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The Difficulties with Conferring Rights on Shareholders to Litigate

3.1 Introduction

Minority shareholders face particular difficulties where they seek redress against wrongdoing directors. Both the defective state of the common law and the detailed design of the new statutory derivative action cause problems. This state of affairs seems to reflect an implicit acceptance by the judiciary, the Law Commission, and the Government that it is somehow undesirable that companies should be exposed to civil litigation by minority shareholders.¹ This type of thinking is rarely (if ever) made explicit; nonetheless, it is likely to continue being the primary policy impediment to enhancing the potential utility of derivative actions.² No assessment of the derivative action can thus proceed very far without having to face the current policy assumptions which underline the restrictive standing rules for individual shareholders. The purpose of this chapter is primarily to inquire into these restrictive standing rules and subsequently to examine policy responses to the problem that the company lacks an authentic decision-making body to determine whether or not a derivative action is in the best interests of the company as a whole.

The chapter proceeds as follows. Section 3.2 discusses the problems with conferring rights on minority shareholders to litigate in respect of wrongs to the company. Section 3.3 then outlines the common law responses to the aforementioned problems in the form of the various restrictions on members’ ability to come before the court as litigants in a derivative action. Through extensive discussion of case law and emerging so-called principles and rules the purpose of this section is to illustrate how procedurally and substantively English law has developed to provide disincentives to prospective shareholder claimants in this


² PL Davies Introduction to Company Law (OUP 2002) 250.
context. Subsequently, two policy responses are analysed. First, section 3.4.1 examines and assesses the competence of three alternative bodies which may assess the merits of a derivative action: a committee of independent directors; an ‘independent organ’ of the company; and the courts. It concludes that courts should discharge the task of deciding this critical question. Section 3.4.2 then explains that once a gatekeeper is put in place, the focus should be on establishing an expeditious means for screening and dismissing non-meritorious cases. It evaluates how well (or rather, badly) current legal screens work. Section 3.5 draws some conclusions.

3.2 The Nature of the Problem with Conferring Rights on Shareholders to Litigate

3.2.1 Introduction
Conferring rights on minority shareholders to litigate in respect of wrongs to the company brings several issues to the fore. There are issues of standing, legal duties traditionally running in a straight line to the company;⁴ of policing the action, since litigious shareholders may not have the purest of intentions; and of corporate governance, requiring a fine balancing of shareholder rights and expectations against the prerogative of management to manage.⁴

At common law, the shareholder’s access to litigation to pursue actions rightly belonging to the company is very restricted. One of the cardinal principles of company law is embodied in the rule in *Foss v Harbottle⁵*—if a company suffers a wrong, then, because it is a separate legal entity from its incorporators, prima facie it is the company that should seek redress for that wrong. Also, if the alleged wrong is one that is capable of being approved or ratified by a majority of the shareholders, then no individual shareholder can maintain an action in respect of that wrong.⁶ Additionally, if an independent organ of the company considers that

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⁴ Percival v Wright [1902] 2 Ch 241; in special circumstances, directors may owe duties to individual shareholders: Peskin v Anderson [2001] 1 BCLC 372.

⁵ (1843) 2 Hare 461; 67 ER 189.

⁶ The majority rule principle is based on the doctrine of separate corporate personality and on the early partnership principle that courts would not interfere between partners except to dissolve the partnership. See *Carlen v Drury* (1812) 1 V & B 154, 158 per Lord Eldon LC: “This Court is not to be required on every occasion to take the management of every playhouse and brewhouse in the
it is not in the interests of the company to pursue a derivative action, the court may prevent the action from proceeding.⁷

The rule in itself is logical and can be said to achieve what is socially and economically desirable. For one, it reduces the scope for wasteful litigation.⁸ The rule also obliterates the potential for duplicated litigation. A wrong that has an adverse impact on a company’s financial position committed against the company could potentially also be detrimental for a number of stakeholder groups. In addition to the company’s shareholders, who could suffer loss because the value of their equity may be decreased as a result of the wrongdoing, the company’s creditors and employees may have cause for complaint. In the case of the company’s creditors, they may worry that there is a higher chance that the company would default on repayment. The employees, on the other hand, may find their jobs in jeopardy.⁹ If all such persons are allowed to sue, the company could be ‘killed by kindness’ by litigation,¹⁰ the court system will be overly burdened, and the defendants will have to face a multiplicity of suits.

The other advantage of the rule lies in the fact that it allows management to decide whether to sue or not, without being second-guessed. As we saw in Chapter 2, litigation may not always be in a company’s best interests and opinions will undoubtedly differ as to what is best for the company. Since deciding whether or not to sue is often a commercial decision, involving as it does a cost-benefit analysis with a necessary consideration of the potential damage to corporate reputation, it should therefore be a decision which management is qualified and competent to make.¹¹ The rule also restricts the scope for tactical or vexatious litigation, ie legal proceedings used as a strategic ploy to gain some personal advantage, such as a good price for the litigant shareholder’s shares, or to pursue a personal vendetta against the directors.

Difficulties, however, arise when a majority of the directors are themselves engaged in conduct detrimental to the company. It is unlikely that the board will take steps to ensure that the company sues the wrongdoers. While it is possible for a majority of shareholders in general meeting to act, this will not be done if the directors themselves are also the controlling shareholders,¹² or it may be unlikely

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⁷ Smith v Croft (No 2) [1988] Ch 114.
⁸ MacDougall v Gardiner (1875) 1 ChD 13, 25 per Mellish LJ.
¹⁰ Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1981] 1 Ch 257, 263.
¹² It is also possible that some shareholders able to exercise decisive votes may have been offered an inducement (such as an indemnity) to vote in favour of the wrongdoers. See Atwool v Merryweather (1867) LR 5 Eq 464. Moreover, in a general meeting of a large public company, directors alleged to
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in widely dispersed companies. In such situations, the position for dissenting minority shareholders is particularly bleak, especially if there is no ready market for their shares or if they faced restrictions on the transfer of shares. In companies with a dispersed shareholding, difficulties associated with collective decision-making will in most cases prevent an action from going to court. One could say that the minority shareholder has reached a legal cul-de-sac. Therefore, if the rule is enforced in every situation, there will be manifest injustice as wrongdoers go unpunished and managerial wrongdoing is not redressed. Investors will be at the mercy of the majority who are advancing their own interests at the expense of the company.

The initial conclusion is that duty-based controls therefore depend very much on some other viable enforcer. Essentially then, the scope of directors’ duties and the ways in which those duties can be enforced are interrelated issues which must be considered together. Reciprocity is a key here. The common law recognized these problems and allowed a shareholder to take action in the company’s name if he could establish two elements: first, that the wrong was one that could not be validly ratified by the majority because it was a fraud on the minority, and secondly that the perpetrators of the fraud were in control of the company. This gave rise to the common law derivative action. Unfortunately, the existing English authorities on the question of what exactly amounts to a fraud on the minority have been conflicting and difficult, which, in turn, has limited the remedy’s reach. Be that as it may, there is an underlying paradox here. As will be seen below, it is almost a maxim of English courts to treat those shareholders who are allowed to take an action in the company’s name with suspicion and some uneasiness with be liable to the company might be able to determine the outcome of a resolution in their own favour by the use of proxy votes. See Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1981] Ch 257; [1980] 2 All ER 841, 871 et seq.


ibid.

Nurcombe v Nurcombe [1985] 1 WLR 370, 378 per Browne-Wilkinson LJ.

ibid 432.


Although it is common to refer to the circumstances which are most frequently found to justify the derivative action as being a ‘fraud on the minority’, any fraud has, in truth, been practised on the company and the award will be in the company’s name. This distinction should be carefully observed. See also C Hale ‘What’s Right with the Rule in Foss v Harbottle?’ [1997] 2 CFILR 219, 221; LS Sealy Cases and Materials in Company Law (7th edn Butterworths 2001) 498.

See discussion in Consultation Paper para 4.9. See also K Wedderburn ‘Derivative Actions and Foss v Harbottle’ (1981) 44 MLR 202, 211–12, who finds the meaning of fraud in the context of derivative actions ‘replete with uncertainty’ in conception, requiring ‘intellectual gymnastics of Olympic quality’ in application and ‘wrong in law and policy’.
respect to their suitability and indeed their appropriateness to assume the role of instigator of proceedings.\textsuperscript{21}

\section*{3.2.2 The policy problem: can a shareholder adequately represent the company?}

In relation to litigation decisions, the crucial question is: who has the power to take these decisions and what, if any, limitations should be placed on their power?\textsuperscript{22} There seems no reason not to permit the board to decide in favour of litigation, if that would normally fall within its grant of management powers.\textsuperscript{23} One might be skeptical about how often a board will decide to sue one of its members, but this in itself does not mean that the board cannot litigate if it chooses to do so.\textsuperscript{24} In any case, the board which decides to sue may no longer contain the wrong-doing directors because there has been a change of management.\textsuperscript{25} More likely perhaps, the management of the company may have passed upon insolvency into the hands of a liquidator, who decides to sue the former directors.\textsuperscript{26}

More problematic are decisions not to sue the wrongdoers. The presence of the wrongdoer on the board, even if he does not vote on the issue, casts a cloud over any such decision by the board.\textsuperscript{27} Here, the common law rule that the company has the right to the unbiased advice of all its directors seems to express itself in the common law principle that, if that is not available because one or more of them has an interest in the transaction in question, then the decision reverts to the shareholders in general meeting,\textsuperscript{28} even though there is a general and exclusive grant of management powers to the board in the articles.\textsuperscript{29} But while the general meeting may have the residual power to litigate in such situations, reliance upon the collective body of shareholders is problematic for two major reasons, one theoretical, the other practical. First, recall that one of the two principles arising from the rule in \textit{Foss v Harbottle} is that the court should not be intervening where the shareholders in general meeting can vote to ratify

\textsuperscript{21} One only has to look to the Court of Appeal's decision in \textit{Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] Ch 204} to discern the judiciary's attitude to minority shareholders.

\textsuperscript{22} PL Davies, above n 2, 193.

\textsuperscript{23} Above n 11 and accompanying text.

\textsuperscript{24} \textit{John Shaw \& Sons (Salford) Ltd v Shaw [1935] 2 KB 113} (CA); PL Davies, above n 2, 193.

\textsuperscript{25} As was the case in \textit{Regal (Hastings) Ltd v Gulliver [1942] 1 All ER 378} (HL).

\textsuperscript{26} See \textit{Insolvency Act 1986, s 212} which permits a liquidator to initiate a summary procedure by which the court inquires into the alleged breaches of duty by directors and orders them to restore property or make payment to the company.

\textsuperscript{27} PL Davies, above n 2, 193.

\textsuperscript{28} \textit{Movitex v Bullfield [1988] BCLC 104}. But cf \textit{Breckland Group Holdings v London \& Suffolk Properties [1989] BCLC 100}.

\textsuperscript{29} As Davies rightly notes (above n 2, 193) this point is not entirely clear, but unless the proposition is accepted, the rule in \textit{Foss v Harbottle} does not make much sense, for that rule says that the individual should not normally be permitted to enforce the company's right but should ask the shareholders collectively whether they wish to do so.
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a breach of duty by a director. Where ratification is effective then, it will inevitably have an effect on a minority shareholder’s action.³⁰ It is not always clear, however, when ratification will be effective. The law is in considerable disarray as to what breaches may be ratified by shareholders.³¹ It is unclear what are the exact circumstances in which ratification may bar a derivative action, and it is impossible to reconcile all the decided cases with any simple set of propositions.³² This has certainly produced a large amount of academic discussion.³³ Another problem with ratification by shareholders in general meeting is that those who are responsible for the alleged wrongdoing may control the voting power of the general meeting at which the ratification took place.³⁴ It is not surprising therefore that it has been suggested that this requirement reveals the same faith in the abilities of shareholders in a general meeting to be making proper decisions as did the judgment in Foss v Harbottle, as it reflects scepticism about the effectiveness of derivative litigation.³⁵

Turning secondly to the practical problem, while the general meeting may have the residual power to litigate in such situations, this is unlikely because (1) in the case of closely held companies the majority shareholders are likely themselves to be the directors; and (2) in the case of public widely held companies, to garner the support required to launch such actions would be a Herculean task in itself. With respect to (1) the problem is obvious. Wrongdoing directors may simply do nothing. Who is to force them to take an action when they simply decide to take the matter no further? Even if we assume for a moment that shareholders

³⁰ This process, like many of those found in company law, seems to have originated in trust law. In simple terms, ratification has been explained as the process by which ‘those to whom duties are owed may release those who owe the duties from their legal obligations . . . prospectively or retrospectively’. See J Payne ‘A Re-examination of Ratification’ (1999) 58 CLJ 604, 606; HC Hirt ‘Ratification of Breaches of Directors’ Duties: The Implications of the Reform Proposal Regarding the Availability of Derivative Actions’ (2004) 25 Company Lawyer 197.
³¹ See, for example, Rolled Steel Products (Holdings) Ltd v British Steel Corp [1986] Ch 246, 296 per Slade LJ. English law, nonetheless, has recognized a category of non-ratifiable wrongs, either because the wrong is not done to the company but to the shareholders in their personal capacity or because the company itself is not ‘legally competent’ to deal with the question. J Payne, above n 30, 614.
³² For example, commentators have not been able satisfactorily to distinguish between cases such as Regal (Hastings) Ltd v Gulliver[1942] 1 All ER 378 (where it was suggested that shareholders could ratify the breach of duty by directors) and Cook v Deeks [1916] AC 554 (the breach of duty by directors was held not to be ratifiable).
³⁴ This is due to the well-established concept in English law that shareholders hold their vote as a piece of property. Based upon this principle it is clear that a shareholder may ratify a wrong which he committed in another capacity, such as a breach of duty as a director: North-West Transportation Co Ltd v Beatty (1887) 12 App Cas 589. But see now CA 2006, s 239, which prohibits self-interested members from participating in the ratification vote, thereby reversing Beatty.
are to consider whether to institute proceedings (while interested shareholders are not entitled to vote on resolutions to enforce the company’s rights against the wrongdoers),³⁶ someone other than the wrongdoing directors needs to summon a meeting of the shareholders. Such provisions are contained in the Companies Act, but they require a relatively large proportion of the shareholders to trigger them.³⁷ Without some way around this, we seem to have reached an impasse.

Turning to (2), we saw in Chapter 1 that shareholders suffer a collective action problem when voting which undermines their effectiveness as a decision-making body.³⁸ A rational shareholder in a public company will not expand the time and effort to evaluate whether a derivative action is in the interests of the company because the shareholder’s vote would have only a small effect on the outcome and the small shareholding means that any gains by reason of the derivative action being successful will only be small.³⁹ Even if a shareholder cannot assess the merits of a proposed derivative action, the shareholder may not abstain from voting but may vote in accordance with a recommendation from the directors that the action be discontinued,⁴⁰ even if the shareholder recognizes that some of these proposals may not be in his interests.⁴¹

Overall, then, it is easy to see why the collective body of shareholders may be an inappropriate decision-making body for assessing the merits of a derivative action. But this leaves a fundamental contradiction from which it appears

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³⁶ As was proposed by the CLR Completing the Structure paras 5.85–5.86. As mentioned above, CA 2006, s 239 now prohibits self-interested members from participating in the ratification vote. This reverses the decision in North-West Transportation Co Ltd v Beatty (1887) 12 App Cas 589 thereby dealing with one of the major weaknesses in the rules relating to the enforcement of directors’ duties. It is noteworthy, however, that s 239(4) does not prevent the director or any such member from attending, being counted towards the quorum, and taking part in the proceedings at any meeting at which the decision is considered. One may wonder what impact this may have on how other members cast their votes in the meeting.

