹⁰⁷ the minority shareholder claimant began a derivative claim and, as required by CPR r.19.9(3), sought the court's permission to continue. Warren J. held that the test to be applied was whether a reasonable independent board could decide that it was appropriate to bring proceedings. The court should not impose its own view of how the board ought to proceed. Only if no reasonable board would bring proceedings should the court refuse to sanction the bringing of the shareholder's derivative claim. However, there was no indication as to how in practice the court could discern the views of the

¹⁰² CA 2006 s.239.

¹⁰³ B. Hannigan, "The Derivative Claim—An Invitation to Litigate?" in *The Companies Act 2006—A Commentary* (London: Butterworths, 2007), Ch.4, para.4.13.

¹⁰⁴ Alex Kay, Tom Platts, Harsh Kumar, "Shareholder Activism, How it Works" (November 2007) I.F.L.R. 54.

¹⁰⁵ CA 2006 s.170(5); see discussion at fn.59.

¹⁰⁶ *High Street Capital Ltd v Tchigimsky (No.2)* [2005] EWHC 1897 (Ch); [2006] B.C.C. 209.

¹⁰⁷ *Airey v Cordell* [2006] EWHC 2728 (Ch); [2007] Bus. L.R. 391.

theoretical independent board. The absence of definitive common law criteria meant that upon commencement of a derivative claim, neither party would be able to predict whether it would proceed beyond the leave stage. The court was concerned not to shut out the minority shareholder on the basis of the court's possibly inadequate assessment of the case at this stage. The proceedings were temporarily stayed to allow negotiations to take place.

This pragmatic approach was echoed in *Callard v Pringle*¹⁰⁸ the Court of Appeal agreed that there was insufficient to determine whether a fair offer had been made to buy out the minority shareholder's shares. As such, there was a triable issue. It was appropriate for the judge to have ordered that the matter be stayed for eight weeks for the parties to attempt mediation.

Although it has been widely anticipated that implementation of the statutory derivative claim would promote an increase in the number of such actions, the more frequently utilised shareholders' remedy of "unfair prejudice"¹⁰⁹ has been endorsed recently in two cases of persuasive authority in the domestic courts, and which may increase the reliance upon s.459 petitions.¹¹⁰

In *O'Donnell v Shanahan*¹¹¹ the traditional expedient approach was maintained, on appeal, the claimant's petition under CA 1985 s.459 was remitted for determination as to whether the claimant was unfairly prejudiced.

*Franbar Holdings Ltd v Patel*¹¹² was one of the first reported cases involving consideration of the new statutory derivative action, the court refusing leave to continue under CA 2006 s.261. The claim had survived the mandatory test adopted by the court, where leave would be refused if a person acting in compliance with s.172¹¹³ would not pursue the claim. Under the discretionary test, the importance that the hypothetical director envisaged by s.263(2)(a) would attach to continuing the claim has next to be considered. The judge examined a wide range of factors when assessing the importance of whether to continue with the claim, including: prospects of success, likelihood of recovery, disruption, cost and risk of harm in the event of failure.

It was held that whilst there was substance to the complaints, and there may have been breaches of duty prohibiting ratification, there was still "work to be done" in advancing a sustainable claim. It was feasible that a hypothetical director would decline to continue with a derivative claim at this stage. It was possible that he may do so in the future, but this was outweighed by the existence of three sets of proceedings where the complaints were similar, including a claim for breach of the SHA, and a s.994 petition through which the company should be able to achieve its objectives.

Accordingly the balancing exercise necessary to achieve justice was best served by declining permission to proceed. There was room for more than one view, and directors might have to take decisions on only a partially informed

¹⁰⁸ *Callard v Pringle* [2007] EWCA Civ 1075; [2007] All E.R. (D) 91.

¹⁰⁹ CA 2006 s.994; see discussion at fn.24.

¹¹⁰ *Chime Corp Ltd* (2004) 7 H.K.C.F.A.R. 546; *Gamelestad AB v Baltic Partners Ltd* [2007] UKPC 26; [2007] 4 All E.R. 164.

¹¹¹ *O'Donnell v Shanahan* [2009] EWCA Civ 751.

¹¹² *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] B.C.C. 885.

