<u>REFLECTIVE LOSSES & DERIVATIVE CLAIMS</u>

A Seminar for the Thames Valley Commercial Lawyers' Association
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<u>Reflective Losses</u>

<u>The Rule in Foss v Harbottle</u>

1. Where a wrong is done to a company and the company suffers a loss this will have an adverse impact on the value of members' shares which is reflective of the company's loss. If the company is unwilling or unable to claim for these losses then the shareholders will be prejudiced unless they can bring their own claim. However, there are substantial obstacles to such claims by shareholders:

   "What [a shareholder] cannot do is to recover damages merely because the company in which he is interested has suffered damage. He cannot recover a sum equal to the diminution in the market value of his shares, or equal to the likely diminution in dividend, because such a "loss" is merely a reflection of the loss suffered by the company. The shareholder does not suffer any personal loss. His only "loss" is through the company, in the diminution in the value of the net assets of the company, in which he has (say) a 3 per cent shareholding." **Prudential Assurance v Newman** [1982] 1 Ch 204 at 210.

   "A claim will not lie by a shareholder to make good a loss which would be made good if the company's assets were replenished through action against the party responsible for the loss, even if the company, acting through its constitutional organs, has declined or failed to make good that loss." **Johnson v Gore Wood** [2002] 2 AC 1 per Lord Bingham at 35F.

2. The principle is generally known as the rule in **Foss v Harbottle** (1843) 2 Hare 461. The leading case is the decision the House of Lords in **Johnson v Gore Wood** which makes clear that the principle preventing recovery of reflective loss applies not only to diminution in value of members' shares but also to loss of dividends and to claims by employees or creditors.

3. The existence of the rule is justified by the need both to prevent double recovery and to provide protection for the company's creditors, who might be prejudiced if the shareholder's claim were to succeed:

   "If the shareholder is allowed to recover in respect of [reflective] loss, then either there will be double recovery at the expense of the defendant or the shareholder will recover at the expense of the company and its creditors and other shareholders. Neither course can be permitted. This is a matter of principle; there is no discretion involved. Justice to the defendant requires the exclusion of one claim or the other; protection of the interests of the company's creditors requires that it is the company which is allowed to recover to the exclusion of the shareholder." **Johnson v Gore Wood** at 62.

4. The prohibition on recovering reflective losses applies even where the facts preclude double recovery, for example where the company has compromised its claim or chosen not to pursue it or where there is a defence to the company's claim (for example, a limitation defence or defence based on estoppel) which does not apply to the shareholder's claim. Equally the prohibition applies in cases where double recovery might be avoided by a suitably drafted court order or where the claimant gives credit in his claim for any damages which the company might have recovered. As was explained in **Day v Cook** [2001] EWCA Civ 592:

"38. ....It is not simply the case that double recovery will not be allowed so that, for instance, if the company's claim is not pursued or there is some defence to the company's claim, the shareholder can pursue his claim. The company's claim, if it exists, will always trump that of the shareholder.
39. Accordingly the court has no discretion. The claim cannot be entertained . . . "

5. The prohibition on recovery of reflective losses applies whether the cause of action is at common law or in equity, and whether the remedy lies in damages or restitution. The principle applies equally to claims in contract and tort. The principle can apply to defamation claims just as to claims based on breach of fiduciary duty. It also applies where the defendant owes completely different duties to the company and to the shareholder, for example where the company's claim is based on breach of fiduciary duty, while the shareholder has a separate claim arising out of a relationship of trustee and beneficiary (see: **Shaker v Al-Bedrawi** [2002] EWCA Civ 1452 at para 81 and **Gardner v Parker** [2004] EWCA Civ 781).

6. These general prohibition on recovery of reflective losses has been applied in the following recent reported cases:

* In **Rushmer v Mervyn Smith** [2009] EWHC 94 (QB) the Claimant, who was a shareholder and guarantor of a company, claimed that he had relied on company accounts that had been negligently prepared by the defendant auditor. It was held that the auditor did not owe the Claimant a duty in respect of guarantee. In any event any loss suffered by the Claimant (including his liability under the guarantee) was reflective of the company's loss and therefore irrecoverable.

* In **Rawnsley v Weatherall Green & Smith** [2009] EWHC 2482 (Ch) a company and its director/ principal shareholder sued a firm of surveyors and an insolvency practitioner. The company was insolvent and it was alleged that the marketing of the company's main asset, a property, had been negligent and that it had been sold at too low a price. The shareholder's claims were struck out on the basis that they were for a purely reflective loss.