³⁷ PL Davies, above n 2, 136–7, 249. CA 2006 may go some way to remedy this, at least with respect to private companies. Section 303 of CA 2006 together with ss 304 and 305 make provision similar to that in s 368 of CA 1985 requiring the directors to call a general meeting if requested by the members. As the Explanatory Notes on the Companies Act 2006 state (paras 547–548, available at <http://www.opsi.gov.uk/acts/en2006/ukpgaen_20060046_en.pdf>), there are three main changes. First, there is a change in the threshold required for a meeting request. For public companies this remains members with voting rights holding at least 10% of the paid-up capital. For private companies the threshold is 5% or 10% of the paid-up capital (or, in a company with no share capital, 5% or 10% of the total voting rights) depending on when there was last a meeting in advance of which members had a right. The threshold is lower if there has been no such meeting in the last 12 months. Secondly, s 303 (4)(b) extends the provisions of CA 1985 by enabling members to include the text of a resolution to be moved at the requested meeting. Section 303 (5) defines what type of resolution may be properly moved. For example, if the resolution would have no effect, then it cannot be properly moved. Thirdly, requests in electronic form are permitted.

³⁸ Under 1.3.1.1.


⁴⁰ I Ramsay, above n 35, 170.

impossible to escape: on the one hand, leaving the decision to sue with the shareholder as a whole, even if interested shareholders are excluded from voting, runs the risk that the shareholders’ collective action problem will lead to less than the optimal amount of litigation. On the other hand, giving an unfettered right to bring a derivative action to any individual shareholder creates the risk that a shareholder who has only a small stake in the company will bring the action, not because it is thought to be in the best interests of the company, but to promote some personal objective.⁴² So, is there a way around this?

The way chosen to mediate between these two competing considerations in English law is to shift decision-making on actions against wrongdoing directors into the hands of any individual shareholder,⁴³ but in order to counteract the potential risk of abuse by the individual shareholder two qualifications have been introduced: (1) the action is allowed to proceed only in very restricted circumstances;⁴⁴ and (2) the court is brought in to adjudicate.⁴⁵ The action

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⁴² Or as Davies puts it, this might be thought to be an example of minority oppression of the majority. PL Davies, above n 2, 249. See in this respect § 147(4) of the German Aktiengesetz (recently abolished by the UMAG) under which if the company loses in court it may recover its expenses from the shareholders who induced the suit in the first place. See further n 70 below.

⁴³ An intermediate solution adopted in CA 1985, PXA (introduced by the Political Parties, Elections and Referendums Act 2000, now contained in CA 2006, Pt 14) is to give the right of suit to any group of shareholders if they are at least 50 in number, or hold at least 5% of the issued share capital, irrespective of the majority’s views. CA 2006, s 370 reproduces the effect of CA 1985, s 3471, except that, in a case where liability is owed by directors of a holding company in relation to a donation made by a subsidiary, the action may be brought by shareholders of the subsidiary or of the holding company. This is an approach to allocation of litigation rights which is used in German law. Thus, new § 148 of the German Aktiengesetz, introduced by Art 1 Nr 15 UMAG, now gives a minority holding 1% of the overall shares or EUR 100,000 in nominal capital the right to induce a pre-procedure for shareholder suits. In this pre-procedure, the court will allow for direct shareholder litigation on behalf of the company (similar to Anglo-American derivative actions) if the shareholders fulfil certain conditions that should function as an obstacle to strike suits. § 148 of the Aktiengesetz requires that (1) the shareholders who intend to sue bought the shares at some point in time before they received knowledge about the inappropriate managerial conduct in question; (2) the shareholder tried to induce the supervisory board to sue the officers before they apply to court; (3) facts indicate a serious breach of managerial duties which caused damage to the company; (4) from the perspective of the company there are no better reasons for abstaining from suing the officers. These strict measures substitute for higher thresholds that were demanded by the Federal Council. See further U Noack and D Zetzsche ‘Corporate Governance Reform in Germany: The Second Decade’ (2005) 5 EBLR 1033. Under Art 2393-bis of the Italian Civil Code the derivative action may be brought also by shareholders representing at least one-twentieth of the corporate capital or the other fraction of capital—in any case not to exceed one-third—set out in the by-laws. As far as companies which resort to capital markets are concerned, the relevant threshold is one-twentieth (and not one-fifth); the by-laws may set out a lower threshold. However, as Davies and Hannigan note, it is unusual in British law and is unlikely to prove of any practical significance. PL Davies, above n 2, 250; BM Hannigan Company Law (Butterworths 2003) 458. cf Art 16 of the EU Draft Fifth Directive (providing that members holding shares of a nominal value of 10% of issued share capital, or such lower percentage as national legislation may provide, may require proceedings to be brought on behalf of the company). See DTI Consultative Document Amended Proposal for a Fifth Directive on the Harmonisation of Company Law in the EEC (1990) art 16.

⁴⁴ Above, nn 5–7 and accompanying text.

⁴⁵ Davies uses the term ‘trustee’ to refer to the courts’ role here (PL Davies, above n 2, 250). The author, however, prefers not to use this well-established concept in the law of trusts.
initiated by the individual may proceed only if the court permits it to do so and on the terms set by the courts.\textsuperscript{46}

At least two points must be made now. First, although this seems trivial, it is important to bear in mind that if the action is to have any prospect of working as a remedy, the two interrelated issues, namely shareholder enforcement and the way in which courts discharge the discretion entrusted to them, must co-exist.\textsuperscript{47} But as will be seen below, because of various constraints, minority shareholder litigation is unlikely to lead to an adequate level of enforcement. Secondly, it is clear that shifting the decision to the court does not alter the basic problem. Doctrinally, the real bite is that the court is faced with an awkward dilemma: leaving a wrong without redress or running the risk that individuals will bring derivative actions without the purest intentions in mind. So how should the court go about this?

At a policy level, there is, of course, more than one way to respond to this.\textsuperscript{48} In English law, the shareholder must run several miles and clear numerous hurdles just to obtain the court’s permission to bring an action on behalf of the company in the first place.\textsuperscript{49} In fact, it is now very difficult to get such an action beyond the threshold stage, and the odds are heavily stacked in favour of a successful application to strike out. The action has been formulated and applied in a more and more restrictive way, so that the chances of a corporate litigant getting even a hearing, still less a ruling, on the merits are so slim that he would probably not think it worthwhile to take the issue to court.\textsuperscript{50} Paradoxically then, although a derivative action (and hence the enforcement of directors’ duties) depends on shareholder enforcement, the shareholder’s unique position in the company has led the court to see much merit in the arguments against enforcement by individual shareholders of the company’s right on the grounds that the company needs to be protected against malicious or misguided minority shareholders. It is therefore worth looking a little more closely at the expressed (and sometimes unexpressed) rationales behind this approach. As will be seen below, there are at least five major issues at play here.

\subsection{3.2.2.1 Perverse incentives}

First, as a matter of policy, questions may be raised in respect to the appropriateness of shareholders to represent the company. These questions relate to at least

\begin{footnotes}
\item[46] CPR r 19.9; CA 2006, s 261(1).
\item[47] See also JE Parkinson, above n 17, 241.
\item[48] Contrast, for example, the different attitudes of judges in England and Australia. See LS Sealy ‘Shareholders’ Remedies in the Common Law World’ [1997] 2 CFILR 172, 179–80.
\item[50] For example, in 1987, Sealy observed that eight out of ten cases reported in Butterworths Company Law Cases, involving a Foss v Harbottle type point, were decided unfavourably to the claimant: LS Sealy ‘Problems of Standing, Pleading and Proof in Corporate Litigation’ in BG Pettet (ed) Company Law in Change (Stevens 1987) 1; LS Sealy, above n 48, 179.
\end{footnotes}
three core principles of company law: the separate legal personality, the concept of majority rule, and the idea that a vote is a piece of property. The shareholders, while being asked to act on behalf of the company in this regard, are in a peculiar position in relation to the company which may make it impossible for them to remain wholly independent when deciding whether or not to bring an action.

As alluded to earlier, an individual shareholder who brings an action on behalf of the company may have poor incentives to maximize shareholders’ wealth. Because of his small stake in the venture, the complaining shareholder has very little incentive to consider the effect of the action on other shareholders, the supposed beneficiaries, who ultimately bear the costs. It could be argued that shareholders have money invested in the company and so the decision whether or not to bring an action in relation to directors’ wrongdoing will often have an economic impact on them. This may often be supposed to sharpen their concern to protect the company since if the company prospers then, generally speaking, the shareholders will also prosper. However, there may well be circumstances in which their economic interests conflict with those of the company, where, for example, the directors have wrongfully paid a dividend to the shareholders out of the capital of the company. Further, one should recall that the shareholders may also be the wrongdoing directors, and, at common law, may use their shares to validate their own wrongdoing to the company.

3.2.3.2 Access to information

Information is the lifeblood of litigation. Litigants battle to learn information, to conceal information, and to spin information so that it might better persuade judges, and opponents, to accept their view of the facts and law. Indeed, it is probably no exaggeration to claim that litigation is all about the process of learning information, the cost of learning information, and the optimal response to information. However, one of the most difficult things to achieve in any litigation

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51 In fact, minorities could become the oppressors of the majority insofar as they could impede the carrying on of the proper business of the company, and English law as it stands provides no formal means of dealing with this. Other jurisdictions, such as France, even go so far as to allow a company to sue a minority shareholder in damages for being obstructive: LS Sealy, above n 48, 173.

52 J Payne, above n 30, 607 and 609.


54 ibid.

55 Or where the claimant was in an acute conflict of interest in pursuing the derivative action, having received money from one of the defendants. See Portfolios of Distinction Ltd v Laird [2004] EWHC 2071 discussed in A Reisberg ‘Judicial Control of Derivative Actions’ (2005) 8 ICCLR 335. See also, Jafari-Fini v Skillglass Ltd [2005] EWCA Civ 356; Harley Street Capital Ltd v Tchigirinsky [2006] BCC 209.

56 North-West Transportation Co Ltd v Beatty (1887) 12 App Cas 589. But see now CA 2006, s 239 (discussed above n 36). This section prohibits self-interested members from participating in the ratification vote, thereby reversing Beatty.

is to gather the facts. In derivative action litigation there is an added concern. Information asymmetries accompany managerial misconduct: directors know the frequency and amount of harm caused by their misconduct, whereas shareholders do not.⁵⁸ Assuming that the shareholders have become aware of possible irregularities or instances of incompetence—say, anecdotally, through press speculation or as a result of ‘whistleblowing’—they will then face the task of obtaining more detailed information to enable them to evaluate the merits of litigation and to begin to put together adequate evidence to support the allegation of wrongdoing.⁵⁹ This can be critical in a derivative action as the majority of information is probably in the hands of the controllers of the company. Those are the persons who would normally be the focus of the litigation. Under English law, however, a shareholder has only very limited rights to inspect company documents.⁶⁰ These include, for example, the statutory registers, the minute books, and directors’ service agreements.⁶¹ Disputes often arise when shareholders become concerned at what has been taking place within a company but are denied access to information.⁶² If the shareholder is not a director or officer he has no right therefore to inspect the company’s files, including its accounting records. Similarly, the case law confines on shareholders only scant corporate rights to ‘internal’ company documents.⁶³ In this respect, minority shareholders not only suffer from serious informational disadvantages compared to the board but this, in turn, may also


⁵⁹ An illustration of this problem can be found in Lord Denning’s graphic account of the difficulties encountered by Mr Moir in Wallersteiner v Moir (No 2) [1975] QB 372. See also JE Parkinson, above n 17, 244–5; GR Sullivan ‘Restating the Scope of the Derivative Action’ [1985] CLJ 236.

⁶⁰ See, for example, Re DPR Futures Ltd [1989] BCLC 634. Similarly, Ferrarini and Giudici argue that the absence of discovery rules is the most significant weakness of Italian derivative actions, and the reason why they will never be really effective in monitoring ex post managers’ and controlling shareholders’ conduct. There was the hope that the statutory auditor appointed by minority shareholders would have helped in the diffusion of information needed to start legal proceedings, but that simply did not happen. See G Ferrarini and P Giudici ‘Financial Scandals and the Role of Private Enforcement: The Parmalat Case’ ECGI Working Paper Series in Law No 40/2005 (May 2005) 53. But compare the Australian approach discussed in D Faber ‘Reform of Shareholders’ Remedies’ in B Rider (ed) Developments in European Company Law (Kluwer Law 1998) Vol 1 119, 127 and the new § 127a of the Aktiengesetz in German law (a special section in the electronic version of the Federal Bulletin) under which shareholders may give notice of their intent to induce the pre-procedure for a particular shareholder suit (new § 148 of the Aktiengesetz introduced by Art 1 Nr 15 UMG discussed above n 43) and, inter alia, may initiate a special investigation of certain managerial conduct or call a shareholder meeting on behalf of the company.

⁶¹ See CA 1985, s 318 (service contracts, now contained in CA 2006, ss 228–229 and 237–238), s 356 (register of members, now contained in CA 2006, ss 116 and 118), s 383 (minute books, now contained in CA 2006, s 358), s 408 (register of charges, now contained in CA 2006, s 877).


not allow them to judge accurately whether or not an action should be instituted or to evaluate the strength of the potential claim.⁶⁴

3.2.3.3 Expertise

A related problem is that the lack of expertise and access to relevant information will frequently make it difficult for shareholders to determine which management actions are inconsistent with maximizing the value of the company.⁶⁵ Further, managers, not small shareholders or claimants’ attorneys, direct the company’s affairs.⁶⁶ What looks like a hasty decision by company managers may simply reflect their knowledge of the subject and their desire to avoid the expense of hiring outside experts.⁶⁷ For example, a seemingly self-interested decision to accelerate the exercise of share options may well be the most efficient method of awarding an increase in compensation.

3.2.3.4 Shareholders’ long-term commitment to a policy of suit

There are other, equally serious, impediments here. Assume that shareholders could without cost commit themselves to sue derivatively on behalf of the company when an action would deter misconduct. Informed shareholders with only investments at stake would then willingly commit themselves in advance to sue when and only when an action would result in an increase in corporate value. It is doubtful, however, whether shareholders could make such a commitment without leadership from the board of directors or a low-cost way to bind all shareholders to the new litigation policy. Likewise, as a legal matter, shareholders cannot commit their successors in an active trading market to a litigation policy.⁶⁸ Moreover, as a matter of policy, it is arguable whether we should encourage or, indeed, welcome as routine a policy of litigation that could have some negative effect on companies in the long run.⁶⁹ In any case, even in the absence of these legal and policy impediments, other obstacles, namely the costs of collective action, imperfect information, and the natural inclination of most shareholders to focus on immediate monetary benefits (as opposed to long-term benefits), would likely preclude any binding agreements among shareholders.

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⁶⁵ See discussion in Ch 2 above under 2.2.