¹¹³ See fn.17, above, for text of CA 2006 s.172.

basis. This case is probably restricted in its wider relevance by the coextensive actions, but emphasises the relative ascendancy of the s.994 petition, with the courts unlikely to go out of their way to encourage derivative claims, at least where there are other options.

Leave to proceed was also refused in *Mission Capital Plc v Sinclair*.¹¹⁴ The court considered the damage claimed “somewhat speculative” and held that the hypothetical director would not regard pursuing the claim as particularly important:

“The statutory derivative action may now be less complicated and unwieldy; however, the priority for the Court still remains avoiding killing the company by kindness. Successful claims may be few and far between.”¹¹⁵

Continuing paradox

With the Act extending the circumstances in which a shareholder can bring a derivative claim, there is now no prerequisite that delinquent directors control the majority of the company’s shares. The modernised procedure may be attractive to disgruntled shareholders, dispensing with the common law limitations, and avoiding the unstructured unfair prejudice action under the old CA 1948 s.459.

It will be some time before a consistent approach is developed by the courts, however, despite the liberalising of the derivative claim and expansion of directors’ duties, there are likely to be sufficient brakes via the two-stage leave process, and other considerations to prevent the courts being inundated with American levels of claims. Also, US contributing factors such as enthusiasm for class actions, contingency fees and damages recovered by the claimant are absent domestically.

These factors therefore, and perhaps needless fears regarding the associated “entrepreneurial litigation” and “tools of extortion”,¹¹⁶ rather than any realistic cross-over impact on UK derivative claims that has prompted concerns in the United Kingdom. They are misplaced, particularly whilst “the English rule” that the loser pays prevails, coupled with the barring of contingent fee arrangements.

Nevertheless, despite the Government asserting that the grounds for bringing an action have not changed, only the procedure, this does not bear scrutiny. The combined liberalisation of derivative claims, extension of director’s duties and other factors including the cultural shift of ESV¹¹⁷ mean there will inevitably be some impact as the new regime beds down. cursory inspection

¹¹⁴ *Mission Capital Plc v Sinclair* [2008] EWHC 1339 (Ch); [2008] B.C.C. 866.

¹¹⁵ Bill Davies, “Codified Obstacles” (2008) N.L.J. 1409.

¹¹⁶ Peta Spender, “Securities Class Actions: A View from the Land of the Great White Shareholder” (2002) 31(2) C.L.W.R. 123.

¹¹⁷ *Modern Company Law for a Competitive Economy: The Strategic Framework*, URN 99/654 (February 1999), para.5.1.17, quoted above at fn.45.

of the sample plain English duties reveals that breaches by directors will be difficult to avoid, even if superficially only “technical”. There is likely to be continued uncertainty and ramifications on reporting and insurance, and in relation to contractual requirements and indemnities.

Derivative claims may become more common, at least in the short term, as the new regime is tested. Providing a forum for disaffected members to expose contentious decisions to public and judicial scrutiny or publicity, is progressive, however it is not clear that the potential fallout has been understood, as it was never intended that the courts would be second-guessing board room business decisions.

Shackles loosened

The shackles on derivative claims have now been loosened. As a result, there is a clear risk that multiple stakeholders might seek to advance their own agendas, at the expense of companies’ and directors’ time, money, stress, and claims upon their D&OI:

“It seems inevitable that, in the short term, more derivative claims will be brought to test the new regime. Single issue groups are likely to claim directors are in breach of duty for not considering (possibly irrelevant) factors in their decisions. . . . There will be some cases where this is a positive development and will lead to greater accountability of directors. However, there is also a risk that it creates a climate in which shareholders may be encouraged to raise potential arguments (characterized as negligence claims) in order to explore an issue publicly or to apply pressure to management.”¹¹⁸

Elsewhere, the concern was that:

“It is a real possibility that a member, having scrutinised the business review, decides that the directors have breached their duty to promote the success of the company and seeks to bring a derivative action as a result.”¹¹⁹

This was the fear of the opposition in Committee in the House of Lords:

“In practice, derivative claims are exceedingly rare. It has been put to us that this codification, if passed as currently worded, will have the minimal positive benefit of modifying a rarely used piece of law while having the damaging and far more significant effect of increasing shareholder litigation and reducing the number of people willing to take directorships.”¹²⁰

¹¹⁸ Alex Kay, Tom Platts, Harsh Kumar, “Shareholder Activism, How it Works” (November 2007) I.F.L.R. 54.