* In **Gaetano Ltd v Obertor Ltd** [2009] EWHC 2653 (Ch) the respondent counterclaimed that the company directors appointed by the applicant had breached their fiduciary duties and causing the respondent financial loss. The Court held that the respondent had wrongly confused the duties of directors to their company and the obligations of joint venturers to each other as set out in a shareholders' agreement. The

loss claimed by the respondent was held to be an irrecoverable reflective loss. It was not separate and distinct from the loss allegedly caused to the company as the diminution in value of the respondent's shareholding and the damage in repayments of priority distribution both resulted purely from the depletion of the company's assets or a reduction in its profits.

7. The prohibition on the recovery of reflective losses can cause injustice in individual cases but does not necessarily leave a shareholder or creditor without a remedy:

"[I]f the company chooses not to exercise its remedy, the loss to the shareholder is caused by the company's decision not to pursue its remedy and not by the defendant's wrongdoing. By parity of reasoning, the same applies if the company settles for less than it might have done. Shareholders (and creditors) who are aggrieved by the liquidator's proposals are not without a remedy; they can have recourse to the Companies Court, or sue the liquidator for negligence." **Johnson v Gore Wood** [2002] 2 AC 1 per Lord Millett at 66D

<u>Limits to the prohibition on recovery of reflective losses</u>

8. Despite the wide scope of the principle that reflective losses are irrecoverable, the Lords in **Johnson v Gore Wood** acknowledged that it has its limits. The key limits are:

* Where the company has no cause of action
* Where the shareholder suffers a separate and distinct loss from that of the company
* Where the wrongdoer has disabled the company from pursuing its claim

<u>Where the Company has no cause of action</u>

9. The main limit on the prohibition is where a company has no cause of action to recover its loss. Then, if the shareholder has a cause of action, he may bring proceedings to recover his loss, even though the shareholder's loss is a diminution in the value of the shareholding. Since the company has no cause of action in respect of its loss, its assets are not depleted by the recovery of damages by the shareholder.

10. In **George Fischer (Great Britain) Ltd v Multi Construction Ltd** [1995] 1 BCLC 260 the claimant holding company contracted with the defendant to install equipment at its subsidiaries' commercial premises. The equipment was faulty, and the subsidiaries suffered loss of sales and increased operating costs. The holding company claimed that it had suffered these losses indirectly, and that its losses were to be measured by reference to the subsidiaries' loss of profits. The Court of Appeal held that, because the contract was between the holding company and the defendant, and because the subsidiaries were not contracting parties and had no claim of their own, the holding company had an unquestionable right of action for (at least nominal) damages for breach of contract.

<u>Where the Shareholder's loss is separate and distinct</u>

11. Similarly, where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss (separate and distinct from that suffered by the company) caused by breach of a duty independently owed to it, each of them may sue to recover the loss caused to it by breach of the duty owed to it. However, neither may recover loss caused to the other by breach of the duty owed to the other. Moreover, even if it does have its own cause of action, a shareholder cannot bring proceedings for damages unless it has suffered loss which is additional to that suffered by the company (see: **Day v Cook** [2001] EWCA Civ 592, per Arden LJ at [79]).

12. This was also explained by Peter Gibson LJ in **Shaker v Al-Bedrawi**:

"In our judgment the [rule against reflective loss] does not preclude an action brought by a claimant not as a shareholder but as a beneficiary under a trust against his trustee for a profit <u>unless it can be shown by the defendants that the whole of the claimed profit reflects what the company has lost and which it has a cause of action to recover</u>. As the principle is an exclusionary rule denying a claimant what otherwise would be his right to sue, the onus must be on the defendants to establish its applicability. Further, it would not be right to bar the claimant's action <u>unless the defendants can establish not merely that the company has a claim to recover a loss reflected by the profit, but that such claim is available on the facts.</u>"

(The significance of there needing to be "*a claim being available on the facts"* is unclear, if for example the company's claim is time barred.)