⁶⁶ For example, under CA 1985, Table A, art 70.

⁶⁷ D Fischel and M Bradley, above n 53, 273.


3.2.3.5 Costs

There is a whole set of issues with respect to the funding of the derivative action. These issues relate to the question of how a shareholder is able to maintain a derivative action without some sort of financial aid. One may wonder what incentive a shareholder will have to sue on behalf of the company as, even if the litigation is successful, any damages recovered accrue to the company and the shareholder will therefore receive only a pro rata share of the gains of a successful action. As will be seen in Chapter 6, the company may be ordered to pay the costs of litigation, but that does not in itself produce a positive incentive to sue.⁷⁰

3.3 The Common Law Response

The preceding discussion sets the stage for an outline of the common law responses to the problems of the various restrictions on members’ ability to come before the court as litigants in a derivative action. Through extensive discussion of case law and emerging so-called principles and rules (for example, the majority rule and proper plaintiff principles), the purpose of this section is to illustrate how procedurally and substantively English law has developed to provide disincentives to prospective claimants in this context. The first part of this section reviews the majority rule and proper plaintiff principles. The second part briefly reviews the circumstances in which members have traditionally been able to bring derivative actions in spite of these principles, such as in cases involving ultra vires transactions, breaches of special resolution procedures, and in particular, the most important exception, namely, cases involving fraud on the minority. In the remainder of this section, additional restrictions which may prevent a minority shareholder from bringing a derivative action are briefly outlined.

3.3.1 The ‘majority rule’ and ‘proper plaintiff’ principles

The starting point for any discussion on the traditional view of derivative actions is by reference to two related principles. The first is the majority rule principle developed as a result of the courts’ historical reluctance to become involved in

⁷⁰ In this respect, it is interesting to note that although the German UMGabolishes the old § 147(4) of the Aktiengesetz, the cost provision that puts minority shareholders at a disadvantage (under which if the company loses in court it may recover its expenses from the shareholders who induced the suit in the first place) it does not necessarily follow that this will offer an incentive to use the procedure available for shareholders under new § 148 of the Aktiengesetz. The same problem exists under Italian law. In case the claim is accepted, the company reimburses the claimants for the legal costs and the expenses borne during the investigation of the events, which the judge did not impose on the losing party or which are not possible to collect further to enforcement against the latter. But as explained elsewhere, removing a deterrent is simply not the same as providing incentives. See further, A Reisberg ‘Funding Derivative Actions: A Re-examination of Costs and Fees as Incentives to Commence Litigation’ (2004) 4 JCLS 345. Chapters 6 and 7 respectively below explore different aspects of this problematic issue.
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disputes over the internal management of business ventures.⁷¹ The second is the proper plaintiff principle⁷² which has been described as 'the elementary principle that A cannot, as a general rule, bring an action against B to recover damages or secure other relief on behalf of C for an injury done by B to C.'⁷³ As a company is a separate legal entity, it is the proper plaintiff where it has suffered injury.

However, these restrictions are not absolute. If they were, they would mean that where a wrong has been done to the company by or with the support of the majority shareholders, there could never be any redress. There are cases, therefore, when the rule will not apply and an individual shareholder will be able to bring an action. These were set out by the Court of Appeal in Edwards v Halliwell⁷⁴ and restated in Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) in the following terms:

1. The proper plaintiff in an action in respect of a wrong alleged to be done to a corporation is, prima facie, the corporation.
2. Where the alleged wrong is a transaction which might be made binding on the corporation and on all its members by a simple majority of the members, no individual member of the corporation is allowed to maintain an action in respect of that matter because, if the majority confirms the transaction, cadit quaestio [the question is at an end]; or, if the majority challenges the transaction, there is no valid reason why the company should not sue.
3. There is no room for the operation of the rule if the alleged wrong is ultra vires the corporation, because the majority of members cannot confirm the transaction.
4. There is also no room for the operation of the rule if the transaction complained of could be validly done or sanctioned only by a special resolution or the like, because a simple majority cannot confirm a transaction which requires the concurrence of a greater majority.
5. There is an exception to the rule where what has been done amounts to fraud and the wrongdoers are themselves in control of the company.

Interestingly, only this last limb of the restatement in Prudential has been described as ‘the only true exception’ to the rule in Foss v Harbottle,⁷⁵ a fair

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⁷¹ The principle is based on the doctrine of separate corporate personality and on the early partnership principle that courts would not interfere between partners except to dissolve the partnership: K W Wedderburn, ‘Shareholders’ Rights and the Rule in Foss v Harbottle’ [1957] CLJ 194, 196. See Carlen v Drury (1812) 1 V & B 154, 158; 35 ER 61, 62 per Lord Eldon LC: ‘This Court is not to be required on every Occasion to take the Management of every Playhouse and Brewhouse in the Kingdom’.

⁷² These principles were applied in the case of Foss v Harbottle (1843) 2 Hare 461; 67 ER 189 and are often applied by the courts as ‘the rule in Foss v Harbottle’. See further, K W Wedderburn, above n 71, 195–8. See also Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] Ch 204, where the Court of Appeal referred to the rule in Foss v Harbottle as embracing both the ‘elementary’ proper plaintiff principle and ‘a related principle, that an individual shareholder cannot bring an action in the courts to complain of an irregularity … if the irregularity is one which can be cured by a vote of the company in general meeting’.

⁷³ Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1981] Ch 257, 323.

⁷⁴ [1950] 2 All ER 1064, 1066–9 per Jenkins LJ.

⁷⁵ Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1981] Ch 257, 323.
description when we consider that the third and fourth limbs are really self-evident and, strictly speaking, not even within the ambit of the rule. The third and fourth limbs are essentially situations where the principles had no application; actions under those limbs can be brought by a shareholder as a personal action in his own right, and need not be brought as a derivative action. By contrast, it is a true ‘exception’ to the rule in *Foss v Harbottle*, in that it permitted a shareholder to bring a derivative action (i.e., an action to enforce the company’s cause of action) in spite of the majority rule and proper plaintiff principles. It is also the broadest exception and thus the one most often invoked by complaining minorities.

The exception included two components: first, those against whom relief was sought had to control the company, thereby preventing an action being brought against them in the company’s name; secondly, the conduct complained of must, in the view of the court, have constituted a fraud. After setting out the fraud on the minority exception to the rule in *Foss v Harbottle*, the Court of Appeal in *Edwards v Halliwell* explained why the exception is necessary. This explanation was set out as follows in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*.⁷⁶

There is an exception to the rule where what has been done amounts to fraud and the wrongdoers are themselves in control of the company. In this case the rule is relaxed in favour of the aggrieved minority, who are allowed to bring a minority shareholders’ action on behalf of themselves and all others. The reason for this is that, if they were denied that right, their grievance could never reach the court because the wrongdoers themselves, being in control, would not allow the company to sue.⁷⁷

### 3.3.2 Fraud on the minority⁷⁸

We will consider next what constitutes ‘fraud’ and ‘control’ and when fraud and control must be shown.

#### 3.3.2.1 Fraud and wrongdoer control

**Fraud**

‘Fraud’ in this context means ‘fraud in the wider equitable sense of that term’.⁷⁹ Essentially, the term encompasses situations such as ‘where the majority are endeavouring directly or indirectly to appropriate to themselves money, property

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⁷⁶ [1982] Ch 204.
⁷⁷ ibid 211. The suggestion in *Edwards v Halliwell* [1950] 2 All ER 1064, 1067 that the rule in *Foss v Harbottle* should be relaxed ‘where necessary in the interests of justice’ was considered but rejected in *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2 and by the Court of Appeal (Vinelott J, [1981] Ch 257, had accepted this further exception at first instance) in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 (although in this latter case the Court of Appeal did not hear full argument on this point). See below under 3.3.5.

⁷⁸ The following review draws heavily on the Law Commission *Shareholder Remedies* (Consultation Paper No 142 1996), in particular, Part 4.

⁷⁹ *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2, 12 per Sir Robert Megarry V-C., discussing the judgment of Templeman J in *Daniels v Daniels* [1978] Ch 406.
or advantages which belong to the company or in which other shareholders are entitled to participate…’. Therefore, attempts by the majority to sell worthless assets to the company, to divert business from the company to themselves in breach of fiduciary duty, or to compromise litigation against bodies in which the majority are interested on terms prejudicial to the company have all been held to amount to ‘fraud’ in this context, entitling minority shareholders to bring derivative actions.

The term has also been applied to the negligent decision of directors, who were also the majority shareholders, to sell company assets to one of their number at an undervalue, and to acts of a controlling shareholder which had the effect of stultifying the purpose for which the company was formed.

‘Fraud’ does not, however, cover the situation where the wrongdoers do not themselves benefit. Thus it does not include mere negligence on the part of the directors, so that a derivative action cannot be brought against directors who mismanage a company and cause it loss, even if they have control. The

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80 Burland v Earle [1902] AC 83, 93 (PC) per Lord Davey.
81 See Atwool v Merryweather (1867) LR 5 Eq 464n where the claimant claimed rescission of a contract entered into by directors and the return of money and shares paid to them in consideration for the sale, claiming that they had made a concealed profit. The court held that the directors had acted fraudulently and upheld the claimant’s claim.
82 See, for example, Cook v Deeks [1916] 1 AC 554 (PC).
83 See Menier v Hooper’s Telegraph Works (1874) 9 Ch App 350 where the claimant minority shareholder in E Ltd claimed that the defendant company, the majority shareholder in E Ltd, had used its votes to procure the diversion of E Ltd’s business to a third company. James LJ referred to Atwool v Merryweather (1867) LR 5 Eq 464n, and upheld the claimant’s claim. See also Estmanco (Kilner House) Ltd v Greater London Council [1982] 1 WLR 2.
84 A purported ratification of wrongful acts might itself, in some circumstances, constitute a fraud on the minority.
85 See Daniels v Daniels [1978] Ch 406, where minority shareholders brought an action against the company’s directors, alleging they had caused the company to sell a piece of land to one of them at an undervalue. Templeman J referred to Alexander v Automatic Telephone Co [1900] 2 Ch 56, Cook v Deeks [1916] 1 AC 554 (PC), and Pavlides v Jensen [1956] Ch 565 and held that the claimants could sue as the case should be covered by the fraud on the minority exception to the rule in Foss v Harbottle. If minority shareholders could sue where there was fraud, he saw no reason why they could not ‘where the action of the majority and the directors, though without fraud, confers some benefit on those directors and majority shareholders themselves’. [1978] Ch 406, 414.
86 Estmanco (Kilner House) Ltd v Greater London Council [1982] 1 WLR 2. In that case, the Council had formed the claimant company to regulate the management of a block of 60 flats being sold off to owner-occupiers, each of whom acquired one of the 60 shares in the company when the sale went through. The Council covenanted with the company to use its best endeavours to sell all the flats. When 12 of the flats had been sold, control of the Council changed, a new housing policy was introduced and the remaining flats were used to house disadvantaged families. At the relevant time the Council had voting control of the company. One of the original occupiers of the flats (so a shareholder in the company) sought leave to bring a derivative action against the Council based on the breach of the covenant. Sir Robert Megarry V-C (p 12) upheld the claimant’s right to bring a derivative action, using the broad definition of fraud in Daniels v Daniels [1978] Ch 406 (see n 85 above) which he said was ‘useful as preventing “fraud” from being read too narrowly’.
87 See Pavlides v Jensen [1956] Ch 565 where the claimant, a minority shareholder, brought an action against the defendant directors alleging that they had negligently sold a mine at a gross undervalue. Danckwerts J held that negligence did not fall within the fraud on the minority exception to the rule in Foss v Harbottle so that the claimant could not sue.
company can never itself enforce the right of action it has against them unless there is a change of control or a liquidator is appointed. However, even where the directors’ negligent mismanagement does not constitute ‘fraud’ for the purposes of the rule in *Foss v Harbottle*, if directors procure the company to omit to take proceedings against them by use of their control, those actions may amount to fraud on the minority. In that case, it would have to be shown at a preliminary hearing that the directors were causing the company to omit to take proceedings for their own personal benefit, rather than in the interests of the company.

**Wrongdoer control**

The fraud on the minority exception is based on the court’s desire ‘to give a remedy for a wrong which would otherwise escape redress’.

The court allows a derivative action to proceed because it recognizes that where the person who has committed a wrong against the company is also in control of that company, he is unlikely to allow the company to bring proceedings against him. Where the company is not under the control of the ‘wrongdoer’ then the usual rule that the company is the proper plaintiff prevails. The court has always required that a shareholder should show ‘wrongdoer control’ of the company before he is allowed to proceed with a derivative action.

It is thus entirely logical for the courts to require the individual shareholder to show that the wrongdoers control the company. In a small private company this may not cause any difficulty in practice. However, in a public listed company with a large share capital there are numerous shareholders (often thousands), and many shares are held by nominees and trustees, so that it is very difficult for an individual shareholder to show who controls the shares, or whether particular shareholders benefit in some way unconnected with the company from the action of which he complains, or have some commercial relationship with the wrongdoer which would cause them to vote with him. Moreover, in a public company a person can, in practice, control votes if shareholders believe that he can produce outstanding profits for the company. There is a reluctance in that situation for shareholders to vote against the wishes of that person in case he decides to leave the company, though subsequently they may find that their belief in his abilities was misplaced. There is also in any listed company a substantial number of

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88 *Burland v Earle* [1902] AC 83, 93 (PC) per Lord Davey.
89 Ibid 93.
91 For example, *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2.
92 Note CA 1985, s 214 (now contained in CA 2006, ss 803–804) which allows members of a public company holding one-tenth of the paid-up voting share capital to requisition the company to exercise its powers under s 212 (now CA 2006, s 793) to investigate the share ownership of the company in the three years preceding the investigation.
shareholders who do not vote at all,⁹³ so that in practice control can be exercised with as little as 20 or 30% of the votes.⁹⁴

The courts are aware of considerations like these and have accepted that the minority shareholder seeking to bring a derivative action under this ‘exception’ need not show that the wrongdoer owns a majority of the company’s shares. However, as yet, there is little guidance as to what other circumstances would evidence ‘control’.⁹⁵ In a small private company this may not cause any difficulty in practice, nonetheless, in a public listed company this may not be the case.

In *Russell v Wakefield Waterworks Co*, Jessel MR stated:⁹⁶

> It is not necessary that the corporation should absolutely refuse by vote at the general meeting, if it can be shown either that the wrong-doer had command of the majority of the votes, so that it would be absurd to call the meeting; or if it can be shown that there has been a general meeting substantially approving of what has been done; or if it can be shown from the acts of the corporation as a corporation, distinguished from the mere acts of the directors of it, that they have approved of what has been done, and have allowed a long time to elapse without interfering, so that they do not intend and are not willing to sue. In all those cases the same doctrine applies, and the individual corporator may maintain the suit.⁹⁷

In *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*,⁹⁸ the Court of Appeal recognised that the term ‘control’ ‘...embraces a broad spectrum extending from an overall absolute majority of votes at one end, to a majority of votes at the other end made up of those likely to be cast by the delinquent himself plus those voting with him as a result of influence or apathy’.⁹⁹ However, this still means that control of over 50% of the votes must be shown. Likewise, it is far from clear what degree of ‘influence’ the wrongdoer must have over a particular shareholder for

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⁹³ They may be dead, or the address to which the company sends notices may be out of date etc.