¹¹⁹ “The new approach to directors’ duties and key changes”, <http://www.semplefraser.co.uk> [Accessed December 31, 2008].

¹²⁰ Lord Hodgson of Astley Abbots, *Hansard*, col.GC3 (February 27, 2006).

However, there remain significant disincentives to shareholders bringing a derivative claim.

Disincentives

The position on costs in relation to statutory derivative claims remains unchanged from the common law, by which a minority shareholder with a reasonable bona fide claim may be indemnified as to costs by the company where the company would benefit from the claim.¹²¹ An abusive majority needs to be restrained, but how can a minority shareholder be encouraged in the fulfilment of such corporate governance objectives?

“He has nothing to gain, but much to lose. He feels strongly that a wrong has been done—and that it should be righted. But he does not feel able to undertake it himself. Faced with an estimate of the costs, he will say; ‘I am not going to throw away good money after bad’. Some wrongdoers know this and take advantage of it. They loot the company’s funds knowing there is little risk of an action being brought against them.”¹²²

This dilemma was resolved by the Court of Appeal introducing a new procedure whereby the minority member claimant may be granted an indemnity for their costs at the conclusion of the trial, provided they acted reasonably in bringing the claim, even if it was unsuccessful. In Lord Denning’s view:

“[A] *prima facie* right of indemnification by the company arose ‘on the plainest principles of equity’ whether the action was successful or not.”¹²³

Although this possibility is also provided for in the CPR,¹²⁴ the expectation that the claimant may benefit from a costs order is hardly guaranteed, and may be restrictively applied.¹²⁵ At the initial leave stage, the claimant may typically include an application for an indemnity costs order.¹²⁶ This will have complemented the principles behind the original *Wallersteiner* costs order, in that a claimant bringing proceedings for the ultimate benefit of the company ought not to have to fund it, whatever the outcome.

However, there has been confusion and inconsistency in the court’s approach; on the one hand, the merits of the case have been brought in to play at the initial leave stage, resulting in increase in expenditure and delay, approaching the “mini-trial” which was to be avoided; the means of the claimant were also to be examined, on the basis that the company

¹²¹ *Wallersteiner v Moir (No.2)* [1975] 1 Q.B. 373; [1975] 2 W.L.R. 389 CA (Civ Div).

¹²² *Wallersteiner v Moir (No.2)* [1975] 2 W.L.R. 389 CA (Civ Div) at 400.

¹²³ *Wallersteiner v Moir (No.2)* [1975] 2 W.L.R. 389 CA (Civ Div) at 403-404.

¹²⁴ CPR r.19.9E(1).

¹²⁵ *Smith v Croft (No.1)* [1986] 1 W.L.R. 580 Ch D; [1986] 2 All E.R. 551; *Mumbray v Lapper* [2005] EWHC 1152 (Ch); [2005] B.C.C. 990.

¹²⁶ CPR r.19.9(7).

should not have to bear the additional financial burden of funding an action where the wealth of the claimant meant that there was no genuine need.¹²⁷ This perpetuates the uncertainty and costs exposure for a potential claimant, rather than encouraging unmeritorious claims. The lack of any more definitive ground rules for a presumed grant of indemnity costs in the new legislation leaves open the judicial flexibility relied on to discourage unmeritorious claims, whilst also in deserving cases facilitating, “the Court’s ultimate intention to deter directors’ wrongdoing by enforcing this tool of the corporate governance system”.¹²⁸

So that the company is bound by the outcome of the derivative claim, it must be joined as a defendant,¹²⁹ as must the parties whose conduct is complained of. As such, there remains a risk that a shareholder personally commencing a derivative claim will not only have to fund their own costs, but if unsuccessful, face an order to pay several other parties’ costs.

It has also been observed that by front-loading costs, the procedure is designed to discourage speculative claims:

“Perhaps the most useful consequence is that this will minimize the initial expense that a company need incur if a potential derivative claim obviously lacks merit.”¹³⁰

However, given the extraordinary pressures, costs and publicity that a derivative claim would entail, it would be perhaps a sanguine board that would choose to limit its input at the second stage of the leave process; the temptation would be to marshal all potential arguments against the claim proceeding any further.

