The Way to Reform and a New Statutory Derivative Action: Much Ado About Nothing?

4.1 Introduction

This chapter analyses the reforms of the derivative action in the UK. The genesis of the Herculean reforms in this area can be traced back to the period between 1995 and 1997 when the English Law Commission conducted an extensive inquiry into shareholder remedies.¹ The reforms have been further appraised and amplified through the deliberations of the Company Law Review Steering Group between 1998 and 2001.² It was then endorsed by the Government³ and finally implemented by the Companies Act 2006,⁴ although not before being modified at almost each stage of its passage.

The chapter begins (section 4.2 below) by highlighting the deficiencies in the common law, the approach to reform, and the guiding principles for resolving the problems identified. Section 4.3 analyses the new statutory derivative action introduced by the Companies Act 2006. It provides a summary of the reform package while discussing the scope of the new derivative action and the procedural framework for the application for leave. Section 4.4 assesses critically the recent reforms, looking in particular at major possible obstacles, drawing on recent experience in foreign jurisdictions in which the derivative action has been put on a statutory footing. This analysis is meant to bring the reader forward to see the impact (in cost/benefit terms) of reforms in what proved to be a rather contentious area of reform. The discussion is also geared towards providing the

² In particular see paras 7.46–7.51 of the CLR Final Report.
³ Namely, in the White Paper Modernising Company Law (Cm 5553-I) (DTI July 2002) (which was surprisingly reticent on the matter) and Company Law Reform (Cm 6456) (DTI March 2005) para 3.4.
⁴ Following the Company Law Reform Bill of November 2005 [HL Bill 34].
reader with critical tools to assess the likely impact of these reforms. Finally, section 4.5 draws some conclusions.

4.2 Deficiencies in the Present Law and the Approach to Reform

4.2.1 Introduction

The need for reform of the common law derivative action is widely acknowledged and is long overdue. As a mechanism for shareholder control of corporate wrongs and thus as a tool of corporate governance, the derivative action has attracted much international attention, particularly in the last decade or so. The extensive inquiry by the English Law Commission resulted in recommendations to abolish the rule in *Foss v Harbottle*⁵ (hereafter ‘Foss’) and its exceptions, at least in part, and to replace the existing derivative procedure with a new derivative action on a statutory basis.

Broadly speaking, the Company Law Review Steering Group, the body established to manage the DTI’s review, has endorsed the recommendations of the Law Commission. As the Law Commission acknowledged, in an age of increasing globalization of investment and growing interest in corporate governance, greater transparency in the requirements for a derivative action is highly desirable.⁶ It considered therefore that the derivative procedure should be rationalized and modernized.⁷

4.2.2 Problems in the common law derivative action

The Law Commission formed the view that, in certain respects, the rule in *Foss* and its exceptions are inflexible and outmoded. It perceived four major problems that should be addressed.⁸

First, the rule in *Foss* cannot be found in any rules of court, but only in case law, much of it decided many years ago. Likewise, since 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 (a claim for negligence is an example of this restriction).⁹ In addition, to obtain a proper understanding of the rule, one needs to examine numerous reported cases decided over a period of 150 years, therefore the law in this respect is virtually inaccessible, except to lawyers specializing in the field. It is not surprising therefore, that the Law Commission concluded that the rule in *Foss* and its exceptions were inflexible and outmoded.

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⁵ (1843) 2 Hare 461; 67 ER 189.
⁶ See Report para 6.9.
⁷ ibid para 6.12.
⁹ See discussion in Ch 3 above under 3.3.2.1.
Secondly, the effect of the exceptions is that an action to recover damages suffered by a company by reason of a director’s breach of fiduciary duty cannot be brought unless the wrongdoers have control of the company. The law as to the meaning of ‘control’ in these circumstances is unclear.\(^{10}\) It is not restricted to situations where wrongdoers have voting control, but its applicability outside these circumstances is in doubt. This is problematic, in particular, in larger companies where, in practice, directors exercise control with less than a majority of the votes. Also there are situations which appear to fall outside the fraud on the minority exception when it might be desirable for a member to be able to bring an action.

Thirdly, a further effect of the exceptions is that an action to recover damages suffered by a company by reason of the negligence of a director cannot be brought by a minority shareholder unless it is possible to prove that the negligence confers a benefit on the controlling shareholders, or that the failure of the other directors to bring an action constitutes a fraud on the minority.\(^{11}\)

The fourth problem identified is that the standing of the member to bring a derivative action has to be established as a preliminary issue by evidence which shows a prima facie case on the merits.\(^{12}\) Without effective case management this can result in a mini trial which increases the length and cost of the litigation.

### 4.2.3 Guiding principles for resolving the problems identified

In response to these problems, the Law Commission put forward its philosophy in addressing these obstacles. Essentially, it wanted to provide speedy, fair and cost-effective mechanisms for resolving disputes between minority shareholders and those running companies without disturbing the balance of power between members and managers.\(^{13}\) It is evident that the Law Commission was conscious of the need to achieve a balance between the ability of the company to function effectively on a day-to-day basis without the unnecessary interference of challenges from shareholders, and the need to protect minority shareholders and enhance shareholder confidence by providing shareholders with a route for redress in certain circumstances.\(^{14}\) However, it is also clear that the Law Commission favoured the balance being in favour of management,\(^{15}\) since its clear policy is that minority shareholder derivative actions should be ‘exceptional’\(^ {16}\) and be

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\(^{10}\) See Ch 3 above under 3.3.2.1 and 3.3.2.2.

\(^{11}\) See discussion in Ch 3 above under 3.3.2.1.

\(^{12}\) *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] Ch 204*. See discussion in Ch 3 above under 3.3.2.2.

\(^{13}\) This is enshrined in the six guiding principles for the proposals in relation to the reform of the law. See Report para 1.9.


\(^{15}\) Consultation Paper para 14.10 expresses the wish not ‘to disturb unduly the balance of power between directors and shareholders’.

\(^{16}\) Consultation Paper para 4.6; Report para 6.4.
subject to ‘tight judicial control at all stages’, however permissive the language of the recommendations might appear.

This balance in favour of unhindered management can be seen in the unquestioning acceptance of the ‘proper plaintiff’ rule and the principle of ‘internal management’, so that if the wrong is a corporate wrong relating to a matter that the majority are entitled to regulate by ordinary resolution, shareholder action will be very much the exception to the rule. It is clear, therefore, that the recommendations did not see an end to the rule in *Foss*. These principles were reinforced by guiding principle (iii): ‘commercial decision’, which is akin to the business judgment rule, and is expressed in terms that the courts should not substitute their decisions for what appear to be reasonable decisions of directors made in good faith. This approach is more clearly expounded in guiding principle (v): ‘freedom from unnecessary shareholder interference’. The pivotal questions must therefore be: when will shareholder interference be ‘unnecessary’ and who is to be the judge of this?

The Law Commission explained this in terms of the need for the shareholder to have good and genuine reasons for pursuing litigation on the company’s behalf so that the courts will need to examine the ‘nuisance factor’ on a case-by-case basis before permitting the derivative action to proceed. However, the implication is that if the board has made a reasonable commercial decision to the effect that litigation ought not to be pursued, the court must not substitute its own judgment on this matter in accordance with guiding principle (iii). It becomes clear then that the Law Commission was wary of increased shareholder litigation in public companies on the basis that it might affect the objective approach to decision-making by the directors. However, as some scholars noted at the time, this must be open to question in the light of experience of the statutory derivative action in Canada where there have been few derivative actions by shareholders in public companies.

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18 J Poole and P Roberts, above n 14, 101.
19 The so-called guiding principles (i) and (ii). These guiding principles are set out at paras 14.11–14.13 of the Consultation Paper and repeated in the Report at para 1.9.
21 Consultation Paper para 14.11.
22 J Poole and P Roberts, above n 14, 101.
23 Consultation Paper para 14.11.
24 The so-called ‘commercial decision’ principle, that the courts should not substitute their decisions for what appear to be reasonable decisions of directors made in good faith.
25 J Poole and P Roberts, above n 14, 102.
26 As Cheffins argues, these shareholders are unlikely to take the risk of pursuing an action since there is no guarantee of securing an indemnity against costs and any remedy will be for the company, with only indirect benefits for the shareholder. These factors lead to what Cheffins refers to as ‘a free-riding’ effect, ie a belief that a fellow shareholder will sue: BR Cheffins, above n 20, 257–8. We revisit this point more fully in Chs 6 and 7 below.
Broadly speaking, the Law Commission’s philosophy appears to be that in order to achieve the desired balance, essential hurdles need to be placed in the path of a potential derivative action, namely notice and leave. However, since the question of leave is to be determined by the court having taken account of the views of management, shareholders, and any independent organ on whether the action should proceed, it seems inevitable that the operation of guiding principle (iii) will have an effect on the practical operation of this judicial discretion. The clear expectation was that the courts will follow a philosophy based on a restrictive attitude to shareholder action. This is in marked contrast to the general approach to the exercise of jurisdiction under s 459 of CA 1985. Finally, it is noteworthy that the final guiding principle of ‘efficiency and cost effectiveness’ appeared to be the fundamental principle for the Law Commission. However, it was rightly noted at the time, that since the Law Commission’s test for the derivative action to proceed is based on leave and judicial control, it seems to follow automatically that this mechanism is unlikely to result in reduced costs and time savings.

4.2.4 The Law Commission’s recommendations

The Law Commission’s Report, although endorsing the proper claimant principle as sound, criticized the rule in *Foss* as being ‘complicated and unwieldy’. More particularly, the Report concludes that the meaning of ‘wrongdoer control’ is far from clear, and that the procedural complexities were such that establishing *locus standi* to bring a derivative action could result in a mini trial which increases the length and cost of litigation. The Law Commission therefore recommended a new form of derivative procedure ‘with more modern, flexible and accessible criteria for determining whether a shareholder can pursue the action’. In the absence of circumstances which justify the court granting leave, the Law Commission was of the view that the proper claimant principle should continue

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27 A similar view was taken in Australia. The Companies and Securities Advisory Committee Report on a Statutory Derivative Action (July 1993) stated that ‘A key objective of shareholder litigation is that of achieving managerial accountability…Consequently, shareholder litigation can be seen as a mechanism for maintaining investor confidence…at the same time however it is clear that management needs to be protected against vexatious and hostile minority shareholders who, when commencing litigation, are not acting in the interests of the company. Therefore, any proposal for law reform in this area must contain mechanisms which operate to prevent needless and harmful shareholder litigation.’

28 J Poole and P Roberts, above n 14, 102.

29 In *Gower’s Principles of Modern Company Law* (6th edn Sweet & Maxwell 1997) 735–6 this is referred to as ‘a partial revolution in judicial attitudes’ towards non-interventionism. CA 1985, s 459 (restated with no changes in CA 2006, s 994) in general and its relationship with the derivative action is discussed in detail in Ch 8 below.

30 J Poole and P Roberts, above n 14, 102.

31 Report para 6.15. As Sealy rightly notes there is a problem with formulations such as these in that they are very short on specifics and loaded with terms that are devoid of any real meaning: ‘modern’, ‘flexible’, and ‘accessible’. This is a common problem with many company law reform programmes. See L Sealy [2006] 18 *Sweet & Maxwell’s Company Law Newsletter* 1.
to apply. The Commission also concluded that derivative actions should continue
to be brought in ‘representative’ form (ie on behalf of all the company’s mem-
bbers other than those who are defendants) with the company being named as a
defendant. As with the position at common law, a decision of the court will thus
be binding on all the parties to the action.

In terms of procedure, it was envisaged that the new derivation action would
be governed by the rules of the court but the basis of the action would be spelt out
in a new statutory provision to be included in any future Companies Act thereby
replacing the current common law action. This means placing the new action on
a similar footing to the unfair prejudice remedy. It should be noted that the
Law Commission’s proposals in respect of the new derivative action do not affect
the position relating to personal actions of the shareholder against the company.

Paragraph 6.49 of the Report sets out the new procedure in the following
terms:

[W]e recommend that the new procedure should only be available if the cause of action
arises as a result of an actual or threatened act or omission involving (a) negligence,
default, breach of duty or breach of trust by a director of the company, or (b) a director
putting himself in a position where his personal interests conflict with his duties to the
company.

By way of precondition to the grant of leave to maintain a derivative action, the
minority shareholder would be required to serve a notice on the company at least
28 days before the commencement of the proceedings specifying the grounds of
the proposed action (Report para 6.59).

