A Proposed Model for Derivative Actions: the Functional and Focused Model (FFM)

A. The Foundations

5.1 Introduction

The existing analysis of how the derivative action functions and how the use of this mechanism in the general scheme of law enforcement may promote deterrence of wrongdoing and compensation of harm, i.e., the two primary objectives identified in Chapter 2, falls short of providing an adequately coherent theoretical account on either descriptive or normative grounds. Analytically, a sound theoretical understanding of the derivative action is necessary for three primary reasons. First, as will be seen in Chapter 6, the use of the derivative action will rarely, if ever, be economically rational. In financial terms, a shareholder lacks any direct remedy that would make the action worthwhile for him or her. If all shareholders share the same view, then no one is likely to step forward even in situations where litigation would increase total share value. Secondly, in order to be socially desirable, policy prescriptions must identify the relevant welfare-enhancing determinants. Finally, in order to be effective, legal reforms and regulatory measures must target and possess a functional capacity to affect the respective incentives that bear an impact on the attainment of the social objectives of law enforcement.

Trying to fill this gap, this chapter develops a model to analyse and explain the use of the derivative action referred to as the Functional and Focused Model (FFM). The premise driving this model is an understanding that a coherent model for the use of the derivative action is required. Consistent with the preceding discussion, its starting premise is that litigation is a fail-safe remedy, a safety net for instances when other mechanisms of accountability fail. Once the role of the action is redefined to meet contemporary challenges as set out below, the challenge is threefold:

to simplify procedures and establish a fair and balanced procedure for derivative action litigation;

(2) to address its core dilemmas, most notably that of properly funding the action and lack of positive inducement to litigate; and

(3) to harness the derivative action closely to the corporate interest it represents by inviting the court to consider the public character of the norms raised by the derivative action.

The FFM puts into operation the constructive attributes described above by validating principles to govern derivative actions and tackle those difficulties that arise only in the context of these unique proceedings. The chapter is organized in two parts. Part A provides the setting. Section 5.2 discusses the role of derivative actions in the corporate governance matrix. It shows how the traditional picture no longer accurately describes the action in the corporate governance setting. Section 5.3 then discusses the specific role that the derivative action may play in such a constantly changing system. The various points teased out throughout the preceding discussion are finally crystallized in Part B of the chapter. Section 5.4 concentrates on the characteristics of the FFM and the potential content to be covered by it. First, section 5.4.1 sets out the aims of the model, followed by an outline and the policy premises underlying the FFM. Section 5.4.2 then unearths and illuminates the value of deterrence against corporate misconduct. Section 5.4.3 considers strategies that can be pursued to reverse the negative effects of those forces that weaken the social meaning of derivative actions (as identified in Chapter 2). Subsequently, these key characteristics are reduced to practical recommendations to be included in the FFM in section 5.4.4. It should be noted that although, structurally, the foundations of the FFM are laid down in this chapter, the complementary building blocks of the FFM are addressed in the last three chapters of this book, namely, Chapters 6–8.

5.2 The Role of Derivative Actions in a Changing Menu of Governance

5.2.1 Introduction

The time is now ripe to pick up from where we left in Chapter 1. We have seen that the director-centric legal system is only a portion of the corporate governance matrix. Law is part of a rich array of constraints that also includes markets and norms as regulators of corporate behaviour. The market for director services influences governance and the takeovers market has become a key component of governance in addition to the product market and the capital market. Effective corporate governance also requires a chain of actors: directors, managers, and gatekeepers, that is professional agents of the board and the shareholders who inform and advise them, such as auditors, attorneys, securities analysts, credit-rating
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agencies, and investment bankers. Private ordering has also provided a variety of monitoring mechanisms including auditors, analysts, and attorneys. Disclosure, a key legal requirement in English law, facilitates monitoring and incentives generated by private ordering.

At the same time that these mechanisms have been growing, derivative actions in English law have been increasingly limited by a variety of procedural and substantive restrictions imposed to prevent perceived abuses generated by such actions. Unlike the situation in the US, as we have seen in the Chapters 2 and 3, the action is now so restrictive under English law that it is not a real alternative. Against this setting, it is not surprising that shareholders are rarely willing to bear the expenses of such actions, with the result that it would be a rare shareholder, indeed, who would fly in the face of this lethal mix of disincentives to commence litigation. The academic analysis of derivative actions, for the most part, reflects the view that derivative actions are an ineffective instrument of corporate governance. The argument, of course, can be viewed from at least two perspectives. Against the claimant shareholder it can be argued that the availability of the derivative action, at least a theoretical availability (for even in the more vigorous atmosphere of the US, the chances of success are indeed slim), encourages frivolous and vexatious litigation and that therefore this action needs to be rigorously controlled. Some even argue, drawing on an economic analysis of law that a litigious model of corporate governance is difficult to sustain. Alternatively, the derivative action could be used as a legitimate corporate governance tool to redress the concerns which all scholars have with issues centred on management accountability and lack of shareholder voice. Indeed, many commentators believe that, despite its limitations, shareholder litigation has an important role to play in effective corporate governance, by giving shareholders effective remedies, maintaining investor confidence or by punishing improper corporate conduct.

For those who contend that derivative action is just another form of litigation, the writer would argue that it is not. Admittedly, it is an imperfect and flawed mechanism, but so are most other mechanisms of corporate governance

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3 See Ch 2 above under 2.4.2.2.
5 For a recent explication of this view, see, for example, J Payne 'Shareholders' Remedies Reassessed' (2004) 67 MLR 500, 504.
7 See, for example, I Lynch Fannon 'A Transatlantic Case: The Derivative Action as a Corporate Governance Tool' (2005) 27 Dublin University Law Journal 1.
9 MJ Duffy, above n 6.
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(including shareholder voting and the market for takeovers), and such a sceptical assessment only suggests the need for reform, not abolition. How this might be done is explained below, but the following comments serve as a useful bridge between the arguments in this section and those still to come.

5.2.2 Enhanced protection of minority shareholders

In discussing how to enhance the potential effectiveness of the action, it is useful first to explain why, potentially, law can play an important role in the corporate governance context. In recent years various economists and academic lawyers have hypothesized on the effect various legal frameworks have had on the evolution of corporate governance. A large and growing body of empirical studies has given the so-called ‘law matters’ theory\(^{11}\) a powerful boost.\(^{12}\) The thinking is that the law ‘matters’, in the sense that a legal regime which allows investors to feel confident about owning a tiny percentage of shares in a firm constitutes the ‘bedrock’ that underpins an economy where widely held public companies dominate (ie the US and the UK).\(^{13}\) This ‘law matters’ theory is primarily utilized for explaining or theorizing developments in various jurisdictions. For the purpose of our discussion, nonetheless, it may shed some light on the normative implications that may induce a better corporate governance regime.

Although in both the US and the UK companies moved to the forefront without the legal system playing a pivotal role,\(^{14}\) the experience in these two countries indicates that a significant growth in the number of people investing in shares can provide a suitable platform for the introduction of reforms designed to assist minority shareholders.\(^{15}\) Recent research suggests that the degree of protection a country’s legal system provides for outside investors has a significant effect on its corporate governance regime. More precisely, laws favouring minority shareholders are associated with a large number of listed companies, more valuable

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\(^{11}\) This is drawn from BR Cheffins ‘Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies’ (2003) 23 OJLS 1.


\(^{13}\) BR Cheffins, above n 11, 2.

\(^{14}\) In the UK mechanisms other than formal legal regulation primarily served to protect shareholders as the country’s system of ownership and control was taking shape; over time, nonetheless, the country adopted an increasingly legalistic regime: BR Cheffins, above n 11, 2.

