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ASSESSING AND RETHINKING THE STATUTORY SCHEME FOR DERIVATIVE ACTIONS UNDER THE COMPANIES ACT 2006

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In October 2007 a statutory scheme, designed to address the issue of derivative actions, came into force. The scheme provided that shareholders wishing to continue (or commence) derivative proceedings in relation to wrongs committed against their company had to obtain the permission/leave of the court. In the subsequent seven years there have been few derivative actions instituted by shareholders and only a small percentage of actions commenced have succeeded in obtaining court permission/leave to proceed. This article undertakes an analytical review of the statutory scheme and identifies reasons why there are so few proceedings in the UK, and more broadly it examines and evaluates the derivative action scheme itself. The paper considers whether the statutory scheme is too narrow and explores some changes that might be made to it in order to make it more accessible and more effective.

Keywords : derivative actions, unfair prejudice petitions, costs

A. INTRODUCTION

An important principle of company law has been, ever since the decision in Foss v Harbottle,[1] that if a company has a cause of action against someone then the company itself,

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and no one else, must bring proceedings in relation to that cause of action. In the past it has sometimes been known as "the proper plaintiff rule." Whether legal proceedings are to be instituted or not is the decision of the company's board of directors. This is because theoretically boards of directors are regarded as being legitimately vested with control of companies, and a company's articles of association will normally vest the board with very broad general management powers.[2] However, a board might decide, in relation to any given cause of action that is available, not to commence proceedings on behalf of the company. This could be for a variety of reasons. The classic situation is where the cause of action is against a person who is the controlling shareholder, an associate of such a shareholder or one or more of the directors of the company. The courts took the view in the nineteenth century that this state of affairs could produce injustice so they provided that on occasions a shareholder could bring proceedings on behalf of the company. These proceedings came to be known as derivative claims.[3] For many years derivative claims were provided for at common law until a statutory derivative proceedings scheme was introduced, in the Companies Act 2006 ("the Act"), following the approach extant in many Commonwealth countries.[4] The reason for enacting a statutory scheme for derivative actions[5] was the simplification and modernisation of the law in order to improve its accessibility as the common law system lacked clarity and was inaccessible.[6] Also, the existence of a statutory scheme was to ensure that the company receives an appropriate remedy, usually

1 (1843) 2 Hare 461; 67 ER 189.

2 If the articles do not do so then model articles will, unless excluded expressly by the articles themselves, grant such power. See The Companies (Tables A-F) Regulations 1985 SI 1985/805 Table A art 70 and The Companies (Model Articles) Regulations 2008 SI 2008/3229 reg 2 and sch 1 art 5(private companies); reg 4 and sch 3 art 5 (public companies)

3 The description was first in the UK by the Court of Appeal in Wallersteiner v Moir (No 2) [1975] QB 373. The description was borrowed from American law.

4 For instance, Canada, Australia, New Zealand, Ghana, South Africa, Singapore.

5 For a discussion of which, see A. Keay and J. Loughrey, "Something Old, Something New, Something Borrowed : An Analysis of the New Derivative Action Under the Companies Act 2006" (2008) LQR 469.

6 Law Commission, Shareholder Remedies: Report on a Reference under section 3(1)(e) of the Law Commissions Act 1965 (Law Com. No. 246, Cm. 3769) (London: Stationery Office, 1997) at p7 and para 6.4. There have been some adjustments to the original recommendations-in England and Wales, for example, the Law Commission's recommendation that a member be required to give 28 days' notice to the company before initiating proceedings was not adopted: ibid, p91.

compensation, for actions that have prejudiced its interests, and to deter the directors from acting improperly.[7] The Law Commission in its report on shareholder remedies in 1997 saw the aim of the introduction of a statutory regime as being "to make shareholder remedies more affordable and more appropriate in modern conditions."[8] The statutory regime, contained in Part 11 of the Act, began to operate from 1 October 2007[9] and its primary characteristic is that the courts are required to perform a gatekeeper role in order to exclude frivolous or unmeritorious cases the costs of which could be required to be paid by the company and such expense might well outweigh the benefit that it receives. This is accomplished by requiring the permission (leave in Northern Ireland and Scotland) of the court to be secured by a shareholder before being able to continue a derivative action against a director (who allegedly breached his or her duties) and/or others who have harmed the interests of the company.[10]

Since 1 October 2007 the regime has not been used frequently. From a search of the Westlaw, Lexis and BAILII databases,[11] for three jurisdictions, namely England and Wales, Scotland and Northern Ireland, in the eight years since the scheme became operative[12] until September 2015[13] there have only been 22 derivative actions instituted[14] and this works out to be an

[7] See, J. Coffee and D. Schwartz, "The Survival of the Derivative Suit : An Explanation and a Proposal for Legislative Reform" (1981) 81 Columbia Law Review 261, 302-309.

[8] Law Commission, Shareholder Remedies: Report on a Reference under section 3(1)(e) of the Law Commissions Act 1965 (Law Com. No. 246, Cm. 3769) (London: Stationery Office, 1997), Executive Summary and referred to in J. Poole and P. Roberts, "Shareholder remedies – corporate wrongs and the derivative action" [1999] JBL 99, 100.

[9] Companies Act 2006 (Commencement No. 3, Consequential Amendments, Transitional Provisions and Savings) Order 2007, SI 2007/2194, art 2(1)(e).

[10] See Civil Procedure Rules, r.19.9A(2) which requires an application is to be made for permission when a claim form for a derivative action is issued. In Scotland leave has to be sought before derivative proceedings can be commenced.

[11] This was conducted on 1 September 2015.

[12] The search was based on locating applications for permission to continue derivative actions up to 1 September 2015. One application was not reported. We know this as the appeal from the application hearing was reported. See, Wright v Pyke [2012] EWCA Civ 931; [2013] BCC 300.

[13] The latest decision dealing with permission or leave was Bridge v Daley [2015] EWHC 2121 (Ch), decided in June 2015 by his Honour Judge Hodge QC (sitting as a Judge of the High Court).

average of 2.75 cases per year, which is actually less than that found in a study conducted in 2010.[15] The figures obtained are likely to represent all attempts to pursue derivative action as leave (Scotland and Northern Ireland) or permission (England and Wales) must be secured before a derivative action can either be instituted (Scotland) or continued (England and Wales and Northern Ireland), and it is likely that all instances of applications will have been reported given the interest in the field. The paucity of cases rebuts concerns that some had before the introduction of the scheme that it would lead to an avalanche of proceedings.

The article undertakes an analytical review of the statutory scheme, which is warranted given the fact that it has now been in operation for in excess of eight years. Specifically, the article identifies reasons why there are so few proceedings in the UK and more broadly examines and evaluates the derivative action regime. The paper considers whether the present statutory scheme is too narrow and explores some changes that might be made to the statutory scheme in order to make it more effective. After providing some background the paper examines possible reasons for the paucity of proceedings. Following this it explores possible modifications that could be made to the regime. Next the article examines the approach taken by the judiciary as far as applications for permission or leave are concerned. The following two sections of the article then focus on two major issues, namely costs and the use of unfair prejudice petitions by shareholders in lieu of derivative actions. Finally, there is a

[14] All of the cases dealt with permission hearings. Cases, such as multiple-derivative actions, based on the common law procedure were not included. A "multiple-derivative" action is a derivative action that is entitled to be brought by minority shareholders of a parent company for a breach of duty owed to a direct or indirect subsidiary, certainly where control of the subsidiary is not independent of the parent company's board. These applications are not brought under the statutory scheme but under the common law. See, Re Fort Gilkicker Ltd [2013] EWHC 348 (Ch); [2013] BCC 365. The issue of these kinds of proceedings are discussed later in text accompanying notes 34-37.

[15] A. Keay and J. Loughrey, "Derivative Proceedings in a Brave New World for Company Management and Shareholders" [2010] JBL 151. This study found the number of cases per annum was 3.2.

conclusion. It is not intended to provide an analysis of the statutory scheme's individual provisions as that has been done previously by several commentators.[16]

For ease of exposition references will be to the provisions of the Act that apply to England and Wales, and Northern Ireland. The provisions applying to Scotland are very similar.

B. BACKGROUND

It is not intended to embark on a lengthy discussion of the theory underpinning, and rationale behind, derivative actions as that has been undertaken on a number of occasions.[17] But it is worth rehearsing the fact that derivative actions exist to provide an effective entry to the courts in order to maintain investor confidence and to deter directorial and other wrongdoing.[18] Derivative actions are seen by many commentators as mechanisms to reduce agency costs.[19] Thus we can say, first, that the derivative action exists to make managers and directors accountable for what they do in their posts. Second, the action can function as a way of giving some teeth to the process of monitoring of directors that shareholders might undertake. If their monitoring detects wrong then shareholders can do more than simply "jump up and down" and complain. Third, the action, if successful, will lead to the company being compensated in relation to the wrong that has been done to it. Fourth, the action can permit something to be done if there is a dispute within the company about what the directors

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16 For instance, see ibid; D. Gibbs, "Has the statutory derivative claim fulfilled its objectives? A prima facie case and the mandatory bar" (2011) 32 Company Lawyer 41; J. Tang, "Shareholder remedies : demise of the derivative claim?" (2012) 1 UCL Journal of Law and Jurisprudence 178.

17 For instance, see A. Reisberg, "Shareholder remedies : the choice of objectives and the social meaning of derivative actions" (2005) 6 EBOR 227; A. Reisberg, Derivative Actions and Corporate Governance (Oxford, OUP, 2007).