The leave of the court to maintain the action would be sought at an early stage,
normally at the close of pleadings. In considering issues relevant to the grant of
leave (see the Consultation Paper at 213–14), the court should take into account
all the relevant circumstances without limit including:

(a) the applicant’s good faith, although good faith should not be a prerequisite to
the grant of leave;

(b) the interests of the company, and in so doing the court should have regard
to the views of directors on commercial matters (however, the court should
refuse leave if it is satisfied that the proceedings are not in the interests of the
company);

(c) whether the wrong has been, or may be, approved by the company in general
meeting (effective ratification would continue to be a complete bar to the
continuation of a derivative action);

(d) whether the company in general meeting has resolved not to pursue the cause
of action (as distinct from ratification in (c) above);

³² Under CA 1985, s 459, restated as CA 2006, s 994.
(e) the views of an independent organ that for commercial reasons the action should or should not be pursued;

(f) the availability of alternative remedies (but that their availability should not necessarily be conclusive on the issue of whether or not leave should be granted).

As noted in Chapter 3, 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.³³ Instead, it concluded that the court should take into account all the relevant circumstances without limit.³⁴ Put simply, these criteria are merely factors to be considered alongside several others, not a mandatory requirement as in Canada. In Chapter 3 we observed that this list illustrates well how procedurally and substantively English law has developed to provide disincentives to prospective claimants.³⁵ And the reader is referred to the critical analysis of these proposals in Chapter 3.³⁶ Here, it would suffice to mention that unsurprisingly, as the Law Commission itself admitted at the time, this approach 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.³⁷

4.2.5 The Company Law Review Steering Group

The Law Commission’s approach towards the reform of shareholder remedies was broadly supported by the Company Law Review Steering Group (hereafter CLR).³⁸ The CLR agreed that the derivative action should be put on a statutory basis, restricted to breaches of directors’ duties, including the duty of care and skill, and should not be confined to cases of self-serving negligence or worse (ie fraud).³⁹ While the 2002 White Paper, Modernising Company Law, was somewhat equivocal on this proposal, preferring to see ‘if a workable scheme can be devised’, the DTI in Company Law Flexibility and Accessibility: A Consultative Document (2004) favoured putting the derivative action on a statutory footing and the March 2005 white paper, Company Law Reform, confirmed that would be the case.⁴⁰

Interestingly, the CLR was also of the view that the law on ratification should be modernized and simplified.⁴¹ More specifically, it stated that the question of ratification of a director’s wrong should be a matter for primary legislation. It was

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³³ Report paras 6.74, 6.76, 6.79.
³⁴ Report para 6.70.
³⁵ Under 3.3 and 3.4.2.2.
³⁶ Under 3.4.2.2–3.4.2.5.
³⁷ Consultation Paper para 16.43.
³⁹ CLR Developing the Framework para 4.127; CLR Final Report para 7.46.
⁴⁰ At 3.4.
⁴¹ CLR Completing the Structure para 5.84.
proposed that the new companies’ legislation will provide that the validity of a decision by the members of the company to ratify a wrong to the company by the directors or by the board of the company not to pursue such a wrong, should depend on whether the necessary majority had been reached without the need to rely upon the votes of the wrongdoers, or of those who were substantially under their influence, or who had a personal interest in the condoning of the wrong. Where a wrong had not been lawfully ratified, nor a decision not to sue lawfully taken, the court will have a discretion to consider all the circumstances in determining whether a derivative action should proceed. In exercising this discretion, it was envisaged that the court will pay particular regard to the issue of whether it is in the best interests of the company in accordance with the criterion set out in the principles on directors’ duties, and in that context to pay particular regard to the views of the majority of members who are not party to and have no personal interest in the wrong complained of.

4.3 The Derivative Action Under the Companies Act 2006

4.3.1 Introduction

As we saw in the previous sections, there never was any doubt that the new Companies Act 2006 would contain a reform of derivative actions, introducing as it does a model that has been used in jurisdictions such as Canada, Australia, and New Zealand, to name few, for some time. The Companies Act 2006 (hereafter in this chapter ‘the Act’) therefore puts derivative actions on a statutory footing for the first time.

42 ibid para 5.85 and CLR Final Report para 7.46. This is now enshrined in CA 2006, s 239. It was rightly noted that it is unclear whether this approach will help clarify the law on ratification. See BM Hannigan Company Law (Butterworths 2003) 464–5 and below under 4.3.5.3.

43 CLR Completing the Structure paras 5.86–5.87; CLR Final Report paras 7.48–7.49.

44 It would be misleading to represent this advent of statutory derivative claims as the only change in the law on shareholder protection of note. In terms of continuity not much will change with regard to unfair prejudice petitions (CA 1985, ss 459–461). These petitions have been relocated into CA 2006 (ss 994–998). This is a positive move particularly as s 260(2)(b) specifically mentions that statutory derivative claims may be launched under the remedies jurisdiction flowing from a successful s 994 petition (and this ties in with CA 1985, s 461(2)(c), restated as CA 2006, s 996(2)(c), which permits the court to ‘authorise civil proceedings to be brought in the name and on behalf of the company by such person or persons and on such terms as the court may direct’. It is also noteworthy that the statutory base for winding up a company on just and equitable grounds remains where it is in s 122(1)(g) of the Insolvency Act 1986. There are other notable changes including encouraging self-help through greater shareholder engagement or usage of new communications technology, for example, under CA 2006, ss 281 and 305. See further, Ch 1 above under 1.3.1.1 and 1.3.1.2.

45 See Ch 5 below under 5.2.4.

46 CA 2006, Pt 11 (ss 260–269). In principle, the new provisions should as a rule be used for all claims brought on or after 1 October 2007. At the time of writing, the Government is considering whether to make transitional and savings provisions so as to maintain the existing approach
There are two initial points to consider. First, although the sections under discussion apply to Northern Ireland, separate, but comparable, provision is made for the pursuit of derivative claims in Scotland. The sections relating to proceedings in England and Wales and Northern Ireland use the term a derivative 'claim' rather than 'action'. The Scottish action is called a derivative ‘action’ rather than ‘claim’. This is deemed to be appropriate because the sections confer the right to raise an action; that is, they confer the right to bring the proceedings in the first place, and then regulate the proceedings. By contrast, the sections relating to proceedings in England and Wales and Northern Ireland assume that there is already a right to bring such proceedings in England and Wales and Northern Ireland; they therefore regulate the proceedings rather than confer the right to bring them. Consistent with this approach, we shall use the term ‘claim’ rather than ‘action’ in this chapter.

The second point is that although, in general terms, the sections of the Act as introduced follow the recommendations discussed above, there are a number of important differences both in style and form and, more importantly, in content, from the proposals in the White Paper or draft sections as discussed above. Most notably, Pt 11 of the Act, on the statutory derivative claim, has brought much interest and no little concern from the City amongst others. It has been modified at almost each successive stage of the parliamentary odyssey, not without some heated debates. The changes are considered in detail below. Nonetheless, the following comments by Lord Goldsmith serve as a useful introduction to the approach prevailing in Pt 11.

Essentially, the intention in Pt 11 was to create a new statutory procedure with criteria for leave based on the Law Commission’s recommendations, differing from the common law in some key respects. First, the Government did not want the claimant to have to show ‘wrongdoer control’, as that may make it impossible for a derivative claim to be brought successfully by a member of a widely held company. Secondly, the Government did want it to be possible to bring a claim in cases of negligence, even if it cannot be shown that the directors have profited from the negligence. Thirdly, the Government was keen to achieve a proper for certain categories of claims (for example, claims where all the events giving rise to the claim took place before commencement day and there are no continuing issues). Readers are therefore advised to follow recent developments and guidance concerning implementation of CA 2006 on the DBERR website (note that the DTI was renamed the Department for Business, Enterprise and Regulatory Reform (DBERR) following the new Prime Minister’s appointment on 28 June 2007) and in particular any regulation in connection with Part 11 of CA 2006.

47 CA 2006, s 260(1).
48 See CA 2006, ss 265–269, where the nomenclature is ‘derivative proceedings’.
51 See discussion in Ch 3 above under 3.3.2.1.
balance between the ability of directors to take business decisions in good faith and shareholders’ rights, so that shareholders could bring meritorious claims against directors on behalf of the company where appropriate. At the same time, the Government wanted unmeritorious claims to be dismissed by the courts at the earliest possible opportunity and without involving companies. As will be seen below, the Act’s provisions try to achieve these principles, for example, by providing that the court should be able to throw out unmeritorious claims at an early stage without involving companies.

4.3.2 General principles

The starting point for considering the new statutory derivative actions is through the interaction with the new sections on directors’ duties. Section 170 (scope and nature of general duties) provides that directors’ general duties are owed to the company rather than to individual members. It follows that only the company can enforce them. The sections do not formulate a substantive rule to replace the rule in Foss, but rather a new procedure for bringing such an action which set down criteria for the court distilled from the Foss jurisprudence. In other words, ss 261–264 do not seek to overturn these well-established principles. Instead, they implement the recommendation of the Law Commission that there should be a ‘new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue an action’. It is noteworthy that these sections are expected to be supplemented by (unspecified at the time of writing) amendments to the Civil Procedure Rules.

When examining the new statutory mechanism a number of questions of interpretation fall to be determined. It is the purpose of the following text to examine the contents of the new procedure. The discussion is organized under the following three headings: scope of application; procedural requirements; and criteria for the grant of leave. In some instances, for example, when considering

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52 In effect, then s 170(1) restates the common law position that the duties of directors are owed to the company (Percival v Wright [1902] 2 Ch 241); in special circumstances, directors may owe duties to individual shareholders (Peskin v Anderson [2001] 1 BCLC 372).
53 It is usually said that there are three main ways in which the company can take legal action against a director (or, more usually, a former director) for breach of duty. First, if the board of directors decides to commence proceedings; secondly, if the liquidator or administrator following the commencement of a formal insolvency procedure such as liquidation or administration decides to commence proceedings; and finally, through a derivative claim or action brought by one or more members to enforce a right which is vested not in himself but in the company. This part of the Act is concerned with the third of these types of action.
55 Report para 6.15.
the criteria which must be taken into account by the court in determining whether to give permission to continue a derivative claim case, the discussion will consist of section by section commentary on the new Act. The relevant sections from the legislation will be set out in full followed by the commentary.

4.3.3 Scope of application

4.3.3.1 The three key elements
The key aspects of a derivative claim are set out in s 260. A derivative claim is defined in s 260 (1). There are three elements to this:

(a) the action is brought by a member of the company;
(b) the cause of action is vested in the company; and
(c) relief is sought on the company’s behalf.

Section 260(5) provides that references to a member in ss 260–264 include a person who is not a member but to whom shares in the company have been transferred or transmitted by operation of law, for example where a trustee in bankruptcy or personal representative of a deceased member’s estate acquires an interest in a share as a result of the bankruptcy or death of a member.

4.3.3.2 Extending the types of breaches under which a derivative claim may be brought
It appears that a derivative claim is no longer barred by the common law requirements under the rule in Foss (namely, the ‘proper plaintiff’ and ‘majority principle’, discussed in Ch 3 above under 3.2.1), although as will be seen below, these factors will clearly still be very much relevant at a later stage in the proceedings. Instead, s 260(3) specifies the types of breaches of duty under which a derivative claim may be brought. A derivative claim is expressly confined under s 260(3) to the enforcement of directors’ duties which are specified as ‘only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company’. As such, a derivative claim may be brought in respect of an alleged breach of any of the general duties of directors in Chap 2 of Pt 10 of the Act, including the duty to exercise reasonable care, skill, and diligence. The welcome

56 It is noteworthy that derivative claims under this provision should be viewed in the light of the special procedure for the pursuit of claims against directors brought by authorized members on behalf of the company in respect of improper political donations under CA 2006, Pt 14 (ss 370–372) (discussed briefly in Ch 3 n 43). Interestingly, s 372 enables advance indemnity orders and the court has full discretion to grant such an indemnity on such terms as it thinks fit.
57 A ‘member’ is defined in CA 2006, s 112 but see below s 260(5) which adds to that.
58 Section 260(2) provides further that the claim may only be brought either under CA 2006, Pt 11, Ch 1 or in pursuance of an order of the court in proceedings under s 994 (formerly CA 1985, s 459).
inclusion of negligence means that any instance of a director’s breach of his duty of care and skill can prima facie, even if capable of being ratified (subject to s 239 of the Act, see below) form the basis for a derivative claim, thereby avoiding the complex distinction under the ‘fraud on the minority’ exception at common law between negligence per se, which as we have seen was not defined as ‘fraud’ and which did not therefore qualify as an exception to *Foss*,⁵⁹ and negligence benefitting the wrongdoer (which did qualify as ‘fraud’).⁶⁰

It seems clear then that the new regime will potentially allow a broader range of claims to be brought more easily than is presently the case at common law. For example, an employee or an environmental group holding shares could potentially bring an action under the new provisions alleging that the directors are in breach of their duty by not taking into account their interests as required by the new statement of directors’ duties.⁶¹ This opening up of derivative actions, by reason of s 260(3) might be regarded by some as a welcome liberalization of the rules governing derivative claims and therefore a potentially beneficial development in terms of general corporate accountability. At the same time, some worry that there is a danger that it will serve to increase the already heightened fears of directors, and in particular non-executive directors.⁶² The latter was described by Lord Hodgson during the Grand Committee Stage as a ‘double whammy’.⁶³ The argument was that directors’ duties are widened in Pt 10, while Pt 11 makes it easier for shareholders to commence actions against directors. This risks enlarging the scope of such derivative claims and that S 260, rather than mirroring the common law as the Government claims, in fact goes further.⁶⁴ Obviously, the word ‘proposed’ does invite possible extra legal actions and so the potential exposure of directors to risk is broadened. The question, however, is whether the safeguards in the rest of the provisions prevent abuse. It has been further argued that this codification will have a minimal positive benefit of clarifying a rarely used piece of law while having the damaging and far more significant effect of increasing shareholder litigation and reducing the number of people willing to take directorships.⁶⁵

The Attorney-General, Lord Goldsmith, put forward a number of points in response.⁶⁶ First, he clarified that the Act does not introduce any major change

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⁶⁰ *Daniels v Daniels* [1978] Ch 406.