Coupled with the fact that the claimant will not receive compensation, whatever the outcome,¹³¹ it is difficult to see how the possibility of a costs indemnity would realistically encourage unreasonable or vexatious derivative claims.¹³² On the contrary, Reisburg suggests that funding such claims is problematic, and that this will remain a disincentive to derivative claims, unless for example American class actions or contingency fee agreements are permitted in the United Kingdom.¹³³ Reisburg has previously argued that only if claimants were granted individual reward or an element of compensation would there be any substantive incentive to the launch of derivative claims by shareholders.¹³⁴

Conversely, the defendant director whose conduct is complained of can have his costs paid by the company, although these must be repaid if the action

¹²⁷ *Smith v Croft (No. 1)* [1986] 1 W.L.R. 580 Ch D; [1986] 2 All E.R. 551; *Mumbray v Lapper* [2005] EWHC 1152 (Ch); [2005] B.C.C. 990.

¹²⁸ Quigxiu Bu, “The indemnity order in a derivative action” (2006) 27(1) *Comp. Law* 2.

¹²⁹ *Spokes v Grosvenor Hotel Co* [1897] 2 Q.B. 124 CA (Civ Div).

¹³⁰ Dov Ohrenstein, “Derivative Action” (2007) N.L.J. 1372, 1373.

¹³¹ *Spokes v Grosvenor Hotel Co* [1897] 2 Q.B. 124 CA (Civ Div).

¹³² Official Report (5th series) HL 679, col.GC13 (February 27, 2006).

¹³³ Arad Reisburg, “Derivative Actions and the Funding Problem: The Way Forward” [2006] J.B.L. 445.

¹³⁴ Reisburg, “Funding Derivative Actions: A re-examination of costs and fees as incentives to commence litigation” (2004) 4 J.C.L.S. 345, 380.

against the director is successful.¹³⁵ Furthermore, D&OI would be in place in larger companies covering legal costs and liability for derivative claims.

Survey

The *Legal Week/EJ Big Question* survey 2007 (“UK firms poised to reap rewards of class action litigation upswing”)¹³⁶ found that 36 per cent of respondents identified shareholder claims as the area where the biggest increase in class actions would occur. 279 UK commercial law firm partners answered the survey. However, this does not reveal any anticipated escalation in shareholder claims attributable to CA 2006, compared with the previous survey published in *Legal Week* on July 15, 2004,¹³⁷ which showed 75 per cent of the 100 respondents anticipated an increase in shareholder litigation in the United Kingdom. Furthermore, 67 per cent of the respondents in 2004 thought that it would represent a negative step if shareholder litigation were to take hold in the United Kingdom. These results could even support the conclusion that substantially fewer respondents believed in 2007 than in 2004 (with the statutory derivative claims provisions coming in to force on October 1, 2007), that shareholder claims would increase. The corollary is that they believed CA 2006 would herald fewer such claims than they had anticipated four years previously, which is perhaps a surprising revelation, supporting the thesis that paradoxes abound within the statutory derivative claims jurisdiction.

Continuing impact

Hitherto, derivative claims were relatively rare, and not encouraged by the courts. Now, the law applicable to company directors is changing fast, and is unlikely to settle. Further changes are possible from the EU Corporate Governance Action Plan. It seems unlikely that this continued welter of legislation will simplify understanding, which was a primary justification for introducing the Act. On the contrary, the quick pace of change, and the unpredictability of how the new provisions will be applied by the courts and work in practice means that directors and shareholders will need to give greater consideration than ever to the legal framework regulating their activities.

The failure within the Act to specifically address the necessity for corporators to consider exit strategies at incorporation has been described as a, “missed opportunity (which) means that it will be for the judiciary to bring some clarity to this area”.¹³⁸ Participators are left wondering where they stand, and how the Act’s objectives of clarity and simplification have been served.

¹³⁵ CA 2006 s.205(1).

¹³⁶ *Legal Week*, September 6 and December 13, 2007.

¹³⁷ Reported by T.R. Peacocke, “Shareholder’s Direct Actions” Seminar (3 Stone Buildings New York: September 2004).