18 J. Coffee and E. Schwartz, "The Survival of the Derivative Suit : An Evaluation and a Proposal for Legislative Reform" (1981) 81 Columbia Law Review 261, 302-309; W. Kaplan and B. Elwood, "The Derivative Action : A Shareholder's 'Bleak House?'" (2003) University of British Columbia Law Review 443, 451, 455.

19 For instance, see R. Posner, Economic Analysis of Law, 3rd ed, New York, Little Brown, 1986, 389.

have done. Of course, this can always be seen as interference in the management of the company, and UK courts as well as courts in other jurisdictions, are usually wary of interfering in the internal affairs of companies save where there are very good grounds for doing so.

Rational shareholders might well reason that it is preferable to exit a company, where they can do so, if the company has been harmed rather than to take derivative action because, on the one hand, the time and possible costs involved, and on the other hand the fact that no benefit will come to the shareholder directly. Nevertheless, the harm caused to the company could have reduced the value of a shareholder's shares that he or she determines that exit is not an appropriate or economical option. In closely held companies exit might not be viable or possible.

Undoubtedly there are grounds for requiring a shareholder to obtain permission before being able to continue a derivative action. Without this requirement a multitude of proceedings could be commenced requiring a company to have to address them all, and thereby causing them unreasonable cost and time, even leading to partial paralysis of their business operations. The requirement also contributes to the position that generally exists in the UK that there should not be interference in the management of companies generally and if there is to be interference then there must be substantial reasons for it.

The gaining of permission is only able to be secured if a shareholder can pass successfully through two stages. First, shareholders have to establish a prima facie case on the merits.[20] The aim of this stage of the permission process is to assess whether the company and the

[20] See section 261(2).

respondent should be put to the expense and inconvenience of considering and contesting the application for permission.[21] If an application is successful on this point, then the matter proceeds to a second stage.[22] In the second stage, according to section 263(2),[23] a court must refuse permission if it is satisfied that one or more of three criteria exist. There is no discretion given to the courts at this point. But if none of the criteria in section 263(2) apply then the court has a discretion whether to allow the claim to proceed. In the process of exercising this discretion the court must take into account factors that are set out in section 263(3) and (4). The UK courts have, compared with the courts in other jurisdictions, a broad discretion when it comes to permitting shareholders to proceed. For instance, in some jurisdictions, such as Germany, if a person has a certain percentage of the issued share capital of the company then he or she has the right to bring derivative proceedings without the need to obtain permission.

C. THE REASONS FOR FEW PROCEEDINGS

The fact that there have been few proceedings is not of itself a reason for seeking changes to the statutory scheme, but given the fact that all applications for permission are likely to have been reported and the aim of the scheme was to make derivative process more accessible to shareholders it is not an unimportant factor. The experience in the UK is to be contrasted to that in New Zealand where the derivative claim has become popular, manifested by the number of proceedings instituted.[24]

21 Langley Ward Ltd v Trevor [2011] EWHC 1893 (Ch), [62]. For an analysis of the first stage, see A. Keay and J. Loughrey, "Derivative Proceedings in a Brave New World for Company Management and Shareholders" [2010] JBL 151; D. Gibbs, "Has the statutory derivative claim fulfilled its objectives? A prima facie case and the mandatory bar" (2011) 32 Company Lawyer 41.

22 Keay and Loughrey, ibid.

23 Except where stated otherwise the provisions referred to are those applying in England and Wales and Northern Ireland.

24 L. Taylor, "The Derivative Action in the Companies Act 1993 : An Empirical Study" (2006) 22 New Zealand Universities Law Review 337, 337.

The following might be reasons for the paucity of cases in the UK. First, shareholders seem to be using section 994 petitions, alleging unfair prejudice against directors, rather than initiating derivative proceedings, as the same facts might lead to a claim on either basis. This is a matter that is discussed later in some depth. Second, there is a costs element to any action and it might dissuade the institution of proceedings. If a permission action is not successful then an applicant shareholder might not only be liable for his or her costs, but the costs of the other parties. If the applicant were successful a court might order that the company is to pay the costs of the action, but a general costs order does not appear to have been made thus far by any court. Again, this is another matter which will be discussed later.

Third, there is lack of a financial incentive for a shareholder to take the time and incur possible costs that prosecuting derivative actions entails, because any relief ordered will be in favour of the company. A shareholder does not receive any direct benefit from the action that he or she takes. In fact the shareholder might not receive any indirect benefit. While a successful outcome to an action might lead to an increase in the value of shares, this is not guaranteed. In fact, there is data from an American empirical study suggesting that there is little positive impact on share values following successful derivative proceedings.[25] The derivative action might, in relation to larger companies in particular, affect the reputation of the company because of a loss of confidence in the directors,[26] and that might in fact reduce the value of shares.

[25] D. Fischel and M. Bradley, "The Role of Liability Rules and the Derivative Suit in Corporate Law : A Theoretical and Empirical Analysis" (1986) 71 Cornell Law Review 261.

[26] J. Wilson, "Attorney Fees and the Decision to Commence Litigation : Analysis, Comparison and an Application to the Shareholders' Derivative Action" (1985) 5 Windsor Yearbook of Access to Justice 142, 177 and referred to in A. Resiberg, Derivative Actions and Corporate Governance, (Oxford, OUP, 2007), 224.

Fourth, shareholders might be dissuaded from taking action because they might feel, with some justification, that the other shareholders are engaging in free-riding. That is, the applicant shareholder is taking all the risks and the other shareholders might well share indirectly in any benefit bestowed on the company by a court in the derivative action. Fifth, as discussed later in the article, the judges do appear to be invoking a fairly strict approach to permission applications, and this might discourage shareholders from taking action. Finally, an action can be pursued only, according to section 260(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.

D IS THERE A NEED FOR CHANGE?

While the statutory scheme has provided a little more certainty concerning when a derivative action might be initiated, when compared with the position at common law, it has clearly not given much encouragement to shareholders, and arguably has not made the derivative action more accessible for shareholders. As a consequence this part of the article analyses the functioning of the scheme and considers several possible changes that might be introduced.

1. The Range of Applicants

The UK scheme limits the bringing of derivative actions to members of the company. This is a more limited approach than that found in other jurisdictions. For instance, section 236 of the Australian Corporations Act 2001 allows, besides members, former members and officers of the company to bring derivative proceedings.[27] Interestingly, the Company and Securities

[27] New Zealand also permits directors to apply : Companies Act 1993, s.165.

Law Review Committee, a body that reviewed company law and considered changes to corporate legislation in Australia, favoured giving a derivative action to creditors as well as shareholders,[28] but this view did not gain the imprimatur of Parliament and, hence, did not find its way into legislation. Importantly though, in the general scheme of things, Australian creditors arguably could secure relief under section 1324 of the Corporations Act, which enables anyone affected, or who could be affected, by a contravention, or proposed contravention, of the legislation to seek injunctive relief. Such relief is not available in the UK.

The approach adopted in Canada and Singapore provides for a much broader range of persons who can take action. Section 238 of the Canada Business Corporations Act 1985 includes members, certain creditors, and directors, and also applications may be made by "any other person who, in the discretion of a court, is a proper person to make an application." Similarly, section 216A(1)(c) of the Singaporean Companies Act provides that the range of persons who can apply for a derivative action includes "any other person who, in the discretion of the Court, is a proper person."

It might be argued that shareholders do not take proceedings save where they are convinced that either they will benefit from the action, at least indirectly, or that the action was likely to harm them in the short term or even in the long term. It is probable that whether or not shareholders would be prepared to institute derivative proceedings will very much depend on what the directors have done. As Janice Dean has asserted in relation to derivative claims : "there seems to be no a priori reason why others [besides shareholders] should not enjoy similar access to the courts to protect the company from harm, under a regime of judicial

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[28] Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action, Report No 12, 1990.

supervision similar to that envisaged to 'manage' shareholder actions."[29] Often many or all of the shareholders do not know what is going on in a company; they are poor monitors. Broadening the range of those who can bring proceedings increases the chances of a company's interests being protected, because someone else might well be aware of something that the shareholders and others are not. For example, employees may be more conversant with the affairs of the company and what directors are doing, and might, therefore, be far better monitors. This is perhaps demonstrated to some degree by the fact that we see, not infrequently, employees acting as "whistleblowers," and disclosing some improper or inappropriate practice of corporate managers.

It is suggested that the legislation should provide that an application could be made by "anyone who appears to the court to be interested in the company."[30] Courts could be granted, by a revised statutory derivative scheme, discretion as to whether any applicant legitimately fell within the category suggested. The present permission procedure should remain. This would ensure that the floodgates would not be opened as far as applications are concerned. It is submitted that in deciding whether "anyone who appears to the court to be interested in the company" is able to bring a derivative action a court should be convinced that the person has either a direct financial interest in the affairs of the company or a particular legitimate interest in the way that the company is being managed. This approach would chime with section 172(1) of the Act which provides, inter alia, that the directors are to promote the success of the company for the benefit of the shareholders and in doing this they must have regard for several constituent interests that are set out in section 172(1)(a)-(f). At present if the directors breach their duty by failing to have regard for these interests only the shareholders could take action. Normally, they will not do so.

[29] Directing Public Companies (London, Cavendish, 2001), 155.
[30] This is reminiscent of the category of persons who were able to apply under s.651 of the Companies Act 1985 for an order declaring the dissolution of a company to be void.