⁶¹ Under CA 2006, s 172. However, it has to be pointed out that whether this will be allowed in practice will depend on how the courts approach their task under the ensuing sections, which require the claimant to seek permission or leave form the court to continue a derivative claim. See below under 4.3.5 and *Gore-Browne on Companies Act 2006* (Jordans, Special Release March 2007) Ch SR13 [6].

⁶² L Roach ‘An Equitable Solution for Non-Executive Directors’ (2006) 17 ICCLR 117, 119. See also discussion in Ch 2 above under 2.2.

⁶³ That is the double-whammy effect of codifying directors’ duties and at the same time creating a statutory basis for members to bring a claim against company directors. See, *Hansard* HL Vol 679, Official Report, 27/2/06, col GC2.

⁶⁴ ibid.

⁶⁵ ibid col GC3.

⁶⁶ ibid cols GC4–5.
of principle to the law in this area. Although, the derivative claim is not at the moment frequently invoked, it is a well-established mechanism by which shareholders can, in certain circumstances, bring an action in the name of the company. Secondly, it is a fail-safe mechanism rather than a weapon of first resort. It is important to remember that damages are paid not to individual shareholders but to the company itself, and yet it is the shareholder, who brings the action, who may be required to bear heavy legal costs. Thirdly and importantly, there will continue to be tight judicial control of cases brought under the new procedure. Fourthly, a derivative action is not and will not be the same thing as an American-style shareholder class action brought in the name of a group of shareholders. Under the reforms of directors’ liabilities, introduced by the Companies (Audit, Investigations and Community Enterprise) Act 2004, companies may already indemnify directors against any liability incurred in respect of such actions, even if judgment is given against the director. Lord Goldsmith was at pains to make it clear that it is not expected there will be a significant increase in the number of derivative claims as a result of putting derivative action on a statutory footing, and the Law Commission did not expect that either. There will continue to be tight judicial control of such cases and more importantly:

we would expect the judiciary to be circumspect when reaching decisions about applications; in particular, we would expect the judiciary to continue to take the view that a disagreement between members should usually be resolved under the company’s constitution without recourse to the courts. The procedure that we have set out provides proper safeguards in that respect.

We also expect the courts to respect commercial judgments; the procedure that we impose will ensure that. It goes without saying—and this is what the Law Commission wanted—that there should be greater clarity about how a shareholder may bring a derivative action. The existing tests have been widely criticised and we firmly believe that they need to be replaced.

May there be cases where courts give permission for cases to continue which might not have been able to previously? Yes, there may be, but in cases where proper claims were improperly being frustrated, that would in general be a welcome development. Certainly I would not expect this to result in opening the floodgates or any other of the horrendous spectacles that I have seen mentioned in some places.

We have to strike a careful balance between protecting directors from vexatious and frivolous claims and protecting the rights of shareholders. It would be dangerous to move too far against either of those interests.

This is not the place to go into the minutiae of the arguments for and against the reform. But the discussion during the Grand Committee Stage shone more of a spotlight on the fortunes of the derivative action than many of the other areas

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67 ibid. See now CA 2006, Pt 10, Chap, 7 (directors’ liabilities).
68 As we further explain below under 4.4 this indeed seems reasonable.
of reform. Much of the remaining argument turns on whether the new structure has enough ‘checks and balances’ to preserve the right approach.

It should be noted that the decision to outline the instances when the statutory claim is available is an interesting one since, for example, there are no express sections under either the applicable Canadian, Israeli, or New Zealand legislative sections as to the causes of action for which the derivative claim is to be available. Such an outline should be helpful to the courts and to those advising shareholders on whether to pursue a derivative claim. At the same time, if this action is to have the width of application proposed, it will be essential that the courts follow the tenor of these proposals and interpret breaches of the company’s constitution, which previously operated as exceptions to Foss, as falling within this definition, for example causing the company to enter into an ultra vires act or to enter into an act on the authority of an ordinary resolution when a special majority is required.

4.3.3.3 Derivative claims against third parties

Section 260(3) further provides that the cause of action may be against the director or against a third party, or both. It is expected that derivative claims against third parties will be permitted only in very few cases, where the damage suffered by the company arose from an act involving a breach of duty etc on the part of the director. This formulation follows the suggestion by the Law Commission that, in this circumstance, a claim against a third party should be possible. However, the claim under this head should be allowed only if there has been a breach of duty by the director.

70 For example, under s 1 of the Israeli Companies Act 1999, derivative action is defined simply as ‘an action brought by a claimant on behalf of a company for a wrong done to the company’. Compare this with s 210 of the Ghanaiian Companies Code 1963 where the action is only available for breaches of duty set out in the statute (ss 203–205). See also s 266 of the South African Companies Act No 61 of 1973 which sets out the circumstances when the shareholder can bring the statutory derivative action as being instances where loss has been caused to the company ‘by a wrong, breach of trust or breach of faith committed by a director, officer, or former director or officer of that company whilst in office…’.

71 The special majorities exception gives rise to the possibility of bringing either a derivative action or a personal action. Since personal actions are not covered by the derivative action, a personal action alleging that a special majority has not been obtained in breach of CA 1985, s 14 (restated in CA 2006, s 33) can still be pursued by an individual shareholder. See Report paras 6.56–6.57 and J Poole and P Roberts, above n 14, 103.

72 Indeed, s 263(3)(f) states that in considering whether to give permission (or leave) the court must take into account, in particular whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company. See further below under 4.3.5.3.

Lord Goldsmith identified a couple of examples (drawing on those posed by the Law Commission) to show why it is desirable that a claim should be capable of being brought in certain circumstances, although certainly not in every case, where the company has a claim against a third party and there has been at some point a breach of duty by the directors. The first example concerns circumstances where, by reason of a breach of duty by the director, a third party has come into possession of property of the company when, according to standard principles of law, it should be required to hand that property back, for example, the property has been transferred in breach of trust or the individual has been giving knowing assistance. In those circumstances, it should be possible for a derivative claim to proceed not only against the director, but against the third party, otherwise the substantive and important belief of getting back for the company from the third party the property that has been transferred would not be adhered to.

Another example concerns a profitable company that is the victim of a tort by a third party. The directors might decide that they do not want to bring that claim against the third party. These directors, although otherwise committed to the well-being of the company, on this occasion do not wish, for bad reason and ulterior motive, to enforce the remedy for tort. They would in those circumstances be in breach of duty, but that breach of duty would not have given rise to the claim, in the words of the Act, the claim is not ‘arising from an actual or proposed act or omission . . . by a director’. So it would not be possible in those circumstances for a member to bring a derivative claim against the third party.

Lord Goldsmith added that it needs to be clear whether it would be standard for the company to want to proceed, and therefore, in the derivative claim, for the shareholders to want to proceed, against both the director and the third party. Lord Grabiner further explained that there may be cases of wrongdoing by a director against whom proceedings could have been brought by the derivative process. For example, he could have acted in cahoots with a third party, or there may simply be a conspiracy between the third party and the director. The provision would enable proceedings to be brought against both or either as appropriate. That would certainly meet the justice of the case and there would not be any advantage in restricting, limiting or barring that derivative process against the third-party conspirator who, on this hypothesis, is not a director of the company.

4.3.3.4 Can the applicant bring a derivative claim in respect of wrongs committed prior to his becoming a member?

Section 260(4) provides that a derivative claim may be brought by a member in respect of wrongs committed prior to his becoming a member. As will be seen

74 ibid. 75 ibid. 76 ibid. 77 ibid. 78 ibid col GC11 (Lord Grabiner).
below, this may have appeared as a revelation to certain Opposition spokes-
persons during the Committees Stage who were concerned about individuals joining
companies simply in order to generate litigation, however it does not represent a
significant change in the present law.⁷⁹ Incoming shareholders tend to get the
benefit of successful management actions and, quite naturally, will suffer from
past mistakes that affect the company adversely, therefore they have a legitimate
right in principle to initiate derivative proceedings.⁸⁰ Historically, this has been
the position under the common law, whereby a member can bring derivative
actions in relation to wrongs which were done to the company before he became
a member.⁸¹ Essentially, this reflects the fact that the rights being enforced are
those of the company rather than those of the member.⁸² As such, the point in
time at which the member became a member is immaterial. If problems develop
with regard to pressure group shareholders initiating opportunistic litigation
which is more concerned with political objectives than protecting the interests of
the company, it appears that the rules on permission outlined in s 263 (discussed
below) will come into play.⁸³

During the Grand Committee Stage, Baroness Goudie moved an unsuccess-
ful amendment to leave out s 260(4) on the grounds that it will attract vulture
funds, benefiting only those funds and their lawyers and making the UK more
litigious. The amendment was directed towards a legitimate concern, namely,
the risk of proliferation of vexatious or near-vexatious litigation. It is usually
said that that would damage commercial activity. Companies will need to seek
more legal advice as the likelihood of litigation increases, management will be
diverted from normal management activities, and UK businesses will become
more risk-averse and less profitable.⁸⁴ Lord Hodgson, in support, made an
important point which is separate to that made by the Baroness Goudie. He
explained that ex ante claims, where people who were not members of the com-
pany at the time seek to buy a single share and build a case against the directors,
are an invitation for all sorts of activities. An example would be environmental
claims, or animal rights activists, who might take advantage of this by finding a
company which had previously done something, buying a share, and building a

⁷⁹ ibid cols GC12–13.
⁸⁰ See also D Milman [2006] 13 Sweet & Maxwell’s Company Law Newsletter 2.
⁸¹ Seaton v Grant (1867) LR 2 Ch App 459. The claimant must be a shareholder when the action
is brought: Birch v Sullivan [1957] 1 WLR 1247.
⁸² Lord Grabiner suggested, rightly it is submitted, that it is not right that only past or previous
shareholders should be allowed the complaint, because you can buy and sell shares in the company
on a daily basis. Once you buy shares, you are party to a changing contract and you derive all the
benefits and rights associated with that contract. The fact that you arrive later rather than earlier
on the scene should not in principle deprive you of the entitlement of that contractual bargain. See
⁸³ D Milman, above n 80.
claim along these lines. It is easy to think of some other examples, such as the venture fund, working in cahoots with the rough equivalent of the ambulance-chasing solicitor, buying a few shares in a targeted company and then bringing a derivative claim, alleging that its rights as a minority shareholder have been abused by the controllers of the company. Lord MacGregor argued that there is a real risk of US-style derivative claims coming to the UK on a much greater scale. For example, one case in respect of a major reconstruction of a UK company was mentioned. It was difficult to sort out, not least because the company was under siege from its creditors. Hedge funds were becoming involved by pursuing their own ends in trying to upset the deal and encourage corporate raiders. The view expressed was that, if dissident shareholder groups’ rights were considerably enhanced, new directors would not take on the task of reconstructing companies because they would be put in a difficult situation. There was the argument not only about disincentives to take it on, but about there being considerable uncertainties about how those new directors would see their way through if they were subject to a large number of derivative actions, too, particularly from hedge funds. Also, it was said that US law firms are keen to take advantage of the proposed provisions.