<u>Where the wrongdoer has disabled the Company</u>

13. The rule preventing claims for reflective losses was apparently relaxed in the case of **Giles v Rhind** [2002] EWCA Civ 1428. There the Defendant director of "SHF" had acted in breach of his obligations by diverting the business of one of SHF's customers to another company owned and controlled by him. The loss of that business drove SHF into liquidation and, as a consequence, proceedings commenced by SHF against the Defendant were discontinued. By this action the Claimant sought to recover the loss in value of his shares in SHF and the loss of the salary and other benefits that he would otherwise have continued to enjoy had SHF continued in business. It was held that the decision in **Johnson v Gore Wood & Co** did not prevent a shareholder from recovering the value of his shares and/or the loss of the salary and other benefits that he would otherwise have continued to enjoy if it was the defendant's wrongdoing which had actually disabled the company from pursuing the cause of action that it had.

14. **Giles v Rhind** was not followed by the Hong Kong Final Court of Appeal in **Waddington v Chan Chun Hoo Thomas** [2008] HK CU 1381 (in which Lord Millett gave the leading judgment). Lord Millett was clearly of the view that **Giles v Rhind** was wrongly decided and that any remedy should have been by way of derivative action not by allowing a claim for reflective losses. Nevertheless, the recent decision of the Court of Appeal in **Webster v Sandersons** [2009] EWCA Civ 830 confirms that **Giles v Rhind** is still good authority and must be followed (unless or until the new Supreme Court considers it).

15. In **Webster v Sandersons** the reflective loss principle was set out in qualified form as follows:

"a loss claimed by a shareholder which is merely reflective of a loss suffered by the company – i.e. a loss which would be made good if the company had enforced in full its rights against the defendant wrongdoer – is not recoverable by the shareholder save in a case where, by reason of the wrong done to it, the company is unable to pursue its claim against the wrongdoer;

(2) where there is no reasonable doubt that that is the case, the court can properly act, in advance of trial, to strike out the offending heads of claim;

(3) The irrecoverable loss (being merely reflective of the company's loss) is not confined to the individual claimant's loss of dividends on his shares or diminution in the value of his shareholding in the company but extends ... to 'all other payments which the shareholder might have obtained from the company if it had not been deprived of its funds' and also to other payments which the company would have made if it had had the necessary funds even if the plaintiff would have received them qua employee and not qua shareholder save that this does not apply to the loss of future benefits to which the claimant had an expectation but no contractual entitlement;

(4) the principle is not rooted simply in the avoidance of double recovery in fact; it extends to heads of loss which the company could have claimed but has chosen not to and therefore includes the case where the company has settled for less than it might"

16. By contrast with **Johnson v Gore Wood** the critical point in **Giles v Rhind** was that the company was disabled from bringing the claim by the very wrongdoing which the defendant had by contract promised him, as a shareholder and the company, that he would not carry out.

The Common Law Derivative Claim

17. In the light of the general prohibition on claims for reflective losses, the Common Law allowed shareholders under certain circumstances to bring claims on behalf of their companies.

18. The two basic requirements at common law for a derivative action were:

* That the alleged wrong or breach of duty was by a director and was incapable of being ratified by a simple majority of the members (eg a fraudulent breach by a director, the deliberate misappropriation of company assets etc, but not a *bona fide* misuse of powers or an incidental profit making); and

* That the alleged wrongdoers are in control of the company, so that the company, which is the *"proper claimant"* cannot claim by itself.

The New Basis for a Derivative Claims

19. Since October 2007 the provisions in the Companies Act 2006 for a statutory derivative action have been in force. The relevant sections are 260 to 264.

20. Although the two basic common law requirements (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 is no longer necessarily a bar to the commencement of proceedings.

Who can bring a statutory Derivative Claim?

21. Section 260(1) of the 2006 Act 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 persons who have been transferred shares by operation of the law. Such a claim can only be brought within chapter 1 of Part 11 of the Act or in pursuance of an order under s.994 (which repeats the unfair prejudice provisions previously found at s.459 of the 1985 Act).

22. No minimum shareholding is required as the amount of the claimant's interest is irrelevant if the claim is one which should otherwise be brought. **Seaton v Grant** (1867) 2 Ch App 459 at 465. In fact, no shareholding at all is required (eg in cases of claims by members of companies limited by guarantee).

23. Nevertheless, a minuscule holding acquired after the conduct complained of occurred and with a view to commencing a derivative claim may raise concerns about the claimant's good faith (see **Harley Street Capital v Tchigirinsky** [2005] EWHC 1897 Ch where a claimant acquired 200 £1 shares out of a capital of £230 million).

When can a shareholder's conduct disqualify him from bringing a claim?