If this proposal were implemented, is there a danger of an avalanche of litigation? It is unlikely; the concern over a deluge of claims is often over-emphasised. Certainly the floodgates do not appear to have opened as far as Canada or Singapore is concerned. It would appear that the leave process has been used in Canada[31] successfully, to prevent an increase of litigation.[32] Indeed in Canada it is the oppression provision which has, just like the UK's unfair prejudice provision, spawned a significant amount of litigation. Also, the permission process should enable the filtering out of unmeritorious or vexatious claims.[33]

It might be argued that the proposal leads to uncertainty, as there would be an open and undefined class of stakeholders who could apply for permission to continue derivative proceedings. But, gradually jurisprudence would develop to provide more certainty. Also, it is likely that the main players (employees, creditors, suppliers etc) would be covered by the formula proposed.

Finally, in relation to the subject of this section of the paper it is perhaps worth considering, albeit briefly because of space constraints,[34] whether, and leaving aside the proposal just articulated above, the present legislation should be broadened to allow so-called "multiple derivative actions" (sometimes referred to as "double derivative actions") to be brought

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[31] Canada Business Corporations Act 1985, s.239(1).

[32] See, I. M. Ramsay and B. Saunders, "Litigation by Shareholders and Directors: An Empirical Study of the Statutory Derivative Action" (2006) 6 JCLS 397.

[33] It has been suggested that in the context of implementing stakeholder theory relief might be limited to injunctions (W. Leung, "The Inadequacy of Shareholder Primacy : A Proposed Corporate Regime that Recognizes Non-Shareholder Interests" (1997) 30 Columbia Journal of Law and Social Problems 589, 625), but this would not be necessary with a permission process in effect.

[34] For more detailed discussion, see, for example, S. Goo, "Multiple derivative action and common law derivative action revisited: a tale of two jurisdictions" (2010) 10 JCLS 255;T. Mascarenhas, "Multiple derivative actions under English law" (2013) 24 ICCLR 336; A. Keay, *Directors' Duties*, 2nd ed (Bristol, Jordan Publishing, 2014) 465-468. For an interesting discussion of the action, see the judgment of Lord Millett in the Hong Kong case of Waddington Ltd v Chan Chun Hoo Thomas [2008] HKCFA 63; (2008) 11 HKCFAR 370; [2009] 4 HKC 381; [2009] 2 BCLC 82

within the ambit of the statute. A “multiple-derivative” action is a derivative action that is entitled to be brought by minority shareholders of a parent company for a breach of duty owed to a direct or indirect subsidiary, certainly where control of the subsidiary is not independent of the parent company’s board. Case law decided since the advent of the derivative action scheme[35] has found that multiple derivative actions may be brought by a shareholder, but they are not brought under the statutory scheme. Rather, they are initiated under the common law. This has, therefore, led to two systems applying to derivative actions. It is submitted that that is not a good state of affairs. The statutory scheme was designed to deal with derivative actions in general, and obviously fails to do so as far as multiple derivative actions are concerned. Inter alia, this can cause confusion and can lead to the existence of two parallel schemes with different principles, which is not helpful. If the proposal advocated earlier in this section of the paper were implemented then that should permit the bringing of multiple derivative actions as members of parent companies might be said to have an interest in what is happening in a subsidiary company. Nevertheless, it is contended that it the UK Parliament should amend the provisions in the legislative scheme for derivative actions so as to accommodate multiple derivative actions. It might be appropriate to proceed along the lines of section 236 of the Australian Corporations Act 2001 where it is provided, in section 236(1)(a)(i), that a claim may be brought by a member of the company or of a related body corporate, as a subsidiary company comes within the latter expression.[36] The New Zealand legislation takes a similar approach.[37] This suggestion could be implemented with little difficulty and, perhaps, would not be as contentious as the proposal I have made earlier about expanding the range of applicants.

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35 See, Re Fort Gilkicker Ltd [2013] EWHC 348 (Ch); [2013] BCC 365; Abouraya v Sigmund [2014] EWHC 277 (Ch); Bhullar v Bhullar [2015] EWHC 1943 (Ch). In all of these cases the applicant succeeded in securing permission to continue the action.

36 See, Oates v Consolidated capital Services Pty Ltd [2008] NSWSC 464.

37 Companies Act 1993, s.165(1)(a).

2. The Range of Actions

The statutory scheme broadened the range of actions that could be initiated by derivative proceedings at common law, primarily in relation to permitting actions based on the negligence of directors to be instigated.[38] But this has not, and is not, likely to provide any great assistance to shareholders because any negligence claim often involves an allegation concerning the judgment of directors and, traditionally, judges are reluctant to second-guess judgments of directors.

The Canadian, New Zealand and Australian legislation provides no limit to the actions that might be the subject of derivative proceedings. It would be much better if the UK scheme permitted shareholders to bring derivative proceedings against anyone under any cause of action that the company has, and where no action has been instigated by the board. Under the present scheme, the action must be one that arose as a result of the actions of the directors.[39] Thus an action that exists because of something that is independent of the actions of the directors cannot be subject to a derivative action. It is unlikely that an action that was not dependent on a breach by a director would be pursued frequently, but there is always the possibility that a board could refrain from proceeding against a third party because that party is associated with one or more of the directors or the controller(s) of the company.

3. Discretion to Order Payment to a Shareholder

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[38] At common law an action for negligence could only be brought where the negligence involved bad faith or was self-serving. See Pavlides v Jensen [1965] Ch 565; Daniels v Daniels [1978] Ch 406.

[39] Section 260(3) of the Act. See, Iesini v Westrip Holdings Ltd [2009] EWHC 2526 (Ch); [2010] BCC 420, [75].

The court has the power at a permission hearing to order the company to indemnify the successful shareholder in relation to his or her costs.[40] But, notwithstanding the fact that the Law Commission said that the inclusion of the power to provide for an indemnity was a significant incentive to shareholders to initiate proceedings,[41] in reality there is little incentive for shareholders because any relief that is ultimately ordered by a court will go wholly to the company itself.[42] The best that shareholders can hope for is that their costs will be covered. Frank Easterbrook and Daniel Fischel have observed that : "A dominating characteristic of the derivative action is the lack of any link between stake and reward – not only on the judge's part but on the plaintiff's."[43] As indicated earlier, this could be a reason for shareholders not commencing derivative actions.

To provide some incentive for shareholders it is submitted that UK courts should be given the power that has been bestowed on New Zealand courts by section 167(d) of the Companies Act 1993, namely to :

> "make an order directing that any amount ordered to be paid by a defendant in the proceedings must be paid, in whole or part, to former and present shareholders of the company… instead of to the company…"

This would be of particular benefit where the company against which proceedings have been instituted is completely controlled by the wrongdoers and it is possible that they will use any benefit that it awarded by a court in derivative proceedings improperly.

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40 CPR 19.9E.

41 Shareholder Remedies, Consultation Paper No 142, 1996, para 18.1

42 For instance, see I. Ramsay, "Corporate governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action (1992) 15 University of New South Wales Law Journal 149, 150 and 164.

43 Economic Structure of Corporate Law (Cambridge, Mass, Harvard University Press, 1991),101.

The Law Commission did not favour this approach as it said that it blurred the distinction between personal and representative actions. But without such a course of action it might see the virtual demise of derivative actions. And in an event, as discussed later, the courts have, arguably, already blurred the distinction between the two kinds of actions by permitting shareholders to succeed on unfair prejudice petitions when the wrong complained of is one sustained by the company.

Even if an indemnity as far as costs is awarded by a court to a shareholder, an issue to be considered later, it is not as if the shareholder is being granted anything that would give him or her an incentive to take proceedings, but giving shareholders the possibility of a share of the rewards might do so. The payment could be justified on the basis that if the company's directors had run the action against the person who had wronged the company then they would be paid by the company for the work that they had done and the costs would have to be paid by the company, so the applicant shareholder should be paid in a like manner.[44] The benefit ordered where the shareholder is successful only follows the bringing of a derivative action to obtain relief for the company and after the company's board failed to take action.[45]

Any award to the shareholder as suggested above might not all be "profit" in the sense that the time and cost expended by the shareholder in bringing the action, such as instructing solicitors, attending conferences with counsel, attending to read and sign witness statements, and giving evidence at the trial cannot be recovered and any indemnity ordered in favour of the shareholder might well not cover his or her own costs in full, as some elements of a party's costs cannot be included in a claim against the other party who is ordered to pay costs.

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44 A. Reisberg, "Funding Derivative Actions : A Re-examination of Costs and Fees as Incentives to Commence Litigation" (2004) 4 JCLS 345, 375.

45 Also, see the comments in ibid, 377.

This proposal is not new. Arad Reisberg argued for it before the advent of the statutory scheme. His view, which has much to commend it, was that the reward given to the shareholder :

> "can be limited to a reasonable percentage of the proceeds and could also be linked to a clear monetary benefit to the company as a result of the action. The court should be provided with discretion to adjust the figure, depending on a number of factors, such as novelty or complexity of issues, quality of representation, risk and the like."[46]

This kind of approach is not unheard of in law. For instance, section 564 of the Australian Corporations Act 2001 authorises courts to confer a special advantage on creditors of a company in liquidation who, by providing the liquidator with an indemnity against the costs of litigation or in some other way taking financial risk upon themselves, have enabled property of the company in liquidation to be preserved or recovered which might otherwise not have been available for the payment of debts.[47]

4. Permission/Leave Required Before Settlement or Discontinuation of an Action

A court in England and Wales may, once it has granted permission for the derivative action to continue, order, under the Civil Procedure Rules,[48] that the claim constituted by the derivative action cannot be discontinued, settled or compromised without its permission. So, whether such an order is made is left squarely in the discretion of the court. It is submitted that the

[46] Ibid, 373.
[47] See A. Keay, McPherson The Law of Company Liquidation, 4th edn (Sydney, Law Book Co, 1999), 580–584.
[48] Rule 19.9F.