¹³⁸ Hannigan, “Altering The Articles To Allow For Compulsory Transfer—Dragging Minority Shareholders To a Reluctant Exit” (2007) J.B.L. 2007 471.

The wider ramifications of CA 2006 oblige the company lawyer to provide alternative and more cost effective commercial solutions to litigation in the drafting of articles of association and SHA).¹³⁹ As the Act may result in an increase in the use of derivative claims it is incumbent on their advisers to protect companies, directors and shareholders from the waste of resources and time which litigation inevitably creates. Consequently, are lawyers negligent if they fail to take reasonable steps to ameliorate such mischief? When drafting a commercial contract, joint venture agreement or partnership deed, the competent draftsman should include alternative dispute resolution (ADR) clauses. Likewise, businesses using the medium of a limited company, ought to have their articles or SHA provide mechanisms for dealing with deadlock.

The restrictive approach of the courts towards unfair prejudice petitions as indicated in *O'Neill v Phillips*¹⁴⁰ imposes an obligation on draftsmen to provide alternatives. Even before CA 2006 it was arguable that solicitors should always provide for future shareholder disputes to be resolved without recourse to public and expensive litigation. Since CA 2006 it is suggested that this is now mandatory.

Whilst “the jury is still probably out”¹⁴¹ and “it is simply too early to say”¹⁴² in considering the verdict on whether CA 2006 does result in increased shareholder litigation, at its lowest it is a risk that lawyers must consider and attempt to mitigate.

Legal practice outcomes

Boards and individual directors ought to analyse their strategy in facing potential derivative claims, and examine D&OI policies to ensure that they cover defence costs. Contracts of service should be reviewed, to ensure indemnities are granted to directors regarding the defence of any actions against them, and whether such extend beyond the director’s period of service.

Directors individually will wish to ascertain whether their terms of employment take advantage of the relaxation in prohibition of companies indemnifying directors for negligence, breach of duty or breach of trust in relation to the company, including claims by third parties, by the company itself, and covering both the claim, and the cost of defending the action. A director would wish to know whether such terms continue after departure, whether through retirement or dismissal.

Whilst an indemnity is reassuring for a director, indemnities ought to be utilised in conjunction with insurance, which would meet a director’s defence costs where for example a company was insolvent.¹⁴³ If the director were held

¹³⁹ The House of Lords in *Russell v Northern Bank Developments Corp Ltd* [1992] 1 W.L.R. 588; [1992] 3 All E.R. 161 emphasised the practical utility of SHAs.

¹⁴⁰ *O'Neill v Phillips* [1999] 1 W.L.R. 1092 HL at 1099; [1999] B.C.C. 600.

¹⁴¹ Jonathon Djanogly MP, January 2, 2008, <http://www.companylawforum.co.uk> [Accessed January 16, 2010].

¹⁴² Stuart Ritchie, Seminar, “Derivative Claims and Unfair Prejudice” (Littleton Chambers, November 2008).

¹⁴³ Partick Beale, “Directors Beware?” (2007) 157 N.L.J. 1033.

responsible, he would be personally liable for the damages and compelled to repay any costs funded by the company.

Directors' exposure

Intervention from shareholders in listed UK companies has been particularly noticeable over recent years, whether due to concern over market performance, financial returns, business strategy or corporate governance. Not only are institutional investors active, but individual members, and pressure groups:

“Listed companies have traditionally pursued dialogue with shareholders. . . . As well as seeking to head off institutional shareholder dissent through such dialogue, boards are now encouraged to take defensive steps to prepare for activists.”¹⁴⁴

The draining of resources, both in terms of expense and time, as well as the risk of adverse publicity means that in particular, boards of listed companies may be inclined to engage and “negotiate with their shareholders behind closed doors, beyond the glare of public scrutiny”.¹⁴⁵

As the legislation beds down, there will inevitably follow a period of considerable uncertainty and speculation, not least as the courts seek to reconcile the adoption of ESV with the potentially conflicting aim of improving competitiveness, and the implicit rejection of the “pluralist model”, whilst balancing a wide range of competing interests. Lord Goldsmith confidently asserted that it was unlikely that there would be any significant increase in actions against directors:

“[I]t is quite rare for companies to sue their directors for breach of duty. That may well continue to be the position. . . . I can say now that we do not see any reason why those provisions should increase litigation.”¹⁴⁶

Practitioners have also echoed this view:

“[T]he reality is likely to be that the courts will adopt as robust an approach to statutory derivative actions as previously occurred under the common law.”¹⁴⁷

However, there is evidence of growing recognition of increased intervention by and influence of shareholders, with the heightened emphasis on shareholders' rights resulting in the United Kingdom continuing to be, “one of the most active major markets for this type of activity”.¹⁴⁸ This is not necessarily a direct, but an indirect consequence of the potential for derivative claims and shareholder action.