\(^{15}\) BR Cheffins, above n 11, 2.
Why should law make so much difference? The method implied by the ‘law matters’ thesis is to give minority shareholders protections against misconduct by fostering investors’ confidence. The essential insight underlying the ‘law matters’ thesis is that, in an unregulated environment there is a real danger that, say, a public company’s insiders, such as senior managers, will cheat ‘outside’ investors who own equity. Such confidence means that investors are willing to pay full value for shares made available for sale, which in turn lowers the cost of capital for firms that choose to sell equity. Public offering of shares can easily follow. The conditions therefore are well suited for a widely dispersed pattern of share ownership. The fact that law may influence the manner in which corporate governance evolves has therefore potentially significant policy implications.

Crucial to the foregoing discussion is one further issue. Recent developments have shed light on the need to rethink the benefits of derivative actions in the international context. As trade barriers fall, markets expand, information flows improve and restrictions on investment disappear, it has become progressively easier for investors from one country to invest in companies in another country. In a competition for global savings, sophisticated investors will be attracted to jurisdictions which have structures that serve shareholders’ interests. A crucial element in the attractiveness of a particular locality will be its system of corporate governance. An important aspect in the matrix of corporate governance is the level of protection it offers for minority shareholders. The discussion of shareholder protection has various dimensions. It is topical in the context of the EU Commission’s proposal to harmonize some aspects of shareholder rights in stock markets, reduced private benefits of control, and a lower concentration of ownership and control.

ibid and the references cited therein.

An illustration of the thesis is provided by the US legal system which regulates quite closely opportunistic conduct by insiders. According to the ‘law matters’ theory, minority shareholders feel ‘comfortable’ in this sort of protective environment. See BR Cheffins, above n 11, 6.

BR Cheffins, above n 11, 6 and the references cited therein.


There is also a wider concern with respect to a claimant who is a shareholder in a large multinational group structure, where, in view of the lack of legal clarity, it is impossible to assess what, if any, internal remedies are realistically open to such a claimant. See I Lynch Fannon, above n 7; J Dine The Governance of Corporate Groups (Cambridge University Press 2000) 53–5.

the EU.\textsuperscript{24} It is significant for the consideration of good corporate governance,\textsuperscript{25} and time and again comes to the forefront in the growing literature on ‘law and finance’.\textsuperscript{26} Following the pioneering work of a group of financial economists, there is an increasing trend to quantify the law in relation to shareholder protection,\textsuperscript{27} although some argue that this has not been done in a satisfactory manner.\textsuperscript{28} There is, indeed, plenty of anecdotal evidence which illustrates that protection of minority shareholders is emerging as an important international corporate governance topic.\textsuperscript{29}

In the UK, fears that top executives lead a privileged existence and have ample scope to act in a misguided or dishonest fashion have helped to make corporate governance a prominent topic in recent years. Concerns about low standards of managerial accountability provided the catalyst for the establishment of the Cadbury, Greenbury, and Hampel Committees.\textsuperscript{30} Since investors in a country with an ‘outsider/arm’s length’ system of ownership and control have good reason to be fearful of ‘agency costs’ arising from self-serving managerial conduct, a key corporate governance objective should be to improve the accountability of corporate executives.\textsuperscript{31} Consistent with such reasoning, the Cadbury, Greenbury, and Hampel Committees sought to influence managerial behaviour by issuing guidelines designed to enhance the role of non-executive directors and to improve links between executive pay and corporate performance. While these committees have clearly improved the situation, as we saw in Chapter 1, recent research has suggested that these mechanisms for controlling managerial power are less effective than they might be.\textsuperscript{32} The point here is not that these mechanisms are


\textsuperscript{26} PP Lele and MM Siems, above n 23.

\textsuperscript{27} The most popular shareholder protection index so far is the one constructed in La Porta et al’s article on ‘Law and Finance’: R La Porta et al ‘Law and Finance’ (1998) 106 Journal of Political Economy 1113.

\textsuperscript{28} PP Lele and MM Siems, above n 23.


\textsuperscript{30} See discussion in Ch 1 above under 1.3.2.2. These three committees, nonetheless, had very little to say on the status of the minority shareholder. Moreover, the Law Commission explicitly distinguished the work it was doing from that which had been attracting attention in corporate governance circles in the UK: Consultation Paper para 1.5.

\textsuperscript{31} BR Cheffins, above n 29, 41.

\textsuperscript{32} See Ch 1 above under 1.3.2.2 and 1.5.
not important but rather that they are imperfect. This, in turn, suggests that the derivative action could have a role in minimizing agency costs.

5.2.3 Historical perspective

It would be useful at this point to add another dimension to our discussion, namely the historical context of derivative actions. We begin by outlining the traditional view of the action. We then show how the traditional picture no longer accurately describes the action in the corporate governance setting. We then go on to discuss the specific role that the derivative action may play in such a system.

The first important point to note is that the decision not to allow the claimants to bring the action in *Foss v Harbottle* seems to have been based primarily upon a desire to uphold contemporary norms of company management and ownership. This desire is understandable if we consider that *Foss* was decided at the height of the industrial revolution, with incorporation not yet being freely available and limited liability still 12 years away. It was noted by Wigram V-C that ‘corporations like this [incorporated by individual private statute]. . . are in truth little more than private partnerships’, suggesting that he was relying on partnership principles, with their connotations of mutual trust and good faith between individual business people, and presupposing mechanisms of consultation, and genuinely universal and equal suffrage among members, as a justification to suppress individual members’ wishes in favour of the will of the majority.

It was thus considered necessary that corporate managers be shielded from undue shareholder interference, to encourage risk-taking and entrepreneurship. The Act which provided for the company’s incorporation clearly placed its management in the hands of the directors, subject only to challenge by all shareholders in general meeting, and thus it would be the very antithesis of the statutory control structure to allow shareholders to make, in essence, a management decision. Injustice, we are to assume, is not a problem because individual shareholders contract into this arrangement upon entering the company and therefore should

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53 B Prunty ‘The Shareholders’ Derivative Suit: Notes on its Derivation’ (1957) 32 *New York University Law Review* 980, 983–4 notes that the right of a shareholder to sue management on the company’s behalf had been recognized prior to *Foss*, in cases like *Hichens v Congreve* (1828) 1 Russ & M 150 but that, by 1843, ‘the prospect of an avalanche of disgruntled or querulous shareholders’ seems to have led the courts to the conclusion that judicial restraint on such action was required.

54 These two characteristics, now central to the utility of the corporate form in modern business, were introduced by the Joint Stock Companies Registration and Regulation Act 1844 and the Limited Liability Act 1855 respectively. The Chartered Companies Act 1837, in force when the case was decided, permitted incorporation only by the granting of letters patent upon regal or ministerial approval.

55 *Foss v Harbottle* (1843) 2 Hare 461, 491.

56 *ibid* 492.
be aware of the consequences. The predominant attitude of the courts, at that
time, towards shareholders’ rights was that the ‘best interests of the company’
(as determined by the wishes of the majority) should necessarily prevail over the
interests of any individual shareholder. This principle was described as fitting
within the ‘formalist model’ of corporate law, in that it provided a mechanism
by which decisions could be justified in an entirely objective way. The resulting
action (or, in the context of Foss, inaction) of the corporation is justified simply on
the grounds that it is what most of the constituents wanted. After all, even if the
minority is profoundly convinced that a decision not to sue is wrong, the minor-
ity is still a minority and not the majority.

This attitude towards corporate management, although understandable and
even perhaps justifiable in the circumstances in which Foss was decided, was
never appropriate as an absolute standard. In Foss itself, Wigram V-C referred to
the possibility of the rule being relaxed in situations where ‘no adequate remedy
remained except that of a suit by individual corporators’ or where ‘the claims of
justice’ required such relaxation.