Where the Shareholder is a wrongdoer

24. In a case concerning a derivative claim under the Common Law, the Court of Appeal in **Nurcombe v Nurcombe** [1985] 1 WLR 370, 376 approved the following passage from *Gower, Modern Company Law*:

"The right to bring a derivative action is afforded the individual member as a matter of grace. Hence the conduct of a shareholder may be regarded by a court of equity as disqualifying him from appearing as plaintiff on the company's behalf. This will be the case, for example, if he participated in the wrong of which he complains."

This approach was followed by Lawrence Collins J in **Konamaneni v Rolls Royce Industrial Power (India) Ltd** [2002] 1 WLR 1269 and ought also to apply equally to statutory derivative claims.

Where the Shareholder is acting for an ulterior purpose

25. In **Barrett v Duckett** [1995] 1 BCLC 243 Peter Gibson LJ said:

"The shareholder will be allowed to sue on behalf of the company if he is bringing the action bona fide for the benefit of the company for wrongs to the company for which no other remedy is available. Conversely if the action is brought for an ulterior purpose or if another adequate remedy is available, the court will not allow the derivative action to proceed."

In **Barrett v Duckett** one of the reasons which led the court to refuse to allow a derivative action to proceed was that it was being pursued as part of a family feud, rather than for the financial benefit of the claimant.

26. While a shareholder who wishes to bring a claim purely for his own collateral benefit and not for the benefit of the company will not be entitled to do so, it has been held that if the claimant intends to bring a derivative claim for the benefit of a company he will not be disqualified from doing so just because there are other benefits that he will derive from the claim. See **Iesini v Westrip** [2009] EWHC 2562 at para 121.

Can a shareholder of a parent company bring a derivative claim on behalf of a subsidiary?

27. The situation where a shareholder of a parent company wishes to bring a derivative claim on behalf of a subsidiary is sometimes referred to as a "multiple derivative action".

28. The shareholder of the parent company is not a member of the subsidiary. Accordingly, the shareholder of the parent cannot simply apply to bring a statutory derivative action on behalf of the subsidiary.

29. Lord Millett in the Hong Kong decision **Waddington v Chan Chun Hoo Thomas** considered that a multiple derivative action could be pursued under the Common Law. When that question had arisen in English cases such as **Airey v Cordell** [2006] EWHC 2728 the point had been conceded (albeit according to some commentators, wrongly).

30. It might be possible for a shareholder of a parent company to apply for permission for a derivative claim to be made by the parent company and that the parent's company's claim would itself be an application for permission to pursue a derivative claim on behalf of the subsidiary. This would be convoluted and cumbersome.

31. A more obvious route to take would be for a petition under s.994. The parent company could then be ordered to take any required steps to ensure that the subsidiary pursued an appropriate claim.

Who can the claim be brought against?

32. A key provision of the legislation is subsection 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."*

(The reference to *"under this Chapter"* means that derivative claims brought as a consequence of an unfair prejudice petition are not subject to this restriction)

33. For the purposes of s.260(3) Director is defined to include shadow directors and former directors.

34. Third Parties

The cause of action may be against the director or against another person or both. Any claim against a 3rd party requires a cause of action connected with a director's conduct. A scenario where a 3rd party would be a defendant would be if the 3rd party dishonestly assisted a director to act in breach of his fiduciary obligations, or if a tracing claim against a 3rd party arose out of some primary wrongdoing committed by the director. It is not necessary to show that the director benefited from the wrongdoing.

However, it is not possible for a derivative claim to be brought where the breach of duty etc is solely that of a third party, such as a negligent auditor, since the claim must arise from an act etc by a director. Arguably a derivative claim could lie where the board's decision not to pursue a claim against a third party is itself a breach of duty by the directors.

35. Former Directors

The inclusion of former directors avoids the problem that they would otherwise be classed as third parties whom the current board would be expected to sue on behalf of the company. A former director remains subject to the duty (in s. 175) to avoid conflicts of interests as regards the exploitation of any property, information or opportunity of which he became aware at the time he was a director; and subject to the duty (in s 176) not to accept benefits from third parties as regards things done or omitted by him before he ceased to be a director (s.170).

36. Shadow Directors

It would be possible to base a claim against a shadow director on the grounds of 'default', for example, for non-compliance with CA 2006, Pt 10, Ch 4, (Transactions with Directors requiring approval of Members) where many of the provisions expressly apply to shadow directors; and also on the basis of being "*another person*"for the purpose of CA 2006, s 260(3).