Lord Goldsmith replied by rightly pointing out that it should not matter whether one became a member before or after the claim came into existence. Company law works on the basis that, when one acquires shares, one gets all the bad and all the good that go with them and sometimes perhaps a bit of both. Another point made was that the measure has the additional benefit of making it clear that it is the people who are members at the time that they wish to bring proceedings that are allowed to begin such actions. You cannot sell your shares and then seek to bring a derivative claim in the name of the company at that stage. Whatever the case may be, although it is presumably true that an activist could join the company simply in order to litigate, it is a very different question whether the court would grant leave to continue in such a case, and another one whether the litigant will be able to clear all the monumental hurdles awaiting him in s 263 (discussed below).

85 ibid col GC12.
86 ibid col GC13 (Lord Grabiner). Lord Grabiner further explained that there might be an additional incentive for such persons to make such claims because it is possible for the court to make an order that indemnity costs can be paid, so that the claimant can claim his costs out of the company and be indemnified fully in respect of those costs. However, as explained in Ch 6 below, this is not entirely supported by the way these costs orders operate.
87 ibid col GC12. In the US ‘a bought out action’ does not normally bar a member from taking action. For the position in other parallel jurisdictions, see 5.4.4.2 below.
88 ibid col GC13. On the distinctive position of US lawyers in derivative action litigation, see discussion above under 1.4.1 and below under 6.2.2. and 6.2.3.
89 ibid col GC15.
90 This seems to reiterate the common law position in cases such as Birch v Sullivan [1957] 1 WLR 1247.
4.3.3.5 Derivative claims against a former director and a shadow director

Section 260(5) makes it clear that the reference to a director includes a former director and that a shadow director is treated as a director.⁹¹ That means that a shadow director is liable in the same way as a fully paid-up registered director of a company and can be the subject of proceedings in a derivative claim by shareholders. This approach was also challenged during the Grand Committee Stage on the grounds that it might discourage people from providing their services to a UK plc. Lord Hodgson argued that given the nature of shadow directors some limitations should be posed and as their name implies, they have ill-defined roles.⁹² The argument was that it is not reasonable or desirable to burden shadow directors with the full brunt of responsibility for everything that occurs in a company in the same way as a director is burdened and that one such issue would be the question of derivative claims.⁹³ However, Lord Hodgson conceded that shadow directors should not always be able to evade responsibility no matter what the facts are. They could be intimately involved in a matter that gave rise to a derivative claim. Lord Goldsmith replied to these concerns:

The noble Lord is right in saying that there is a lack of law at the moment on the extent to which the general duties of directors apply to shadow directors. There are differences of view about it as well. The law commissions took the view that the duties apply to a shadow director where he effectively acts as a director through the people whom he can influence, and recommended that the duties should apply to shadow directors... However, several consultation responses argued that the general duties do not and should not apply to shadow directors. On top of that, although there are cases in the past that suggest that some of the general duties may apply to a shadow director, a recent well argued and impressive judgment suggests the opposite.⁹⁴

Lord Goldsmith explained that s 170 provides that the general duties apply to shadow directors when, and to the extent, that the corresponding common law rules or equitable principles so apply.⁹⁵ That was a way in which to say that it is not clear at the moment how far exactly those general duties apply, so it was best left open to the law to develop and to identify precisely the degree of that responsibility.⁹⁶ The provision in s 260(5) is thus simply a consequential effect of that.

⁹¹ For the meaning of ‘director’ see CA 2006, s 250; for ‘shadow director’ see CA 2006, s 251. See also Ultraframe (UK) Ltd v Fielding [2005] EWHC 1638.
⁹⁵ The term ‘director’ is defined in s 233 and the duties extend to both de facto directors and shadow directors by reason of s 171(5). For the definition of the term ‘shadow director’, see s 251.
4.3.4 Procedural requirements

4.3.4.1 General principles

Let us look now at the procedural requirements contained in the new Act. The application for leave procedure is the subject of s 261. In principle, s 261 provides that it is for the courts to determine whether an action for a corporate wrong should proceed, taking account of the matters specified in s 263. Section 261 requires permission to continue the claim. When deciding whether to grant ‘permission’ two levels of test have to be applied. Permission must be refused if a prima facie case is not disclosed on the evidence filed with the application.\(^97\) Section 263 reinforces this absolute bar by requiring the court to refuse permission if directors acting in accordance with the duty to promote the success of the company (s 172) would not have pursued it. Moreover, where the matter complained of was authorized in advance or ratified, the court must refuse permission. In other cases the grant or refusal of permission becomes a matter of judicial discretion governed by the criteria laid down in s 263(3) and (4), both of which are discussed below. That discretion must be exercised judicially and to that end certain factors are identified as relevant. It is noteworthy that this is regarded by some as a change in emphasis away from control of corporate litigation by management in favour of judicial control.\(^98\) However, the reality is that there is a requirement to apply for leave under CPR r 19.9(3), which expressly requires the court’s approval for the continuance of a derivative action.\(^99\) In a similar fashion, s 261 provides that, once proceedings have been brought, the member is required to apply to the court for permission to continue the claim. Under s 261(2) the court was given power to make consequential orders on dismissal of the application. This would presumably relate to costs. Part 11 is expected to be supplemented by (unspecified at the time of writing) amendments to the Civil Procedure Rules, although there was no talk, at the time of writing, of substantial changes to the spirit of CPR r 19.9.\(^100\) Interestingly, under s 261(3), if the application is not dismissed under subs (2), the court may give directions as to the evidence to be provided by the company, and may adjourn the proceedings to enable the evidence to be obtained. Time will tell whether these powers granted to the

\(^{97}\) CA 2006, s 261(2).

\(^{98}\) Report Draft Rule 50.6.

\(^{99}\) It has been held that the mandatory requirement for permission under CPR r 19.9 cannot be dismissed as a mere technicality and reflects the real and important principles that the Court of Appeal reaffirmed in *Barrett v Duckett* and underlines the need for the court to retain control over all the stages of a derivative action. See *Portfolios of Distinction Ltd v Laird* [2004] EWHC 2071, and also *Jafari–Fini v Skillglass Ltd* [2005] EWCA Civ 356; *Harley Street Capital Ltd v Tchigirinsky* [2006] BCC 209.

\(^{100}\) This rule, while expressly authorizing the court to give the claimant an indemnity against costs out of the assets of the company on such terms as it thinks appropriate, also expressly requires the court’s approval for the continuance of a derivative action. See discussion in Ch 6 below under 6.3.2.
court will be enough to address the thorny issue of disclosure and information asymmetries which exist between management and shareholders or between large and small shareholders.¹⁰¹ Recall that current case law generally confers on shareholders only scant corporate rights to ‘internal’ company documents¹⁰² so it will be interesting to watch whether this provision will provide a point for departure from this or whether litigants will still face up to the traditional suspicion of the English courts towards derivative claims. Finally, under s 261(4) the court has discretion to grant permission, to refuse permission and dismiss the claim, or adjourn the proceedings and give such directions as it thinks fit.

4.3.4.2 Permission to continue claim as a derivative claim

Sections 262 and 264 address explicitly the possibility that, where a company or a member has brought a derivative claim, the manner in which the company or the member commenced or continued the claim may be inappropriate. First, s 262 addresses the possibility that, where a company has brought a claim and the cause of action on which the claim is based could be pursued by a member as a derivative action, the manner in which the company commenced or continued the claim may amount to an abuse of the court,¹⁰³ or the company may fail to prosecute the claim diligently or it may be appropriate for a member to continue the claim as a derivative claim. The section provides that, in these circumstances, a member may apply to the court to continue the claim as a derivative action. As with s 261(4) (see above), under s 262(3) the court can respond to the application in a variety of ways. It is interesting to note that at Report Stage in the House of Lords the need to show a prima facie case under s 262(3) was added to enable the court to make a speedy decision to dismiss.¹⁰⁴

An interesting question is what prosecuting a claim diligently would involve.¹⁰⁵ It appears that a company would have to pursue the claim in a reasonable way. If somebody were merely to issue a writ and then take no further action to serve subsequent pleadings, or were to delay unduly the serving of pleadings with a view to frustrating someone else’s capacity to bring a claim, there would clearly have been a lack of due diligence.¹⁰⁶ A member would then be able to seek consent, but would have to show that there had been such a lack of due diligence. If

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¹⁰¹ As was explained above, information asymmetries accompany managerial misconduct: directors know the frequency and amount of harm caused by their misconduct, whereas shareholders do not. See discussion in Ch 3 above under 3.2.3.2 and Ch 5 below under 5.4.4.3(g).

¹⁰² *Arrow Trading and Investments v Edwardian Group Ltd* [2004] EWHC 1319; *Re DPR Futures Ltd* [1989] BCLC 634. See discussion in Ch 3 above under 3.2.3.2 and Ch 5 below under 5.4.4.3(g).

¹⁰³ Abuse of the court would be, for example, if a company brought a claim to prevent a member from bringing a derivative claim and to frustrate that member: *Hansard* HC, Official Report, 13/7/2006, col 674 (the Solicitor-General).


¹⁰⁵ Under s 262(2)(b).

he failed to do that, the court would take the view that the member could not take action.¹⁰⁷ There is broad latitude available to companies in how they pursue claims. The issue is whether a reasonable amount of diligence is used and whether the company is willing to take action.¹⁰⁸

Similarly, s 264 addresses the possibility that, where the court has already decided that there is an appropriate case for a derivative claim (and a member has commenced a claim) another member may apply to the court to continue the claim as a derivative action. This will be possible in one of three circumstances. First, the manner in which the member commenced or continued the claim may amount to an abuse of the court.¹⁰⁹ Alternatively, the member may fail to prosecute the claim diligently, or finally, it may be appropriate for another member to continue the claim.¹¹⁰ Presumably, these will all be rare cases. As with s 262(3) (see above) at the Report Stage in the House of Lords, the need to show a prima facie case under s 264(3) was added to enable the court to make a speedy decision to dismiss.¹¹¹ Likewise, as with ss 261(4) and 262(3) (see above), under s 265(5) the court can respond to the application in a variety of ways.

4.3.4.3 An assessment

At first blush it appears that the procedural rules under ss 260–264 of the Act will indeed achieve greater clarity and rationality.¹¹² However, on a closer look, it appears to be the case that such rules, and their practical operation, are unlikely to be simpler or more efficient than the procedural rules under CPR r 19.9 (3).¹¹³ In order to obtain leave under CPR r 19.9 (3) it is necessary to establish both a prima facie case that the company is entitled to the relief sought and that the action falls within an exception to Foss.¹¹⁴ This has resulted in lengthy hearings and extensive pleadings at the leave stage. Indeed, it has been held that the mandatory requirement for permission under CPR r 19.9 cannot be dismissed as a mere technicality and reflects the real and important principles that the Court of Appeal reaffirmed in Barrett v Duckett¹¹⁵ and underlines the need for the court to retain control over all the stages of a derivative action.¹¹⁶

¹⁰⁷ ibid.
¹⁰⁸ In the words of the Solicitor-General: ‘If a company acts in a way that enables someone to say, “You are not being diligent. You are not being reasonable about this. You are deliberately taking the view that you will not pursue this claim”, that person will be able to seek a derivative claim instead.’ ibid.
¹⁰⁹ For example, the member brought the claim with a view to preventing another member from bringing the claim.
¹¹⁰ For example, because the member who brought the claim has become very ill.
¹¹³ See, for example, J Poole and P Roberts, above n 14, 104.
¹¹⁴ Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] Ch 204.
¹¹⁵ [1995] 1 BCLC 73.
The Law Commission’s view was that the above procedural rules ‘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’.¹¹⁷ It is true that the real difference between the previous position and the new section is that what needs to be established is set out with greater precision. Nonetheless, it will still be necessary to satisfy the criteria for the granting of leave under s 263 (discussed below). And, as will be seen below, for example, cases where the wrong in question has been ratified will be surrounded with the same arguments relating to whether the ratification is valid since s 263 clearly suggests that leave should not be granted if the wrong has been ratified. This means that in many instances the effectiveness of a purported ratification will dominate the hearing for leave and it is therefore unlikely to result in change of emphasis in favour of a broad judicial discretion.¹¹⁸ Finally, it should be noted that some issues, such as a requirement that some form of notice should be sent to the company, might well be introduced in the future, but at the time of writing, they do not form part of the Act.¹¹⁹

4.3.5 Criteria for the grant of leave

4.3.5.1 Background

Section 263 sets out the criteria which must be taken into account by the court in considering whether to give permission to continue a derivative claim.¹²⁰ The first striking point to note is that the content of this important section is somewhat different from the previous drafts discussed in section 4.2 above. There are a number of additions and, in some cases, some arguably important omissions. Recall that the subject of derivative claims proved to be rather controversial during the Grand Committee Stage discussions, due largely to fears expressed by companies that the new rules would make it easier for activist shareholders and special interest groups to take actions against directors. In response to the concerns raised that the court should be able to throw out unmeritorious claims at an early stage without involving companies and recognizing that the Bill’s provisions could do more to achieve this, the Government tabled a package of amendments in May 2006. It was hoped that these amendments would have a number of effects.¹²¹ First, the amendments introduced a two-stage procedure for permission to continue a derivative claim. At the first stage, the applicant would be

EWCA Civ 356; Harley Street Capital Ltd v Tchigirinsky [2006] BCC 209; Airey v Cordell [2006]
EWHC 2728 (Ch).