⁹⁴ Note that under Rule 9.1 of the Takeover Code, which applies principally to public companies, a person acquiring 30% or more of the voting power of a company must make an offer to purchase the shares of the remaining shareholders, unless the Panel on Takeovers and Mergers otherwise consents. See <http://www.thetakeoverpanel.org.uk/new/>. See also, CA 2006, Pt 28, which implements Directive 2004/25/EC on Takeover Bids [2004] OJ L142/12.

⁹⁵ Such control could arise on the basis of agreements or understandings between members, minority control through other members’ apathy or inability to participate, board control when no members hold sufficient votes to exercise control in larger companies, and personal influence between shareholders; see MA Pickering ‘Shareholders’ Voting Rights and Company Control’ (1965) 81 LQR 248, 269–72. See also KW Wedderburn’s theory in ‘Derivative Actions and Foss v Harbottle’ (1981) 44 MLR 202, 205, that ‘control exists if it would be futile to call a general meeting because the wrongdoers would directly or indirectly exercise a decisive influence over the result’.

⁹⁶ (1875) LR 20 Eq 474.

⁹⁷ ibid 482. Ratification as a possible manifestation of wrongdoer control.

⁹⁸ [1982] Ch 204.

⁹⁹ ibid 219 (emphasis added). It is far from clear what degree of ‘influence’ the wrongdoer must have over a particular shareholder for the shareholder’s votes to be under the wrongdoer’s control. Similarly there is little guidance as to what conduct by a shareholder would be sufficient to establish ‘apathy’ in this context. See also the first instance decision of Vinelott J, [1981] Ch 257, which provides a useful discussion of these issues.
the shareholder’s votes to be under the wrongdoer’s control. And there is little
guidance as to what conduct by a shareholder would be sufficient to establish
‘apathy’ in this context.¹⁰⁰

3.3.2.2 When fraud and control must be shown

In Prudential Assurance Co Ltd v Newman Industries Ltd (No 2),¹⁰¹ the Court of
Appeal held:

We do not think it right that the right to bring a derivative action should be decided as a
preliminary issue upon the hypothesis that all the allegations in the statement of claim
of ‘fraud’ and ‘control’ are facts, as they would be on the trial of a preliminary point of
law. In our view, whatever may be the properly defined boundaries of the exception to the
rule, the plaintiff ought at least to be required before proceeding with his action to estab-
lish a prima facie case (i) that the company is entitled to the relief claimed, and (ii) that
the action falls within the proper boundaries to the rule in Foss v Harbottle.¹⁰²

This led in due course to the introduction of RSC Ord 15, r 12A, which
required a preliminary application in all derivative actions. Later, the revised
procedure was re-enacted in simplified form as part of CPR r 19.9 (Derivative
Claims) which expressly requires the court’s approval for the continuance of a
derivative action.¹⁰³ However, it will be appreciated from the explanation of the
law given above, that the factual difficulty of proving fraud and control will often
make the preliminary application extremely complicated and lengthy. Moreover,
if, as is almost inevitable, the application is opposed the defendants are likely to
introduce a number of other issues said to be relevant to the question whether the
derivative action should proceed.

3.3.3 Ultra vires transactions

The third part of the Edwards v Halliwell statement of the rule in Foss v Harbottle,
was restated in Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)¹⁰⁴ as
follows:

There is no room for the operation of the rule if the alleged wrong is ultra vires the corpor-
ation, because the majority of members cannot confirm the transaction.¹⁰⁵

Ultra vires acts include acts which are beyond the capacity of the company as
prescribed by its memorandum.¹⁰⁶ The possibility of a transaction being ultra

¹⁰⁰ See also the first instance decision of Vinelott J, [1981] Ch 257, which provides a useful
discussion of these issues.
¹⁰¹ [1982] Ch 204.
¹⁰² ibid 221–2.
¹⁰³ Now contained in CA 2006, s 261(1) discussed in Ch 4 below under 4.3.4 and 4.3.5.3.
¹⁰⁴ [1982] Ch 204.
¹⁰⁵ ibid 210.
¹⁰⁶ Ashbury Railway Carriage and Iron Co Ltd v Riche (1875) LR 7 HL 653. Acts which are ultra
vires the company should be distinguished from acts which are outside the powers of the directors.
Ultra vires acts also include acts which are beyond the powers given to the company by the Companies Acts, as where a company repays its capital in a manner not authorized by the Companies Acts. Such a repayment would be an unlawful reduction of capital and ultra vires. However, where an act which a company commits is illegal, it is not also ultra vires unless it is also beyond the capacity it is given by the Companies Acts. In *Smith v Croft (No 2)*, the illegal act was conceded to be ultra vires because it involved the giving of financial assistance for the purpose of acquiring shares in the company in a manner which the Companies Act 1981 did not allow. The description of the rule in *Foss v Harbottle* that is given above applies to illegal acts which are ultra vires in this sense. Where the company proposes to do some other illegal act, a member may bring proceedings to restrain the company from so acting, but it is doubtful whether he can bring proceedings to recover damages for any loss which the company may suffer as a result without showing a fraud on the minority.

At common law, shareholders could not approve ultra vires acts in advance. As we have already noted, shareholders could bring personal actions to restrain threatened ultra vires acts and this is still good law. Moreover, shareholders could not ratify ultra vires acts at common law. Section 35(3) of CA 1985 has amended the law in this respect and provided that a company can ratify, by special resolution, a director’s act which is ultra vires the company. This resolution in itself (see the dicta of Slade and Browne-Wilkinson LJJ in *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1986] Ch 246, 297 and 302–4 respectively).

The standard practice is to include a long list of objects and powers in the memorandum covering every conceivable business activity. Under CA 1985, s 3A, it is possible for the memorandum to state that the object of the company is to carry on business as a general commercial company. This is then defined as meaning that the object of the company is to carry on any trade or business whatsoever, and the company has power to do all such things as are incidental or conducive to the carrying on of any trade or business by it. Because of doubts as to the precise effect of this provision, it does not appear to be being used as frequently as originally envisaged; see NJM Grier *The Companies Act 1989—a Curate’s Egg* (1995) 16 Co Law 3, 5. It is noteworthy that CA 2006, s 31 (statement of company’s objects) provides for a new approach to the question of a company’s objects. Based on a recommendation of the CLR (Final Report, para 9.10), instead of companies being required to specify their objects, companies will have unrestricted objects unless the objects are specifically restricted by the articles (see s 31 (1)). This will mean that unless a company makes a deliberate choice to restrict its objects, the objects will have no bearing on what it can do. Some companies will continue to restrict their objects. Companies that are charities will need to restrict their objects (under charities legislation) and some community interest companies may also choose to do so. See further, Explanatory Notes on the Companies Act 2006, paras 98–104, available at <http://www.opsi.gov.uk/acts/en2006/ukpga_en_20060046_en.pdf>
will not relieve directors of their liability to the company arising out of the ultra vires act, although s 35(3) allows members to pass a further special resolution absolving the directors from liability. On normal principles, if a special resolution under s 35(3) was not passed bona fide in the interests of the company but to confer a benefit on the majority shareholders, a minority shareholder could bring a derivative action¹¹¹ on the basis of fraud on the minority, for a declaration that the resolution was not binding and for the recovery of damages from the directors. However, his action might be prevented if an independent organ of the company did not want it to proceed.

In Smith v Croft (No 2)¹¹² the transactions under consideration constituted unlawful financial assistance for the purchase of the shares of the company in issue,¹¹³ and so were both ultra vires and illegal. The defendant wrongdoers held or controlled about 66% of the voting rights in the company and the plaintiffs held (through themselves and other shareholders whom they controlled) about 14% of the voting rights. About 19% was held by a shareholder (who thus held a majority of the minority of approximately 33%) who was held to be independent and who also opposed the action being brought.

On the question of the nature of the wrong, Knox J held that where the plaintiffs sought compensation for the company for loss caused by ultra vires acts, the wrong was a wrong to the company, which had the right to redress.¹¹⁴ However, Knox J held that it was not necessary in this situation to show fraud on the minority.¹¹⁵ Knox J accepted that the rule in Foss v Harbottle was inapplicable to proceedings to restrain ultra vires acts, as members could bring personal actions in that case. He also accepted that past ultra vires acts could not be ratified, but distinguished

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¹¹¹ Following Smith v Croft (No 2) [1988] Ch 114, the passing of such resolutions is likely to be seen as a wrong to the company, so that a personal right of action would not lie. It is possible that other grounds of challenge could include those applied in the alteration of articles cases or other grounds. In Re Halt Garage (1964) Ltd [1982] 3 All ER 1016, 1036 Oliver J held that the company could be restrained from acting on resolutions ‘…in appropriate circumstances, such as oppression or fraud on a minority’. See also dicta in North-West Transportation Co Ltd v Beatty (1887) 12 App Cas 589, 600–1 (PC) per Sir Richard Baggallay.


¹¹³ Such transactions are prohibited under s 151 of CA 1985 (now CA 2006, ss 678–680) and, at the time of the case, transgressed s 42 of CA 1981.

¹¹⁴ [1988] Ch 114, 170. It appears that, before Smith v Croft (No 2), shareholders brought personal actions in claims relating to past ultra vires acts. See, for example, Holmes v Newcastle-upon-Tyne Freehold Abattoir Co (1875) 1 Ch D 682 and see K Wedderburn, ‘Shareholders’ Rights and the Rule in Foss v Harbottle’ [1957] CLJ 194, 206. The effect of the decision in Smith v Croft (No 2) is to link the first limb (relating to the proper plaintiff) to the third limb (relating to ultra vires acts) of the Edwards v Halliwell rewording of the rule in Foss v Harbottle as restated in Prudential Assurance Co Ltd v Newman Industries Ltd (No 2). Where there is a fraud on the minority, the fifth limb will also be relevant.

¹¹⁵ [1988] Ch 114, 177.
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resolutions ‘... abandoning, compromising or not pursuing rights of action arising out of a past ultra vires transaction’.¹¹⁶ Such resolutions could prevent the company, and therefore a minority shareholder, from bringing an action. If an ‘independent organ’ did not wish the action to proceed, the shareholder should not be allowed to do so.¹¹⁷ The court would not necessarily require a meeting of the company to be held to discuss this issue.¹¹⁸ In considering the test of independence for these purposes, Knox J considered cases involving challenges to resolutions passed by or with the help of votes, the validity of which was impugned. He stated that ‘... in general terms I would seek to apply the test applied by the Court of Appeal in Allen v Gold Reefs of West Africa Ltd’.¹¹⁹, ¹²⁰ However, on the facts before him, he thought that it was possible to give a more specific test and held that ‘... votes should be disregarded if, but only if, the court is satisfied either that the vote or its equivalent is actually cast with a view to supporting the defendants rather than securing benefit to the company, or that the situation of the person whose vote is considered is such that there is a substantial risk of that happening’.¹²¹ He continued, ‘[t]he court should not substitute its own opinion but can, and in my view should, assess whether the decision making process is vitiated by being or being likely to be directed to an improper purpose’.¹²²

3.3.4 Breaches of special resolution procedures

The fourth part of the Edwards v Halliwell definition of the rule in Foss v Harbottle was restated in Prudential Assurance Co Ltd v Newman Industries (No 2)¹²³

¹¹⁶ Section 35(3) was introduced into CA 1985 after the decision in Smith v Croft (No 2) [1988] Ch 114, 172. However, CA 2006, s 39 does not contain a provision corresponding to s 35 (3) of CA 1985 as this was seen as unnecessary (see n 110 above).

¹¹⁷ [1988] Ch 114, 185. Knox J considered the decision in Taylor v National Union of Mineworkers (Derbyshire Area) [1985] BCLC 237, where the court had held that, although an ultra vires payment of union funds could not be ratified by the members, they could resolve to take no action to remedy the wrong, provided that such resolution was made in good faith and for the benefit of the union. cf the test used by the court to assess the validity of resolutions amending the company’s articles, which was also used by Knox J in assessing the concept of the ‘independent organ’ of the company.

¹¹⁸ On the facts before him, there was no point in adjourning for a meeting to be called since it was quite plain that the votes would be cast as to 14% by the plaintiffs in favour of the action, as to 19% by the ‘independent’ shareholder against the action and as to 66% by the defendants against the action. See also Taylor v National Union of Mineworkers (Derbyshire Area) [1985] BCLC 237.

¹¹⁹ [1900] 1 Ch 656, 671. In this case the test was whether the votes in question were ‘exercised bona fide for the benefit of the company as a whole’. But contrast the views of Sir Robert Megarry V-C in Estmanco (Kilner House) Ltd v Greater London Council [1982] 1 WLR 2. He noted that, to that date, the line of authority on resolutions altering the articles of association had never been applied to the exceptions to the rule in Foss v Harbottle and said ‘[i]f a case falls within one of the exceptions from Foss v Harbottle, I cannot see why the right of the minority to sue under that exception should be taken away from them merely because the majority of the company reasonably believe it to be in the best interests of the company that this should be done. This is particularly so if the exception from the rule falls under the rubric of “fraud on a minority”’: ibid 12.


¹²¹ ibid.

¹²² ibid.
Shareholders are generally able to pursue derivative actions where a special majority procedure has not been followed as the majority rule principle cannot apply; otherwise the majority would have the power ‘...to do de facto by ordinary resolution that which according to its own regulations could only be done by special resolution’.¹²⁴ To this extent, the fourth limb of the rule is the natural corollary to the second.¹²⁵ Members can, therefore, bring derivative actions to restrain breaches of special majority procedures and to prevent the company from acting on resolutions passed as a result of such breaches. They can also apply to the court to restrain the company from acting on an ordinary resolution if it should have been passed as a special or an extraordinary resolution.¹²⁶ As we have seen, however, in some cases, the courts have held¹²⁷ that acts done in breach of the articles can be ratified by ordinary resolution, but, in other cases, a breach of the articles may involve a breach of a shareholder’s personal rights and found a personal action. In Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)¹²⁸ the court held that shareholders would not be permitted to bring personal actions for damages for loss in the value of their shares to avoid the restrictions of the rule in Foss v Harbottle. In Smith v Croft (No 2),¹²⁹ the court held that an action to recover damages for an ultra vires act was a derivative action. Accordingly, recent

¹²⁴ Edwards v Halliwell [1950] 2 All ER 1064, 1067 per Jenkins LJ. The members of a trade union had obtained a declaration that a union decision increasing union dues was invalid as the requirement that a two-thirds majority of members should agree had not been observed. See also Cotter v National Union of Seamen [1929] 2 Ch 58, 69–70 per Romer J, and Baillie v Oriental Telephone and Electric Co Ltd [1915] 1 Ch 503, 515 where Lord Cozens-Hardy MR was ‘not prepared for one moment’ to assent to the proposition ‘that the company by an ordinary resolution can indirectly do that which ... can only be done by a special resolution’.
¹²⁵ It is generally assumed that a member can sue where there has been a breach of a special resolution, notwithstanding proof that those who oppose him are sufficiently numerous to pass the special resolution which is needed. See RJ Smith ‘Minority Shareholders and Corporate Irregularities’ (1978) 41 MLR 147, 160 who suggests, however, that ‘an irregularity in a special resolution should be regarded as being ratifiable by a three-quarters majority...’ and that the concept ‘that the irregularity must be ratifiable by straight majority seems linked to the use of the corporate name in litigation by the majority and the need to avoid a straight majority doing what a special majority is required for’. This point may be arguable in principle but it has not been applied by the courts.
¹²⁶ See Edwards v Halliwell [1950] 2 All ER 1064. See also provisions which specify special resolution procedures, for example, CA 1985, s 151 (financial assistance for the purchase of the company’s shares, now contained in CA 2006, ss 678–680). Special resolutions amending the company’s articles which are not passed bona fide for the benefit of the company as a whole may themselves be challenged by members bringing personal actions.
¹²⁷ See for example, Normandy v Ind Coope & Co Ltd [1908] 1 Ch 84.
¹²⁸ [1982] Ch 204.
¹²⁹ [1988] Ch 114. On reflective loss see further Ch 7 below under 7.2.2.3.
cases have had the effect of reducing the possibility of using the personal action as a means of avoiding the restrictions of a derivative action.