It is uncertain whether or not the extension of derivative claims to shadow directors is of any wider significance, given that it is not clear that shadow directors owe fiduciary duties to the company. (See **Ultraframe (UK) Ltd v Fielding** [2005] EWHC 1638 (Ch) where Lewison J stated that the *"indirect influence exerted by a paradigm shadow director who does not directly deal with or claim the right to deal directly with the company's assets will not usually be enough to impose fiduciary duties upon him; although he will, of course, be subject to those statutory duties and disabilities which the Companies Act creates"*, although a director in control of a company's assets would be in a different position.)

What causes of action can be pursued in a derivative claim?

37. The range of claims

Part 11 of the Act 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 (including breaches of statutory obligations), breach of duty or breach of trust, subject to the court allowing the action to proceed. This covers a broader range of conduct than existed under the Common Law which was based on the concept of a *"fraud on the minority"*. For example, shareholders can now 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 Common Law position (see **Pavlides v Jensen [1956] 1 Ch 565**).

38. Negligence

The extension of the derivative action to negligence was recommended by the Law Commission which noted that, while investors take the risk that those who manage companies may make mistakes, they do not have to accept that directors will fail to comply with their duties. It is no longer necessary therefore to show that the negligence is of the self-serving variety seen in **Daniels v Daniels** [1978] Ch 406 where the board sold an asset at a gross undervalue to one of the directors. Of course, while negligence will found a derivative claim, the courts will continue to distinguish between mere commercial misjudgements and negligent conduct.

39. Breaches of the Company's constitution

The existence now of a specific statutory duty on directors to act in accordance with the constitution (s171) does not confer on members a right to enforce every provision of the constitution. The preservation of the common law on authorisation by s180(4)(a) means that the distinction drawn in the case law between matters of internal management (within the control of the majority, **MacDougall v Gardiner** (1875) 1 Ch D 13) and rights conferred by the constitution qua member (and not within the control of the majority, **Pender v Lushington** [(1877) 6 Ch D 70)) remains. Nor can it be argued that the position has been altered by the rewording of the statutory contract (CA 1985, s 14, now the CA 2006, s 33) as between the company and the members. The only purpose of the amended wording in CA 2006, s 33 is to state the law explicitly, ie that the provisions of the company's constitution have effect as if there were covenants on the part of the company and of each member to observe its provisions (as established by **Hickman v Kent or Romney Marsh Sheep Breeders Assoc** [1915] 1 Ch 881).

What are the requirements for permission?

40. The first hurdle- When must permission be refused?

Section 263(2) sets out three situations in which permission for a derivative claim (not being brought as part of an unfair prejudice petition under s.994) must be refused:

"(2) Permission (or leave) must be refused if the court is satisfied-

(a) 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

(b) 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

(c) where the cause of action arises from an act or omission that has already occurred, that the act or omission-

(i) was authorised by the company before it occurred, or

(ii) has been ratified by the company since it occurred."

41. The Second Hurdle- The Discretionary Factors

If an application overcomes the hurdles in 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-

(a) whether the member is acting in good faith in seeking to continue the claim;

(b) the importance that a person acting in accordance with section 172 (duty to promote the success of the company) would attach to continuing it;

(c) 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-

(i) authorised by the company before it occurs, or

(ii) ratified by the company after it occurs;

(d) 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;

(e) whether the company has decided not to pursue the claim;

(f) 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."

42. Section 263 allows the Secretary of State to make regulations altering the criteria to which the court must have regard in determining whether to grant permission for a derivative action.

Issues concerning authorisation & ratification

43. 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. By contrast:

* the first hurdle in the statutory regime prevents any derivative claim proceeding where there has been ratification or authorisation.

* the second hurdle considers whether the conduct could be and is likely to be ratified.

44. Authorisation

The 2006 Act allows disinterested directors to authorise a director to exploit property, information or opportunity, though there is a conflict between the director's interests and the interests of the company (s175). Such exploitation of company property etc by a director where he has a conflict of interest is precisely the type of conduct which at common law was an unratifiable "*fraud on the minority*" i.e. conduct which justified bringing a derivative claim. Now, though such conduct still cannot be ratified (the common law on ratification having been preserved by CA 2006, s 239(7)), it can be authorised in advance by the directors under CA 2006, s 175. This change, assuming a director can secure authorisation, significantly reduces any risk to directors arising from the potentially wide statutory jurisdiction to bring a derivative claim for any breach of any duty.