¹¹⁷ Report para 6.14. The Law Commission clearly regarded one of the failings of the common law as being the uncertainty over the scope of the exception to Foss and considered ‘greater transparency in the requirements for a derivative action’ to be highly desirable: ibid para 6.9.
¹¹⁸ See also J Poole and P Roberts, above n 14, 104.
¹²⁰ Readers are advised to read s 263 set out in Appendix 1 below before proceeding further.
required to make a prima facie case. The court would be required to consider the issue on the basis of the evidence filed by the claimant only, without requiring any evidence from the defendant. The courts must dismiss the application at this stage if what was filed did not show there was a good case.¹²² This should ensure the prompt dismissal of claims that are obviously frivolous, both as regards the underlying merits and, perhaps more significantly, where the applicant should not be bringing the claim on behalf of the company. However, it will be rare for a claim to be so poorly compiled that it cannot withstand this initial scrutiny. At the second stage, but still before the substantive action begins, the court would consider if the decision of the directors was one which the company could reasonably and independently have taken.¹²³

Secondly, these amendments make it clear that the court may make any consequential order it considers appropriate, for example, a cost order or a civil restraint order against the applicant.¹²⁴ That would give the court explicit power to adjourn the permission application, either for a specific event, such as a general meeting of the company and other soundings, or more generally, so that it can revisit the question of permission at a later stage.¹²⁵ Finally, the factors which the court must take into account under s 263 in deciding whether to permit a derivative claim to continue are amended so that they include, ‘any evidence…as to the views of members of the company who have no personal interest, direct or indirect, in the matter’.¹²⁶ It was thought that this would help to address concerns that it would not be practical or desirable for major quoted companies to ask shareholders formally to approve directors’ commercial decisions. Lord Goldsmith believed that this package of measures, which has been the subject of very careful consideration, both delivered the Government’s objectives in Part 11 and addressed concerns that the derivative procedure should not be abused.¹²⁷ It remains to be seen whether this will indeed be the case. It was already noted that if anything, the cumulative effect of these amendments will be stiffening, or even stifling, the procedure by which such claims might be made.¹²⁸

¹²² CA 2006, ss 261(2) and 263(4).
¹²³ CA 2006, s 263(4). In 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.
¹²⁴ CA 2006, s 261(2), see above n 122 and accompanying text.
¹²⁵ CA 2006, s 261 (4) and (5).
¹²⁶ CA 2006, s 263(4), see below under 4.3.5.2.
¹²⁷ Hansard HL Vol 681, Official Report, 9/5/2006, col 884. In Lord Goldsmith’s own words: ‘we have put forward a package that strikes the right balance between a degree of long-stop accountability for the directors—which is what derivative action is, not a first resort but the last—and freedom from frivolous claims’: ibid col 887.
¹²⁸ ibid; col 885 (Lord Sharman). Historically, as was explained in Ch 3 above (under 3.3), most claims have been struck out at this stage. Since 2004, there have only been seven reported cases on
4.3.5.2 The new framework

The first of the two-limb process for consideration by the court of whether or not to permit a claim to be continued (permission hearing) is set out in s 263(2). In general terms, section 263(2) provides that the court must refuse leave to continue a derivative claim if any of the three conditions identified in this subsection are present. It follows that if it is satisfied that either a person acting in accordance with the general duty of directors to promote the success of the company¹²⁹ would not seek to continue the claim;¹³⁰ or alternatively, the act or omission giving rise to the cause of action has been authorized or ratified by the company, then leave must be refused.

Section 263(3) sets out the criteria which the court must, in particular, take into account in considering whether or not to grant permission for the derivative claim to be continued (discussed in detail below). Interestingly, s 263(4) then directs the court to 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. It is noteworthy that the reference here is to the views of members without a personal interest rather than to independent directors (bearing in mind that the decision of a company to embark on litigation is usually a matter for the directors not for the shareholders). Arguably, this last factor may be seen as the most important of the criteria because of the added emphasis given to it (‘the court shall have particular regard’).¹³¹ As mentioned above, s 263(4) was a late amendment to the factors which the court must take into account under s 263 in deciding whether to permit a derivative claim to continue. Lord Goldsmith anticipates that it is for courts to decide but if, for example, the courts knew that there was a substantial and highly respectable institutional investor who knew what the circumstances were and thought that the directors were doing the right thing in not pursuing the claim, then that would be influential with the court.¹³² This may well prove to be a difficult factor to apply in practice. For example, how

derivative claims, and in the only one of these where permission was granted the company did not oppose the application.

¹²⁹ As set out in s 172.

¹³⁰ Interestingly, the sentence uses ‘would not’ (as opposed to say, ‘might not’), so there is arguably a difference between establishing at a preliminary stage that a hypothetical person ‘might not’ pursue the claim and satisfying the court that he ‘would not’. See further, J Palmer and G Milner-Moore ‘Derivative Actions: A Step Too Far?’, available at <http://corporate.practicallaw.com/9-202-0407>

¹³¹ Particular regard is to be had to those views, they are not merely a factor to be ‘taken into account’ as is the case with the others factors in s 263(3). This emphasis may have some consequence if all other factors are finely balanced. See also, Gore-Browne on Companies Act 2006, above n 61, Ch SR13 [11].

¹³² Hansard HL Vol 681, Official Report, 9/5/2006, col 888. It also appears to be the case that if a decision not to pursue a claim was the decision of the general meeting acting independently of any views of interested parties, that would be regarded as the view on an independent organ and is likely therefore to be decisive. See Gore-Browne on Companies Act 2006, above n 61.
would the court know that this institutional investor is not pursuing his own agenda? After all, this is a very subjective point. Why should the court prefer the views of this particular shareholder to, say, that of someone with less substantial holding in the company? Is it simply because of the size of his holdings in the company? Although Lord Goldsmith believed that this factor will help to address concerns that it is not practicable or desirable for major quoted companies to ask shareholders formally to approve directors' commercial decisions,¹³³ as explained above, it is doubtful whether this is a welcome addition.¹³⁴

Section 263(5) confers on the Secretary of State a power to make regulations with regard to the criteria to which the court must have regard in determining whether to grant leave to continue a derivative claim and where leave of the court must be refused. This means that the Secretary of State will keep a watching brief on developments and is empowered by s 263(5) to change the criteria governing permission by making delegated legislation under the affirmative resolution procedure.¹³⁵ Section 263(6) provides that before making any such regulations, the Secretary of State must consult with such persons and organisations as he considers appropriate.¹³⁶

As noted above, the Law Commission canvassed views on whether there should be a threshold test on the merits of the case.¹³⁷ The Commission's concern was that, if an express test was included, that would increase the risk of a detailed investigation into the merits of the case taking place at the stage of leave or permission, and that such a mini trial could be time-consuming and expensive. The Commission accepted that there would have to be some consideration of merits, because it would be wrong for the court to allow a clearly hopeless case to proceed. In this respect, Lord Goldsmith explained that under the Civil Procedure Rules the court has the power to dismiss a claim at an early stage when that claim

¹³⁴ See discussion in Ch 3 above under 3.4.2.5. The problem lies with the fact that it is clearly putting into statutory form the arguably unwelcome effect of the decision in Smith v Croft (No 2) [1988] Ch 114 where the views of a substantial so-called ‘independent’ shareholder were the critical factor in refusing to allow a derivative action to proceed. Recall also that 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 (Draft Rule 50.7(2)(e)). 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. See above under 3.4.2.2 and see also Airey v Cordell [2006] EWHC 2728 (Ch).
¹³⁵ See CA 2006, 263(7). For the affirmative resolution procedure see CA 2006, s 1290. In practice, this means that the regulations or order must not be made unless a draft of the statutory instrument containing them has been laid before Parliament and approved by a resolution of each House of Parliament. Lord Goldsmith explained that this provision is simply there due to a requirement for the affirmative resolution procedure. To allow for the possibility of a degree of flexibility to take account of changing circumstances without the need for new primary legislation seems a sensible balance to strike. See Hansard HL Vol 679, Official Report, 27/2/2006, col GC32.
¹³⁶ The power reflects a recommendation by the Law Commission in its 1997 report on shareholder remedies in respect of analogous shareholder actions in Scotland.
¹³⁷ Above under 4.2.3.
has no realistic prospect of success. But the Law Commission’s view was that it would be undesirable to encourage the parties to bring evidence to show that the case met, or failed to meet, a particular merits test. There would be a real risk of satellite litigation, which could balloon out of all proportion, if that approach was adopted. Most respondents to the consultation agreed with that view. Lord Goldsmith explained that the Government’s view was that there was a real risk, as the Law Commission had said, that a threshold test would lead to fine distinctions being drawn about whether the facts of an individual case fell on one side or another of an individual test. Therefore, the Government preferred to leave, as s 263(3) does, a much broader set of requirements, which the court must take into account in deciding in its discretion whether to allow the case to proceed. Whether the court, when it develops its principled approach, decides to include some statement about a merits test generally to be reached or always to be reached would be for the court to develop. But, following the Law Commission’s line, it is clear that the Government was not disposed to build another threshold test into the statute.¹³⁸

4.3.5.3 The specific criteria

The specific criteria under which the permission (or leave) must be refused are set out in s 263(2).¹³⁹ Section 263(2)(a) states that the court must be satisfied:

that a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim.

The requirement that a person acting in accordance with the general duty of directors to promote the success of the company under s 172¹⁴⁰ would not seek to continue the claim appears to replace the former requirement of ‘interests of the company’¹⁴¹ in the Draft Rule.¹⁴² Not only is this specified as being a factor to

¹³⁹ cf the following specific criteria with the Canadian model under CBCA, s 239(2), which was cited as a model for the Law Commission’s proposed framework (Consultation Paper 165). See discussion in Ch 3 above under 3.4.2.2.
¹⁴⁰ This duty, which codifies the current law, enshrines in statute what is commonly referred to as the principle of ‘enlightened shareholder value’. The duty 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 the factors listed. This list is not exhaustive, but highlights areas of particular importance which reflect wider expectations of responsible business behaviour, such as the interests of the company’s employees and the impact of the company’s operations on the community and the environment. 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. See, the Explanatory Notes on the Companies Act 2006 paras 325–332, available at <http://www.dti.gov.uk/bls/co-act-2006/index.html>.
¹⁴¹ On the grounds that ‘it is surely important that clause 172 and part 11 use consistent wording’. See Hansard HC, Official Report, 13/7/2006, col 679 (the Solicitor-General).
¹⁴² Draft Rule 50.8(3) provides that ‘The court must refuse leave and dismiss the derivative claim if it is satisfied that the claim is not in the interests of the company’.
be taken into account in determining the issue of leave, but in accordance with the desires of those responding to the Consultation Paper, it is now a prerequisite, which accords with its standing in Canada and New Zealand.¹⁴³

A major concern in relation to s 263(2)(a) is that the inclusion of specific matters to have regard to in fulfilling a director’s duty may lead to increased activity, or at the very least attempted activity, on the part of activists or disgruntled shareholders.¹⁴⁴ For example, animal rights activists shareholders in a pharmaceutical company may seek to rely on s 172(1)(e), which refers to ‘maintaining a reputation for high standards of business conduct’, or another sort of activist shareholder may seek to rely on s 172(1)(d), which refers to ‘the impact of the company’s operations on the community and the environment’. The fear is that this hits the directors twice, first by making them liable for more things, in Pt 10, and secondly by then giving a greater opportunity for disgruntled shareholders to bring claims against them.¹⁴⁵

Responding to these fears, Lord Goldsmith explained that the Government prefers to use the formulation put forward by the CLR because it answers the question in whose interests companies should be run.¹⁴⁶ That answer may not be quite the same in relation to a company that is purely profit-making, as opposed to a company that has different public interest measures in mind. This phrase appears twice.¹⁴⁷ The Government believes this to be a very proper thing to do. As long as the duty in s 172 remains as it is, that duty should be the test for determining whether the claim should be stopped.¹⁴⁸