New Zealand equivalent is much more satisfactory as it provides that : "No proceedings…may be settled or compromised or discontinued without the approval of the court."[49] A similar approach, which makes it mandatory for court permission for any discontinuance etc, is taken in Australia,[50] Canada[51] and Singapore.[52] Such an approach permits the court to keep greater control over the matter following the permission hearing, and this is in line with the policy behind past reforms in England and Wales to court procedure and the introduction of things like case management hearings. It might be felt that if a court grants an indemnity to a shareholder then it should have the right to be advised of any intended discontinuance or settlement and be able to veto it. Such action ensures that the directors and other defendants do not "buy off" the claimant/shareholder and potentially deprive the company of some relief. The legislature's concern over possible collusion between directors and a shareholder in this regard is manifested, for instance, by the fact that section 264 of the Act allows a shareholder to seek permission to continue an existing derivative action where it has not been prosecuted diligently.

If the claimant decides to discontinue or settle the action then the court should have the opportunity of re-considering any award of costs that had been made, certainly in relation to costs incurred after the permission hearing.

5. The Place of Ratification[53]

49 Companies Act 1993, s.168.
50 Corporations Act 2001, s.240.
51 Canada Business Corporations Act 1985, s.242(2).
52 Companies Act, s.216B(2).
53 For a detailed recent study of this topic, see C. Riley, "Derivative claims and ratification : time to ditch some baggage" (2013) 34 Legal Studies 582.

As at common law, the question of whether a wrong has, or could be, ratified might remain critical as to whether permission will be given to allow a derivative claim to continue.[54] Section 263(2)(c) provides that if the cause of action that is the subject of a derivative claim has been ratified then permission cannot be granted to the shareholder. Also, under section 263(3)(c) the court must take into account in its decision whether to give permission the likelihood of the cause of action being ratified if it had not been ratified before the permission hearing.

The law on ratification was described by the Australian Companies and Securities Advisory Committee in its report on the possible introduction of a statutory derivative action as : "Undoubtedly the greatest legal difficulty with the existing derivative remedy."[55] One commentator has said, in relation to how it affected derivative actions at common law, that : "the mere possibility of ratification was sufficient to deprive a shareholder of the ability to bring a derivative action."[56] Certain wrongs are not able to be ratified, so the issue of ratification will not always apply, but the danger is, as Tony Boyle pointed out, it may result in leave hearings becoming dominated by arguments over whether the alleged wrongs were ratifiable or not.[57] The case law has not helped.[58] The fact is that the law on what can be ratified is not clear, and so this adds one more uncertain issue to a permission hearing.

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54 In addition even where the wrong is ratifiable , the court will need to determine whether the conditions for ratification are met and in particular where the purported ratification is by the general meeting, whether the shareholders were properly informed given that the directors who have been engaged in wrongdoing are likely to conceal matters that might result in the shareholder vote being adverse for them: see Stainer v Lee [2011] EWHC 2287 (Ch), [45]-[46]

55 Report on a Statutory Derivative Action, July 1993, 6.

56 S. Fridman, "Ratification of Directors' Breaches" (1992) 10 Company and Securities Law Journal 252, 252 and quoted in I.M. Ramsay and B. Saunders, "Litigation by Shareholders and Directors: An Empirical Study of the Statutory Derivative Action" (2006) 6 JCLS 397, 406.

57 A. J. Boyle, "The New Derivative Action" (1997) 18 Company Lawyer 256 at 258. Also, see J. Poole and P. Roberts, "Shareholder remedies – corporate wrongs and the derivative action" [1999] JBL 99, 109.

58 For instance, see Franbar Holdings Ltd v Patel [2008] EWHC 1534 (Ch); [2008] BCC 885 where the deputy judge linked wrongdoer control and ratification. For further discussion, see A. Keay and J. Loughrey, "An assessment of the present state of statutory derivative proceedings" in J. Loughrey (ed), *Directors' Duties* and Shareholder Litigation in the Wake of the Financial Crisis, (Cheltenham, Edward Elgar, 2012), 202-207.

The better approach would be to remove any reference to ratification in the statutory regime. This would bring the UK scheme in line with other common law jurisdictions, such as Canada, Singapore, Australia and New Zealand that do not provide ratification as a factor that can prevent permission being granted for the continuation of derivative actions. In fact the New Zealand legislation does not even mention ratification in the context of derivative actions. While the Canadian legislation does so,[59] it states that the fact that a wrong has been ratified can be taken into account by the court only in deciding what relief it is going to give. The Australian legislation does include a reference to ratification, but expressly provides that ratification does not prevent a person from bringing proceedings with leave.[60] The Explanatory Memorandum to the Corporate Law Economic Reform Bill that included a new statutory derivative action scheme for Australia indicated that ratification or possible ratification caused significant barriers to shareholders.[61] The Australian legislation, like the Canadian, provides that if there is ratification then the Court may take that into account in deciding what order to make at the hearing of the derivative claim.[62] That means that it is not of relevance at the permission stage. So, in New Zealand ratification is not relevant and its importance is far less in Australia and Canada when compared with the UK.

As mentioned above, it is not just the fact that ratification has occurred that the courts have to take into account and which will effectively bar permission,[63] they have to consider the likelihood of ratification in the future.[64] In Franbar Holdings Ltd v Patel[65] the court cited the fact that ratification was likely as one reason which led it to deny permission.

59 Canada Business Corporations Act 1985, s.242.
60 Corporations Act 2001, s.239(1).
61 At para 6.15.
62 Section 239(2). See, P. Prince, "Australia's Statutory Derivative Action : Using the New Zealand Experience" (2000) 18 Company and Securities Law Journal 493, 500.
63 Section 262(2)(c)(ii).
64 Section 263(3)(d).
65 [2008] EWHC 1534 (Ch), [37].

The Law Commission was concerned in its report in 1997 that its efforts to simplify the derivative action could be undermined by the complexities that arise where an alleged wrongdoing has been or might be ratified.[66] What is proposed here, namely the removal of any reference to ratification, would address those fears.

E. THE JUDICIAL APPROACH

The fact that there have been relatively few proceedings instituted is not sufficient alone to indicate that the courts have been overly restrictive in their approach, because the applications thus far might be categorised as weak or relatively so. Nevertheless, there have been judgments that indicate that courts have adopted a tough approach and it seems that the general approach of the courts, generally speaking, seems to lend support to Reisberg's view, emitted in the early days following codification, that the traditional suspicion of the English courts towards derivative actions will continue especially now that they are "'armed' with a very restrictive legislation to 'justify' their attitudes."[67]

There are some indications that the courts might be deferring overly to the decisions of boards. For instance, in Iesini v Westrip Holdings Ltd,[68] when addressing the issue of whether a hypothetical director acting in accordance with section 172 would continue the claim, Lewison J (as he then was) said that "the weighing of all of these considerations is essentially a commercial decision, which the court is ill-equipped to take, except in a clear case."[69] Further, in Kleanthous v Paphitis[70] Newey J was content to rely on the view of two directors of the company as to where the commercial interests of the company lay. His Lordship was

66 Para 6.81.
67 "Shadows of the Past and Back to the Future: Part 11 of the UK Companies Act 2006 (in)action" [2009] ECFR 219, 225.
68 [2009] EWHC 2526 (Ch); [2010] BCC 420.
69 Ibid, [85].
70 [2011] EWHC 2287 (Ch), [45]-[68].

very ready to say that the chief executive officer and the finance director were better placed than he was to assess what was in the company's commercial interest.[71] While the respondents in this latter case argued that these directors were independent, and Newey J appears to have accepted this, the applicant argued, perhaps with some validity, that they were not independent enough. This was based on the fact that the directors were executives of the company, they had been involved with the company for some time and one of them had been a director of a number of companies associated with the leading respondent.[72]

The case law appears to suggest that the judges' policy has been to pull back from "an actual assessment of these business considerations into the comfort zone of the law."[73] But when we look at the role that has been assigned to the judges by the derivative action scheme it seems to require judges to decide whether the refusal to initiate proceedings is in the company's commercial interests. Arguably the statutory process inevitably requires judges to make judgments concerning the interests of the company, because every examination by a judge of the directors' decision will often involve, to some extent, second-guessing the judgments made by directors. The statutory regime seems to make it plain that judges must decide for themselves whether the claim that is the subject of the action promotes the success of the company.