Since then, however, developments in the business environment and in the
characteristics of the corporate form itself have prompted a shift away from
treating majority rule as the principle which will prima facie be followed by the
courts in shareholder disputes, and towards a more balanced view of the rights
of minorities in relation to those of the majority. The corporate group, rather than
what Wigram V-C described as the ‘private partnership’, has become ‘the quint-
essential model of corporate business activity in the late twentieth century’. In
this context, corporate activity (and in particular the exercising of directors’
discretion in business decision-making) has become more of a ‘public’ concern, which should therefore be subject to greater judicial scrutiny in order to protect
individual members’ rights. It follows that, in the case of larger companies at
least, the liberalization of shareholder remedies is a recognition that the indi-
vidual members of such companies do not normally have the means to control
errant directors without judicial interference. However, the same liberalization is

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38 S Bottomley ‘Shareholders’ Derivative Actions and Public Interest Suits: Two Versions of the
Law Review 1277, 1282.
40 MacDougall v Gardiner (1875) 1 Ch D 13.
41 (1843) 2 Hare 461, 492.
42 M Berkahn ‘The Derivative Action in Australia and New Zealand: Will The Statutory
jurisprudence surrounding the unfair prejudice remedy is a fine illustration of this, as will be seen
in Ch 8 below.
43 S Bottomley, above n 38, 141–2.
44 See in this respect the discussion in Ch 2 above under 2.4.2.1.
45 JE Parkinson Corporate Power and Responsibility—Issues in the Theory of Company Law
also evident in cases involving smaller, closely held companies which, although relatively less significant in economic terms, still make up the vast majority of companies (and thus also the majority of companies involved in litigation arising from intra-corporate disputes). This appears to be based on a realization by the courts that, although these companies may in practical terms be little more than incorporated partnerships, there are certain characteristics of the corporate form which can result in a member’s legitimate expectations regarding his or her role within the company being frustrated. The trend towards greater recognition of minority enforcement rights is also evident from the introduction of several exceptions to the rule in Foss in the years following the judgment, and from the broadening of the scope of these exceptions.

5.2.4 Policy shift

Thus far we have seen that some change to the existing rules was necessary in order to give shareholders a more significant role in corporate governance. As a result, numerous jurisdictions put the derivative action under the microscope, and a ‘second generation’ in the guise of a statutory procedure has emerged. In fact, shareholder-initiated actions are now being accommodated in countries that had previously rendered them ineffective. The lack of a derivative action in

46 At the end of 2005 public companies constituted only 0.5% of the register: DTI Companies in 2005–2006, Table A2.

47 Such as the majority rule principle, the presumption that management power will reside solely with the directors rather than shareholders, and the existence of a written constitution which may purport to exhaustively define members’ rights and duties.

48 As the rich case law on the unfair prejudice remedy well illustrates: discussion in Ch 8 below.

49 As set out by the Court of Appeal in Edwards v Halliwell [1950] 2 All ER 1064 and restated in Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] Ch 204.

50 For example, New Zealand and Singapore introduced the statutory derivative action in 1993. Australia and Israel followed suit in 2000 after nearly a decade of study and deliberation. The statutory derivative action has been around for some time in Canada and South Africa.

51 Germany recently enacted the Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG) altering the relevant provisions of the German Act on public companies. These reforms generally strengthen shareholder rights to sue to a significant degree. See further U Noack and D Zetzsche ’Corporate Governance Reform in Germany: The Second Decade’ (2005) 5 European Business Law Review 1033, 1053. It should however be noted that in the GmbH, the German private limited company, the derivative action or actio pro socio is available under similar circumstances than in the UK, cf BGH NJW 1990, 2627; NJW 1998, 1951; OLG Koln NJW-RR 1994, 616; OLG Dusseldorf ZIP 1994, 619, 621; H Altmepen in GH Roth/H Altmepen (eds) GmbHG (5th edn CH Beck 2005) § 13 nn 16 et seq. In a highly publicized attempt to develop private enforcement as a tool to influence companies’ corporate governance, the Consolidated Financial Services Act (CFSA) introduced derivative actions into Italian law in 1998 (Art 129 CFSA). Many problems affected the new system, which has been recently introduced further to a wide reform of Italian company law as a standard rule also in the general law of joint-stock companies (Italian Civil Code, Art 2393-bis; see generally, A De Nicola, Soci di minoranza e amministratori: un rapporto difficile (il Mulino 2005). Japan has altered its rules on attorney’s fees to create meaningful incentives for shareholder litigation and in response Japanese shareholders have been stepping up lawsuits against corporate leaders using the derivative action. While shareholders in Japan filed fewer than 20 derivative actions against directors from 1950 to 1990, West reports
China was said, at the time, to be a serious deficiency in the remedies available to shareholders. The introduction of the statutory derivative action in many of these jurisdictions was prompted by the recognition that an enhanced shareholder role (as owner and investor) is necessary if management’s obligations and duties to its shareholders are to constitute more than a precatory body of law. It is perhaps helpful, at this point, to survey briefly the reasons put forward in favour of allowing the derivative action to function as an effective tool of corporate governance.

In the US, the derivative action is seen as a regulator of corporate management and one of the most effective means of enforcing the management’s duties and obligations under the law. It is regarded as a means of complementing and enhancing the existing regulatory capability of social and market forces as well as public administration. In other jurisdictions, the introduction of a statutory procedure to govern the conduct of derivative actions was considered necessary to counter the restrictive nature of the rule in *Foss* and to allow the derivative action to function as an effective tool of corporate governance. In Canada, the Dickerson Committee felt that the best means of enforcing a corporation law is to confer reasonable power on the allegedly aggrieved party to initiate legal action to resolve the problem. In New Zealand, the statutory derivative action is seen as a means for the more effective enforcement of the obligations under the constitution of the company and under their Act. In Australia, the desire was for a more potent and accessible weapon to deter and punish managerial misconduct, the state of the existing law being inadequate for this purpose because of the restrictive

that by the end of 1993, 84 suits were pending in Japanese courts. By 1996, that number rose to 174, and by the end of 1999, there were 286 such suits, including 95 filed in 1999 alone. This is an increase of over 10,000%: MD West ‘Why Shareholders Sue: The Evidence from Japan’ Michigan Law and Economics Research Paper No 00–010 (November 2000), available at <http://ssrn.com/abstract=251012>. See also A Williams ‘Japan’s Recipe for Dispute Resolution’ [1996] *International Commercial Litigation* 2; C Milhaupt ‘Property Rights in Firms’ in J Gordon and M Roe (eds) *Convergence and Persistence in Corporate Governance* (Cambridge University Press 2004) 246. See further Ch 6 below under 6.2.1 and H Hansmann and R Kraakman, above n 20, 53–4.


53 *Cohen v Beneficial Industrial Loan Corp* 337 US 541, 548 (1949) (describing the derivative action as ‘the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders’ interests’). But cf GT Washington ‘Stockholders’ Derivative Suits: The Company’s Role, and a Suggestion’ (1940) 25 *Cornell Law Quarterly* 361, 375 (branding derivative actions ‘expensive, hazardous and clumsy’).

54 This statement must be seen in the context of the unique environment for derivative actions in the US, which provides a financial incentive to attorneys to police management. See Ch 6 below under 6.2.2.

55 See generally MP Doole *Foundations of Corporation Law* (Foundation Press 1995); RC Clark *Corporate Law* (Little Boston 1986).