45. In practice, it may be difficult for a potential claimants to determine whether or not authorisation has been given, particularly where there is reliance on an informal unanimous assent given before he became a member. In the absence of general meetings in private companies, a member will need to exercise his inspection rights under s 358 to determine whether authorisation (or ratification, where ratification is possible) has occurred. Crucially, there is no requirement for board authorisation of conflicts of interest under s 175 to be disclosed to the shareholders.

46. <u>Ratification</u>
As regards ratification, the change made by the 2006 Act is that, on any resolution to ratify a breach of duty, the votes of the interested director (if a member of the company) and any member connected with him (as defined in CA 2006, ss 252–255) must be disregarded (see CA 2006, s 239(3), (4)) – the text of CA 2006, s 239 is set out at para 3.74.1 Determining whose votes must be disregarded will not be straightforward, given the breadth of the definition of a connected person, and the issue of whether or not there has been effective ratification may quickly evolve into an expensive preliminary issue.

47. Even if a director cannot muster sufficient votes for ratification, it does not necessarily follow that a derivative claim can be brought. Effective ratification is an absolute bar to a claim, but its absence merely means that the court has a discretion as to whether the claim can proceed which it must exercise in the light of the factors set out in s 263(3).

48. <u>Adjournments to obtain authorisation / ratification</u>
The courts may be reluctant to decide under CA 2006, s 263(2)(a) that a director would not continue the case and to dismiss the claim on that basis. It is also quite likely that there will be no evidence of authorisation or ratification for, had there been, the shareholder would not have considered bringing a derivative claim (unless he wishes to dispute whether the matter was capable of authorisation or validly ratified). The result may be that, in most instances, there will be no basis on which to dismiss the claim under CA 2006, s 263(2) for, had there been evidence to support dismissal under that provision, the claim would not have progressed to this stage. In practice, successful reliance on CA 2006, s 263(2) will most likely arise where the court has adjourned proceedings under CA 2006, s 261(3) or (4) and the company uses the adjournment to authorise or ratify the breach of duty which allows the court to dismiss the case under CA 2006, s 263(2)(b) or (2)(c).

<u>The Views of a hypothetical independent director</u>

49. Subsection 263(2)(b) reflects the decision in **Airey v Cordell** [2006] EWHC 2728 (Ch) 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.

50. The difficulties concerning the question of whether someone with a duty acting to promote the success of the company (i.e. a hypothetical independent director) would seek to continue the claim or not were considered in **Franbar Holdings v Patel** [2008] EWHC 1534:

"In my judgment, this is one of those cases in which there is room for more than one view. Directors are often in the position of having to make what is no more than a partially informed decision on whether or not the institution of legal proceedings is appropriate, without having a very clear idea of how the proceedings will turn out. Some directors might wish to spend more time investigating and strengthening the company's case before issuing process, while others would wish to press on with proceedings straight away; in a case such as this one, both approaches would be entirely appropriate. It is my view that there is sufficient material for the hypothetical director to conclude that the conduct of Medicentres' business by those in control of it had given rise to actionable breaches of duty. As it seems likely that Mr Patel and Dr du Plessis were behind much of that conduct, I cannot be satisfied that a hypothetical director acting in accordance with section 172 would conclude that the case advanced was insufficiently cogent to justify continuation of the claim. Even though he may take a healthily sceptical approach to Medicentres' ability to prove the allegations at trial, it does not follow that the claim should not be continued on that ground alone."

The practical effect of this is that so long as a hypothetical independent director might be willing to pursue the claim, then s. 232(2)(b) will not bar a claim.

51. Nevertheless, even if a claim is not barred under s.232(2)(b), the views of hypothetical independent directors need to be considered as a discretionary factor under s.232(3)(b), i.e. *"the importance that a person acting in accordance with section 172 (duty to promote the success of the company) would attach to continuing it;"*

<u>The views of any independent shareholders</u>

52. In addition, the views of any actual independent shareholders (which may match the views of hypothetical directors) need to be taken account of under s.263(4) which states:

"(4) In considering whether to give permission (or leave) the court shall have particular 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."

53. 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) [1988] Ch 114).**

*	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 of independent directors. This was an issue which was apparently the subject of debate within the Law Commission when the statute was being drafted.