This requirement is a matter of concern since it is likely to result in a restrictive approach to the grant of leave.¹⁴⁹ The court is expressly required to have regard to all the elements in s 172. As we saw above, the duty 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 the factors listed in s 172(1)(a)–(f). This list is not exhaustive, but highlights areas of particular importance which reflect wider expectations of responsible business behaviour, such as the interests of the company’s employees and the impact of the company’s operations on the community and the environment. 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. It appears that this requirement is an application of business judgment, and accords

¹⁴³ Report paras 6.78–6.79 and Draft Rule 50.8(3).
¹⁴⁵ ibid col GC23.
¹⁴⁶ ibid col GC23.
¹⁴⁷ In s 263(2)(a) and (3)(b).
¹⁴⁹ See also J Poole and P Roberts, above n 14, 108–9.
with guiding principle (iii) ‘commercial decision’,¹⁵⁰ but it can operate to abrogate the court’s discretion in favour of that of the company’s management, who could effectively scupper any derivative action.¹⁵¹ Directors might well argue that they did have regard for all of the matters mentioned in s 172(1)(a)–(f) and simply believed that what they did promoted the success of the company for the benefit of the members.¹⁵² If so, it might well be difficult for a member to challenge such an assertion successfully, and to establish that the directors did not have regard for the relevant matters.¹⁵³

In most other jurisdictions this specific reference to the views of the directors is not included since the danger must surely be that the courts will give too much weight to the views of those who may be involved in the wrongdoing and as such the courts must be encouraged to question the background to the views of directors.¹⁵⁴ However, the business judgment principle provides that the court cannot question the judgment of the directors who are in the best position to make such decisions. As the Consultation Paper argues, if the directors are the wrongdoers their decisions on whether action is in the interests of the company will not normally be made in good faith.¹⁵⁵

Permission (or leave) will also be refused if the court is satisfied that:

(b) where the cause of action arises from an act or omission that is yet to occur, that the act or omission has been authorised by the company, or
(c) where the cause of action arises from an act or omission that has already occurred, that the act or omission—
   (i) was authorised by the company before it occurred or
   (ii) has been ratified by the company since it occurred.

What therefore must be taken into account in determining leave is whether the breach of duty in question either has been approved by the company in general meeting or may so be approved. Arguably, these provisions appear to contain the problem that the alleged wrongdoers are themselves in a position to authorise or ratify their wrongdoing.¹⁵⁶ Under s 263(2)(b) and (c) where such ratification or authorisation has occurred, the claim must be discontinued. Similarly, s 263(3) allows the court to give consideration as to whether this would be likely to occur. In this regard, it has been argued that there is a danger of this undermining the

¹⁵⁰ Consultation Paper para 14.11. This is akin to the business judgment rule and is expressed in terms that the courts should not substitute their decisions for what appear to be reasonable decisions of directors made in good faith.
¹⁵¹ J Poole and P Roberts, above n 14, 109.
¹⁵³ ibid.
¹⁵⁴ ibid.
¹⁵⁵ And in case now subject to s 239 CA 2006, which prohibits self-interested members from participating in the ratification vote, thereby reversing North-West Transportation Co Ltd v Beaty (1887) 12 App Cas 589. See Ch 3 above under 3.2.2.
whole purpose of Part 11.¹⁵⁷ What is to stop an unscrupulous director ratifying his own action and so preventing a claim against him and his colleagues on behalf of the company? The answer lies elsewhere. Section 180(4) preserves any rule of law enabling the company to give authority for anything that would otherwise be a breach of duty. Section 239 preserves the current law on ratification of acts of directors, but with one significant change. The intention is that any decision by a company to ratify conduct by a director amounting to negligence, default, breach of duty, or breach of trust in relation to the company must be taken by the members, and without reliance on the votes of those members with a personal interest in the ratification.¹⁵⁸ This is a difficult and controversial issue, which the Report acknowledges. In para 6.81 the Report states that:

There is a danger that our desire to simplify the derivative action could be undermined by the complexities which arise where it is claimed that the relevant breach of duty has been (or may be) ratified.

Nevertheless, the Report concluded that there ought to be no change to the law on ratification so that no leave should be granted where ‘effective’ ratification has occurred.¹⁵⁹ This means that the question of whether a ratification is ‘effective’ will have to be addressed at the leave stage in the proceedings and there is a danger that it will reintroduce pleadings similar to those necessary under the common law to establish fraud by wrongdoers in control, at a time when the Law Commission wishes to get away from difficult questions such as the meaning of ‘control’.¹⁶⁰

This position will not, of course, prevent a shareholder from commencing a derivative action and obtaining leave if the wrong in question is capable of ratification but not yet ratified. There is, nevertheless, a continuing risk that the action will be struck out if ratification should occur. For example, under s 261(3)(b) and (4)(c), the court has the power to adjourn the derivative action for a meeting to be held (at which the wrong could be ratified). It must be questioned whether this is a cost-effective way of proceeding. It is certainly arguable that, having been given

¹⁵⁷ ibid col GC24.

¹⁵⁸ ibid col GC25 (Lord Goldsmith). As already noted, CA 2006, s 239 now prohibits self-interested members from participating in the ratification vote, thereby reversing North-West Transportation Co Ltd v Beatty (1887) 12 App Cas 589. 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. See Ch 3 above under 3.2.2. See also BM Hannigan Company Law (Butterworths 2003) 464–5.

¹⁵⁹ This expression is used in the recommendation (para 6.86) but not in Draft Rule 50.8(4).

the opportunity to take action via the notice requirement,¹⁶¹ if the company chooses not to do so at this initial stage, it ought not to be given the opportunity at a later stage in the proceedings unless there are exceptional circumstances.¹⁶² It might also be simpler to provide that, having been given notice, if the company does not ratify the wrong it ought to pursue the action to redress the corporate wrong. Similarly, if the company considers that it is not in the interests of the company to pursue the matter, it ought to ratify and cure the defect. This would retain control with the company itself and would accord with guiding principles (iii) and (v) by leaving decisions on litigation with the company and preventing unwelcome shareholder interference.¹⁶³ In any event, there is a continuing danger that although ratification has not taken place at the time of the application for leave, the court will be concerned with this when determining leave, especially when it is considered that the policy is only exceptionally to allow derivative actions.¹⁶⁴

In other jurisdictions this approach has been rejected and even the fact of ratification is not fatal to the derivative action. For example, s 263 of CBCA provides that the action shall not be stayed or dismissed on the basis that the wrong has been ratified but it can be taken into account by the court when deciding on an appropriate remedial order. The fundamental problem with the ratification issue is that what is required is a thorough assessment of the complexities of the law on ratification in the context of directors’ duties. However, at the time, this was considered to be outside the remit of the Law Commission as being concerned with rights rather than remedies. It is for this reason that the Law Commission preferred to preserve the status quo on the effect of ratification,¹⁶⁵ although later the CLR tackled this issue head on.¹⁶⁶ Unfortunately, the two are interdependent and it is not possible to make any truly effective recommendations on shareholders’ remedies without first rationalizing the effect of ratification.¹⁶⁷ In addition, as noted above, cases where the wrong in question has been ratified will be surrounded with the same arguments relating to whether the ratification is valid. This means that in many instances the effectiveness of a purported ratification will dominate the hearing for leave and there will be no change of emphasis in favour of a broad judicial discretion.¹⁶⁸

The Report also considered that in determining the question of leave the court should take account of any resolution by the company in general meeting not to

¹⁶¹ It is assumed here that the requirement that some form of notice should be sent to the company will be introduced in the future (see Hansard HL Vol 679, Official Report, 27/2/06, col GC8 and Report para 6.49), although at the time of writing, this does not form part of the Act.
¹⁶² J Poole and P Roberts, above n 14, 108.
¹⁶³ ibid.
¹⁶⁴ ibid.
¹⁶⁶ For the CLR’s proposals see 4.2.5 above. This is now enshrined in CA 2006, s 239.
¹⁶⁷ J Poole and P Roberts, above n 14, 110.
¹⁶⁸ ibid 104.
pursue the breach of duty. Although this is not the same as ratification, it is affected by the same difficulties, namely the question of whether that decision was obtained after shareholders had been presented with the full facts and whether there was any control by the wrongdoers. Arguably it is for these reasons that this is not a factor that has concerned legislators in other jurisdictions.

4.3.5.4 Matters that the court must take into account when considering an application for permission to proceed with a derivative claim

Let us look now at the specific issues which the court must take into account under s 263(3) in considering whether or not to grant permission for the derivative claim to be continued. Although, to a certain extent, it could be argued that it rehearses the criteria set out in subs (2), Lord Goldsmith explained that the formulation here is somewhat different. The Government believed it is better to set out the requirements which the court must have regard to under s 263(3). They include a number of matters, one being that the company has decided not to pursue the claim. In circumstances where the company has decided not to pursue the claim, the court will want to look at why it decided that. There are a number of possibilities. One would be that it had made a bona fide decision that the claim ought not to be pursued. Such a decision would be very influential with the court, which may decide not to allow the claim to go ahead. Alternatively, the company may have decided not to pursue the claim for reasons that the court finds unsatisfactory, which might have the opposite effect. It would be for the court to determine. Another important factor listed in s 263(3) is the importance that a person acting in accordance with s 172 (duty to promote the success of the company) would attach to continuing it.

During the Grand Committee Stage Lord Goldsmith took the opportunity to explain a little more about the Government’s thinking on s 263(3). This was in response to Lord Hodgson seeking clarification, arguing that the courts might be confused about how to apply the six important but different factors. In particular, clarification was sought on whether the list is in order of importance or whether each factor must be given equal weight by the court. One of the issues is the mixture of subjective and objective facts in the list. For example, is it more

169 Report para 6.87 and Draft Rule 50.7(2)(d).
170 J Poole and P Roberts, above n 14, 110.
171 See Appendix 1 below.
173 ibid col GC8.
174 ibid.
175 Under s 263(3)(b). As was discussed above under 4.3.5.3 the same requirement appears under s 263(3)(a). This seems in line with the decision in Airey v Cordell [2006] EWHC 2728 (Ch) where it was held that the appropriate test for permission to bring a derivative claim was the view of a hypothetical and independent board of directors. The court made clear in that case that its task was not to assert its own view but merely to be satisfied that such a board could take the decision that the minority shareholder applying for permission to proceed would like it to take.
important that the member is acting in good faith or that the company has decided not to pursue the claim?

Lord Goldsmith expected the court, in exercising its discretion, to take into account all the factors set out. They are a mixture of the objective and the factual and it is expected that the court will consider them together. It would not be a question of taking it step by step in a particular order. The test of whether a claim is a sensible one to bring, which is what s 263(3)(b) deals with, is objective, since, by definition, what is at issue is whether the director has acted properly. It is coupled with a series of tests which are designed to look at what the company actually wants rather than at what an abstract company would want. It has a sense of reality about it. How important each factor is in any particular case would be for the court to determine on the facts of the case, having regard to all the circumstances and all the factors that are set out.

An interesting question is whether the effect of a combination of s 263(2) and (3) is to make it necessary for the court to review any decision by the board not to pursue a claim? Lord Goldsmith suggested that under s 263(2)(a), the court would look at the question of whether a person acting in accordance with the duty to promote the success of the company would not seek to continue the claim. If the court is satisfied that such a person would not seek to continue the claim, that would be an end to the derivative claim. When it comes to the discretionary element under s 263(3)(e), namely, ‘whether the company has decided not to pursue the claim’, the court would look to see whether the company had decided not to pursue the claim. If it had, that would be a powerful factor, but it would not be conclusive. Looking at all the circumstances, the court might see that there were ulterior reasons for doing so, or even that it was an obviously bad decision. It appears then that the court will need to look at the circumstances and independence of decisions reached, but it is impossible to predict what weight will be given to them. There is certainly no suggestion that they would operate as an absolute bar and much will depend on how the case law develops.