56 Proposals for a New Business Corporations Law for Canada (Dickerson Report 1971) 476.


nature of the rule in *Foss*. Some Australian commentators questioned the need to introduce a statutory form of the derivative action. This was due to the observation that the Australian judiciary appears more than willing to avoid the insidious web woven by the rule in *Foss*. In particular, this robust attitude towards minority shareholder rights was manifested in the increasing judicial support for a fifth exception ‘in the interests of justice’ to the rule in *Foss*, and in the expansive view taken of shareholders’ personal rights, which effectively bypassed the procedural difficulties of *Foss*. Nevertheless, it was considered that this attitude of the courts in itself engendered a certain amount of uncertainty, and the availability of a ‘direct accountability mechanism that can be used by shareholders in an efficient and effective manner’ would do much to remove this uncertainty in the interests of enhancing corporate governance and maintaining investor confidence. According to the Corporations Law Simplification Task Force, the overall objective of introducing a statutory derivative action to confer rights on shareholders should be to provide an incentive for management to exercise its powers appropriately and discharge its functions for the ultimate advantage of the shareholders. In Israel, the introduction of the statutory derivative action in 2000 was unequivocally premised on the objective of encouraging the use of derivative actions. The new procedure includes several features which illustrate the legislator’s will to turn the derivative action into a beneficial tool in enforcing corporate accountability. The derivative action is made more widely accessible for prospective claimants through a variety of ways of mitigating the effect of distorted litigation incentives. Finally, in Singapore, the Select Committee clarified that the primary purpose for the inclusion of the derivative action was to provide minority shareholders with greater remedies, thereby strengthening the rights of the minority shareholder.


61 Biala Pty Ltd v Mallina Holdings Ltd (No 2) (1993) 11 ACSR 785, 848 per Ipp J. For further discussion on this exception see E Boros *Minority Shareholders’ Remedies* (OUP 1995) 185–9.

62 Corporate Law Economic Reform Program (CLERP) Proposals for Reform *Directors’ Duties and Corporate Governance* (Paper No 3 1997) para 5.3.2.

63 ibid.


66 In the first reported decision on the statutory derivative action in *Teo Gek Luang v Ng Ai Tiong* [1999] 1 SLR 434, 438, Lai Kew Chai J stated that ‘such derivative ... actions are intended to improve the standards of private corporate governance since directors who breach their duties to the company could be made accountable’.
5.3 The Derivative Action as a Constraint on Management Misconduct

So, what role should the derivative action have in corporate governance? A useful starting point is to examine the role that might be taken in relation to public companies.

5.3.1 Public companies—constraints and limitations of other mechanisms

Let us assume, for the purpose of our discussion, that shareholders in the UK are not allowed to bring derivative actions against public companies. Interestingly, such a case exists. The Singapore statutory derivative action applies only in connection with companies that are not listed on the Singapore Stock Exchange. So, would it be sensible to follow this? The Singapore Select Committee gave its reasons for the exclusion of the listed company in the following terms:

The Committee was of the view that the proceedings and performance of public listed companies are already monitored by various regulatory authorities and disgruntled shareholders of such companies have an avenue in that they can sell their shares in the open market.

The arguments in the following pages concern themselves with explaining why the above two objections, properly understood, are in relation to the UK incoherent and erroneous respectively. There are at least five strong indications supporting the extension of the applicability of the derivative action to listed companies.

First, to deny the listed shareholder the availability of a statutory derivative action on the basis that he has the option of selling his shares on the market is to ignore the deterrent effect of the action. Perversely, this may actually provide wrongdoers with a perceived sense of immunity. After all, the derivative action’s usual raison d’être is ‘a form of pleading originally introduced on the ground of necessity alone in order to prevent a wrong going without redress’.

The Singapore derivative action is modelled after the statutory derivative action in the Canadian Business Corporations Act and is found in ss 216A and 216B of the Companies Act (c 50). For a critical and comparative examination of the derivative action in Singapore see PKM Choo, above n 58.

This view is merely meant to provide us with a starting point to the theoretical discussion which follows. It is by no means a comparative inquiry.

Report of the Select Committee on the Companies (Amendment) Bill para 45.

See discussion in Ch 2 above under 2.3.3.

Recall the powerful words of Lord Denning in Wallersteiner v Moir (No 2) [1975] QB 373, 395: ‘Some wrongdoers know this and take advantage of it. They loot the company’s funds knowing there is little risk of an action being brought against them.’

Smith v Croft (No 2) [1988] Ch 114, 185 per Knox J.
is important to remember that the derivative action is a remedy for shareholders who want to remain in the company and challenge the wrongdoing by directors. It is not for those shareholders who are disinterested and would prefer to sell their share and exit the company. In any event, sale may not always be the best option, for example if an alleged wrongdoing has depressed share values.

Secondly, the argument that the proceedings and performance of public listed companies are already monitored by various regulatory authorities misses the point. It is easy to see why those whose function it is to represent the interests of large public companies are likely to resist any changes in the law which might encourage an ‘active’ market in civil litigation by minority shareholders. The ability of regulatory authorities and agencies to monitor management, however, is necessarily bound by practical, budgetary, and perhaps political constraints, as we saw in Chapter 1. While the exclusion can perhaps be justified to some extent by reference to the checks imposed by market forces, as we saw, the effectiveness of market forces, particularly in relation to one-time breaches of duty, is limited. Put simply, the derivative action and, say, the hostile takeover are not substitutes for one another in a public policy sense. It should come as no surprise then that the move to exclude listed companies from the Singapore statutory derivative action was not without controversy.

Thirdly, although listed companies have widely dispersed shareholdings, inherently the very composition of the board would probably depend on the majority shareholders and it is not inconceivable that the personal preferences, objectives or vision of these shareholders be prioritized at the expense of the minority. It is important, particularly in the case of public listed companies with widely scattered shareholdings where the board is in de facto control, that serious fraud or misappropriation of assets by officers and managers (also below board level) should not be immune from derivative actions. It is possible that the board members may have their own motives for suppressing litigation. In short, dismissal of dishonest officers or senior managers should not be allowed to become the only possible remedy.

Fourthly, as more powers in relation to the running of the company were conferred on the management, the shareholder’s position in the company was

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73 See, for example, S Deakin E Ferran and R Nolan ‘Shareholders’ Rights and Remedies: An Overview’ [1997] 2 CFILR 162, 163 (quoting BM Hannigan in a panel discussion at a conference on Shareholders’ Rights and Remedies in Cambridge in April 1997); L Kosmin ‘Minority Shareholders’ Remedies: A Practitioner Perspective’ [1997] 2 CFILR 201, 213; PKM Choo, above n 58, 82.

74 Such as the CBI and leading firms of City solicitors. For explication of these views see AJ Boyle Minority Shareholders’ Remedies (Cambridge University Press 2002) 12–13.


76 PKM Choo, above n 58, 82.

77 A Boyle, above n 74, 66.

78 This state of affairs is even more unsatisfactory in the case of groups of companies. See below 5.4.4.1(b).
increasingly being relegated to a backseat, simply waiting to receive dividends, if these were declared. With shareholders’ hands tied with legal strings, courtesy of Foss, an important check on mismanagement was not allowed its full potential. But potential investors must have the confidence that the officers of corporate entities operate them honestly and in the best interests of the shareholders, both majority and minority. If not, they must believe that they can do something about it. It would certainly be too late to make legislative amends if perceived managerial ineptitude and corporate wrongdoing were manifested in the form of a lack of investor confidence. A certain level of shareholder activism ought thus to be encouraged.79 Inevitably, allowing for increased shareholder activism will foster a new reality that management will have to take greater account of shareholder interests and rights.80 As Professor Coffee opined more than a decade ago, ‘the knowledge that one is being watched and that one must justify one’s actions improves the behaviour of most individuals’.81

Indeed, shareholders have in recent times been taking directors of listed companies to task over issues such as director remuneration and dividend payments.82 The ousting of Michael Green from his planned role at the merged Carlton–Granada group was described ‘as the most naked display of shareholder power for a decade’.83 These kinds of sentiments lie behind the renewed movement of shareholder activism84 which has been coming to the fore over the last several years