Member's own rights of action

54. If a member can pursue his own right of action that could be a powerful argument as to why permission would not be granted to continue a derivative action (s.263(3)(f)). This may include not only a personal action for damages (subject to problems of reflective loss) but also proceedings pursuant to CA s.994 (unfair prejudice).

55. In **Mission Capital Plc v Sinclair & Anor** [2008] EWHC 1339 the former executive directors of a company "M" tried to bring a derivative claim on behalf of M against the non executive directors and their replacement director "P" claiming that M would suffer damage from their wrongful dismissal and that P would act improperly. It was held that as the former executive directors could potentially recover what they sought by an unfair prejudice petition under s.994. It was also unlikely that an independent director would attach much importance to the company pursuing the speculative claim against the non executive directors and P. Permission to bring a derivative action was therefore refused by Floyd J.

56. In **Franbar Holdings Ltd v Patel & Ors** [2008] EWHC 1534 the applicant unsuccessfully applied for permission to bring a derivative claim against directors who were accused of negligence and default. At the same time an application was made under s.994. It was held that although there was substance in the complaints made and the application was made in good faith, the applicant was motivated by a desire to ensure that it extracted full and fair value from its shareholding. Also, various complaints could be pursued as breaches of the shareholder's agreement.

57. The interaction between unfair prejudice petitions and derivative claims is illustrated by **Lowe v Fahey** [1996] 1 BCLC 262 which held:

"In my judgment, where for example the unfairly prejudicial conduct involves the diversion of company funds, a petitioner is entitled as a matter of jurisdiction to seek an order under s 461 for payment to the company itself not only against members, former members or directors allegedly involved in the unlawful diversion, but also against third parties who have knowingly received or improperly assisted in the wrongful diversion.

This is not to say that in a case where the only substantive relief being sought was a claim on behalf of the company against such a third party that a claimant could always proceed by petition instead of derivative action."

58. As Lewison J. pointed out in **Iestini v Westrip** an aggrieved shareholder may obtain under the unfair prejudice jurisdiction in CA 2006 s.996 an appropriate remedy compelling the company to pursue a claim. This could have a similar effect to being given permission to bring a derivative claim under ss 260-262:

"82. Accordingly it seems to me that where the petitioner's complaint is that the company has failed to assert a good claim against a third party the court's powers under section 996 would include the making of an order requiring the company to assert that claim, if necessary by taking or defending proceedings. Since the company's claim would be a claim against a third party, once the court had decided that a failure to assert that claim had unfairly prejudiced the petitioner, the directors would not need to be parties to the subsequent claim against the third party. In addition the width of the court's jurisdiction under section 996 enables the joinder of third parties to the petition itself, at least where relief is claimed against them: ***Re Little Olympian Each-Ways Ltd*** *[1994] 2 BCLC 420;* ***Lowe v Fahey*** *[1996] 1 BCLC 262.*
83. On the other hand, it may be that the company's cause of action is a cause of action only against the directors for loss suffered as a result of their default or breach of duty (etc.). In such a case the directors will be necessary parties to the company's claim. It may be, therefore, that different procedural routes will be adopted depending on the company's underlying claim."

<u>The Statutory Derivative Claim Procedure</u>

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

60. 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 claim being commenced. Situations when s. 262 will be relied upon are unlikely to arise frequently. The Law Commission explained the thinking behind s.262:

"6.63...We do not want individual shareholders to apply to take over current litigation being pursued by their company just because they are not happy with the progress being made. The provision is intended to deal with those situations where the company's real intention in commencing proceedings is to prevent a successful claim being brought" (Emphasis in the original)

61. Under both s.261 and s.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.

62. Stage 1

* The Claim Form must be marked "*Derivative Claim*" (see CPR PD 19C) and should include any claim for a costs indemnity. It should be accompanied by a standard application notice but the company is not to be named as respondent. The member must file sufficient evidence to establish a prima face entitlement to bring a derivative claim.

* Usually the company must be notified as soon as the Claim and application are issued save that where notifying the company of the permission application would be likely to frustrate some party of the remedy sought, the court may, on application by the claimant, order that the company need not be notified for such period after the issue of the claim form as the court directs.

* At this stage there will be an *ex parte* hearing at which the court needs only to consider the evidence filed on behalf of the Claimant. If the court does not dismiss the application appropriate consequential directions will be ordered, eg for the company (and any necessary 3rd parties) to be added as respondent and for the filing of the respondent's evidence.