Of the 22 cases heard thus far, a shareholder has only succeeded in getting permission or leave in eight of them, which is a 36 per cent strike rate, and in two of the cases[74] permission was only granted until the disclosure stage. The strike rate seems to be very low, especially when one compares it with the Australian position, and even more so when compared with the New Zealand experience. In the period of March 2000 to August 2005 a study found,

71 Ibid at [75].
72 Ibid.
73 D. Kershaw, Company Law in Context : Text and Materials, (Oxford, OUP, 2009), 560.
74 Kiani v Cooper [2010] EWHC 577 (Ch); [2010] BCC 463, [46]; McAskill v Fulton 2014 WL 8106597, [47].

taking into account applications in all Australian jurisdictions, a success rate of 61 per cent.[75] In New Zealand a study in 2006 showed a 70 per cent success rate.[76]

Rupert Reed asserted, before the commencement of the statutory scheme, that masters were reluctant to refrain from granting permission for shareholders to proceed with a derivative action as they did not want to be seen as stifling actions.[77] But under the statutory scheme we appear to have seen the pendulum swing appreciably in the other direction. Perhaps the judges are concerned about a marked increase in litigation, which was a concern of the Law Commission and was one reason for its decision to recommend that court permission had to be obtained is in relation to a proposed derivative action.[78]

In relation to the situation at common law it has been said that judges were faced with difficulty in granting leave to proceed as the amount of evidence adduced was limited. But under the very formal system that now exists, that situation has been remedied to a large degree. Besides the fact that applicants are likely to produce more evidence than before, given the greater formality of the permission process, and the fact that if they do not they could fail to succeed at the first stage of that process, courts have, after determining that the shareholder has got through the first stage of the process, the power to direct the company to provide certain evidence,[79] in order to assist them making an informed decisions on the application.

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75 I. M. Ramsay and B. Saunders, "Litigation by Shareholders and Directors: An Empirical Study of the Statutory Derivative Action" (2006) 6 JCLS 397, 445.

76 L. Taylor, "The Derivative Action in the Companies Act 1993 : An Empirical Study" (2006) 22 New Zealand Universities Law Review 337, 354.

77 R. Reed, "Derivative Claims : The Application for Permission to Continue" (2000) 21 Company Lawyer 156, 157.

78 Shareholders Remedies, Report No 246, 1997, para 6.69.

79 Section 261(3).

F. COSTS

At common law the courts were able to order the company to indemnify a shareholder when granting permission to the shareholder to pursue a derivative action. The power to make such an order is now found in rule 19.9E of the Civil Procedure Rules. It provides that a court may order the company to indemnify the shareholder bringing the derivative action against any costs incurred in relation to the permission application or the derivative action or both.

Costs is always a concern in most litigation in the UK, largely because of the fact that litigants can be held liable for the costs of the other parties (as well as having to pay their own costs), usually where they lose, and derivative action litigation is no different. It has been a constant and major problem with such actions. When it comes to quasi-partnerships it was said, before the advent of the statutory regime, that the prospect of a costs order persuaded a shareholder to follow the derivative action route rather than presenting a petition alleging unfair prejudice.[80]

The case law, under both the common law and the statutory regime, provides mixed messages when it comes to costs. Some cases under the common law process suggested that provided a shareholder could persuade a court, at an ex parte preliminary hearing, that the proceedings were justified, he or she would get an indemnity order for costs. This is exemplified by what Lord Denning MR stated in the celebrated case of Wallersteiner v Moir (no 2) :[81]

> "The minority shareholder, being an agent acting on behalf of the company, is entitled to be indemnified by the company against all costs and expenses

[80] R. Reed, "Derivative Claims : The Application for Permission to Continue" (2000) 21 Company Lawyer 156, 158.
[81] [1975] QB 371 at 391.

reasonably incurred by him in the course of the agency... Seeing that, if the action succeeds the whole benefit will go to the company, it is only just that the minority shareholder should be indemnified against the costs he incurs on its behalf…"

Lord Denning MR almost went to the point of saying that if a shareholder is bringing a legitimate derivative action then it follows that he or she should be indemnified.[82]

Some judgments given under the statutory scheme have also provided some encouragement to would-be applicants for permission. *Carlisle & Cumbria United Independent Supporters'* Society Ltd v CUFC Holdings Ltd[83] was a case which involved an appeal from a costs order made in relation to a claim relating to a breach of a director's duty, but which had been settled before the application to obtain permission to continue the claim as a derivative action was determined. Arden LJ said that : "As the action was a derivative action on behalf of the club, the trust [the applicant]had an expectation of receiving its proper costs from the companies on an indemnity basis if the action had gone forward…"[84] In Stainer v Lee[85] Roth J said that a shareholder who obtains the permission of the court to proceed "should normally be indemnified as to his reasonable costs by the company..."[86] (my emphasis). Barrett J of the New South Wales Supreme Court in Foyster v Foyster Holdings Pty Ltd[87] embraced the views of many commentators when he said that shareholders are deserving of their costs because in legitimate cases they have been forced to embrace the derivative action process in order to protect the company and as their actions are necessary because the normal decision makers of the company have not been forthcoming, they should not be required to fund the

82 Ibid at 391-392.
83 [2010] EWCA Civ 463; [2011] BCC 855.
84 Ibid, [8] and referring to Wallersteiner v Moir (no 2).
85 [2010] EWHC 1539 (Ch).
86 Ibid, [56].
87 [2003] NSWSC 135 at [13].

proceedings. Canadian commentators have even said that the "only compelling justification for a leave requirement is the possibility of interim funding."[88]

But other English judges, both when deciding matters at common law[89] and under the statutory scheme, have tended to be more cautious when it comes to ordering an award of costs in the context of derivative actions, and the circumstances in which an order is to be made are rather obscured.[90] In fact the recent case law clearly demonstrates that the expectation referred to by Arden LJ in the previous paragraph is not being fulfilled.

In Parliament, when the Companies Bill 2005 was being debated, there were suggestions that the inclusion of a power to make indemnity costs orders in the statutory scheme would act as an incentive to some to bring vexatious claims.[91] This has clearly not been the case. The reference to costs orders acting as an incentive is not a new idea, for from time to time it has been raised, perhaps most importantly by the Law Commission.[92] But, the granting of costs is not really an incentive.[93] Providing an incentive assumes that the one being incentivised will get something additional for the course of action they are taking. But a costs order simply maintains the status quo in that the shareholder has not gained anything, but he or she has not lost anything. This might not be true, of course, in every case as the shareholder might have to pay costs to his or her solicitors that are not covered by the indemnity; in instructing solicitors the shareholder will be principally liable for the costs incurred whatever happens.

88 W. Kaplan and B. Elwood, "The Derivative Action : A Shareholder's 'Bleak House?'" (2003) University of British Columbia Law Review 443, 478.
89 For example, see McDonald v Horn [1995] 1 All ER 961, 974.
90 C. Paul, "Derivative Actions under England German Law" (2010) ECFR 81, 96.
91 HL Debates, 27 February 2006, vol 679, col GC13.
92 Law Commission, Shareholder Remedies, Consultation Paper No 142, 1996, para 18.1
93 A. Reisberg, "Funding Derivative Actions : A Re-examination of Costs and Fees as Incentives to Commence Litigation" (2004) 4 JCLS 345, 355.

The broad discretion that courts are granted on the issue of costs "denies the successful applicant [at the permission hearing] the assurance that court recognition will result in the company becoming liable for the reasonable costs of litigating on its behalf."[94] The consequence is that the "incentive" of costs is a mere prospect and is dependent on the uncertainty that is the judicial discretion.[95] The concern is that shareholders do not have any real idea as to when an indemnity for costs will be awarded as there are no guidelines on awarding indemnities and so shareholders do not know whether they are likely to obtain any assistance on costs when contemplating the institution of derivative proceedings. What we seem to get from the cases is that the courts are inclined, if deciding to award costs, to make limited orders, which does not provide shareholders with any great confidence. Thus far no court has awarded an unlimited costs order to any successful applicant. It is submitted that the courts need to be more ready to award an indemnity in relation to the costs of shareholders who successfully obtain permission to continue a derivative action. The position adopted under the present scheme is harsh.

The cautious approach of the courts[96] is manifested by the fact that in only two of the eight cases[97] where the shareholder has been successful under the statutory regime, has the court granted costs, and in these cases it declined to grant costs without limit. For instance, in Stainer v Lee[98] Roth J ordered an indemnity to a limit of £40,000. In New Zealand the courts have awarded costs in 37.5 per cent of cases where leave was sought, and while this might not seem to be significant, one must remember that courts have given permission in far more

94 K. Fletcher, "CLERP and Minority Shareholder Rights" (2001) 13 Australian Journal of Corporate Law 290, 299.
95 A. Hargovan, "Under Judicial and Legislative Attack : The Rule in Foss v Harbottle" (1996) 113 South African Law Journal 631, 648.
96 Also the position in Australia : I. M. Ramsay and B. Saunders, "Litigation by Shareholders and Directors: An Empirical Study of the Statutory Derivative Action" (2006) 6 JCLS 397, 432.
97 But the applicant in one case where permission was given, Cullen Investments Ltd v Brown [2015] EWHC 473 (Ch) did not seek an order that the company fund the litigation.
98 [2010] EWHC 1539 (Ch), [56].

cases in New Zealand, so we are dealing with larger numbers, and in 40 per cent of the cases where no order as to costs was made the applicant actually did not seek an order in relation to costs.[99]

It does seem rather unfair and difficult to understand why a court would deny an indemnity for costs when an applicant for permission to continue derivative proceedings has jumped over all of the hurdles contained in the two stage process. It causes one to ask : what else must the applicant do? The problem is that there is nothing in the legislation or the rules of court that instructs the shareholder in this regard. The concern is that the shareholder is at the mercy of the court's discretion.[100] It has been suggested that to the extent that an applicant succeeds and costs are not ordered to be paid by the company, the company is unjustly enriched (and, possibly, so are other shareholders and non-shareholding stakeholders) as it gets the benefit from the efforts of the shareholder.[101] Further, if a court declines to award costs then a successful applicant might decide not to pursue the derivative action and this could mean that the ones who harmed the company get away scot free.