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79 PKM Choo, above n 58, 93–4.
80 See in this respect the major role the Government provided in CA 2006 for ‘enhancing shareholder engagement and a long-term investment culture’ as ‘shareholders have a key role to play in driving long-term company performance and economic prosperity. Informed, engaged shareholders—or those acting on their behalf—are the means by which the directors are held to account for business strategy and performance and by which investment decisions are taken which reflect the most efficient allocation of capital’. See White Paper Company Law Reform (Cm 6456) (DTI March 2005) Ch 3 available at <http://www.dti.gov.uk/files/file25407.pdf>. So, for example, as we saw in Ch 1, above under 1.3.1, to allow early delivery of the benefits of e-communications—including significant cost-savings to business, improved accessibility to information, and enhanced immediacy of dialogue between companies and shareholders—a number of measures to this effect have been introduced in January 2007. See, <http://www.dti.gov.uk/files/file36201.doc>.
81 JC Coffee ‘New Myths and Old Realities: The American Law Institute Faces the Derivative Action’ (1993) 48 Business Lawyer 1407, 1425. See also Cialdini’s study referred to in Ch 2 above under 2.4.1.
82 Galbraith has explained that excessive pay represents the peddling of an ‘innocent fraud’, as he calls it; see JK Galbraith Guardian (14 August 2004) and The Economics of Innocent Fraud (Houghton Mifflin 2004). Additionally, Galbraith writes about missing corporate funds that vary in size with the business cycle. The missing funds tend not to be noticed during times of prosperity, but they come to light when earnings turn downward. When that time comes, we can expect a lot of investor unhappiness and, inevitably, more active actions by shareholders. See JK Galbraith The Great Crash 1929 (1955) (Mariner Books Reprint edn 1997) 137–8.
83 Guardian (3 November 2003). The 2003 AGM season was described as ‘stormy and directors’ pay was commonly at the epicentre of the storm. Outright rejection of reports was rare but levels of abstentions and “no” votes were sufficiently large to cause embarrassment in some cases’: E Ferran ‘Company Law Reform in the UK: A Progress Report’ (March 2005) ECGI—Law Working Paper No 27/2005, available at <http://ssrn.com/abstract=644203>.
84 See, for example, the growing number of shareholders’ associations in the UK (such as the UK Shareholders’ Association (<http://www.uksa.org.uk>), Manifest (<http://www.manifest.co.uk>)}
and which reached its zenith with the ousting of Green.\(^85\) In this respect, if the derivative action were seen as a viable option for shareholders, they would potentially have a bigger role in the governance of management and a greater chance of protecting their interests.\(^86\) In the long run, the availability of the derivative action could reduce the need for public enforcement and bureaucratic oversight of corporate conduct.\(^87\) Likewise, private enforcement multiplies society’s enforcement resources, and probably minimizes enforcement costs, because the private enforcer will be restrained by the fact that it is typically compensated only when successful. There is thus no surprise that the DBERR sees the topic of shareholder activism as a natural progression from the reforms of boardroom practice and executive pay that have occupied it for much of the past few years.\(^88\)

A fifth aspect shaping shareholder influence relates to the potential for a much bigger role in corporate governance for the institutional investor, particularly in public companies where the ability of institutional investors to threaten proceedings would seem to be powerful sanction where recalcitrant directors refuse to respond to other forms of pressure.\(^89\) Much has been written and said in relation to the role of institutional shareholders in English law both in terms of their contribution to short-termist English industry rather than long-term planning, and in terms of their contribution to corporate governance.\(^90\) Given the constraints of space, this important subject cannot be discussed in any length. Instead, several brief comments can be made.

and ProShare (<http://www.proshare.org.uk>) who call for such a role by providing shareholders with information on company issues as they come up.


\(^86\) PKM Choo, above n 58, 83.

\(^87\) See also American Law Institute Principles of Corporate Governance and Structure: Restatement and Recommendations (Tentative Draft No 1 1982) Ch 1.

\(^88\) As we mentioned above, this view seems to underlie many of the measures in the White Paper Company Law Reform (Cm 6456) (DTI March 2005) 5: ‘Shareholders are the lifeblood of a company, whatever its size. We want to promote wide participation of shareholders, ensuring that they are informed and involved, as they should be’. These measures were subsequently introduced in CA 2006. See above n 80 and Ch 1 under 1.3.1.

\(^89\) S Deakin E Ferran and R Nolan, above n 73, 163; AJ Boyle, above n 74, 12–13.

The argument is that apart from the greater likelihood of a direct return from their efforts, investors with sizeable stakes in a large number of companies may see some advantage by seeking occasionally to hold wrongdoing or inept directors to account. It is unfortunate in this respect that the Court of Appeal in Prudential should have sought to discourage such initiatives. See also JE Parkinson, above n 45, 242.

Also, for the institutional investor, the typical ‘dumping’ response to mismanagement in listed companies would not be a viable option. The sale of large blocks of shares by an institutional investor is very likely to send the wrong kind of signal to the market, resulting in an adverse effect on the share price. To protect their portfolios, therefore, it may be that increased activism on the part of institutional investors would be the only responsible way forward. Indeed, it has been acknowledged that there is considerably more institutional activism today than, say, a quarter of a century ago and that this activism is continuing to grow.

In short, institutional shareholders need to be encouraged to litigate in what they deem is an appropriate case to protect their own investors. Fostering institutional activism must be coupled with tackling the impediments to
increased shareholder activism as outlined in the 2005 White Paper and implemented in CA 2006.\textsuperscript{99} Solutions that can provide for this will ultimately enhance better corporate governance, but more on this later.

5.3.2 Policing management in closely held corporations

It is noteworthy to point out here that derivative actions retain also an important role in policing management in closely held corporations.\textsuperscript{100} Unlike public corporations, there is no market for a private company’s stock or similar constraints on manager’s misuse of the centralized power that is given to directors. Ultimately, the fragility of the minority shareholder’s position and the insecurity of his interests leave him open to majority abuse. Derivative actions can play an important role in protecting minority shareholder rights in this setting. And although English law caters well for most of the needs of the minority shareholders in private companies, through, for example, the case law on the unfair prejudice remedy coupled with developments in the law of just and equitable winding up,\textsuperscript{101} it will be seen in Chapter 8, nonetheless, that several important factors (including recent empirical evidence which suggest that the derivative action has been much more widely used in small proprietary companies) combine to ensure that the derivative action has still an important role to play in private companies.

5.4 Synthesis—the Functional and Focused Model

5.4.1 Introduction

It is fruitful to pull together now the various strands of discussion so far. Having established the need for a redefined role for the derivative action in English law, we turn to the methodology to be used in developing the content of this new role in corporate governance. The adoption of a \textit{Functional and Focused Model} (FFM) for derivative action litigation is proposed. In this introductory section the aims of the model will be set out, followed by an outline and the policy premises.

5.4.1.1 Aims of the model

The FFM builds on the view of the derivative action laid out in the first part of this book (namely Chapters 1–4) and finalized in the preceding sections of this chapter. Its aim is to:

(1) simplify procedures and establish a fair and balanced procedure for derivative action litigation;

\textsuperscript{99} Above n 80.
\textsuperscript{100} This point is discussed fully in Ch 8 below under 8.3.1 and 8.3.3.
\textsuperscript{101} See generally A Boyle, above n 74.
address its core dilemmas, most notably that of properly funding the action and lack of positive inducement to litigate; and

(3) closely harness the derivative action to the corporate interest it represents by inviting the court to consider the public character of the norms raised by the derivative action.