Another interesting question relates to the fact that under the section as drafted, arguably claimants may pursue a derivative claim where there has been no loss to the company. This may be seen as an undesirable consequence of the drafting. Nowhere in the list of matters for the court to consider is this mentioned, nor is it

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177 ibid col GC26.
178 ibid col GC29.
179 See also J Palmer and G Milner-Moore, above n 130.
180 Hansard HL Vol 679, Official Report, 27/2/2006, col GC30 (Lord Hodgson). This relates to the ‘reflective loss’ rule which is discussed in detail below under 7.2.2.3. Painting with a broad brush, this rule proscribes a shareholder from recovering for damage which is merely a reflection of the company’s damage. This principle was clearly established in Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] 1 Ch 204, 222–3 and followed or distinguished in various cases until it was reconsidered and endorsed by the House of Lords in Johnson v Gore Wood [2002] 2 AC 1.
included in the factors that trigger automatic refusal of permission by the court given in subs (2). However, Lord Goldsmith thought it unnecessary to state this as a particular factor for the court to take into account. The general discretion and the absolute bars are better dealt with by the procedures set out in subs (2) and (3).¹⁸¹

Section 263(3)(d) requires that ‘where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company’. It appears then that the new law will depend on a factual inquiry into whether the breach is ‘likely to be ratified’ and even then this is simply a factor for the court. Adjournment of the permission hearing for ratification is one possible solution and is, as some suspect, likely to be adopted increasingly by the courts.¹⁸² This may also mean an additional administrative burden. For some companies, this will be an expensive formality giving leverage to minorities of itself.¹⁸³

With respect to the requirement to examine whether the member is acting in good faith in seeking to continue the claim (s 263(3)(a)), we have already discussed this problematic test at some length in Ch 3 above under s 3.4.2.4. As noted, in most cases the term ‘good faith’ functions as a rhetorical device rather than a substantive standard. It was concluded that it is an open-textured term, which operates as a speech-act, as opposed to a structured mode of analysis. It is interesting that in considering whether to give permission (or leave) the court must take into account whether the member is acting in good faith in seeking to continue the claim. The Law Commission specifically considered that this should not be a prerequisite for leave as in Canada, but rather a relevant factor to be taken into account, so it is interesting to speculate why this more strict approach was eventually preferred. It is likely that it must have more weight than the Law Commission accepted since it is impossible to countenance the court granting leave to an applicant exhibiting bad faith.¹⁸⁴ Indeed the Law Commission has deliberately decided that ‘good faith’ should not be defined in the rules of court, on the assumption that there is no great debate on this matter since the meaning of good faith is ‘generally readily recognisable’.¹⁸⁵ That may be true, but it lends itself to subjective interpretation and might lead to differences of opinion and hence to complexity of case law.¹⁸⁶ On the other hand, the Report does indicate that the Law Commission favours a test of whether the applicant is acting ‘honestly’ and ‘without ulterior motive’. It gives as an example a situation where the applicant would benefit financially from a successful derivative action (and thus have an ulterior motive) but, if acting honestly, the court might still grant leave.¹⁸⁶ It will be interesting to see whether this interpretation will be preferred under this more strict approach.

¹⁸² J Palmer and G Milner-Moore, above n 130.
¹⁸³ ibid.
¹⁸⁴ J Poole and P Roberts, above n 14, 107.
¹⁸⁵ See case law discussed in Ch 3 above under 3.4.2.4.
¹⁸⁶ Report paras 6.75–6.76.
One final point should be made in relation to s 263(3) (f). Generally speaking, this is potentially an important criterion and an interesting addition. It ought to have received a more detailed evaluation during the Grand Committee Stage. The special majorities exception gives rise to the possibility of bringing either a derivative action or a personal action. Since personal actions are not covered by the derivative action, a personal action, alleging that a special majority has not been obtained in breach of CA 1985, s 14 (the so-called ‘company’s contract’, restated in CA 2006 s 33), can arguably still be pursued by an individual shareholder.

4.3.5.5 What is not there?

Finally, two, arguably important, omissions from Pt 11 of CA 2006 should be briefly highlighted. First, an interesting omission from the final version relates to the availability of alternative remedies. The final criteria in the Report required that before granting leave the court should take account of any alternative remedy to that available in a derivative claim. Whilst the Law Commission clearly has in mind the alternative of winding up, this might also include the unfair prejudice remedy since, in principle, a corporate remedy is obtainable if specifically sought. Although the availability of an alternative remedy is not conclusive on the issue of leave, if s 994 were to be considered an alternative, it would mean that despite complying with notice, leave for the derivative action might be refused and the applicant would have to start again by issuing an s 994 petition. Thankfully then, this factor did not find its way to the final legislation. Interestingly, the Law Society insisted that this additional general factor needed to be included in the list specified in s 260(3). See Parliamentary Brief of 25 May 2006 prepared for the Second Reading, House of Commons in June 2006, available at <www.lawsociety.org.uk>.

An action by a shareholder of a parent company on behalf of a subsidiary is called a ‘double’ derivative action and, if on behalf of a ‘second tier’ subsidiary, it would be called a ‘triple’ derivative action. It is therefore easier to refer to all these actions as ‘multiple’ derivative actions. See Consultation Paper paras 9.9–9.13.

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187 Which reads as follows: ‘whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.’
188 See n 71 above.
189 See Report paras 6.56–6.57. See further, J Poole and P Roberts, above n 14, 103.
191 Consultation Paper para 16.4.
192 Under CA 1985, s 459, restated in CA 2006, s 994.
194 Interestingly, the Law Society insisted that this additional general factor needed to be included in the list specified in s 260(3). See Parliamentary Brief of 25 May 2006 prepared for the Second Reading, House of Commons in June 2006, available at <www.lawsociety.org.uk>.
195 An action by a shareholder of a parent company on behalf of a subsidiary is called a ‘double’ derivative action and, if on behalf of a ‘second tier’ subsidiary, it would be called a ‘triple’ derivative action. It is therefore easier to refer to all these actions as ‘multiple’ derivative actions. See Consultation Paper paras 9.9–9.13.
196 See Ch 5 below under 5.4.4.1(b).
4.4 An assessment of the likely impact of the new regime

We are now finally in a position to assess a number of questions put forward at the outset. So, is this the promised ‘new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue an action’?¹⁹⁷ Do the above changes provide for speedy, fair and cost-effective mechanisms for resolving disputes between minority shareholders and those running companies without disturbing the balance of power between members and managers?¹⁹⁸ Or was the Minister, Alun Michael, too quick to claim in his letter of 9 November 2005 to the *Financial Times* that the Act will make the law in this area clearer and more accessible, but will not result in a major change in the law? Does the approach finally adopted, not before being modified at almost each stage of its parliamentary passage (following significant lobbying by companies, accountants, the CBI, and many interest groups, including many City solicitors) improve clarity for the layperson? Does it encourage high-quality men and women to serve on boards of British companies? Or will it open up the possibility of a culture of litigation, which exists in the US in the area of derivative actions?

Although it is still early days and one cannot predict with any degree of accuracy how things will develop, the purpose of this concluding section is to shed some light on these questions. There has already been much debate on the impact of the new derivative claim and in particular whether it will provide an opportunity to harass company directors, a spectre frequently raised in the parliamentary debates. At one level, there should be no great change in that the purpose of the reform is essentially procedural.¹⁹⁹ However, tucked away in the minutiae of the new framework are provisions that are capable of making some dramatic impact, for example by extending directors’ exposure to risk.²⁰⁰ Section 260(3) suggests that a director can be made the subject of a derivative claim for acts of pure negligence²⁰¹ and indeed this seems to be the intention here.²⁰² It could be argued that the opening up of derivative claims, by reason of s 260(3), is a potentially beneficial development in terms of general corporate accountability, as it holds out the possibility of greater levels of enforcement of directors’ duties,

¹⁹⁷ To use the words of the Law Commissioner, Diana Faber, in describing the purpose of the proposed changes at the early stages of the reform process. See Report para 6.15. Although one should not expect too much from formulations such as these in that they are very short on specifics and loaded with terms that are devoid of any real meaning: ‘modern’, ‘flexible’ and ‘accessible’. This is a common problem with many company law reform programmes. See L Sealy, above n 31.

¹⁹⁸ See Report para 1.9.

¹⁹⁹ D Milman, above n 80.

²⁰⁰ ibid.

²⁰¹ At common law a director cannot be made the subject of a derivative action for acts of pure negligence. What is required at common law is negligence coupled with some other element such as personal profit accruing to the alleged wrongdoer. See *Pavlides v Jensen* [1956] Ch 565; cf *Daniels v Daniels* [1978] Ch 406.

²⁰² See discussion above under 4.3.3.2.
especially breaches of their duty of care, currently excluded from the scope of the common law derivative action.²⁰³ On the other hand, this very fact may serve as a disincentive to men and women of quality and experience to serve on the boards of public companies. Potentially, in extending the conduct in respect of which shareholders can complain, there is a risk that the new provisions may be abused by disgruntled or activist shareholders.²⁰⁴ In turn, this could lead to a rise in directors’ and officers’ (D&O) premiums. It seems likely that insurers would seek to increase rates as the derivative action could, in theory at least, increase the scope of negligence claims against executive management.

In addition to the possibility of claims for negligence, the ability to claim for breach of duty would allow a shareholder to bring a claim for breach of any of the new general statutory duties as well as regulatory obligations, such as environmental or health and safety obligations, of which there are many. Potentially, shareholders in quoted companies could bring claims for matters such as breaches of the Listing Rules or the Disclosure Rules.²⁰⁵ The new statutory right might provide another tool for use by activist shareholders to push for change at underperforming companies. If it does, then some may argue that this cannot be in the interests of UK plc.²⁰⁶ Whether the potential for extending directors’ exposure to risk will be realized will depend, to a large extent, on how the courts discharge the wide discretion entrusted to them. The Law Commission itself evidently approves of the policies which underline the present restrictive standing rules for individual shareholders. Paragraph 6.13 of the Law Commission Report is quite telling:

\[\ldots\text{we do not accept that the proposals will make significant changes to the availability of the action. In some respects, the availability may be slightly wider; in others it may be slightly narrower. But in all cases the new procedure will be subject to tight judicial control.}\]

The Government has argued that the new legislation does not result in a major change in the law. That was the view expressed by the Minister, Alun Michael, in his letter to the Financial Times²⁰⁷ in which he said: ‘It should not give rise to concern on the part of the millions of directors in this country who have high standards of conduct and make such an important contribution to Britain’s economy’.²⁰⁸ The Government insisted that the new provisions provide sufficient safeguards

²⁰⁴ Although it should be remembered that even activist shareholders are still likely to be discouraged from bringing such claims by the fact that any damages recovered will go to the company, and not the shareholder personally. See discussion on the financial problems in Ch 6 below.
²⁰⁵ In any event, it would be wise for companies to review the wording of their D&O insurance policies to ensure that defending derivative claims is covered.
²⁰⁷ 9 November 2005.
²⁰⁸ Hansard HL Vol 678, Official Report, 6/2/06, cols GC242–243. This view was followed through in Committee when he said: ‘I can say now that we do not see any reason why those provisions should increase litigation’: Hansard HL Vol 679, Official Report, 27/2/06, col GC2.
against the development of a litigation culture, as the aim was to prevent a pressure-group level of litigation against particular companies. The writer believes that it is possible but unlikely that the change will significantly affect the number of cases brought. The number of such cases is low and the impact on the courts likely to be negligible. Although focusing on the infrequency of proceedings may portray an overall misleading picture, this may, nonetheless, have a chilling effect on the judiciary. The problem remains that if the courts simply transfer those policies from the common law to their interpretation of the discretion conferred upon them, then the changes brought about by the reform will be very limited indeed. Also, if the courts are effective in weeding out cases where the derivative action is brought to further the personal interests of the individual shareholder, one may wonder what incentive the shareholder will have to seek the court’s leave to sue on behalf of the company. As will be seen in Chapter 6, the company may be ordered to pay the costs of the litigation but that does not in itself produce a positive incentive to sue. If the individual has only a small shareholding in the company, that may not act as a big enough positive incentive either.

This means that the success of any replacement to the common law action would best be judged not by the quantity of the case law generated under the new procedure, but by whether the rules governing the circumstances in which such an action may be brought are made more comprehensible and accessible so that, in exceptional circumstances, the commencement of a derivative action will be regarded as a remedy worth pursuing instead of being ruled out at an early stage of a dispute as being far too difficult even to contemplate. Here, the decision
to outline the instances when the statutory claim is available should be helpful to
the courts and to those advising shareholders on whether to pursue a derivative
claim. Putting derivative claims into statute is a positive step forward in terms
of enabling shareholders to enforce the duties directors owe to the company.
Derivative claims provide an important mechanism by which shareholders can
hold directors to account in exceptional and clearly defined circumstances.

The question, however, is whether the drafting is helpful in providing a more
meaningful guidance for the courts in deciding how to implement their role as
formal gatekeepers to such actions. Here the concern must be that this guidance
may not be sufficiently detailed to limit the court’s tendency to rely instead on
existing case law. Recall that a complex body of case law has developed regarding
the limits of this derivative action.²¹⁶ And in any case, these precedents are not at
all favourable towards shareholders taking an action on behalf of the company.²¹⁷
This is problematic, since if it is the case that the Government’s intention is not
just to put such actions on a statutory footing but also to remove many of the bar-
riers to appropriate cases being brought, the danger might be that in the absence
of a more substantial codification and clarification of the regime, the discretion
afforded to the courts may continue to impose the same barriers to derivative
claims as previously existed.