3.3.5 The ‘interests of justice’?

It has been suggested at various times that there was another exception to *Foss v Harbottle*, commonly described at the ‘interests of justice’ exception. Interestingly, this view can be traced back to the words of Sir James Wigram in *Foss v Harbottle* itself:

If a case should arise of injury to a corporation by some part of its members, for which no adequate remedy remains, except that of a suit by individual corporators . . . , *the claims of justice would be found* superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue.¹³⁰ (emphasis supplied).

However, English courts during the 1980s and 1990s avoided classifying the interests of justice as a distinct exception to the rule.¹³¹ Osunbor, for example, explains that although recent English cases show that the courts are prepared to relax the rule where necessary to bring about justice in the circumstances presented to the court, the ‘interests of justice’ by themselves are not an exception to the rule as they are too nebulous, vague, and infinitely elastic.¹³² Others have described decisions such as those in the *Prudential* and *Estmanco* cases as ‘laudable’ in the sense that they provided justice for the participants, but unhelpful in providing a sound basis of principle, from which accurate observations of the law could be made.¹³³

By contrast, the approach taken by the Australian courts, and to a more limited extent those of New Zealand and Israeli courts have generally shown a willingness to grant a shareholder standing where justice requires it but, unlike the English courts, they have also shown an inclination effectively to ‘brush aside’ the procedural barriers of *Foss v Harbottle* where they stand in the way of justice being served.¹³⁴ Sealy, for example, describes the picture that consistently comes through from Australian cases as one of a willingness to get to the substantial

¹³⁰ (1847) 2 Hare 461, 492.

¹³¹ For example, in *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2, 10–11, Sir Robert Megarry explained: ‘I do not think that it can simply be said that there is an exception from the rule whenever the justice of the case requires it’. He did, however, also hold that ‘although the concept of justice is not the test, I think that it is nevertheless a reason, and an important one, for making exceptions to the rule’. In *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 claimed it was ‘not a practical test’ preferring instead to extend the bounds of the existing ‘fraud on the minority’ exception to the point where ‘injustice’ could almost be said to have overtaken the original test.


issue, undistracted by any consideration of locus standi or procedure.¹³⁵ This difference between the English and Australian approaches has been described as the difference between ‘Why should we?’ and ‘Why not?’.¹³⁶ This attitude has continued in recent Australian cases, with the most obvious point of contrast lying in the Australian courts’ willingness to embrace the ‘interests of justice’ as an exception to Foss v Harbottle in its own right.¹³⁷

3.3.6 Additional restrictions on members’ ability to bring actions on behalf of the company¹³⁸

Thus far we have seen that the circumstances in which a minority shareholder could bring a derivative action were limited to the situations permitted by the rule in Foss v Harbottle. It is the purpose of this section to highlight briefly other restrictions which may prevent a minority shareholder from bringing a derivative action, that is apart from the rule in Foss v Harbottle itself and any other additional practical problems such as the cost of bringing proceedings.

3.3.6.1 ‘Independent organ’ does not wish the action to proceed

In Smith v Croft (No 2), Knox J stated: ‘ultimately the question which has to be answered in order to determine whether the rule in Foss v Harbottle applies to prevent a minority shareholder seeking relief as plaintiff for the benefit of the company is “Is the plaintiff being improperly prevented from bringing these proceedings on behalf of the company?”’¹³⁹ Knox J submitted that if an ‘independent organ’ of the company considered that such an action would not be in the interests of the company, the action was properly prevented. Section 3.4.1.2 below will evaluate the competence of this ‘independent organ’ to determine whether a derivative action is in the best interests of the company.

3.3.6.2 Ratification

In section 3.2.2 above it was noted that in some situations, the underlying wrong of which the minority shareholder complains can, as a matter of substantive law, be cured by ratification.¹⁴⁰ Where ratification is effective in this way it will inevitably have an effect on the shareholder’s right to take an action on behalf of

¹³⁶ ibid.
¹³⁷ The judgment of Ipp J in the Supreme Court of Western Australia decision in Biala Pty Ltd v Mallina Holdings Ltd (1993) 11 ACSR 785 is the leading Australian authority on the application of this ‘justice exception’.
¹³⁸ The following review draws heavily on the Law Commission Shareholder Remedies (Consultation Paper No 142 1996) (hereafter ‘Consultation Paper’), in particular, Part 5.
¹⁴⁰ Consultation Paper paras 5.2–5.17.
the company. However, as noted above under 3.2.2 it is not always clear when ratification will be effective, and what are the exact circumstances in which ratification may bar a derivative action, as it is impossible to reconcile all the decided cases with any simple set of propositions.

3.3.6.3 Inequitable conduct of the minority shareholder

At common law derivative actions are allowed to proceed by virtue of an equitable concession by the Court of Chancery which makes an exception to the general rule that the proper plaintiff in an action seeking redress for a wrong done to a company is the company itself. It follows that a shareholder wishing to take advantage of this concession may be prevented from doing so if there is evidence of behaviour by the minority shareholder, which, in the eyes of equity, would render it unjust to allow a claim brought by the company at his insistence to succeed. So, for example, the shareholder must ‘come with clean hands’.¹⁴¹ A shareholder may therefore not be able to proceed with a derivative action in relation to an ultra vires transaction if he has knowingly received the proceeds of the ultra vires transaction,¹⁴² or in respect of a misappropriation of company assets where he has received a lump-sum settlement on divorce which has made allowance for the misappropriated assets.¹⁴³ As will be seen in Chapter 5 (under 5.4.4.3(F)) there is no reason, nonetheless, why equitable defences (such as clean hands) which exist between a minority shareholder personally and a wrongdoer should be relevant for the purpose of deciding whether to allow a derivative action to proceed.

3.3.6.4 Availability of other adequate remedies

In Barrett v Duckett Peter Gibson LJ stated:

The shareholder will be allowed to sue on behalf of the company if he is bringing the action bona fide for the benefit of the company for wrongs to the company for which no other remedy is available. Conversely if the action is brought for an ulterior purpose or if another adequate remedy is available, the court will not allow the derivative action to proceed.¹⁴⁴

In this case, the alternative remedy was winding up. One of the defendant shareholders had brought proceedings for winding up. The plaintiff did not have the means to pursue the derivative action and the Court of Appeal held that it was better for the liquidator to determine whether to pursue the action. Moreover, the plaintiff was acting for an ulterior purpose and not bona fide on behalf of the company.

But, on a broader level, what exactly does the expression ‘adequate remedy available’ mean? For example, does the ‘unfair prejudice’ remedy provide a

¹⁴¹ Nurcombe v Nurcombe [1985] 1 WLR 370, 378 per Browne-Wilkinson LJ.
method of side-stepping many of the difficulties surrounding the rule in *Foss v Harbottle* and the derivative action while it offers more appropriate relief? Or, to use the words of Hoffmann LJ ‘enabling the court in appropriate cases to outflank the rule in *Foss v Harbottle* was one of the purposes of the section’.¹⁴⁵ Or maybe the unfair prejudice and the derivative action are aimed at redressing different wrongs and, if so, how does one distinguish between the two. These important questions will be returned to in Chapter 8 when the potential for interrelationship and interaction between the remedy of unfair prejudice and the derivative action is examined.

### 3.3.6.5 Companies in liquidation

The derivative action is ‘... a form of pleading originally introduced on the ground of necessity alone in order to prevent a wrong going without redress’.¹⁴⁶ It follows, that where a company has gone into liquidation, there is no need for such a device as the liquidator, an independent third party, will have taken control of the company’s affairs from the alleged wrongdoers. If there is a reasonable cause of action against the wrongdoers, the liquidator can cause the company to bring an action and, if the liquidator refuses, the complainant shareholder may be able to obtain either an order (under insolvency legislation) directing the liquidator to bring such an action or an order allowing the shareholder to bring an action in the name of the company.¹⁴⁷

### 3.3.7 Conclusion

The rule in *Foss v Harbottle* represents the courts’ view that as a matter of policy the circumstances in which a shareholder can bring an action to enforce a cause of action vested in the company should be strictly limited; in the words of Knox J, the question is ultimately whether the plaintiff is being improperly prevented from bringing the action. If the answer to that question is yes, he is permitted to bring a derivative action. However, the rule in *Foss v Harbottle* is not stated in terms of this underlying principle; rather, because the rule has been formulated as one which permits the derivative action only in set circumstances, the possibility that the rule could develop in a principled way to cover new situations is restricted.¹⁴⁸ Moreover, to obtain a proper understanding of the rule, one needs to examine numerous reported cases decided over a period of 150 years, thus

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¹⁴⁵ *Re Saul D Harrison & Sons plc* [1995] 1 BCLC 14, 18 per Hoffmann LJ (as he then was).

¹⁴⁶ *Smith v Croft (No 2)* [1988] Ch 114, 185 per Knox J.

¹⁴⁷ *Fargro Ltd v Godfroy* [1986] 1 WLR 1134, 1136 per Walton J and *Barrett v Duckett* [1995] 1 BCLC 243, 255 per Peter Gibson LJ. The courts, however, are reluctant to interfere with a liquidator’s decision unless he exercises his discretion mala fide or comes to a decision which no reasonable liquidator could have come to. See *Leon v York-O-Matic Ltd* [1966] 1 WLR 1450, 1455 per Plowman J.

¹⁴⁸ A claim for negligence is an example of this restriction. See discussion above under 3.3.2.1.
the law in this respect is virtually inaccessible, save to lawyers specializing in the field.¹⁴⁹ It is therefore clear that at common law the derivative action is not to be regarded as a normal part of the enforcement apparatus of the law, but as a weapon of last resort, carefully controlled, and limited to the case where the company has been prevented from taking a truly corporate view of the prospects for litigation.

3.4 Policy Evaluation: Old Myths and New Realities

3.4.1 Policy response number one: reallocating the responsibility to determine the merits of the action

The preceding discussion has set the stage for us now to examine ways to respond to the issues raised in section 3.2. We have seen that the company lacks an authentic decision-making body. The individual shareholder may not be the most appropriate person to be determining whether a derivative action is in the best interests of the company; the company’s board may be too tainted with self-interest to take the decision to litigate, and the company in general meeting is in the same position. The need then arises to cast around for an alternative voice. In this section, we evaluate the competence of three bodies that may, theoretically, be given such a role: a committee of independent directors, an ‘independent organ,’ and the court.¹⁵⁰ As will be seen, there is no ready answer for the question which of these imperfect classes of decision-makers is more likely to make decisions that increase the value of the company.¹⁵¹

¹⁴⁹ Consultation Paper para 4.35.
¹⁵⁰ Theoretically, there may be other bodies such as creditors or employees who may fill this role, but the focus here is on those bodies which fit the shareholder-focused model of company law in English law (see CA 2006, s 172). While the Company Law Review Steering Group (Modern Company Law for a Competitive Economy: Developing the Framework (DTI March 2000) paras 2.21–2.22) describes the model adopted as ‘enlightened shareholder value’ since it requires that directors take into consideration the interests of other stakeholders, it is clear the interests of other stakeholders are to be considered only insofar as to do so serves the interests of the members. Put simply, shareholder interests remain the focus of company law and directors’ duties. See RC Nolan ‘The Continuing Evolution of Shareholder Governance’ (2006) 65 CLJ 92, 94–95.

¹⁵¹ See also F Easterbrook and D Fischel The Economic Structure of Corporate Law (Harvard University Press Reprint edn 1996) 106.
3.4.1.1 Committee of independent directors

A possible decision-making body for determining whether a derivative action is in the interests of the company is a committee of independent directors.¹⁵² The use of Special Litigation Committees (SLCs) comprising independent directors is common in the US.¹⁵³ What is the rationale for the use of these committees? One reason is that directors possess more information about the company’s affairs than a shareholder who does not have ready access to this information. In addition, as already noted, decisions to litigate are in a sense commercial decisions, involving not only cost-benefit analyses but also considerations of potential damage to the company’s reputation.¹⁵⁴ Undue and unnecessary litigation will certainly do more harm than good for the company. As one commentator puts it, ‘there will often be sound reasons for avoiding the washing of corporate linen in the courtroom’.¹⁵⁵ There is therefore merit in saying that these are decisions best made by a commercially minded board.

One important statistic, however, casts immediate doubt on the use of these committees. These committees in the US have rarely, if ever, recommended that a derivative action in its entirety be continued.¹⁵⁶ This record demonstrates what some commentators refer to as a structural bias on the part of independent directors.¹⁵⁷ The credibility of reliance upon independent directors is called into question by the uniformity with which committees determine derivative actions not to be in the corporation’s best interests.¹⁵⁸ What, then, might explain this?