One commentator has asserted that the courts need to engage in a balancing exercise, ensuring that they are not too generous in granting indemnity orders, but not too harsh as this may hinder valid claims.[102] With respect, this might be a fair assertion in relation to the decision as to whether to grant permission or not, but once the court has decided in favour of

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99 L. Taylor, "The Derivative Action in the Companies Act 1993 : An Empirical Study" (2006) 22 New Zealand Universities Law Review 337, 355.

100 L. Thai, "How Popular are Statutory Derivative Actions in Australia? Comparisons with the United States, Canada and New Zealand" (2002) 30 Australian Business Law Review 118, 136.

101 J. Wilson, 'Attorney Fees and the Decision to Commence Litigation : Analysis, Comparison and an Application to the Shareholders' Derivative Action' (1985) 5 Windsor Yearbook of Access to Justice 142, 177 and referred to in I. M. Ramsay, "Corporate Governance, Shareholder Litigation and Prospects for a Statutory Derivative Action" (1992) 15 University of New South Wales Law Journal 149, 164.

102 J. Tang, "Shareholder remedies : demise of the derivative claim?" (2012) 1 UCL Journal of Law and Jurisprudence 178, 203.

the applicant then surely costs should be awarded unless there are exceptional circumstances militating against such an award.

It might be argued that courts should not be providing shareholders with carte blanche when it comes to costs, but it must be remembered that the costs that will be claimed by the shareholder as far as his or her costs are concerned and any costs that have to be paid to the respondents if the shareholder loses, will have to be reasonable and subject to judicial scrutiny. Also, parties to proceedings today have to provide costs budgets to the courts at a case management hearing before trial so that costs are monitored and controlled to a greater degree than in the past.[103]

Other jurisdictions are far more generous to shareholders. In Germany if a shareholder's action is admitted then he or she will be indemnified.[104] The following position applies in New Zealand :

> "The court shall, on the application of the shareholder or director to whom leave was granted under section 165 to bring or intervene in the proceedings, order that the whole or part of the reasonable costs of bringing or intervening in the proceedings, including any costs relating to any settlement, compromise, or discontinuance approved under section 168, must be met by the company unless the court considers that it would be unjust or inequitable for the company to bear those costs."[105]

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[103] See, CPR, Part 3 and the Court of Appeal's interpretation of this Part that permits the setting of costs budgets : Griffiths v Solutia (UK) Ltd [2001] EWCA Civ 736.

[104] C. Paul, "Derivative Actions under English and German Law" (2010) ECFR 81, 113.

[105] Section 166.

This provides a statutory presumption that courts will grant costs, with a reserved discretionary power not to grant costs only where it would be unjust or inequitable. And the way that the New Zealand legislation is drafted it does tend to suggest that there is a greater likelihood of an award of full costs. This might constitute a reason as to why the derivative action procedure has been far more popular in New Zealand compared with the UK. The New Zealand provision seems to fit in with the approach that was articulated in Wallersteiner v Moir (no 2),[106] and if such an approach were adopted in the UK there would be greater certainty for shareholders, and, at the same time, courts could still control the process to a large degree. For reasons discussed in this section of the article it is submitted that the New Zealand approach should be implemented in the UK as it provides greater likelihood of a shareholder being awarded costs, but still gives some power to courts to stop this where it would be inequitable.

G. UNFAIR PREJUDICE PETITIONS

According to section 263(f) courts must, in permission hearings, consider whether the action which is the subject of the derivative claim could be pursued by the member in his or her own right. This has led courts to consider whether a member could present a petition under section 994 of the Act on the basis of unfair prejudice. It has been suggested that the existence of an alternative remedy, such as a claim under section 994, is a comprehensive barrier to instituting a derivative action. Yet this is not the case as there have been judgments in which the availability of an alternative remedy has not been treated as compelling. The appeal court in Wishart did not consider it to be grounds for refusing permission because proceedings under section 994 would constitute an indirect means of achieving what could be achieved

106 [1975] QB 371, 391.

directly through the use of derivative action.[107] In two cases, Kiani v Cooper[108] and Ritchie v Union of Construction, Allied Trades and Technicians[109] Proudman J said that the availability of an alternative remedy under the unfair prejudice ground did not prevent permission being granted.[110] According to her Ladyship, the availability of the ground was merely one factor, albeit an important one, to be taken into account in the exercise of a court's discretion.[111]

While the fact that a shareholder might have a right to bring a section 994 petition is not an absolute bar to the prosecution of a derivative action, there are indications from the judiciary that it is willing to support the use of such petitions when a wrong has been done to the company, and notwithstanding the fact that they provide a less structured form of obtaining relief. This has led to a problem for litigants : on which basis should an action be initiated? The problem emanates, as Jill Poole and Pauline Roberts have noted, from the failure to distinguish between the wrongs that should be remedied by a derivative action and those by an unfair prejudice action, and this is due to the fact that the courts have not listed the personal rights of shareholders that will be protected by section 994.[112] This is a major issue and while there is not sufficient space in this article to discuss it thoroughly,[113] it is necessary that it is discussed to some extent as it is required in any contemporary assessment of derivative proceedings.

107 [2009] CSIH 65; 2009 S.L.T. 812, [46]. His Honour Judge Behrens (sitting as a Judge of the High Court) reached a similar conclusion in Parry v Bartlett [2011] EWHC 3146 (Ch), [88]-[92].

108 [2010] EWHC 577 (Ch); [2010] BCC 463.

109 [2011] EWHC 3613 (Ch)

110 This was emphasised in the recent decision of Norris J in Cullen Investments Ltd v Brown [2015] EWHC 473 (Ch) at [61].

111 [2011] EWHC 3613 (Ch), [67], [68].

112 J. Poole and P. Roberts, "Shareholder remedies – corporate wrongs and the derivative action" [1999] JBL 99, 113-114.

113 It is discussed in detail in several articles, such as, J. Payne, "Sections 459-461 Companies Act 1985 in Flux : The Future of Shareholder Protection" (2005) 64 CLJ 647; R. Cheung, "Corporate wrongs litigated in the context of unfair prejudice claims : reforming the unfair prejudice remedy for the redress of corporate wrongs" (2008) 29 Company Lawyer 98; B. Hannigan, "Drawing Boundaries Between Derivative Claims and Unfairly Prejudicial Petitions" [2009] JBL 606; A. Gray, "The statutory derivative claim : an outmoded superfluousness?" (2012) 33 Company Lawyer 295.

A derivative action is a representative type action and any relief ordered is to benefit the company, such that it is "oriented towards collective outcomes,"[114] whereas an action brought under section 994 is a personal action potentially producing personal benefits for the petitioning shareholder. If unfair petitions are preferred over derivative actions the company could lose out, because it obviously gets nothing, usually, from a personal action.

It was suggested before the advent of the UK's derivative actions scheme that the Canadian experience, where oppression actions far outweigh derivative actions,[115] indicates that there is a danger that the latter will be regarded as more complex and relied on less than the unfair prejudice petition, unless there are some parameters applied to the unfair prejudice ground. At present there have not been any applied and some are of the view that it has led to the virtual redundancy of derivative actions. Nevertheless, it was pointed out by the Law Commission in 1997 that there were still situations in which a derivative action was the only or the most appropriate way to proceed.[116] The Commission felt that two distinct remedies should be preserved, adding that the unfair prejudice petition has largely been seen as an exit remedy because the usual order sought is that the shares of the petitioner be purchased by the respondent.[117]

Section 994 petitions are being founded on wrongs done to the company and the courts have tended to be rather generous[118] in acceding to claims in unfair prejudice petitions where the basis for the claims are based on grounds such as breaches of directors' duties. It was said in

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[114] S. Bottomley, The Constitutional Corporation (Aldershot, Ashgate, 2007), 167.

[115] See, B. Cheffins and J. Dine, "Shareholder Remedies : Lessons from Canada" (1992) 13 Company Lawyer 89.

[116] Para 6.11.

[117] Ibid.

[118] See D. Sugarman, "Reconceptualising company law : reflections on the Law Commission's consultation paper on shareholder remedies - Part 1" (1997) 18 Company Lawyer 226 at 239.

Re Macro (Ipswich) Ltd[119] that section 994 gives "an elastic quality which enables the courts to mould the concepts of unfair prejudice according to the circumstances of the case."[120] There have been several claims under section 994 or its immediate forebear where the petitioner claims that there has been a breach of directors' duties.[121] The argument that would be mounted by a claimant is that the breach has unfairly prejudiced the interests of members generally. This is notwithstanding the fact that according to section 170(1) of the Act the directors owe their duties to the company. Some will argue that that this effectively means the shareholders as a whole, but this view existed before the drafting of section 170 and one would have thought that the section might well have said, in common with provisions in the corporate legislation of many American states, that the duties are owed "to the company and the shareholders" if this interpretation were intended.