¹⁴⁴ Gavin Davies, “Shareholder Activism” (2008) 2 J.I.B.F.L. 100.

¹⁴⁵ Alex Kay, Tom Platts, Harsh Kumar, “Shareholder Activism, How it Works” (November 2007) I.F.L.R. 54.

¹⁴⁶ *Hansard*, col.GC242-3 (February 6, 2006).

¹⁴⁷ Dov Ohrenstein, “Derivative Action” (2007) N.L.J. 1372.

¹⁴⁸ Gavin Davies, “Shareholder Activism” (2008) 2 J.I.B.F.L. 100.

Future development

There remains a paradox exemplified by the demand for the court's development of clearer principles, whilst retaining flexibility at the expense of certainty and predictability. The Executive's over-arching objectives clearly extended beyond mere codification of the common law, yet this is balanced by continued reliance on judicial dynamism and the expectation that the courts will interpret the new regime in a commercially realistic manner.

The need for judicial control of derivative claims was examined in *Barrett v Duckett*¹⁴⁹ as more recently re-emphasised in *Portfolios of Distinction Ltd v Laird*¹⁵⁰ the necessity for the court to have control of the action at all stages was important, not only at the initial leave stage.¹⁵¹ Any offer of settlement must also be referred back to the court,¹⁵² such judicial scrutiny being the price for potential funding of the shareholder's costs by the company, and a necessary component of such a unique construction, where the subject and beneficiary of the claim is the company, whereas the protagonist bringing the action is the individual member. This was an exception to the:

“[E]lementary principle that A cannot, as a general rule, bring an action against B to recover damages or secure other relief on behalf of C for an injury done by B to C. C is the proper plaintiff because C is the party injured, and, therefore, the person in whom the cause of action is vested.”¹⁵³

Judicial supervision is required so as to ensure that justice is done to the company as a whole, rather than prioritising the interests of the petitioning member. The claimant may not be best placed to determine matters such as whether to expend the company's time, assets and resources on such litigation, or whether doing so would be in the company's best interests.¹⁵⁴ An individual shareholder may be mistaken on a particular issue, even where not influenced by selfish motives, and the court must determine whether pursuit of the claim is, “bona fide on behalf of the company”.¹⁵⁵

In *Portfolios of Distinction*,¹⁵⁶ “tight judicial control”¹⁵⁷ was essential. The court must scrutinise each stage of the derivative claim and exercise careful control otherwise it could become an, “instrument of oppression”¹⁵⁸ in the context of a s.459 petition:

¹⁴⁹ *Barrett v Duckett* [1995] B.C.C. 362; [1995] 1 B.C.L.C. 243 CA (Civ Div).

¹⁵⁰ *Portfolios of Distinction Ltd v Laird* [2004] EWHC 2071 (Ch); [2005] B.C.C. 216.

¹⁵¹ Civil Procedure Rules 1998 (SI 1998/3132) r.19.9.

¹⁵² Civil Procedure Rules 1998 (SI 1998/3132) r.19.9.

¹⁵³ *Prudential Assurance Co Ltd v Newman Industries Ltd (No.2)* [1982] Ch. 204 at 210; [1982] 2 W.L.R. 31 CA (Civ Div).

¹⁵⁴ *Prudential Assurance Co Ltd v Newman Industries Ltd (No.2)* [1982] Ch. 204 at 210 CA (Civ Div).

¹⁵⁵ *Barrett v Duckett* [1995] B.C.C. 362; [1995] 1 B.C.L.C. 243 CA (Civ Div).

¹⁵⁶ *Portfolios of Distinction Ltd v Laird* [2004] EWHC 2071 (Ch); [2005] B.C.C. 216.

