

Derivative action

Shareholders now have a statutory right to sue directors in derivative actions. Will they use it? asks **Dov Ohrenstein**

IN BRIEF

- Under CA 2006 shareholders have for the first time a statutory right to sue directors in a derivative action on behalf of the company for negligence.
- This covers a broader range of conduct than exists under the present common law.
- Shareholders will be able to bring a derivative action against directors for negligence even if the directors concerned have not benefited from their negligence.

For over 150 years the rule in *Foss v Harbottle* (1843) 2 Hare 461 has been a familiar part of the company law landscape. The rule prevents claims by shareholders for reflective losses and provides that if a wrong is done to a company then the company is usually the proper claimant in respect of that wrong. Only in exceptional circumstances, for example where the wrongdoer is a majority shareholder, have minority shareholders been able to obtain the court's permission to bring a derivative claim on behalf of the company.

The two basic requirements at common law for a derivative action are:

- that the alleged wrong or breach of duty is one that is incapable of being ratified by a simple majority of the members; and
- that the alleged wrongdoers are in control of the company, so that the company, which is the "proper claimant" can not claim by itself.

THE NEW BASIS FOR A DERIVATIVE ACTION

From 1 October 2007 the provisions in the Companies Act 2006 (CA 2006) for a statutory derivative action apply. Although the

two factors set out above will continue to be relevant to statutory derivative actions, and will play a part in the later stages of any litigation, the absence of one or other will no longer necessarily be a bar to the commencement of proceedings.

CA 2006, s 260(1) defines a derivative claim as one brought by a member of a company in respect of a cause of action vested in the company and seeking relief on behalf of the company. For this purpose "member" includes trustees in bankruptcy and other people who have been transferred shares by operation of the law. Such a claim can only be brought within CA 2006, Pt 11, Ch 1 or in pursuance of an order under s 994—which repeats the unfair prejudice provisions previously found in the Companies Act 1985, s 459.

A key provision of CA 2006 is s 260(3) which states:

"(3) A derivative claim under this Chapter may be brought only 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."

Director is defined to include shadow directors and former directors.

The cause of action may be against the director or against another person or both. A scenario where a third party would be a defendant would be if the third party dishonestly assisted a director to act in breach of his fiduciary obligations, or if a tracing claim against a third party arose out of some primary wrongdoing committed by the director. It is not necessary to show that the director benefited from the wrongdoing.

CA 2006, Pt 11 therefore gives shareholders for the first time a statutory right to sue directors in a derivative action on behalf of the company for negligence, default, breach of duty or breach of trust, subject to the court allowing the action to proceed. This covers a broader range of conduct than exists under the present common law. For example, shareholders will be able to bring a derivative action against directors for negligence even if the directors concerned have not benefited from their negligence. This is a significant change from the present law (see *Pavlides v Jensen* [1956] 2 All ER 518, [1956] 3 WLR 224). However, safeguards have been introduced to protect directors from ill-founded claims, the main one being that shareholders will need to obtain the court's consent to continue a claim by showing that they have a prima facie case.

In cases where a member originally brings a derivative action, permission must be sought under s 261.

There is also the possibility under s 262 of an alternative scenario when a company has brought a claim and a member applies to the court so that the cause of action is then pursued as a derivative claim. An example of such a scenario would be if the company has failed to pursue a claim diligently, particularly if the company had only brought the claim in an attempt to stop a derivative action being commenced. Situations when s 262 will be relied upon are unlikely to arise frequently.

THE PROCEDURE

Under CA 2006, ss 261 and 262 the court has the same discretion. The member seeking the court's permission to bring a derivative claim must follow a two-stage process before any substantive proceedings can be commenced.

- The member must file sufficient evidence to establish a prima facie entitlement to bring a derivative claim. At this stage the court the case needs only to consider the evidence filed on behalf of the claimant. If the court does not dismiss the applica-

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tion appropriate consequential directions will be ordered, eg for the company to file evidence. The merits of the application may then be reconsidered at an adjourned hearing.

- The member needs to persuade the court that a derivative action is appropriate at any adjourned hearing where the evidence of the both parties will be before the court.

This process is designed to ensure that the claimant is serious about pursuing the claim and has sufficient grounds to do so. The front loading of costs on the claimant might deter some of the more frivolous or vexatious claims. Perhaps the most useful consequence is that it will minimise the initial expense that a company need incur if a potential derivative claim obviously lacks merit.

Section 263(2) sets out three situations in which permission for a derivative claim must be refused:

“(2) Permission (or leave) must be refused if the court is satisfied—

- that a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim, or
- where the cause of action arises from an act or omission that is yet to occur, that the act or omission has been authorised by the company, or
- where the cause of action arises from an act or omission that has already occurred, that the act or omission—
 - was authorised by the company before it occurred, or
 - has been ratified by the company since it occurred.”

It should be noted that at common law a relevant question was whether or not the relevant act or omission was capable of being ratified, not whether or not it had been.

If an application overcomes the hurdles in CA 2006, s 263(2) the court will then take into account the discretionary factors set out in s 263(3) which states:

“(3) In considering whether to give permission (or leave) the court must take into account, in particular—

- whether the member is acting in good faith in seeking to continue the claim;
- the importance that a person acting in accordance with section 172 (duty to promote the success of the company) would attach to continuing it;
- where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be—
 - authorised by the company before it occurs, or
 - ratified by the company after it occurs;
- where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company;
- whether the company has decided not to pursue the claim;
- whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.”

CA 2006, s 263(2)(b) reflects the recent decision in *Airey v Cordell* [2006] EWHC 2728 (Ch), [2006] All ER (D) 111 (Aug) where it was held that the appropriate test for permission to bring a derivative claim was the view of a hypothetical and independent board of directors. The court made clear in that case that its task was not to assert its own view but merely to be satisfied that such a board could take the decision that the minority shareholder applying for permission to proceed would like it to take.

Another important provision is s 263(4) which states:

“(4) In considering whether to give permission (or leave) the court shall have particu-

lar regard to any evidence before it as to the views of members of the company who have no personal interest, direct or indirect, in the matter.”

Points to note include:

- The views that matter under s 263(4) are of independent members. This provision reflects the attitude of the courts in relation to common law claims (eg see *Smith v Croft (No 2)* [1987] 3 All ER 909, [1987] 3 WLR 405).
- Particular regard is to be had to those views, they are not merely a factor to be “taken into account”. This emphasis may have some marginal consequence if all other factors are finely balanced.
- The decision of a company to embark on litigation is usually a matter for the directors not for the shareholders yet it should be noted that the reference in s 263(4) is to the views of members without a personal interest rather than those of independent directors. This was an issue which was apparently the subject of some debate within the Law Commission.

Section 263 allows the secretary of state to make regulations altering the criteria to which the court must have regard in determining whether or not to grant permission for a derivative action.

Pursuant to s 264, one member can apply to take over the derivative action of another member, eg where a derivative claim has been brought but not pursued diligently.

Coupled with the new duty to promote the success of the company, concerns have been raised that shareholders, especially activist shareholders of traded companies, will use these provisions to bring unmeritorious claims that will take up valuable management time, as well as result in adverse publicity for the company. However, the 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.

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