The model throws light on the challenges facing minority shareholders. It explains how these problems can be dealt with. It balances the gains and misgivings of litigation as a means to redress wrongs. The FFM developed here focuses, then, on what makes derivative actions special. It addresses the procedural complexity of derivative actions and seeks to replace overbroad restrictions on the shareholder’s standing to sue with more specifically focused tests to discourage non-meritorious litigation. As will be seen in Chapters 6 and 7, a primary interest of the theoretical inquiry of the FFM is in gaining insight into how the derivative action mechanism shapes the incentives of private agents, namely shareholders and their attorneys, and how these incentives affect the magnitude of the deterrence and compensation effects of the derivative action (the two primary objectives of the action). By doing so, the FFM provides a standpoint from which to judge any future reform. As demonstrated below, the FFM offers novel descriptive insights that significantly enhance the existing understanding of derivative action. These insights, in turn, carry far-reaching implications for designing and implementing welfare-enhancing social policy at legislative, rule-making, and judicial levels.

5.4.1.2 Outline of the model

Two words describe the proposed model best: ‘functional’ and ‘focused’. It is functional, for the derivative action should be used only if it serves one of its prime functions, namely deterrence and compensation. By this is meant that the model highlights the functional logic behind the derivative action. It is in this sense that functionalism is a question and not an answer. The ‘functional’ aspect of the inquiry involves closely harnessing the derivative action to the corporate interest it represents by inviting the court to consider the public character of the norms raised by the derivative action as set out below. Secondly, the framework that the model develops is also ‘focused’ in the sense that the litigation should be focused on (1) those areas or instances in which other mechanisms of accountability fail, and (2) the nature of inquiry conducted by the court.

Intertwining these conceptual observations into a cohesive model of derivative actions, the model conceptualizes derivative action law enforcement as a theoretical as well as practical device. More concretely, the model explicates that there is room to develop and put forward a policy of promoting the use of the derivative action, when, and only when, it can further one of its prime functions. This policy of the FFM is based on the value to shareholders of having this ‘weapon of

¹⁰² See the corresponding test proposed below under 5.4.4.3.
last resort’ which could benefit them both in the rare instances in which it would be actually used and, more importantly, in the instances in which its mere existence would induce management to act in shareholders’ interests.\(^{103}\) This is not to encourage shareholder litigation for its own sake, but instead to ensure that the exercise of bona fide shareholder power to commence litigation is not discouraged, and also to ensure that the derivative action has a fair chance of reaching its potential as a tool in corporate governance. At the same time, increasing the scope for shareholder intervention in the hope of enhancing corporate accountability is laudable, provided the necessary safeguards are in place. The risk, of course, is that encouraging shareholder involvement may result in increased counter-productive litigation.

In attempting to steer a middle course between excessive reliance on a litigation remedy and judicial recourse for the shareholders on the one hand, and unreasonable interference in the affairs of the company on the other hand, the FFM is particularly sensitive to the danger of over-deterrence and the impact of the potential risk of litigation on the willingness of well-meaning directors to serve, as well as on their conduct as directors.\(^{104}\) In striking the proper balance, the FFM also recognizes that the derivative action is neither the initial nor the primary protection for shareholders against managerial misconduct.\(^ {105}\) Ultimately, litigation is a fail-safe remedy, a safety net for instances when other mechanisms fail.\(^ {106}\) This, in turn, requires a revised, more modest and yet more realistic approach to derivative action litigation in English law. When properly structured, then, the derivative action should enhance the capabilities of other mechanisms of accountability by: (1) ensuring a measure of judicial oversight; (2) providing for a remedy that does not depend upon the ability of widely dispersed shareholders to co-ordinate action; (3) protecting transactions by corporate controllers from unreasonable interference; and (4) increasing deterrence of misconduct or generation of net recoveries (the two primary objectives).

The two major tensions analysed in the preceding discussion—that between the need to make the action effective and the danger of its exploitation and that between the rationales of deterrence and compensation—explain the basic architecture of this model. The following premises illustrate the model’s desire to seek a balance that recognizes the merits on both sides of these issues.

5.4.1.3 Policy premises
The policy premises can be brief and reasonably straightforward:

(1) Deterrence should be recognized as a major benefit of the derivative action. Shareholders have generic interests in the observance by corporate fiduciaries

\(^{103}\) See Ch 2 above under 2.3.3.1.

\(^{104}\) See discussion in Ch 2 above under 2.2.

\(^{105}\) As explicated in Ch 1.

\(^{106}\) See generally JC Coffee, above n 81.
of their duties and such interests may sometimes outbalance their financial interest in a recovery in a specific action. Correspondingly, compensation can also be achieved through a derivative action, even if it will be sometimes insufficient or misdirected. The model seeks to balance and accommodate the two rationales rather than assign a uniform priority to one over the other. This is reflected in the test provided below.

(2) It should be made clear that the deterrent value of shareholder litigation is tied to the public’s perception of the value of such litigation. Accordingly, efforts should be made:

(a) to reverse the negative effects of those forces that weaken the social meaning of derivative actions so that the action is more likely to be viewed as an instrument that affirms desirable norms in the corporate setting, and

(b) to enhance the public aspect of the derivative action.

(3) The model acknowledges the legitimacy of the company’s need to seek the termination of a derivative action that is adverse to its best interests, but also acknowledges the fact that shareholders should not be denied any realistic access to a litigation remedy solely on the basis of their standing. It follows that the scope of the remedy should be confined to and focused on those areas where it is mostly needed. The model recommends procedural safeguards subject to judicial scrutiny.

(4) The screening procedure needs to ensure that it will develop and frame the central issues in the litigation for judicial examination in a manner that is both reliable and efficient. It should lay down clear, balanced and coherent criteria to be met for the grant of leave.

(5) The model recognizes the critical role of:

(a) conditions that may facilitate litigation (for example, access to information), and

(b) costs and fees as incentives to commence litigation.

In response, the FMM puts into operation strategies to resolve the problems of funding and lack of incentives respectively.

Before it is possible to reduce the characteristics of the FFM to the contents to be covered by it (as set out in section 5.4.4 below) there are two broad themes underlying the analysis in the following two sections. First, section 5.4.2 attempts to unearth and illuminate the value of deterrence against corporate misconduct. Secondly, section 5.4.3 considers strategies that can be pursued to reverse the negative effects of those forces (as identified in Chapter 2) that

\[^{107}\text{See Ch 2 above under 2.3.3.1.}\]
\[^{108}\text{See Ch 2 above under 2.3.2.}\]
\[^{109}\text{See also American Law Institute Principles of Corporate Governance and Structure: Restatement and Recommendations (Tentative Draft No 1 1982) 236.}\]
\[^{110}\text{As explained below under 5.4.3.}\]
\[^{111}\text{As set out below in Chs 6 and 7.}\]
\[^{112}\text{As set out below in Chs 6 and 7.}\]
weaken the social meaning of derivative actions, so that the action is more likely to be viewed as an instrument that affirms desirable norms in the corporate setting. It will be seen that elements discussed in the first three chapters surface again in different guises in subsequent sections below, reinforcing and illuminating what has gone before.

5.4.2 The value of deterrence against corporate misconduct

5.4.2.1 Introduction

A significant value of derivative action arguably lies in its deterrent capacity. This is often overlooked in empirical studies because researchers cannot quantify its effects precisely. It will be seen below that while we do not know what percentage of frauds or self-dealing transactions are deterred because of the possibility of being exposed or challenged in shareholder litigation, the probability of detection of corporate wrongdoing is greater when private claimants are able to pursue such actions. This value should therefore be added to the balance sheet on the benefit side of the ledger. Using that lens to focus on potential deterrent or influential conduct, let us look at a few specifics.

5.4.2.2 The deterrence rationale in company law

At least two points must be briefly explained here. The first is that there is nothing unique in assigning a deterrent role to derivative actions as this rationale plays a major part in English company law. One could perhaps be forgiven the assumption that to assert that the derivative action should be seen as dealing with issues at the heart of company law is to assert something trivial and banal. And yet this section wishes to emphasize this proposition, in order to show that it fits neatly with current policies shaping English company law.