¹⁵⁷ The Law Commission, *Shareholder Remedies* (1997), Law Com. No.246, para.6.13.

¹⁵⁸ *Company (No.005685 of 1988) (No.2), Re* [1989] B.C.L.C. 427, at 437 per Peter Gibson L.J.; *Rock Ltd v RCO Holdings Ltd* [2004] EWCA Civ 118; [2004] B.C.C. 466.

“Rule 19.9 of the CPR clearly requires judicial scrutiny (and sanction) of every step in a derivative action and to have one that is properly constituted is a powerful tool in the hands of a minority shareholder, although there is no doubt that the threshold is quite a high one (and rightly so).”¹⁵⁹

Derivative claims can fulfil the functions of a “positive social force”.¹⁶⁰ Reisberg suggests, quoting American research,¹⁶¹ that, “the higher the public esteem of the derivative claim, the greater will be its deterrent value”.¹⁶² Specifically, screening by the court of a derivative claim’s merits is particularly potent at the initial leave stage, where non-meritorious cases are weeded out prior to any trial, and also by the necessity of obtaining the court’s approval of any settlement.

Derivative claims which clear the hurdle will inevitably reflect matters of real and substantial concern and thereby engender public approbation, certainly to a greater extent than if there were no such court supervision. This “positive winnowing effect”¹⁶³ results in the correct perception that claims which survive the initial leave stage have earned the right to be adjudicated upon, which in turn garners,

“some sort of public status on the action, a strength in the settlement process enables the derivative action to secure its position as a mechanism for vindicating public norms”¹⁶⁴

thereby enhancing the deterrent effect against directors of reprehensible conduct.

This work would be incomplete if it ignored the recent world-wide banking collapse and the resultant potential for derivative and minority shareholder claims. This was presaged in the United Kingdom by the failure of Northern Rock Plc. Although understandable, calls to hold someone to account in such circumstances have to be tempered by the fact that where a remedy is sought by a shareholder in considering a derivative claim (for example due to misleading statements by a director or adviser), they are:

“[L]ikely to find that the company itself has suffered no loss and indeed may have gained. There may be loss to the shareholder but that is an individual loss and one would have to look at other rights that might accrue to the shareholder. The shareholder may not be able to bring his own claim because the loss is merely a reflection of the claim by the company.”¹⁶⁵

¹⁵⁹ Reisberg, “Judicial Control of Derivative Actions” (2005) 16(8) I.C.C.L.R. 335, 339.

¹⁶⁰ Reisberg, “Judicial Control of Derivative Actions” (2005) 16(8) I.C.C.L.R. 335, 339.

¹⁶¹ J. Cox, “The Social Meaning of Shareholder Suits” (1999) 65 *Brooklyn Law Review* 3.

¹⁶² Reisberg, “Judicial Control of Derivative Actions” (2005) 16(8) I.C.C.L.R. 335, 338.

¹⁶³ Reisberg, “Judicial Control of Derivative Actions” (2005) 16(8) I.C.C.L.R. 335, 338.

¹⁶⁴ Reisberg, “Judicial Control of Derivative Actions” (2005) 16(8) I.C.C.L.R. 335, 339.

¹⁶⁵ David Greene, “Northern Rock: potential false market shareholder claims” (2008) 2 J.I.B.F.L. 67.

More generally, “[w]idespread expectations of a litigation frenzy following the financial markets meltdown are . . . wishful thinking and unrealistic”.¹⁶⁶

Conclusions

The grounds for bringing a derivative claim have been substantially expanded and the procedure for bringing such proceedings modernised. There will no longer be a requirement to prove a fraud on the minority, that a director has benefited personally, or that the delinquent directors are in control.

Under *Foss v Harbottle*,¹⁶⁷ courts would not interfere with the internal or business decisions of the company acting within its powers, but CA 2006 extends directors’ duties. The “double whammy” of increased duties on directors and expansion of derivative claims for mere negligence, default, breach of duty, or breach of trust by a director (and extension of the duties to include claims against shadow or former directors or any relevant third party) significantly widens scope for minority shareholder and derivative claims. The Act’s objectives including simplification, modernisation and a “think small first approach”, combined with the unprecedented extension of the derivative claim and imposition of different and wider duties constitute a paradox that may be irreconcilable, at least in the short term.