There are several reasons to believe that the SLCs’ independence may be more apparent than real. Here it will suffice to repeat the thrust of the argument. Some would respond with lengthy organizational, psychological, or sociological critiques of the board’s capability or objectivity.¹⁵⁹ The concern is founded on the observation that the defendants and the members of the SLC share a common cultural bond: directorship of a public company. The natural empathy and

¹⁵³ It derives, in part, from r 23.1 of the Federal Rules of Civil Procedure which provides that the ‘complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority’.
¹⁵⁴ See above n 11 and accompanying text.
¹⁵⁵ C Hale, above n 19, 225.
¹⁵⁷ I Ramsay, above n 35, 172.
¹⁵⁸ De Mott notes that in some reported cases, the committee’s recommendation appears to be at odds with advice as to the merits of the action received from the company’s outside lawyers: D DeMott, above n 152, 277.
¹⁵⁹ For an elaborate summary of these arguments, see J Cox and H Munsinger ‘Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion’ (1985) 48 Law & Contemporary Problems 83.
collegiality that this bond engenders makes an adverse judgment of a colleague’s
behaviour distasteful at best. Further, when the committee is formed after the
instigation of the derivative action, the situation is ripe with opportunities for
the defendants to select for committee membership those directors most symp-
thetic to their position.¹⁶⁰ Likewise, SLCs operate under the constant threat
of dissolution should they displease the board by pursuing the plaintiff’s cause
with excessive zeal.¹⁶¹ Consequently, this structural bias, when applied to SLCs,
equates to an inescapable and conclusive assumption against nearly any deriva-
tive action on the part of members of the committee.¹⁶² Overall then, there are
sufficient reasons to believe that in deciding that an action should not be brought
against one of their number, the independence and neutrality of the committee
must always be suspect.¹⁶³

The reliance upon independent directors is also called into question by the
fact that it still needs to be the subject of judicial review. This raises several ques-
tions. First, should the court accept the ‘business judgment’ of the committee or
review the decision itself? Or should it only do so if its independence is suspect?
To what extent, then, should a court defer to a recommendation of SLCs?¹⁶⁴ In
practice, this fundamental question has been fiercely debated in US courts¹⁶⁵

¹⁶⁰ The process of director selection and socialization, which incumbent management domi-
nates, may cause even the outside director to perceive his role, once litigation is commenced, as that
of a buffer by which to shelter and protect management from hostile and litigious stockholders.
In particular, a derivative action evokes a response of group loyalty, so that even a ‘maverick’ dir-
ector may feel compelled to close ranks and protect his fellows. See J Coffee and D Schwartz ‘The
Colombia Law Review 261, 283.
¹⁶¹ JD Cox ‘Searching for the Corporation’s Voice in Derivative Suit Litigation: A Critique
¹⁶² PN Edwards ‘Compelled Termination and Corporate Governance: The Big Picture’ (1985)
Journal of Corporation Law 373, 398.
¹⁶³ See also DD Prentice ‘Notes: Shareholder Actions: The Rule in Foss v Harbottle’ (1988) 104
LQR 341, 346.
¹⁶⁴ LS Sealy, above n 48, 182–3; J Solovy B Levenstam and DS Goldman ‘The Role of
Special Litigation Committees in Shareholder Derivative Litigation’ (1990) Tort and Insurance
Journal 864.
¹⁶⁵ While some courts have shown considerable deference to recommendations of SLCs
(Auerbach v Benett 47 NY 2d 619, 393 NE 2s 994 (1979)), others rejected any notion of whole-
sale deference to the recommendation of the SLC. For example, the influential Delaware Supreme
Court decision in Zapata Corp v Maldonado 430 A2d 779 (Del 1981) applied a two-stage test on
whether to accept its recommendations. First, the court should inquire into the independence and
good faith of the committee and the grounds supporting its recommendation. Secondly, the court
applies its own independent business judgment to determine whether the derivative action should be
dismissed. The Zapata analysis has subsequently been applied by the Delaware Court of Chancery
numerous times. Outside of Delaware, in many states (including California, Colorado, Georgia,
Maryland, Michigan, Ohio, and Virginia) there appears to be no clear decision by the highest state
court on the status of SLCs, but federal courts hearing derivative actions based on diversity juris-
diction have reached decisions construing the authority of such a committee. Although some argue
that the law on derivative actions is uniform nationally in the sense that everyone has followed
Delaware, Coffee believes that it is an egregious overstatement to characterize the law on SLCs as
largely resolved. See cases cited in JC Coffee ‘New Myths and Old Realities: The American Law
and proposed Model Acts¹⁶⁶ with no clear resolution emerging. Secondly, if judicial review of the merits of a decision of a committee of independent directors is utilized, this may be seen as an undesirable duplication of tasks.¹⁶⁷ Still, a third and somewhat deeper reason also explains why this system is deeply flawed. Arguably, there is a case for the committees’ views to be justified to the court, even when the board is clearly independent. Although the conventional wisdom seems to assume that the granting of any residual oversight to the court subtracts from the power in the board, this is an unconvincing premise. The existence of judicial oversight may, in fact, enhance the board’s leverage. The knowledge that one is being watched and that one must justify one’s actions improves the behaviour of most individuals. Above all, the need to explain one’s justifications to the court gives disinterested directors a basis for refusing to accept reasons that merely are pretextual or cosmetic. Absent judicial oversight, passivity may sometimes be the path of least resistance. But once it is understood that the director’s position must ultimately be defended in court, passive acquiescence becomes less attractive. Internally, disinterested directors can justify their resistance not in terms of their personal objections or misgivings, but in terms of the legal risks or public appearances. In short, the existence of judicial review is needed to strengthen the hands of outside directors and enhance internal systems of accountability.¹⁶⁸

decision in Re Oracle Corp Derivative Litigation 824 A2d 917 (Del Ch 2003) the Delaware Court of Chancery denied the motion of a SLC to dismiss derivative claims brought by Oracle stockholders. The SLC was established by the board of directors of the Oracle Corporation to investigate claims of insider trading and breach of the fiduciary duty of loyalty brought against Oracle directors. The court based its finding on the SLC’s inability to prove the independence of its two members, and thus the committee itself, from the directors being investigated. In doing so, the court applied an independence inquiry that expanded upon the traditional ‘domination and control’ notion of independence, to include personal and philanthropic connections with the directors, which the court concluded created an ‘unacceptable risk of bias’. Arguably, this represents a broadening of the inquiry of director independence by the Delaware Court of Chancery. See further JJ Kobeski ‘Has a New Species of Director Independence Been Uncovered?’ (2004) 29 Delaware Journal of Corporate Law 849.

¹⁶⁶ Contrast the Model Business Corporation Act (drafted by the American Bar Association’s committee on Corporate Governance) which provides that a derivative action shall be dismissed by the court where a committee of independent directors has determined in its business judgment that the action is not in the best interest of the company, with that of the American Law Institute, which allows more scope for judicial review of the recommendations of SLCs (American Law Institute Principles of Corporate Governance: Analysis and Recommendations Proposed Final Draft, 1992, 725–66).

¹⁶⁷ I Ramsay, above n 35, 173.

¹⁶⁸ In essence, the debate about the merits of litigation committees is linked to a much wider debate—whether the legitimacy of the business corporation should rest solely on a single premise (ie the capacity of independent directors to manage all aspects of corporate affairs) or whether additional safeguards remain prudent. The latter view prescribes that corporate governance rests on a stronger, more stable foundation for the long run when the law permits a limited role for judicial oversight. See, JC Coffee, above n 156, 1425–6.
3.4.1.2 Independent organ

A variation on the US style committee of independent directors was formulated under English law but, as will be seen, this is an even more debatable criterion.¹⁶⁹ In Smith v Croft (No 2) Knox J held that ultimately there is one question which has to be answered in order to determine the rule in Foss v Harbottle: ‘is the plaintiff being improperly prevented from bringing these proceedings on behalf of the company?’¹⁷⁰ Knox J submitted that if an ‘independent organ’ of the company considered that such an action would not be in the interests of the company, the action was properly prevented.¹⁷¹ Knox J suggested that term ‘independent organ’ describes a group of persons within the company whose views would be taken into account for these purposes. Essentially these are persons whose votes would not be disregarded on the grounds that they had been (or would be) ‘cast with a view to supporting the defendants rather than securing benefit to the company, or that the situation of the person whose vote is considered is such that there is a substantial risk of that happening’.¹⁷² As to the question of what constitutes an independent organ, Knox J held that ‘[t]he appropriate independent organ will vary according to the constitution of the company concerned and the identity of the defendants who will in most cases be disqualified from participating by voting in expressing the corporate will’.¹⁷³

The judgment is superficially attractive in that it leaves the decision whether or not to bring an action with the independent majority.¹⁷⁴ However, there are a number of difficulties inherent in the decision, not least that it makes minority claims even less likely to succeed. It has rightly been the subject of critical

¹⁶⁹ Although no explicit reference to those American developments is made in Smith v Croft (No 2), it is reasonable to believe that Knox J was influenced by these innovative features.


¹⁷¹ ibid (relying on the decision in Taylor v National Union of Mineworkers (Derbyshire Area) [1985] BCLC 237). In a recent case (Airey v Cordell [2006] EWHC 2728 (Ch)) Warren J held that the question that a court should consider in determining whether to permit a shareholder to continue with its derivative action, is whether an independent board of the relevant company would sanction the pursuit of the claim. He held that, in considering this matter, it is not for the court to assert its own view of what it would do if it was the board; it must rather decide on the view of a hypothetical and independent board. Warren J did not, however, provide any practical guidance as to how the court would assume the mind of an independent board.

¹⁷² [1988] Ch 114, 185. This seems similar to the view expressed in some US cases, where it was proposed that the court might, in its discretion, appoint a special committee of independent and knowledgeable persons to determine whether the continuance of the action would be in the company’s best interest. See, for example, Miller v Register and Tribune Syndicate 336 NW 2d 709 (Iowa 1983). The difference would be that the committee might be less likely to have a pro-defendant bias, as the case with the common litigation committees in the US. See further RC Clark, above n 156, 649.


¹⁷⁴ This is the first time that the concept of the ‘independent’ shareholder has been articulated by the courts as having a role to play in company law. Normally, the fact that a shareholder is interested in a transaction does not preclude him from exercising his rights. Above n 56.
comment.¹⁷⁵ Let us focus now on several problems with the role that Knox J gave to the ‘majority within the minority’. To simplify the discussion, these problems will be classified under two headings, namely conceptual problems and policy issues.

(a) Conceptual problems
First, as a concept, ‘independent organ’ is not clearly defined in the Consultation Paper¹⁷⁶ or the Report¹⁷⁷ and was only vaguely delineated in Smith v Croft. The Report recommended that the court should take account of the views of an independent organ that for commercial reasons the action should or should not be pursued. It conceded, however, that since the law in this area is still ‘in a state of development by the courts’, the views of an independent organ should not be conclusive on the issue whether or not leave should be granted.¹⁷⁸

It is difficult to agree with this. First, it has been suggested that in the ‘wrong’ judicial hands the ability to invoke majority shareholders’ power (or other independent organ’s power) may well enable the worst aspects of the Court of Appeal’s decision in Prudential to be smuggled back in the exercise of the new statutory discretion to grant leave. In the case of listed companies it might kill off the use of this remedy at an early stage.¹⁷⁹ Secondly, if the views of the independent organ need only ‘to be taken into account’, the same concerns with respect to the US style litigation committees arise here: this may be seen simply as an undesirable duplication of tasks. Thirdly, there is a problem with the burden of proof on minority shareholders to establish a lack of independence on the part of any particular shareholder. This can be a real obstacle to a successful derivative action.¹⁸⁰ It will be necessary for the minority shareholder to adduce evidence to show that, on the balance of probabilities, there is a substantial risk that the votes were cast in order to support the majority rather than derive any advantage to the company. Knox J did not discuss whether this was a subjective or objective test; indeed, the test to be applied in relation to cases concerning alteration of articles is itself not free from doubt.¹⁸¹ Finally, in many situations, it will be difficult to ascertain shareholders’ independence adequately without a full hearing as this may be the only way. But such an inquiry would contravene the admonition in Prudential that the Foss point should be dealt with early in the proceedings, which should

¹⁷⁷ Report para 6.89, where it concedes that the meaning of ‘independent organ’ is far from being clear.
¹⁷⁸ Report para 6.90.
¹⁷⁹ AJ Boyle, above n 1, 79–80.
¹⁸⁰ See also M Stamp, above n 175, 135–6.
¹⁸¹ See, for example, Greenhalgh v Ardene Cinemas Ltd [1951] 1 Ch 286.
not be allowed to devolve into a full trial on the merits.¹⁸² Moreover, in many cases, there may not, as a matter of fact, be such an organ capable of making this decision, especially in the case of listed companies.¹⁸³ It is also possible that if the independent organ is a group of shareholders, they are not required to hold any particular percentage of shares, and so the percentage may be a small one. In large companies the practicality of identifying the independent group among thousands of shareholders would probably prove insurmountable.¹⁸⁴ Where the shareholders are divided into, say, two 'camps', the 'independent organ' will not be discoverable.¹⁸⁵ Moreover, it appears that the appropriate independent organ need not be a group of shareholders and may even be the directors or a committee of the directors, in which case the observations made with respect to the US litigation committee will equally apply.¹⁸⁶ In fact, it would be an effective tactic for a board faced with what it saw as inappropriate derivative litigation to form a sub-committee to look into the matter (for example, by commissioning a firm of accountants) which could, in turn, resolve to terminate the derivative action. It may well be that the sub-committee would then be held to be an appropriate independent organ within the *Smith* doctrine.

(b) Policy issues

From a policy viewpoint, it is highly questionable whether there is any serious need to model new devices to control English derivative actions on what are in fact specifically American developments. First, judicial review of the work of the special litigation committees in the US has a very different procedural context from the *Smith* litigation. The problems of abuse in the context of the American derivative action are on a wholly different scale from anything that is likely to occur in English courts.¹⁸⁷ Secondly, given all the difficulties and the credibility of reliance upon the SLC device in the US discussed above, it ought not to commend itself to other jurisdictions.¹⁸⁸

3.4.1.3 Judicial oversight

The foregoing analysis clearly indicates that a need persists for a measure of judicial oversight. If such a need exists, it is because the existence of the bodies discussed above as a complete and wholly pre-emptive substitute for judicial oversight is

¹⁸² [1982] Ch 204, 221.
¹⁸³ Take, for example, the first instance decision in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 and *Taylor v National Union of Mineworkers (Derbyshire Area)* [1985] BCLC 237.
¹⁸⁴ The costs alone associated with such a procedure would be horrendous.
¹⁸⁵ As well illustrated in *Barrett v Duckett* [1995] 1 BCLC 73. See also AJ Boyle, above n 1, 29. Consultation Paper para 16.44.
¹⁸⁶ Above under 3.4.1.2 (a).
¹⁸⁷ As will be seen in Ch 6 below (under 6.2 and, in particular, 6.2.3) the English system of costs works in a wholly different way from 'counsel fee awards' in derivative actions in the US.
¹⁸⁸ D DeMott, above n 152, 279; AJ Boyle, *Company Lawyer*, above n 175.
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in doubt. Some, of course, may question whether courts are the best body to be determining the merits of the action.¹⁸⁹ The thrust of the argument is that judges have been habitually cautious when faced with litigation which invited them to intervene in corporate law issues.¹⁹⁰ It has been further suggested that courts are inappropriate for certain tasks such as reviewing managerial business incompetence, under-performance or inefficiency. Also, there are problems with an over-reliance on courts.¹⁹¹ In short, the critical charge is that courts do not understand business decision-making and fail to recognize that legitimate reasons sometimes exist why even a meritorious litigation should not be pursued.