Take for example the Company Directors Disqualification Act 1986. A major objective of disqualification is to raise standards of conduct among directors generally. The idea is that other directors will be influenced to behave in accordance with the standards which the disqualified director has failed to

¹¹³ See Ch 2 above under 2.3.3.1.
¹¹⁴ Deterrence also plays an important part in other areas, most notably, insolvency legislation. White Paper *A Revised Framework for Insolvency Law* (Cmd 9175), (1984) para 2. A salient example is s 214 of the Insolvency Act 1986. The threat of personal liability for the company’s obligations, which s 214 creates, does something to provide a counter-incentive for directors. See *A Keye McPherson’s Law of Company Liquidation* (Sweet & Maxwell 2001) 621–34. Moreover, s 214 can operate at the point of the incorporation (*Re Purpoint Ltd* [1991] BCLC 491, 498) and this theoretically acts as a deterrent against the incorporation of economically non-viable companies. See further DD Prentice ‘The Incorporation Theory—The United Kingdom’ (2003) 14 EBLR 631.
Put simply, disqualification is concerned with general deterrence. And although different judicial philosophies or rationales can be discerned from the case law, there is no doubt, as Hoffmann LJ held, that Parliament intended mandatory disqualification to serve a wider purpose than simply protecting the public from the disqualified director:

The purpose of making disqualification [under s 6] mandatory was to ensure that everyone whose conduct had fallen below the appropriate standard was disqualified for at least two years, whether in the individual case the court thought that this was necessary in the public interest or not. Parliament has decided that it is occasionally necessary to disqualify a company director to encourage the others. (emphasis added)

This quotation is reproduced in full to highlight a simple point: a similar reasoning is used by the American judiciary to justify the deterrence objective underlying derivative actions.

The second point is that because it is accepted that derivative actions are obsolete, the law turns to other means, at times less adequate. For example, broadly speaking, a company commits an offence if it gives unlawful financial assistance and, inter alia, is liable to a fine. Arguments for imposing criminal as well as civil sanctions on directors for unlawful assistance include their deterrent effect, but also the existence of structural and commercial factors that may inhibit companies from commencing litigation against their officers, because it is notoriously difficult for shareholders to establish standing with this type of claim. In other words, the law turns to these alternative means, partly because the derivative action is not a viable option! So, following this logic, if proposals aimed at diffusing problems and flaws identified in the initiation of these actions can be put forward, then, theoretically, making derivative actions a viable option may also mean that (1) there might be less need to employ these, arguably, less than

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116 ibid.
117 On whether the deterrent effect of the director disqualification rules has been a success in terms of yielding a net social benefit, see, for example, V Finch Corporate Insolvency Law (Cambridge University Press 2002) 536; E Ferran ‘The Role of the Shareholder in Internal Corporate Governance: Enabling Shareholders to Make Better-informed Decisions’ (2003) 4 EBOLR 491, 501–3 and the evidence therein.
119 Re Grayan Building Services Ltd (In Liquidation) [1995] Ch 241, 253. Deterrence is emphasized in other cases such as Re Swift Ltd Secretary of State for Trade and Industry v Ettinger [1993] BCLC 896; see further A Walters and M Davis-White Directors’ Disqualification: Law and Practice (Sweet & Maxwell 1999) especially Chs 2 and 4.
120 For example, in City of Riverside v Rivera 106 S Ct 2686 (1986) a derivative action was allowed to continue, even in the absence of profits for the company in question, on the grounds that the public benefits in such actions outweigh its private benefits.
121 CA 1985, s 151(3), as restated in CA 2006, s 680. Every officer of the company who is also in default is also guilty of a criminal offence: CA 2006, s 693.
122 E Ferran Company Law and Corporate Finance (OUP 1999) 403.
123 ibid.
adequate penalties (at least not to the same extent);\textsuperscript{124} and (2) the derivative action may, in turn, be used as a legitimate corporate governance tool to redress the concerns with issues raised above.

5.4.2.3 ‘Private’ remedies or ‘non legally enforceable norms’

A somewhat overlooked benefit of the deterrence aspect of the derivative action relates to the impact it may have internally on the company subject to the litigation.\textsuperscript{125} US case law has recognized that when the derivative action is dismissed (for whatever reason), the claimant may have nonetheless conferred a benefit on the company.\textsuperscript{126} Such a benefit can arise when internal remedies or reforms are instituted following the litigation. This may include the departure of key personnel who may have been involved in alleged wrongdoing, or structural reforms such as non-cosmetic organizational reform, provision for a review of compensation practices, or modifications of compensation plans. We illustrate next why, arguably, there would be such a benefit.

Assume shareholder A brings a meritorious derivative action against director B who sits on the board of company C alleging material self-dealing by director B. Further assume that after an initial court hearing, the action is not allowed to proceed by the court, say because the court believes the shareholder will not be able to represent the company properly. By that time, however, alerted by the allegations, the board investigates the matter further and reaches a settlement with director B. Alternatively, the board takes internal corrective or disciplinary action (i.e., suspension from taking part in board meetings and reduction in remuneration). Either way, it can be presumed that shareholder A has ‘caused’ the settlement or corrective action by alerting the board of company C. Arguably then, even if an action is unsuccessful at the end of the day, it may nevertheless induce or push for some positive measures from the point of view of better governance. This may also have a forward-looking benefit in


\textsuperscript{125} A growing area of corporate law scholarship in the US considers the dissonance between the relationship of company law and modern commercial and corporate practices which leaves a vacuum. Arguably, this is currently filled by the adoption of private remedies. See generally Symposium ‘Norms and Corporate Law’ (2001) 149 University of Pennsylvania Law Review 161; Symposium ‘Social Norms, Social Meaning and the Economic Analysis of Law’ (1998) 27 JLS 537.

\textsuperscript{126} See, for example, Lewis v Anderson 81 FRD 436, 439 (SDNY 1978); United Operating Co v Karnes 482 F Supp 1029 (SDNY 1980).
the form of future protection and avoidance of continuing abuse.¹²⁷ Viewed in this way, shareholder A has rendered a substantial service to the governance of company C, its shareholders and the class of shareholders generally. Arguably, shareholder A in our example, could have alerted the board without the need to resort to costly litigation. However, the point here is that the threat of the action itself and, say, the adverse publicity it might entail, have prompted the board to introduce corrective measures. It is doubtful whether, without the threat of the action, such drastic measures or corrective actions would have been introduced in the first place.

Although it would not always be easy to pinpoint that any resulting benefit to the company was causally related to the derivative action, a recent example involving Allied Irish Banks plc (AIB) in the City of Baltimore Circuit Court, Maryland, illustrates what may be the consequences when it does.¹²⁸ For present purposes, it is not necessary to repeat the complex sets of events; it is only relevant to note that in February 2002 it was discovered that substantial losses were incurred during the period 1997 through 2002 by the unauthorized currency trading activities of an employee of AllFirst Bank (a subsidiary of AIB). Media attention prompted an investigation which was authorized by AIB management, designed to establish the sequence of events and to consider questions regarding management infrastructure, governance and oversight mechanisms in the group. The investigation eventually led to a report which was published at the time on the AIB website¹²⁹ as an attempt to ameliorate shareholders’ fears regarding transparency. However, some US holders of ADRs (American Depository Receipts) were not satisfied either with the actions of the management of AllFirst, nor were they satisfied with the actions of the Board of AIB in relation to the fraudulent activities of individual traders at AllFirst. Accordingly, a company known as Tomran Inc (a holder of ADRs in AIB) filed a derivative action on behalf of AIB against the current and former directors of AllFirst Bank and against AllFirst Bank to recover losses caused to the company arising from this trading. The first hurdle (that of locus standi) turned out to be the last, as the standing of the beneficial owner was fatal to its claim. The derivative action was dismissed.¹³⁰ However, the response of the Board of AIB following the litigation included rigorous structural changes and prompted the departure of key personnel. It also induced behavioural changes. The point ought by now to be clear. The derivative action added to deterrence. The critical point here is that it accomplished intrinsic benefits which corrected an abuse which would have been prejudicial to the rights and