The unfair prejudice petition might generally appear to be more attractive than a derivative action due to the fact that there is not the same permission process that applies to the latter, and the claimant is able to get a remedy that relates to his or her own personal interests. Also, as a court has complete discretion as to what order it makes, it could make one that benefits the company. But this has rarely been done.[122] In the Hong Kong case of Re Chime Corp[123] Lord Scott was of the view that as a general rule courts should not make orders requiring the respondent to pay the company a sum on an unfair prejudice petition. Of relevance is the fact that section 996(2)(c) specifically provides that courts can authorise a shareholder to bring proceedings to be brought in the name of the company. This would, however, involve two

119 [1994] 2 BCLC 354.
120 Ibid, 404.
121 For example, see Re Cumuana Ltd [1986] BCLC 430; Lowe v Fahley [1996] 1 BCLC 262; Atlasview Ltd v Brightview Ltd [2004] EWHC 1056 (Ch); [2004] BCC 542; Grace Biagioli [2006] BCLC 70; Re McCarthy Surfacing Ltd [2009] 1 BCLC 622.
122 An example is Clark v Cutland [2003] EWCA Civ 810; [2004] 1 WLR 783..
123 (2004) 7 HKCFAR 546, [62]. Lord Scott was sitting as a non-permanent judge of the Court of Final Appeal.

sets of proceedings and would, obviously, be more costly than commencing and prosecuting a derivative action. This approach has not been commonly employed.

Looking at the bigger picture, the fact that a shareholder might be able to obtain the usual order sought with section 994 petitions, namely that the respondent buys the shareholder's shares, does not rectify a problem that is likely to be of critical importance to the company, that is, it would not receive relief for the wrongful action taken against it.[124] The resolution of a petition could well be merely papering over the cracks if wrongdoers are in control of the company and are not being brought to book concerning their action against the company's interests. Unless relief for the company was sought at the hearing of a section 994 petition, the only way of possibly resolving this state of affairs is if all of the minority shareholders presented section 994 petitions and received individual relief. Yet this does not seem an efficient, effective or likely way of addressing the central problem.

Hoffmann LJ (as he then was) did say that one of the purposes of unfair prejudice petitions was to permit courts, in appropriate cases, to outflank Foss v Harbottle,[125] but surely this was intended so as to ensure that the excessively strict requirements of the common law did not thwart deserving shareholders.[126] One cannot interpret the decision as indicating that the unfair prejudice provision could be used "routinely to sidestep the reformed statutory regime governing the derivative action."[127]It is not unimportant that his Lordship's judgment, in *O'Neill* v Phillips,[128] indicated that he wished to see courts pull back somewhat from giving

124 A similar concern might be implied from the comments of the judge in Cullen Investments Ltd v Brown [2015] EWHC 473 (Ch) at [61].

125 Re Saul D Harrison Ltd [1994] BCC 475, 489.

126 P. Davies and S. Worthington, *Gower and Davies' Principles of Modern Company Law*, 9th ed, (London, Sweet and Maxwell, 2012), 735.

127 Ibid.

128 [1999] 1 WLR 1092; [1999] BCC 600.

as much leeway to section 994 petitioners as they had in the preceding years, and, arguably, the judgment narrowed the ambit of such claims.[129]

Notwithstanding the support of judges for a wide application of section 994, some courts have cautioned against the use of unfair prejudice petitions in relation to wrongs committed against the company.[130] In one of these cases, Lord Scott held that it was an abuse of process to use an unfair prejudice petition in order to circumvent the rule in Foss v Harbottle.[131] His Lordship said that an order would only be made on an unfair prejudice petition that involved a corporate wrong if the order sought corresponded with the order that would have been made in a derivative claim or it was clear from the outset that the issue could be conveniently dealt with at the hearing of the petition.[132]

It might be thought that one of the main barriers to a corporate claim under section 994 is the policy that prevents claims for reflective loss. This provides that shareholders cannot recover a sum that is equal to the reduction either in the market value of their shares or the amount of a dividend where such loss reflects the loss sustained by the company.[133] But it appears the courts have allowed some claimants to use section 994 petitions when claims involve reflective loss.[134] The cases where this has been allowed have involved situations where a court agrees to order that the claimant's shares be purchased. The value of the shares might

129 A view subscribed to by the Company Law Review Steering Group : Company Law Review, Modern Company Law for a Competitive Economy : Completing the Structure, 2000, London, DTI, para 5.75.

130 For example, see Re Charnley Davies [1990] BCLC 760; Re Chime Corp (2004) 7 HKCFAR 546.

131 Re Chime Corp (2004) 7 HKCFAR 546, [63].

132 Ibid, [62].

133 Johnson v Gore Wood [2000] UKHL 65; [2002] AC 1; [2001] 1 BCLC 313. Claims for reflective loss have not been allowed in the US. For instance, see Armstrong v Frostie Co 453 F 914, 917 (1971, 4th Cir).

134 Atlasview Ltd v Brightview Ltd [2004] EWHC 1056 (Ch); [2004] BCC 542. This point is subject to some criticism by Rita Cheung in "Corporate wrongs litigated in the context of unfair prejudice claims : reforming the unfair prejudice remedy for the redress of corporate wrongs" (2008) 29 Company Lawyer 98, 101. It is notable that in Cullen Investments Ltd v Brown [2015] EWHC 473 (Ch) the judge said that there was a real possibility that the losses caused by the alleged wrongdoing were such that only the company could recover them (at [60].

well reflect the loss sustained by the company because of the action of the respondent in breaching his or her duties as the court[135] is likely to take the loss into account in the process of valuing the shares.[136] As Brenda Hannigan[137] has pointed out, this is a concern if the company was in the vicinity of insolvency or actually insolvent, as the creditors should be entitled to payment out of funds that really belonged to the company before the shareholders received anything.[138]

Jennifer Payne,[139] writing prior to the enactment of the statutory scheme, took the view that eventually section 994 petitions would supersede derivative actions, although perhaps not in relation to public companies,[140] while Hannigan,[141] writing after the enactment of the scheme, was of the opinion that the courts should be "very cautious about allowing corporate relief to be sought and granted on an unfairly prejudicial petition."[142] Hannigan also suggested that the cases of Clark v Cutland[143] and Gamlestraden Fastigheter AB v Baltic Partners Ltd,[144] where unfair prejudice petitions were employed, and where orders were made in favour of the company, were in fact classic derivative actions and not section 994 cases. In her opinion they were exceptional cases. Gray has said that if Gameslestraden had occurred after the advent of the statutory derivative action scheme then the action would have been pursued as a

135 This was the case in Atlasview Ltd v Brightview Ltd [2004] EWHC 1056 (Ch); [2004] BCC 542; [2004] 2 BCLC 191.

136 See, B. Hannigan, "Drawing Boundaries Between Derivative Claims and Unfairly Prejudicial Petitions" [2009] JBL 606, 615-616.

137 Ibid, 617.

138 This is effectively supported by the approach taken by Norris J in McAskill v Fulton 2014 WL 8106597, [45].

139 J. Payne, "Sections 459-461 Companies Act 1985 in Flux : The Future of Shareholder Protection" (2005) 64 CLJ 647, 676-677.

140 J. Payne, "Shareholders' Remedies Reassessed" (2004) 67 MLR 500, 501.

141 B. Hannigan, "Drawing Boundaries Between Derivative Claims and Unfairly Prejudicial Petitions" [2009] JBL 606.

142 Ibid, 626.

143 [2003] EWCA Civ 810; [2004] 1 WLR 783.

144 [2007] UKPC 26; [2008] 1 BCLC 468.

derivative action as negligence is now permitted as a ground for a claim while at the time of the case it was not.[145]

In dealing with whether a derivative action or an unfair prejudice was the correct way to proceed, Millett J (as he then was) said in Re Charnley Davies Ltd (No 2)[146] that the same facts could found either action, but the nature of the complaint and the appropriate relief will be different. His Lordship went on to say that if a shareholder's essential complaint was of the unlawfulness of a respondent's conduct, with the result that any order made would be for restitution, then a derivative action would have been appropriate and not an unfair prejudice petition. But if a respondent's unlawful conduct is alleged to be evidence of the manner in which he or she had conducted the company's affairs in disregard of the shareholder's interests and the latter wished to have their shares purchased, then an unfair prejudice was appropriate.[147] In a recent derivative claim, Stainer v Lee,[148] Roth J referred approvingly to Millett J's judgment, and in LPD Holdings (Aust) Pty Ltd v Phillips[149] the Queensland Supreme Court recently took the same view as Millett J and said that in many cases conduct can have a dual character, namely actionable either as a derivative action or under the oppression provision. In Canada it has been said that there is not a bright-line distinction between the claims that may be advanced under the derivative action section and those that may be brought under the oppression provision.[150] This is undoubtedly correct as far as the UK is concerned.

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145 A. Gray, "The statutory derivative claim : an outmoded superfluousness?" (2012) 33 Company Lawyer 295.

146 1990] BCLC 760, 783.

147 Ibid.

148 [2010] EWHC 1539 (Ch); [2011] BCC 134, [51].

149 [2013] QSC 225, [40]-[42].

150 Malata Group (HK) Ltd v Jung 2008 ONCA 11 per Armstrong JA. This view was also expressed by Basten JA in Campbell v Back Office Investments Pty Ltd [2008] NSWCA 95, [214].