Such criticisms have an apparent ‘obviousness’ about them. And although there is an essential core of truth in these allegations, they simply miss the point. The question on which the suitability of the court should be assessed is rather simple: how well can courts perform the specific task of evaluating the potential success of litigation? For such a task, arguably, the court is the most qualified body considering the alternatives discussed above. First, courts do have expertise in evaluating the potential success of litigation. The talents that a court is generally thought to lack, namely business intuition, a feel for the marketplace, and the ability to trade off risk for return, are not called for here in the same degree.¹⁹² Indeed, to the extent that the determination hinges on an appraisal of the merits of the litigation, it has been suggested that the court’s perspective and expertise are superior to the board’s.¹⁹³ Further, there is no reason why an independent expert may not, in appropriate cases, be allowed to investigate and advise the court on the action, which, in turn, may provide the court with better and more neutral information than either a resolution in a shareholders’ meeting or the views of an allegedly ‘independent’ organ.¹⁹⁴ Finally, courts have a lengthy history of determining cases involving breaches of duty and have developed considerable expertise and knowledge in this area.¹⁹⁵ It should come as no surprise then that both the Law Commission and the Company Law Review proposed that the court will be expected to discharge the task of determining whether a derivative action proposed by the individual shareholder is in fact in the best

¹⁸⁹ D Fischel and M Bradley, above n 53, 273 (‘judges lack business expertise and strong incentives to maximize the value of the firm’); FA Gevurtz, above n 150.
¹⁹⁰ As explicitly stated in Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] 1 Ch 204, 224; See also K Uff ‘Class, Representative and Shareholders’ Derivative Actions in English Law’ (1986) 5 Civil Justice Quarterly 50, 61. In the past, it was argued that judicial intervention under English law in the affairs of public companies remains firmly within the realm of private law, and is limited to affording a practical remedy to a wronged claimant. See further GR Sullivan, above n 59, 237.
¹⁹³ J Coffee and D Schwartz, above n 160, 282–3. Recall that special litigation committees tend to recommend dismissal almost invariably.
¹⁹⁴ As the case in South African and Australian legislation. See Ch 5 below under 5.4.4.3 (g).
¹⁹⁵ See Ch 2 above under 2.4.2.1.
interests of the shareholders as a whole.¹⁹⁶ It is now, indeed, widely acknowledged in invariably all jurisdictions in which the derivative action has been put on a statutory footing that the court should be entrusted with this task.¹⁹⁷

3.4.2 Policy response number two: formulating proper screening mechanism

Thus far we have seen that because the company lacks an authentic decision-making body to determine whether or not a derivative action is in the best interests of the company as a whole, the court is expected to discharge the task of determining this question. In this section, we examine a second, and complementary, response to the problem that the litigating shareholders may not have the purest of intentions in mind. Most commonly, the solution is to set out various preconditions to the court granting leave that would constitute a screening mechanism to sift out cases that are without merit. If these are properly devised, then, theoretically, the derivative action should not be cast in an unfavourable light.

3.4.2.1 Current screening mechanisms

So, how should the criteria be structured? A fine balance is needed here. On the one hand, it is important to establish an expeditious means for screening and dismissing non-meritorious cases. On the other hand, it is critical that the sets of hurdles should not form a formidable barrier that will prove insuperable to minority shareholders. In many ways, the precise threshold requirement chosen reflects the attitudes towards the derivative action device in that particular jurisdiction.

In this respect, the position in the UK reflects the unfavourable views on the derivative action.¹⁹⁸ But even if the criteria hold out the possibility of greater levels of enforcement of directors’ duties, nonetheless whether this potential will be

¹⁹⁶ Consultation Paper paras 16.32–16.34; Report paras 6.77–6.79. And see now CA 2006, s 261.
¹⁹⁷ New Zealand and Singapore introduced the statutory derivative action in 1993. Australia and Israel followed suit in 2000 after nearly a decade of study and deliberation. In a highly publicized attempt to develop private enforcement as a tool to influence companies’ corporate governance, the Consolidated Financial Services Act (CFSA) introduced in 1998 derivative actions into Italian law (Art 129 CFSA). In a wide reform of Italian company law derivative actions were also introduced as a standard rule in the general law of joint-stock companies (Art 2393-bis of the Italian Civil Code). Recall that Germany very recently enacted the UMAG altering the relevant provisions of the Aktiengesetz. In this pre-procedure, the court will allow for direct shareholder litigation on behalf of the company (similar to Anglo-American derivative actions) if the shareholders fulfil certain conditions that should function as an obstacle to strike suits (above n 43 and accompanying text). Note further that with regard to the GmbH, the *actio pro socio* is deemed a subsidiary remedy, the admissibility of which is subject to a court’s finding that the regular way via the general meeting is ‘unacceptable’ for the claimant. The statutory derivative action has been around for some time in Canada and South Africa. In all of these jurisdictions the court is discharged with the task of determining whether a derivative action should proceed. See also Ch 5 below under 5.2.4.
¹⁹⁸ See also DD Prentice, above n 163, 346.
realized will depend largely on how the courts discharge the discretion entrusted to them. The danger must be that the judiciary will adopt an overly restrictive approach to the Law Commission’s criteria in order to give effect to the perceived exceptional nature of shareholder derivative actions.\textsuperscript{199} Therefore the true test of the effectiveness of the action will be whether the complexity surrounding the ability to pursue a derivative action will continue to act as a deterrent to potential actions when compared with viable alternatives.\textsuperscript{200}

3.4.2.2 Issues relevant to the grant of leave

The purpose of this section is to explore and contrast the general approaches of the English Law Commission Report,\textsuperscript{201} which well illustrates the current overriding views in English law, with Canadian statutes on a policy level.\textsuperscript{202} This comparative perspective will illustrate the relative strengths and deficiencies of the present position.

Under Canadian law, four statutory criteria \textit{must} be satisfied before leave is granted by the court:\textsuperscript{203}

(1) that reasonable notice has been given to the directors of an intention to apply for leave to commence derivative action;
(2) that the directors will not bring, diligently prosecute or defend, or discontinue the action;
(3) that the complainant is acting in good faith: and
(4) that it appears to be in the interests of the company that the actions be brought, prosecuted, defended or discontinued.

As will be seen, Canadian courts have adopted a fairly flexible approach to each of the above criteria, although the steps taken by the shareholder to meet the s 239 criteria can also be extremely time-consuming and may not be cost-effective.\textsuperscript{204}


\textsuperscript{200} See further Ch 8 below.

\textsuperscript{201} Which, as will be seen in the next chapter, formed the basis and theoretical foundation for the new derivative action procedure under Pt 11 of CA 2006, albeit subject to certain modifications. See Ch 4 below under 4.3.

\textsuperscript{202} The Canadian statutes on derivative actions have been around since the 1970s and are found in s 238–240 and s 242 of the Canada Business Corporations Act 1985 (CBCA) and ss 244–246 of the Ontario Business Corporations Act 1982 (OBCA). A number of statutory derivative actions were modelled on them (for example, the Australian statutory derivative action introduced into the Corporations Act 2001 on March 2000); further, the CBCA marked the first decisive break with the English model by a major Commonwealth jurisdiction and, in particular, it has been said that the aim was to depart from the common law restrictions contained in \textit{Foss v Harbottle} and the related exceptions. See RW Dickerson et al \textit{Proposals for a New Business Corporations Law in Canada} (Information Canada 1971) Vol 1.

\textsuperscript{203} CBCA, s 239(2). The wording of the derivative action provision in both CBCA and OBCA is largely very similar. We shall focus on CBCA.

\textsuperscript{204} L Thai ‘How Popular are Statutory Derivative Actions in Australia? Comparisons with United States, Canada and New Zealand’ (2002) 30 \textit{Australian Business Law Review} 118, 126.
Under the Law Commission Report, the principal screening devices are ‘modern, flexible and accessible criteria for determining whether a shareholder can pursue the action’.²⁰⁵ The Report opposed any definitive criteria for granting leave on the basis that there is a danger that they would be incomplete and would not fit the circumstances of each case.²⁰⁶ Instead, it concluded that the court should take into account all the relevant circumstances without limit, but it also listed specific matters which it considered the court should take into account.²⁰⁷ Put simply, these criteria are merely factors to be considered alongside several others, not a mandatory requirement as in Canada. The paragraph setting out the specific matters deserves to be reproduced in full;²⁰⁸

Application under rule 50.9—relevant matters

50.10 (1) In considering an application under rule 50.9 the court must take all relevant matters into account.

(2) In particular the court must take the following matters into account

(a) whether the member is acting in good faith in seeking to continue the claim as a derivative claim;
(b) whether the claim is in the interests of the company, taking account of the views of the company’s directors on commercial matters;
(c) whether the directors’ activity as a result of which the cause of action is alleged to arise may be approved by the company in general meeting and (if it may be) whether it has been;
(d) whether the company in general meeting has resolved not to pursue the cause of action;
(e) the opinion (if any) of an independent organ that for commercial reasons the claim should or (as the case may be) should not be pursued;
(f) whether a remedy is available as an alternative to the claim.

So, what may be the cumulative effect of these fairly elaborate provisions? Perhaps the first striking point to note (that is if the reader has not been exhausted by simply reading this lengthy list), is that this list well illustrates how procedurally and substantively English law has developed to provide disincentives to prospective plaintiffs. Imagine a bona fide shareholder who genuinely contemplates taking an action and reads through this (non-exhaustive, it should be stressed) list. It is no surprise, as the Law Commission itself admits, that it could easily be seen as maintaining a policy of not favouring derivative actions and as a signal of an over-restrictive approach to shareholders which would over-deter them (see below). Faced with these complexities, the average shareholder will often give up in despair already at this early stage.

²⁰⁵ As part of the proposed new derivative procedure: Report para 6.15.
²⁰⁶ Report paras 6.74, 6.76, 6.79.
²⁰⁷ Report para 6.70.
²⁰⁸ Report, Draft CPR r 50.9 and r 50.10 in Appendix B. But see now CA 2006, Pt 11, discussed fully in Ch 4 below under 4.3.
3.4.2.3 Rationales

The point has already been made above that with respect to (c), (d), and (e)—it is highly questionable whether any of these matters may be relied on when deciding whether the action should be continued. We shall deal with (f) later.²⁰⁹ This leaves us with (a) and (b), both of which are considered in detail next. Before, it is useful to examine the arguments on which the Law Commission relies in formulating its wide discretion. First, it considers that such discretion will give courts the flexibility to allow cases to proceed in appropriate circumstances, while giving advisers and shareholders the necessary guidance on the matters which the court will take into account in deciding whether to grant leave.²¹⁰ Secondly, it explains that the wording makes plain that the discretion is wide and that the matters set out are only some examples of the matters to which the courts should have regard. The Consultation Paper concludes that the most important advantage of listing these factors is that these proposed provisions should assist in building up a body of reported cases which will guide shareholders and advisers.²¹¹

There are, nonetheless, various difficulties with this approach. As the Consultation Paper elsewhere admits, it could be argued that because the factors are not weighted, the discretion is so open that the case law will provide little guidance because invariably each case will turn on its own facts.²¹² More importantly, it may also produce, as did the case law on the common law derivative action, over-cautious judicial decisions.²¹³ It is also open to debate whether the list of non-binding criteria may have the benign effect that the Law Commission intends.²¹⁴ In fact, the Law Commission itself listed a number of arguments against the approach it has adopted.²¹⁵ If anything, given that the tendency of courts is to erect as many obstacles as possible in the way of a minority applicant who comes before the court as a litigant in a derivative action, these arguments are much more compelling. First, a list may appear to be a set of hurdles which applicants have to overcome and which would deter them. Secondly, it could be seen as maintaining a policy of not favouring derivative actions and as a signal to adopt an over-restrictive approach to them. Thirdly, it could be seen as constraining the approach which the courts will adopt.

²⁰⁹ It relates to the relationship between the derivative action and the unfair prejudice remedy, and in particular, whether the unfair prejudice remedy can be used to ‘outflank’ the derivative action (Re Saul Harrison & Sons plc [1995] 1 BCLC 14) discussed in Ch 8 below.
²¹¹ Consultation Paper para 16.44.
²¹² See also AJ Boyle, above n 1, 73.
²¹³ This may be most evident when respect to public listed companies. It is likely that all the old Foss attitudes may be reintroduced in the exercise of the new judicial discretion. Coupled with the fact that the Report is somehow more restrictive in setting forth the specific matters which the court must take into account, and the new specific guideline of ‘whether the company in general meeting has resolved not to pursue the cause of action’, all this may prove to have a deadly effect in ‘choking off’ derivative actions. See further A Boyle above n 1, 73–74.
²¹⁴ A Boyle, above n 1, 73.
²¹⁵ Consultation Paper para 16.43.
flexible exercise of discretion which the Law Commission was anxious to encour-
age, in that the inclusion of these and the omission of others may suggest that
these are the only relevant criteria or the most important. Finally, it is not truly
helpful by way of guidance to advisers or shareholders in relation to ‘good faith’
and ‘interests of the company’ because these are open-textured phrases which
have been given numerous meaning by different courts.

As will be highlighted next, there is much substance in these arguments. The
use of these last two tests is replete with uncertainty in conception and highly
unworkable in practice. These are two of the most common tests in use in case
law, statutory derivative actions across jurisdictions, and various law reforms.
They may thus illustrate best the difficulties with the content of current screening
mechanisms. The argument that follows is not that the policy premise these two
tests reflect is not a sound one. There is no doubt that they both represent vital
checks before commencing litigation on behalf of the company for the various
conscerns set out above. But the question is whether there is a need to resort to these
two somewhat tortuous and indirect terms that function as rhetorical devices
rather than substantive standards in assisting the court to determine the merits of
the case in question. It will be left to the next chapter to explain how these issues
can be addressed. For now, it will suffice to concentrate on the problems.

3.4.2.4 Applicant’s good faith

The requirement that the shareholder is acting in good faith can be found in
almost all jurisdictions where the derivative action has been put on a statutory
footing.²¹⁶ A number of reasons have been typically put forward for the inclu-
sion of good faith.²¹⁷ These include the need to determine whether the appli-
cant has been complicit in the matters complained of, the prevention of strike
suits²¹⁸ brought, for example, to further the interests of a business competitor
or someone making a proposed takeover offer, or the need to preclude personal
vendettas and vexatious actions.²¹⁹ The test is widely used in other contexts in

²¹⁶ Such as CBCA, s 239(2)(b) 5 or Israeli Companies Act 1999, s 198. The new § 148 of the
Aktiengesetz (introduced by the UMAG) requires, inter alia, that the shareholders who intend to
sue bought the shares at some point in time before they received knowledge about the inappro-
priate managerial conduct in question, which arguably is linked to the ‘good faith’ of the share-
holders in pursuing the action on behalf of the company. CA 2006, s 263(3) (discussed in Ch 4
below under 4.3.5) states: ‘In considering whether to give permission (or leave) the court must
take into account, in particular—(a) whether the member is acting in good faith in seeking to
continue the claim.

²¹⁷ See generally Enforcement of the Duties of Directors and Officers of a Company by Means of a

²¹⁸ ‘A phrase used in North America to describe applications made in order to further the inter-
ests of someone other than the company’: Consultation Paper 162 n 89.

²¹⁹ This may help, for example, protect against complicity and against the purchase of shares
for the purpose of litigation by vexatious litigants. See in this respect Lord Bingham’s discussion of
company law, such as under CA 1985, s 35A(1), and the requirement that a
director must exercise any power vested in him ‘honestly, in good faith and in
the interests of the company’, which was most recently formulated as part
of the centerpiece requirement relating to directors’ duties under CA 2006,
s 172, which requires a director to act in the way he or she considers, in good
faith, would be most likely to promote the success of the company for the
benefit of its members as a whole and, in doing so, have regard to a number of
factors listed.

The definition of ‘good faith’ is somewhat tortuous and indirect. Serious
questions have been raised as to whether this requirement has a valid and inde-
pendent role to play, for if the case is itself meritorious, good faith of the applicant
is likely to be present in any event. Conversely, a court would generally refuse
leave to an applicant whom it considered to be acting in bad faith so that it may
not be necessary to state this factor specifically. The Law Commission, indeed,
noticed that it was unlikely that a court would grant leave to an applicant whom it
considered was acting in bad faith, but considered that since it is a relevant cri-
erion it was of sufficient importance to be mentioned expressly.