No additional requirement of bad faith or gain is needed. This substantially extends the reach of the derivative claim, whereby any individual shareholder with a single share may bring a claim for any breach of duty or negligence by a director.

However, this extension is balanced by numerous safeguards, checks and balances introduced to prevent unmeritorious claims, primarily that consent from the court is required by demonstrating a prima facie case ex parte.

The new regime will inevitably result in a period of uncertainty, perhaps prolonged, and risks opening the floodgates to activist shareholders, diverting valuable management time and constituting a drain on business efficiency. There is a clear shift in power towards shareholders, but the court retains its fundamental role in supervising such claims, and it was never intended that court should be required to second-guess commercial decisions. Whilst fear of paralysis in board rooms is far-fetched, the vast resources expended in familiarisation—and testing untried new provisions—are overlooked, as is grafting new and potentially conflicting statutory codification on to existing common law.

The new statutory procedure for derivative claims comprises various brakes on the expanded jurisdiction: derivative claims remain subject to the overriding principle of majority rule, and the scope for claims based on “fraud on the minority” is significantly reduced due to directors now being able to authorise conflicts of interests.¹⁶⁸

¹⁶⁶ James Dean quoting Tony Brown, “Litigation claims” (2008) L.S.G.

¹⁶⁷ *Foss v Harbottle* 67 E.R. 189 Ch D; (1843) 2 Hare 461.

¹⁶⁸ CA 2006 s.175.

The combined effects of threshold tests,¹⁶⁹ the two stage leave process, information imbalance, costs exposure of and no personal recovery for claimants and judicial control mean that it is unlikely that the floodgates will be open to any significant increase in derivative claims. The experience of other common law jurisdictions which have adopted the statutory derivative claim is that they have not led to any dramatic impact.¹⁷⁰ There is no reason based on CA 2006 or otherwise to expect any different outcome in the United Kingdom.

The courts may wish to prevent extension of the derivative claim, and instead encourage shareholders to pursue claims on a personal basis under CA 2006 s.994. This stance may prevail in the average OMB dispute or quasi-partnership company, but if such complainants were excluded from the derivative claim jurisdiction and dealt with instead solely via personal remedies, that could render the new statutory derivative claim otiose.

Whilst the potential for shareholders to bring claims has clearly expanded significantly, it is unlikely that this will provoke widespread growth of such claims. The status quo is not likely to undergo any significant change, in that it will continue to be preferable for an aggrieved shareholder to issue a petition based on unfair prejudice,¹⁷¹ which requires no leave of the court, and offers the reward of individual compensation. The alternative route of pursuing a winding up petition on “just and equitable” grounds under Insolvency Act 1986 (IA 1986) may also continue to be preferred, for similar reasons.

The new codified duties for directors are likely to result in extended bureaucracy for companies, and at least initially in increased record keeping. However, in the long run, scrutiny and openness may be generally beneficial, curbing bad practice, unwelcome excesses, and promoting participation of and investment by shareholders with the concomitant enhancement of ESV. Ultimately, despite a period of uncertainty, it is unlikely that judges will abandon their traditional pragmatic, restrictive, commercial approach in applying the new duties, rights and procedures, whilst balancing these against the new concept of ESV.

There will be short-term uncertainty, but such claims were always unpredictable, turning on their individual facts, and the new provisions incorporate the traditional flexibility for the judiciary, which will continue, with commercial decision making by directors being untrammelled. The outcome is likely to be increased flexibility and personal benefit to individual shareholders, whilst vindicating public norms, and enhancing the prospects for business. It is contended that paradoxically, despite or perhaps because of the compromises and accommodations that will be essential, the effects of the Act’s new regime will be positive for shareholders and business.

¹⁶⁹ CA 2006 s.263.

¹⁷⁰ Cheffins, “Reforming the Derivative Action: The Canadian Experience and British Prospects” [1997] *CF.L.R.* 227, 244; Ramsay and Saunders, “Litigation by Shareholders and Directors: An Empirical Study of the Australian Statutory Derivative Action” (2006) 6 *J.C.L.S.* 397, 427, 442–433.

¹⁷¹ CA 2006 s.994; see discussion at fn.24.