Notwithstanding the approach taken by Millett J and the fact that it is supported in some quarters, it does seem that UK courts have undermined the rules that apply to wrongs perpetrated against companies by permitting the merging of corporate and personal claims. It is to be regretted that the legislature has failed to draw the boundaries between the two kinds of actions, thereby causing some uncertainty. If unfair petitions are to be used in cases involving wrongs done to the company, one wonders why the legislature extended the kind of claims that could be the subject of a derivative action, such as negligence, in the statutory scheme. It seems rather strange that the derivative action would be extended on the one hand and yet truncated severely on the other by section 994 subverting its application. In Australia there is concern over the ambit of oppression actions, the equivalent of section 994, and the New South Wales Court of Appeal in Campbell v Back Office Investments Pty Ltd,[151] acknowledged that there had to be some parameters established for oppression cases[152] as they had a potentially wide operation, and they must not be used to subvert established constraints on the availability of the derivative action.[153]

It would seem that there are several potential problems and concerns with permitting unfair prejudice petitions where the company has been wronged. First, the company does not benefit usually by relief granted in section 994 petitions, and hence, the other shareholders do not benefit indirectly; an order providing for a buy out of the shareholder is of no assistance to the company. Also, non-shareholder stakeholders do not benefit. The riposte to that might be that as far as shareholders are concerned, it is up to them to take action themselves. But, of course, some shareholders might not have the resources. As far as other stakeholders are concerned, they simply do not have any right to bring proceedings.

151 [2008] NSWCA 95, [361].
152 Corporations Act 2001, s.232.
153 [2008] NSWCA 95, [199].

Second, while it might be possible for the court to grant to a shareholder in a section 994 petition his or her share of the reflected loss that the company has sustained, and the court could do this over and over again with subsequent petitions by individual shareholders, it would lead to multiplicity of proceedings in relation to the one wrong, and it could lead to inefficiencies and inconvenience, and, more particularly, the incurring of more costs than if there were one derivative action. Naturally this was one of the concerns that led to the rule in Foss v Harbottle and the reluctance of courts to allow actions other than those commenced by the company. Another problem is that a payment made to a petitioner could mean that the respondent is unable to meet subsequent claims by other shareholders to the same extent.[154]

Third, the presentation of an unfair prejudice petition in order to obtain relief for the company would mean that there is no prospect of obtaining an indemnity costs order from the court like there is with a derivative action. A further issue for a shareholder to consider is that he or she would have the burden not only of establishing, say a breach of directors' duties, but also that the action complained of was unfairly prejudicial, and that is not always easily done.[155]

Fourth, it is arguable that it is not theoretically proper that section 994 petitions are used in preference to derivative actions. It must not be forgotten that the unfair prejudice ground was not devised to redress corporate wrongs, the domain of the derivative action. Rather the unfair prejudice ground was introduced to protect minority shareholders. And the derivative claim "while perhaps not mechanically perfect, is undoubtedly a manifestation of sound company law theory operating in practice…"[156] Using section 994 to deal with wrongs against the company offends against the fundamental principle of company law, namely that

154 H. Hirt, "In what circumstances should breaches of directors' duties give rise to a remedy under ss.459-461 of the Companies Act 1985?" (2003) 24 Company Lawyer 100, 109.

155 A. Gray, "The statutory derivative claim : an outmoded superfluousness?" (2012) 33 Company Lawyer 295.

156 Ibid, 302.

the company is an entity that is separate from the shareholders. The exceptions to the rule in Foss v Harbottle and the new statutory regime do compromise that principle, but they do so only to protect the company.

Fifth, replacing derivative actions with unfair prejudice cases means that there is no permission hearing, which, while the permission hearing process might have its faults, it eliminates unwarranted cases. Also, with unfair prejudice petitions there is no judicial oversight and scrutiny (save that which applies to all cases in the courts today subsequent to the advent of the Civil Procedure Rules) which can ensure that justice is done rather than the enrichment of one party. At the moment, and this has been acknowledged by those suggesting that section 994 petitions have superseded derivative actions, that there is no adequate process that enables courts to screen out those actions that are not appropriate,[157] and the hurdles that apply to derivative actions are vital to protect the company where the power to take action is being delegated to the shareholders.[158] It is not possible to discern any intention on the part of the legislature to permit a shareholder to use unfair prejudice petitions to avoid the obstructions placed in the way of derivative claims where the action essentially is to right a wrong done to the company.[159] It has been suggested that new tools have to be designed to enable this to be accomplished,[160] perhaps including an ex ante hearing, as presently applies to derivative actions.[161] The fact that changes to the unfair prejudice procedure have to be made in order to accommodate actions that involve corporate claims

157 J. Payne, "Shareholders' Remedies Reassessed" (2004) 67MLR 500, 504.
158 Ibid, 507.
159 H. Hirt, "In what circumstances should breaches of directors' duties give rise to a remedy under ss.459-461 of the Companies Act 1985?" (2003) 24 Company Lawyer 100, 103.
160 J. Payne, "Shareholders' Remedies Reassessed" (2004) 67 MLR 500, 505
161 J. Payne, "Sections 459-461 Companies Act 1985 in Flux : The Future of Shareholder Protection" (2005) 64 CLJ 647, 658. At the moment there is only provision for a case management conference or a pre-trial review : CPR r.29(2)(b).

surely suggests that it is not the appropriate process for claims that the company has. Is it appropriate or necessary to adapt another avenue for relief when one exists already?

I end this section with what I submit are the adroit words of Hannigan on this matter:

> "The important point is that issues as to the appropriateness of petitions or derivative claims are not solely matters of choice for the aggrieved shareholder, but matter of jurisdiction for the court, which in resolving the issue must be mindful of the fundamental principles underlying the rule in Foss v Harbottle, the derivative claim and the rule against recovery of reflective loss.
>
> It is time to develop a workable derivative claim and the courts should continue to be very cautious about allowing corporate relief to be sought and granted on an unfairly prejudicial petition."[162]

H. CONCLUSION

It might be argued that the steps required to obtain permission to continue a derivative action are "many and taxing"[163] and that it is arguable that the present regime has short-changed shareholders.[164] The accessibility and flexibility that the Law Commission said was needed for derivative actions does not seem to have been achieved.[165] If anything, the statutory scheme's introduction has stultified the derivative claim. The evidence we have at the moment suggests that the courts have not adopted a different approach to derivative actions

162 B. Hannigan, "Drawing Boundaries Between Derivative Claims and Unfairly Prejudicial Petitions" [2009] JBL 606, 626.
163 K. Fletcher, "CLERP and Minority Shareholder Rights" (2001) 13 Australian Journal of Corporate Law 290, 296.
164 Ibid, 300.
165 Law Commission, Shareholder Remedies: Report on a Reference under section 3(1)(e) of the Law Commissions Act 1965 (Law Com. No. 246, Cm. 3769) (London: Stationery Office, 1997), para 6.15.

under the statutory scheme from that applying at common law. They remain suspicion of them and expediency seems to characterise the permission process. Paul Davies sums it up well when he states : "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."[166] This is not a cause for concern if companies' interests are being safeguarded in some other way. The obvious possibility in this regard is the unfair prejudice petition, but a concern is that these petitions could be settled without any court approval needed and with the risk that it affects the company and other shareholders who are not parties to them.

The derivative action scheme has built into it tight judicial control as envisaged by the Law Commission[167] in order to address concerns over an avalanche of actions, and this gives courts adequate measures to deal with abuses, but it has tended to be too rigidly enforced. Arguably most if not all of the schemes that apply in Commonwealth countries and particularly those in New Zealand, Canada, Singapore and Australia are more generous in allowing derivative actions to be either instituted or continued.

The conclusion that we can draw from the present statutory scheme and the judicial interpretation and application of it is that rarely will shareholders seek to litigate a case under the scheme rather than doing nothing or exiting the company. The latter is, of course, not always an option for a shareholder; it will depend on several things such as the basis on which the company was set up, the relations between the shareholders and what has actually been done to cause the shareholder to become disgruntled.

166 "Codified obstacles" (2008) 158 NLJ 1409

167 Law Commission, Shareholder Remedies: Report on a Reference under section 3(1)(e) of the Law Commissions Act 1965 (Law Com. No. 246, Cm. 3769) (London: Stationery Office, 1997), para 6.10.

It has been argued in this article that there need to be changes made to the statutory scheme and the ones suggested herein would give the scheme an effective place in the corporate world and "beef up" shareholders' rights. It would also provide non-shareholder stakeholders with an opportunity to be heard as the article has proposed a wider range of persons who can apply for permission to continue derivative actions. Furthermore, the present scheme has inherited much of the uncertainty and complexity of the common law approach and added obstacles of its own.[168]

There are positive things that come out of the reform of the derivative process in the Act, such as the fact that an action might be taken in relation to a wider range of wrongdoing and against a greater range of respondents. But outweighing these factors are ones that have made things difficult for shareholders, such as the retention of ratification as a way of thwarting a derivative claim. Also the courts have, it is submitted, continued to appear suspicious of derivative actions and have denied the continuation of actions and, where applicants have been successful they have been denied costs orders by the courts. Simultaneously the courts seem to be pushing shareholders in the direction of section 994 petitions. It has been argued that there should be a clear distinction made between claims that can be brought under section 994 and those that can be initiated as derivative proceedings, and that the derivative action process should remain viable and accessible to shareholders.

If derivative actions are to be anything other than a dead letter then something needs to be done. What the law has to do is to find a balance between, on the one hand, ensuring that proceedings cannot be brought so as to disrupt corporate life unnecessarily, and, on the other,

[168] Similar to the Canadian approach : W. Kaplan and B. Elwood, "The Derivative Action : A Shareholder's 'Bleak House'" (2003) 36 University of British Columbia Law Review 443, 444.

ensuring that shareholders are not overly deterred and that they have a reasonable avenue for complaining about wrongs against their company.