The experience in Canada serves to illustrate the difficulty in construing the
term in the context of granting leave to continue a derivative action, as it is also
not defined in the Canadian statutes. Canadian courts have not given a blanket
definition. Instead some courts have adopted the ‘merits approach’, considering
the facts of each case on its own merits. But there have been other cases in
which the good faith requirement was considered a serious issue to be considered
so that a lack of good faith was ground enough for denying an application for
leave. In the latter cases, the onus of demonstrating good faith is one that must
be discharged by the applicant. For example, the court has identified the applicant
to be acting in bad faith in a case where the applicant was motivated by poten-
tial tactical advantages in commencing the action. It can be seen then, that in
most cases good faith functions as a rhetorical device rather than a substantive

²²⁰ Restated in CA 2006, s 40.
²²² The Explanatory Notes on the Companies Act 2006 state that the decision as to what will
promote the success of the company, and what constitutes such success, is one for the director’s
good faith judgment. This ensures that business decisions on, for example, strategy and tactics are
for the directors, and not subject to decision by the courts, subject to good faith. Paragraph 327
²²³ And as the Law Commission acknowledged, its express presence could encourage litigation
as to its meaning in this context: Consultation Paper 163. The Report (para 6.76) takes the view,
nonetheless, that it should not be defined. It believed that while extremely difficult to define it was
generally readily recognizable.
²²⁴ B Welling Corporate Law in Canada (2nd edn 1992) 528.
²²⁵ A Reisberg, above n 134, 253.
²²⁶ BR Cheffins, above n 9, 249.
²²⁷ ibid.
²²⁸ Vedova v Garden House Inn Ltd (1985) 29 BLR 239 (Ont HC).
3.4.2.5 Interests of the company

Draft CPR r 50.10 also requires the court to take into account the views of the company’s directors on commercial matters when considering whether the claim is in the interests of the company.²³⁰ The Report clarifies that this does not mean that the court would be bound to accept the views of the directors. In fact, the existence of a conflict of interest may affect the weight to be given to them, and the court would give no weight to views which no reasonable director in that position could hold.²³¹ This flexible approach adopted by the Report is effectively an application of the US business judgment rule.²³² Such an approach deals with the legitimate concerns thrown up by shifting the decision to litigate away from the commercial arena to one that is in the purview of the courts, a task that may not be relished by the judiciary.²³³ The fear, however, is that too much deference to the business judgment rule will remove much of the bite from the derivative action and deprive it of the ability to perform the very function it was created to perform, that of policing boards of directors. Some middle path must therefore


²³⁰ This was later formulated in CA 2006, s 263(2)(a) as ‘a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim’. See also s 263(4) which requires that ‘in considering whether to give permission (or leave) the court shall have particular regard to any evidence before it as to the views of members of the company who have no personal interest, direct or indirect, in the matter.’ See further, Ch 4 below under 4.3.5.

²³¹ The Report thus holds firmly the view that it is not appropriate to require an applicant for leave to prove that the action is in the interests of the company. On the other hand, where the court is satisfied that the proceedings are not in the interests of the company, there is no good reason why the proceedings should continue, and the court should refuse leave. See Report para 6.79.

²³² This judge-made rule is a judicial gloss on duty of care standards which sharply reduces exposure to liability for claims for breach of duty/negligence where certain factors are established. Its purpose is to encourage capable persons to serve as directors by reducing their risk exposure to hindsight reviews of their unsuccessful decisions, to limit litigation over corporate decision-making, and, importantly, to avoid intrusiveness by public officials (judges) into private sector business affairs. See Joy v North 692 F 2d 880, 893 (2d Cir 1982). See also RC Clark Corporate Law (Little Boston 1986) 124–41; ME Eisenberg ‘The Duty of Care and the Business Judgment Rule in American Corporate Law’ [1997] 2 CFILR 185. Despite its ubiquity in corporate law, the business judgment rule remains a doctrinal puzzle. Both courts and scholars offer different understandings of the rule’s role in litigation brought against corporate directors and different justifications for its deployment to insulate such directors from liability for breaches of fiduciary duties. For a view which rejects all existing justifications for the rule and argues that it is no longer needed to protect directors from liability, see J Telman ‘The Business Judgment Rule, Disclosure and Executive Compensation’ (3 March 2006), available at <http://ssrn.com/abstract=895548>.

²³³ PKM Choo, above n 13, 78.
be found, something undoubtedly easier said than done. Development of a business judgment rule is a possibility latent within English law, and there are those who believe that such a development seems desirable. But it is beyond the scope of this chapter to examine this subject in any detail.

Let us refocus now on the test itself. It is found in most jurisdictions where the derivative action has been put on a statutory footing. It seems to reflect the view at common law that the action must be brought genuinely in the interests of the company and not for the benefit of a rival company which has fostered the litigation and indemnified the litigant against costs. Although understandable and commendable as a concept, since an action which is clearly not in the interest of the company should not, indeed, be allowed to proceed, arguably it is a concept which is notoriously difficult to ascertain and is open to wide judicial interpretation.

The fundamental question is how one can ascertain, ahead of the litigation itself, whether that particular action is or is not in the best interests of the company (or ‘will promote the success of the company’, to use the terminology used in CA 2006, s 172). On the one hand, it has been suggested that in some cases it would be relatively straightforward to satisfy this test. The clearest case would be where directors had no legitimate reason for refusing to take action for loss caused by breach of duty. Conversely, the fact that a derivative action is used as a vehicle to carry on a bitter dispute between shareholders may indicate

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234 One possibility is to follow s 237(3) of the Australian Corporations Act 2001, which provides for a link between the business judgment rule and the statutory derivative action in the form of a rebuttable presumption that, in certain spelt-out situations, proceeding with litigation will not be in the company’s interests.

235 See, for example, S Deakin E Ferran and R Nolan, above n 18, 167. On the ways in which English law might properly develop this doctrine, see ME Eisenberg, above n 232.

236 See, for example, CBCA, s 239(2)(c). As mentioned above, under CA 2006, s 263(2)(a), the court must refuse leave to continue a derivative action if satisfied, inter alia, that ‘a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim’. See also s 263(4) which requires that ‘in considering whether to give permission (or leave) the court shall have particular regard to any evidence before it as to the views of members of the company who have no personal interest, direct or indirect, in the matter.’ See further, Ch 4 below under 4.3.5.

237 Barrett v Duckett [1995] 1 BCLC 243, 250 per Peter Gibson LJ. It has been suggested that this question can be answered only on the facts of a particular case: PL Davies Gower and Davies’ Principles of Modern Company Law (7th edn Sweet & Maxwell 2003) 443.

238 Forrest v Manchester, Sheffield and Lincolnshire Rly (1861) 4 De GF & J 126.

239 The difficulty with this concept can be seen in other areas of company law, such as alterations of the articles. See Peters’ American Delicacy Co Ltd v Heath (1939) 61 CLR 457, 512; Redwood Master Fund Ltd v TD Bank Europe Ltd [2002] EWHC 2703. See further DD Prentice ‘Alteration of Articles of Association—Expropriation of Shares’ (1996) 112 LQR 194, 195–6.

240 The focus below is on the term ‘best interests of the company’. Clearly these are not identical terms, nonetheless they both suffer from the same ‘vagueness’ problem and, at heart, serve the same purpose (see below).

that the case has not been brought in the best interests of the company.²⁴² There could also be good commercial reasons for not taking action. These could include, for example, the board’s reluctance to disturb a long-standing profitable relationship with a customer, or its conviction that the recovery by the company would be much less than the costs of the proceedings. Usefully, Gevurtz has identified some issues that may assist the court when addressing the question of whether it is ‘in the interests of the company’ to pursue a derivative action. These include the probability of success, the intangible costs to the company, such as distraction of personnel and the time lost by litigation, or the size of the potential recovery.²⁴³

This calculus, however, is somewhat indefinite and rather complicated. Equally, it may not be easily quantified or detected. First, the concept of ‘the interests of the company’ is a notoriously fragmented one because it is almost impossible to say who ‘the company’ is for this purpose.²⁴⁴ Must the interests of creditors, shareholders who do not support the proceedings, or employees be considered here?²⁴⁵ Consider, for example, the following scenario. Two minority shareholders in a private company decide to bring a derivative action against two directors who between them hold, say, 75% of the shares. Further assume that there are no other shareholders in the company, and that the company is extremely profitable with ample reserves and there is no question of any creditor having an interest in the outcome of the litigation. Who then is ‘the company’ in this situation? It is surely absurd to divorce the company from the underlying protagonists in such a situation.²⁴⁶ Another problem is that it is more difficult for a shareholder to fulfil the ‘best interests’ criterion than one would think. In particular, in a large company, the shareholder may need to gather support from other shareholders in order to obtain a desired number to show that it is ‘in the interests of the company’ to institute proceedings.²⁴⁷

²⁴² See, for example, Barrett v Duckett [1995] 1 BCLC 243, 250.
²⁴³ FA Gevurtz, above n 150.
²⁴⁴ An illustration of this difficulty may be found in Lord Wilberforce’s comments in Ebrahim v Westbourne Galleries Ltd [1973] AC 360, 381, where he said that this phrase should not become little more than an alibi for a refusal to consider the merits of a case. On the facts of the case, it meant little more than ‘...in the interests of the majority’. On this account, the use of the term ‘promote the success of the company’ suffers from the same vagueness problem.
²⁴⁵ It is unclear whether s 172 of CA 2006 (duty to promote the success of the company) will remove this vagueness. This model of ‘enlightened shareholder value’ requires that directors take into consideration the interests of other stakeholders, but it is also clear that the interests of other stakeholders are to be considered only insofar as to do so serves the interests of the members. Put simply, shareholder interests remain the focus of company law and directors’ duties. See RC Nolan ‘The Continuing Evolution of Shareholder Governance’ (2006) 65 CLJ 92, 94–5.
²⁴⁷ FH Buckley M Gillen and R Yalden Corporations: Principles and Policies (3rd edn Emond Montgomery 1995) 702. There is no reason to believe this will be much different with the need to contradict the requirement that ‘a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim’ under CA 2006, s 263(2)(a).
Arguably, this veritable Pandora’s box of unanswered questions raises more problems than it solves.²⁴⁸ In deciding that an action is or is not ‘in the interest of the company’ or ‘will promote the success of the company’, how is a court to determine the inherently speculative costs of future attorney’s fees and expenses related to litigation, or time spent by corporate personnel preparing for trial? How is a court to quantify the effect of the case on corporate goodwill, corporate morale, and the distraction of key personnel?²⁴⁹ Should the court also take into account the potential adverse impact of continuing litigation upon the company’s ability to finance its operation? What about cases which the court considers at the outset to be arguable but not likely to succeed, but which ultimately bring rewards? Should future costs be discounted to present value and, if so, at what value? Should financial considerations, such as possible gains for the company, be taken into account here? What if the court finds a likely net return to the company which is not substantial in relation to the shareholder equity? Should the court grant leave for actions which are clearly not going to bring any direct proceeds to the company but which nonetheless involve wrongdoing by a company’s own directors?²⁵⁰

Moreover, the ambiguous concept of ‘in the interests of the company’ may lead courts to adopt different interpretations of the same concept, resulting in considerable uncertainty for the business community. This last point is usefully illustrated by contrasting the various interpretations the term has received from the Canadian and Israeli courts. Curiously, under this criterion, Canadian courts tend to distinguish a derivative action from a personal claim. Leave to bring a derivative action is denied where the dispute is more correctly characterized as a personal dispute between the complainant and some other shareholder within the company.²⁵¹ Israeli courts, on the other hand, tend to link this concept to the ‘good faith’ of the plaintiff.²⁵² The case law suggests that the good faith requirement will likely be met if the derivative action appears to be in the interest of the company.²⁵³ Perhaps this illustrates best how these two criteria are linked and the fact that it is, indeed, very hard to make a distinction between the two.²⁵⁴

²⁴⁸ See also Joy v North 692 F 2d 880, 898 (2d Cir 1982). Interestingly, during the Report Stage of the Company Law Reform Bill 2005, (renamed the Companies Bill on 20 July 2006) Lord Goldsmith refused to accept an amendment that would put an absolute bar on bringing a claim on the grounds ‘that pursuing the claim would not be in the interests of the company’. See Official Report, 9/5/06; col 886. Lord Goldsmith stated that ‘others have been concerned about it in the past by requiring the courts to second guess what is in the company’s interests? It directly requires the courts to take that view’: Official Report, 9/5/06, col 886.

²⁴⁹ See Ch 2 above under 2.2.

²⁵⁰ See further A Reisberg, above n 134, 254.


²⁵² Conversely, it is arguable that the lack of good faith indicates that conducting the proceedings is not in the interests of the company. See the case of Ben-Ari v Avner (2004) TA 8794/03 (Israel) and the decision of the Supreme Court of South Australia in Hurley v BGH (1982) 6 ACLR 791, 797–8 per Chief Justice King.

²⁵³ See further A Reisberg, above n 134, 253–5.
3.5 Conclusion

This chapter argued that good intentions often make bad law. There is no doubt that some of the hurdles facing shareholders which make the derivative action cumbersome are there to perform a vital function, namely to protect the company against the single shareholder who through malice or misjudgment will waste the company’s time and money. Although each of these policies has its own logic, they reflect in the aggregate a deep-rooted tension between the courts’ recognition that some legal form is necessary by which to hold corporate directors accountable and the fear that an overly liberal remedy would be exploited by shareholders in an abusive manner. What is extraordinary in this context is how procedurally and substantively English law has developed to provide disincentives to prospective claimants. Although any empirical data has generally been lacking by which to corroborate either the critics or the defenders of the derivative action, the common law, the Law Commission, and more recently the Government, as will be seen in the next chapter with respect to CA 2006, have all been more impressed by the risk of derivative actions being motivated by personal objections than they have by the risk that confining derivative actions will lead to less litigation than the company’s interest requires. Since *Prudential Assurance v Newman Industries (No 2)*, which perfectly illustrated the procedural complexity of the law and more importantly, the hostility of the courts to derivative actions, very few derivative actions were successfully initiated.²⁵⁴ But if the current policies are maintained, then no shareholder is likely to step forward even in situations where litigation would increase total share value.

In striking a proper balance for the tension identified above, this chapter has laid the foundations for the discussion in subsequent chapters. In particular, the chapter has highlighted the importance of two methods that are imposed in order to protect against abuse of these proceedings: (1) reallocating the responsibility to determine the merits of actions from the shareholder to courts; and (2) providing a screening mechanism to identify cases that are without merit. Chapter 5 will address the procedural complexity of derivative actions and will seek to replace overbroad restrictions to the claimant’s standing to sue with more specifically focused checks to discourage non-meritorious litigation. The argument is that the baby should not be thrown out with the bath water by denying shareholders any realistic access to a litigation remedy. If the mechanisms that are employed to protect against abuse of these proceedings are properly devised, then the court should not view the utility of the derivative action with such hostility and disdain. But before that, the following chapter turns to unravel the extraordinary long journey of the derivative action from common law so-called rules and principles to a statutory procedure under the Companies Act 2006, with what will be argued next, a relatively modest expected impact.

²⁵⁴ For rare illustrations see *Knight v Frost* [1999] 1 BCLC 364 and *Clark v Cutland* [2003] EWCA Civ 810 discussed in Ch 8 below under 8.3.1 and 8.4.2.