63. Stage 2:

* If the Stage 1 hurdle is passed then the merits of the application the continue the claim as a derivative claim will be reconsidered at an adjourned *inter partes* hearing.

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

* At the *inter partes* hearing the court does not simply have to be satisfied that there is a *prima facie* claim. Instead something more is required - the court needs to form a provisional view on the strength of the claim to properly consider the requirements of s.263(2)(a) and s.263(2)(b). However the hearing should not amount to a mini trial of the action. See **Iesini v Westrip** [2009] EWHC 2562 and **Fanmailuk.com v Cooper** [2008] EWHC 2198 (Ch).

64. 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.

Conclusions

65. 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. Historically, the courts have taken a restrictive approach to allowing derivative claims. In the words of Lord Eldon in **Carlen v Drury** (1812)1 Ves & B 154:

"This court is not to be required on each occasion to take the management of every playhouse and brewhouse in the kingdom"

The Courts are likely to adopt as robust an approach to statutory derivative actions as previously occurred under the common law.

November 2009

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PART 11
DERIVATIVE CLAIMS AND PROCEEDINGS BY MEMBERS
CHAPTER 1
DERIVATIVE CLAIMS IN ENGLAND AND WALES OR NORTHERN IRELAND

260 Derivative claims

(1) This Chapter applies to proceedings in England and Wales or Northern Ireland by a member of a company—

(a) in respect of a cause of action vested in the company, and
(b) seeking relief on behalf of the company.
This is referred to in this Chapter as a "derivative claim".

(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).

(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.
The cause of action may be against the director or another person (or both).

(4) It is immaterial whether the cause of action arose before or after the person seeking to bring or continue the derivative claim became a member of the company.

(5) For the purposes of this Chapter—

(a) "director" includes a former director;
(b) a shadow director is treated as a director; and
(c) references to a member of a company include a person who is not a member but to whom shares in the company have been transferred or transmitted by operation of law.

261 Application for permission to continue derivative claim

(1) A member of a company who brings a derivative claim under this Chapter must apply to the court for permission (in Northern Ireland, leave) to continue it.

(2) If it appears to the court that the application and the evidence filed by the applicant in support of it do not disclose a prima facie case for giving permission (or leave), the court—

(a) must dismiss the application, and
(b) may make any consequential order it considers appropriate.

(3) If the application is not dismissed under subsection (2), the court—

(a) may give directions as to the evidence to be provided by the company, and
(b) may adjourn the proceedings to enable the evidence to be obtained.

(4) On hearing the application, the court may—

(a) give permission (or leave) to continue the claim on such terms as it thinks fit,

(b) refuse permission (or leave) and dismiss the claim, or

(c) adjourn the proceedings on the application and give such directions as it thinks fit.

262 Application for permission to continue claim as a derivative claim

(1) This section applies where—

(a) a company has brought a claim, and

(b) the cause of action on which the claim is based could be pursued as a derivative claim under this Chapter.

(2) A member of the company may apply to the court for permission (in Northern Ireland, leave) to continue the claim as a derivative claim on the ground that—

(a) the manner in which the company commenced or continued the claim amounts to an abuse of the process of the court,

(b) the company has failed to prosecute the claim diligently, and

(c) it is appropriate for the member to continue the claim as a derivative claim.

(3) If it appears to the court that the application and the evidence filed by the applicant in support of it do not disclose a prima facie case for giving permission (or leave), the court—

(a) must dismiss the application, and

(b) may make any consequential order it considers appropriate.

(4) If the application is not dismissed under subsection (3), the court—

(a) may give directions as to the evidence to be provided by the company, and

(b) may adjourn the proceedings to enable the evidence to be obtained.

COMPANIES ACT 2006

PROTECTION OF MEMBERS AGAINST UNFAIR PREJUDICE

Main provisions

994 Petition by company member

(1) A member of a company may apply to the court by petition for an order under this Part on the ground—

(a) that the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of members generally or of some part of its members (including at least himself), or

(b) that an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

(2) The provisions of this Part apply to a person who is not a member of a company but to whom shares in the company have been transferred or transmitted by operation of law as they apply to a member of a company.

(3) In this section, and so far as applicable for the purposes of this section in the other provisions of this Part, "company" means—

(a) a company within the meaning of this Act, or

(b) a company that is not such a company but is a statutory water company within the meaning of the Statutory Water Companies Act 1991 (c. 58).