There is also a concern with the breadth of this discretion. For example, the
process is likely in practice to involve consideration of the merits of the underlying
claim even though the applicant has not yet been given the right to proceed.²¹⁸
The danger must be that the judiciary will adopt an overly restrictive approach to
Part 11 of CA 2006 in order to give effect to the perceived exceptional nature of
derivative actions. As was apparent during the Standing Committee Stage it is the
view of many law firms that the form of Part 11 does not address concerns about
the court having an unlimited discretion in deciding whether to allow derivative
actions to proceed.²¹⁹ Therefore, the true test of the effectiveness of this action
will be whether the complexity surrounding the ability to pursue a derivative
claim will continue to act as a deterrent to potential actions when compared with
the broad scope of s 994 of CA 2006.²²⁰

²¹⁶ The Law Commission has formed the view that the law in this area is inflexible and out-
moded: Consultation Paper para 14.1, discussed above in Ch 3 under 3.3 and Ch 4 under 4.2.2.
²¹⁷ See discussion in Ch 3 above under 3.2.2.
²¹⁸ Thus reintroducing in the back door all the concerns raised by the Law Commission with
respect to the common law that standing of the member to bring a derivative action has to be estab-
lished as a preliminary issue by evidence which shows a prima facie case on the merits. Without
effective case management, however, this can result in a minitrial which increases the length and
cost of the litigation. See Consultation Paper para 14.1. See further Ch 6 below under 6.3.3.2.
²¹⁹ Hansard HC, Official Report, 13/7/06, col 654.
²²⁰ Formerly CA 1985, s 459. It may also be the case that unless the derivative action is seen
as the only way to achieve the desired remedy, the procedure and potential hurdles in the way of
applicants will deter most potential derivative actions. See Ch 8 below and J Poole and P Roberts,
above n 14, 111.
In this respect a major flaw in the new procedure is that although the Government has tried to put to rest some old (and troubling) demons,\textsuperscript{221} it has not pursued this policy all the way through. One salient example is the difficulties associated with ratification. The current bar to derivative claims where the wrong is ratifiable may potentially be diluted because the possibilities for ratification have been tightened up by s 239, which prohibits self-interested members from participating in the ratification vote,\textsuperscript{222} thereby undermining old case law.\textsuperscript{223} However, as we explained above,\textsuperscript{224} cases where the wrong in question has been ratified will be surrounded with established arguments relating to whether the ratification is valid since s 263 clearly suggests that leave should not be granted if the wrong has been ratified. This means that in many instances the effectiveness of a purported ratification will dominate the hearing for leave and it is therefore unlikely to result in change of emphasis in favour of a broad judicial discretion. This is a difficult and controversial issue, which is unlikely to be resolved with the new procedure. Another difficulty can be found in s 263(4) which is exclusively directed at an important point of procedure.\textsuperscript{225} It is concerned with ensuring that the court will take into account exactly the right considerations when considering whether to give permission (or leave). However, in light of past experience, this might subsequently require some amendment or revision without the need to return to primary legislation, with all the complications and expense associated with it. Indeed, in the areas where 'leave must be refused', practitioners may be concerned that it will be some years before one quite knows how s 263(3) will work in terms of the jurisprudence.\textsuperscript{226}

It appears that the answer to the questions posed at the beginning of this section may also well depend upon the precise parameters of directors’ duties under the new regime. Most of the uncertainty surrounds the exact scope of s 172 (duty to promote the success of the company) and it is apparent that it will take some time until its precise scope will be clarified in practice. But even if duties of directors are sufficiently clarified, it will take a while before the mechanics of the new procedure governing derivative claims will be fully tested in practice. As the new legislation does not replicate existing case law, a body of case law will be slow to develop. Although of persuasive nature, the previous rules

\textsuperscript{221} The claimant does not need to show 'wrongdoer control'—that is, to show that the company is controlled by the directors whom the claimant believes to have acted in breach of their duties—as that might make it impossible for a derivative claim to be brought successfully by a member of a widely held company, including almost all major quoted companies. See Ch 3 above under 3.3.2.

\textsuperscript{222} This section preserves the previous law on ratification of acts of directors, but with one significant change. Any decision by a company to ratify conduct by a director amounting to negligence, default, breach of duty, or breach of trust in relation to the company must be taken by the members, and without reliance on the votes of those members with a personal interest in the ratification.

\textsuperscript{223} North-West Transportation Co Ltd v Beatty (1887) 12 App Cas 589.

\textsuperscript{224} Under 4.3.4 and discussion under 4.3.5.3.

\textsuperscript{225} See discussion in Ch 3 above under 3.3.6.1 and 3.4.1.2.

\textsuperscript{226} Hansard HL Vol 681, Official Report, 9/5/06, col 889 (Lord Hodgson). Of course, this is the 'price' of any new legislation.
in *Foss* and other cases will not be directly relevant in determining whether the provisions of the legislation have been applied.²²⁷ That will create uncertainty for some period as to the extent of the derivative claim provisions, and the burden of that will largely fall on the company. Although the effect of this statutory form of derivative action has probably been exaggerated, there is little doubt that there is more potential for tactical proceedings to be brought by shareholders against an incumbent board, and faith must therefore be placed in the willingness of the courts to exercise restraint in stifling such claims at an early stage. Likewise, the new procedural rules are positive but they cannot change the fundamental difficulties standing in the way of minorities.

Another related difficulty is illustrated by the experience in Canada, namely, that the derivative action will be perceived as more procedurally complex and the less favourable form of action without some limit being placed upon the scope of the unfairly prejudicial conduct action.²²⁸

Regrettably, there is also no mention of ‘multiple’ derivative actions in Part 11. However, as will be seen in Chapter 5, the need to expose fraud and serious abuse in groups of companies would seem to require a more realistic approach. This means that the particular needs of groups of companies should be considered and catered for.²²⁹

Another critical issue that will determine the accessibility of the new procedure is access to information. Given the difficulty of obtaining, in advance of litigation, adequate evidence to support alleged wrongdoing (even where this is strongly suspected), the effort to streamline litigation must address the thorny issue of disclosure and the information asymmetries which exist between management and shareholders or between large and small shareholders.²³⁰ Time will tell whether the powers granted to the court under s 261(3) will be enough in this respect.²³¹

²²⁷ Although the courts will still be referring to it and the Government indeed reaffirmed the purpose behind the rule in *Foss* and that it did not in any way seek to repeal it (see, for example, Hansard HC, Official Report, 13/7/2006, col 661 (the Solicitor-General)), there is no direct reference to the rule in the new legislation nor does the statute say what the purpose of the rule is. The problem with such an approach is obvious: if the old rule still permeates the new rule, will there ever be an effective change?

²²⁸ This is the position despite the fact that when bringing such action shareholders face potential liability for costs. See further Ch 8 below (where the potential for interrelationship and interaction between the remedy of unfair prejudice and the derivative action is examined) and BR Cheffins ‘Reforming the Derivative Action: The Canadian Experience and British Prospects’ [1997] 2 CFILR 227, 259; BR Cheffins and J Dine ‘Shareholder Remedies: Lessons from Canada’ (1992) 13 Company Lawyer 89; JG MacIntosh ‘The Oppression Remedy: Personal or Derivative?’ (1991) 70 Canada Bar Review 29. This appears to be at variance with the experience in Australia. See I Ramsay and B Saunders, ‘Litigation by Shareholders and Directors: An Empirical Study of the Statutory Derivative Action’ (2006) 6 JCLS 397, Table 8.

²²⁹ See Ch 5 below under 5.4.4.1(b).

²³⁰ See above under 4.3.4.1 and discussion in Ch 3 above under 3.2.3.2 and Ch 5 below under 5.4.4.3(g).

²³¹ Under s 261(3) (application for permission to continue derivative claim), if the application is not dismissed under subs (2), the court may give directions as to the evidence to be provided by the company, and may adjourn the proceedings to enable the evidence to be obtained.
Current case law generally confers on shareholders only scant corporate rights to ‘internal’ company documents so it will be interesting to watch whether this provision will provide a point for departure from this or whether litigants will still face up to the traditional suspicion of the English courts towards derivative claims.

Difficulties may also arise in relation to transitional issues, as the recent experience in Australia illustrates. The new statutory derivative action in Australia replaced the pre-existing law dealing with derivative actions in March 2000. Since then, in several cases difficulties have confronted the courts when the acts complained of were committed before the new statutory derivative action came into operation, but the application for leave was brought after it came into operation.

Finally, and most importantly, there is nothing in the new procedure that will convince a rational shareholder he should be better off litigating the case on behalf of the company rather than selling his shares. The common law position on costs of derivative actions (where the company may reimburse the shareholder for bringing the action if the court grants leave to continue) does not appear to have changed. If leave is not granted, the applicant will have to bear the costs of the application. Even more problematic is the fact that in financial terms, a shareholder lacks any direct remedy that would make the action worthwhile for him or her. Even if the litigation is successful, the proceeds of the litigation will still accrue to the company, rather than directly to the individual shareholders bringing the action.

4.5 Conclusion

This Chapter analysed the reforms of the derivative action in the UK. After highlighting the deficiencies in the common law, the approach to reform and the


233 Recall that the new provisions under Part 11 of CA 2006 should as a rule be used for all claims brought on or after 1 October 2007. At the time of writing, the Government is considering whether to make transitional and savings provisions so as to maintain the existing approach for certain categories of claims (for example, claims where all the events giving rise to the claim took place before commencement day and there are no continuing issues). Readers are therefore advised to follow recent developments and guidance concerning implementation of Part 11 on the DBERR website (http://www.dti.gov.uk/bbf/co-act-2006/index.html).

234 For a discussion of the inconsistent case law which emerged on this question, see I Ramsay and B Saunders, above n 228, 443–4.

235 See, Wallersteiner v Moir (No 2) [1975] QB 373 and CPR r.19.9(7), discussed in Ch 6 below under 6.3.2.

236 This relates to the fundamental problem of lack of proper incentives to take on an action on behalf of the company which is discussed in some length in Chs 6 and 7 below. Also, advance indemnities, along the lines of those supported in Wallersteiner v Moir (No 2) [1975] QB 373 (and CPR r.19.9(7)), will be difficult to obtain as the statutory reforms fail to induce the courts to rethink their cautious position here. See D Milman, above n 80, 3.
guiding principles for resolving the problems identified, the chapter examined the scope of the new statutory derivative action and the procedural framework for the application to leave as introduced by the Companies Act 2006. It critically assessed the reform plans, looking in particular at major possible obstacles on the way to reform. The discussion was geared toward providing the reader with critical tools to assess the likely impact of these reforms.

In a way, the whole new statutory derivative claim is vulnerable to the objection, expressed by some against the whole thrust of the Act, that it tries to put into statutory form a very complex area of case law. There is no denying that it is difficult to encapsulate very complex cases in statute. And one could argue that the Government did not get it quite right. Or that it should not have been engaged in such an exercise in the first place. Equally, there is no denying that the new statutory restatement of the derivative action broadens the circumstances in which, at least in theory, it may be brought. In particular, such a claim may now be brought in respect of any negligence, default, breach of duty, or breach of trust by a director. This is much broader in principle than the common law position by including claims of negligence. There have also been a number of other changes, such as the removal of the concept of ‘fraud on the minority’.

In practice, however, it may be doubted whether this will result in any significant extension of the circumstances in which such claims may be expected. Concerns that this will fuel the development of US-style litigation are probably quite far off the mark. A number of reasons combined to ensure that this may not prove to be the case. First, we have seen that courts will continue to retain a wide discretion over whether a derivative action may proceed, and permission to do so will be refused where, amongst other things, the claimant shareholder is not acting in good faith or where a disinterested director would not consider that continuing such a claim would promote the success of the company (in line with CA 2006, s 172). Litigants must still face up to the traditional suspicion of the English courts towards such claims, albeit this time courts are ‘armed’ with a very restrictive legislation to ‘justify’ their attitudes. Secondly, permission to continue a derivative action will in any event be refused in respect of a claim against a director based upon an act or omission that could be authorised or ratified by the company. In practice, this is likely to exclude the possibility of such claims in respect of ordinary negligence by directors. Finally, and most importantly, the practicalities of financing shareholder litigation will remain a major obstacle. Parliamentary minds and judicial attitudes need to focus upon this determining feature of the new regime. As will be seen in Chapters 6 and 7 below, costs and fees rules need to be re-evaluated if any real change is to occur.

²³⁸ For a comprehensive review of these reasons see above under 4.4.
²³⁹ As already stated, the court is reminded it ‘must dismiss the application’ (or that ‘permission (or leave) must be refused’) no less than four times in ss 261–264 of CA 2006.