¹²⁷ Both internally in the particular company and for the benefit of all shareholders in the market, in part because shareholders hold diversified portfolios and will benefit from the decision’s impact on other companies. See Ch 2 above under 2.3.3.1.
¹²⁸ See further I Lynch Fannon, above n 7.
¹²⁹ Available at <www.aib.ie>.
¹³⁰ The substantial difficulties encountered in the case are discussed in I Lynch Fannon, above n 7.
interests of the company or would have affected the enjoyment of protection of an essential right to the shareholder’s interest.131

5.4.2.4 Infrequency of proceedings

There is an important point to be made now. The UK does not have nor, despite proposed reforms to the derivative action,132 is it likely in future to have a large number of derivative actions.133 In Canada, where the statutory derivative action has been operative for many years, there has not been an abundance of cases in the area, although there have been some important cases. Canadian writers have therefore opined that the statutory derivative action has failed to make a dramatic practical impact.134 Focusing on the infrequency of proceedings may, nonetheless, portray an overall misleading picture. It is not necessarily a flaw that there may in practice be few cases brought under the derivative action jurisdiction.135 In fact, this is in line with the very nature of the derivative action, as is explained next.

First and foremost, a derivative action is an action that should only be brought in exceptional circumstances. The principle underlying the limitations on the derivative action, that generally the company is the proper claimant and that only in exceptional circumstances cases should shareholders be able to sue on its behalf, is a sound one.136 No one would welcome a change in the law which opened the floodgates to corporate litigation. The real problem with the law as it stands at present is that, although in theory it contains a derivative action, the rules relating to it have become so uncertain and obscure that no one can predict with much confidence when such an action will be allowed to proceed, if at all.137 This means that the success of any replacement 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 were made more comprehensible and accessible so that, in exceptional circumstances, the commencement of a derivative action was regarded as a remedy worth pursuing instead of being ruled out at an early stage of a dispute as being

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131 See also Bosch v Meeker Cooperative Light & Power Association 257 Minn 362, 101 NW 2d 423 (1960).
132 As the White Paper acknowledged it is possible but unlikely that putting derivative actions on a statutory footing will affect the low number of cases brought: White Paper Company Law Reform (Cm 6456) (DTI March 2005) Annex A, 277. See also, discussion in Ch 4 above under 4.4 and recent evidence brought therein from Australia.
135 S Deakin E Ferran and R Nolan, above n 73, 164; PKM Choo, above n 58, 81.
136 See Ch 3 above under 3.2.1.
137 S Deakin E Ferran and R Nolan, above n 73, 164.
far too difficult even to contemplate. This last point is indeed confirmed by the view of one practitioner.

Secondly, given the deterrent objective of the action, a positive interpretation could be that the evidence in Canada indicates that the action is indeed working! A low number of actions litigated is not necessarily an indication that the derivative action is failing to make an impact. In fact, if the courts had been swamped with derivative applications, the fear expressed by the UK Law Commission and others that the availability of the action would enhance the scope for involving companies in futile and disruptive litigation would certainly have been vindicated. There will always be frauds and corporate malpractice. The law has not eliminated these, nor will derivative actions or any other mechanism of corporate governance. It is nevertheless likely that the derivative action, if perceived as a potent threat and if freed of its procedural handcuffs, may have an effect on those involved in corporate governance and, over the long run, may change their values and the ways in which they go about their tasks. There will be cases where such proceedings prove justified as a technique of redressing serious corporate abuse ‘on the ground of necessity alone in order to prevent a wrong going without redress’.

Finally, that the infrequency of proceedings is probably not an accurate pointer to the effectiveness of the derivative action can also be seen from the experience with wrongful trading actions. The available evidence indicates a relatively low number of wrongful trading petitions, especially compared with disqualification proceedings. There are different views about the extent to which s 214 has been a success. At the same time, although there has not been an abundance of cases in the area, there have been some important ones. More importantly, it has been

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138 ibid 165.
139 Kosmin suggests that the average practitioner often gives up in despair and turns to alternative routes, not always successful ones, and that the Law Commission’s description of the law in this area as being virtually inaccessible save to lawyers specializing in the field is being too generous. L Kosmin, above n 73, 212–213.
140 For a firm advocate of this view, see, for example, C Hale ‘What’s Right with the Rule in Foss v Harbottle?’ [1997] 2 CFILR 219, 226.
141 See also PKM Choo, above n 58, 81.
142 Smith v Croft (No 2) [1988] Ch 114, 185 per Knox J.
143 Under Insolvency Act 1986, 214. See also the stimulating discussion on what is generally the socially optimal level of litigation given its expense and how it compares to the privately determined level of litigation in S Shavell ‘The Level of Litigation: Private Versus Social Optimality’ John M Olin Center for Law, Economics, and Business Harvard Law School (Discussion Paper No 184 June 1996).
145 See, for example, B Pettet Company Law (2nd edn Longman 2005) 36–7; F Oditah ‘Wrongful Trading’ [1990] LMCLQ 205; R Mokal, above n 144.
suggested that the infrequency of proceedings is probably not an accurate pointer to the effectiveness of the provisions.\textsuperscript{147} In many situations the wrongful trading provisions are operating on the minds of directors who will have been warned about the dangers they face once the company becomes insolvent.\textsuperscript{148} It can be seen then that the legislation presents an important theoretical limitation on the otherwise prevalent doctrine of limited liability. And there is no reason to assume that the same incentives could not present themselves with respect to derivative action litigation. In fact, almost 20 years ago, Sullivan argued that Vinelott J’s judgment in the first instance in \textit{Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)},\textsuperscript{149} if rightly understood at the time, could have increased the potential efficacy of the derivative action in relation to particular instances of misconduct and as a general deterrent.\textsuperscript{150}

5.4.2.5 \textit{A note on insurance and indemnity}

At least two final points must be explained here. Note first that although the FFM recognizes that the real benefit of the derivative action is more likely to lie in the deterrence rationale rather than the financial recovery it yields, it by no means seeks to maximize deterrence. Only a system that restricted insurance or invoked punitive damages\textsuperscript{151} for knowing breaches of duty could conceivably deter in terms of the traditional logic of deterrence.\textsuperscript{152} We stop short of such an attempt here. Still, some deterrence is better than no deterrence at all, particularly in a world where other market, social, and cultural forces also play a restraining role.\textsuperscript{153} Secondly, the deterrent threat of the derivative action may arguably be undercut to some extent in cases where the company has, at an earlier stage, bought the director insurance against liability for breach of duty. In 1989 s 310 of CA 1985 was amended so as to permit such insurance to be purchased at the company’s expense and for the benefit of the director.\textsuperscript{154} However, although such insurance has the unattractive feature of shareholders paying to protect their

\begin{itemize}
\item[]{147} B Pettet, above n 145, 36–7.
\item[]{148} ibid.
\item[]{149} [1981] Ch 229.
\item[]{150} In particular, Sullivan argued that it is open for future courts to build on this analysis as a valuable means towards increasing the accountability of corporate controllers: GR Sullivan ‘Restating the Scope of the Derivative Action’ [1985] CLJ 236, 239.
\item[]{151} Such as the US where they are common. Until recently, punitive damages were rarely if ever used in the UK, although there is now some evidence of a potential drift towards ‘punitive’ approaches to regulation in the UK where greater emphasis is placed on criminal sanctions. See R Baldwin ‘The New Punitive Regulation’ (2004) 67 MLR 351.
\item[]{152} See Ch 2 above under 2.3.3.3.
\item[]{153} As highlighted in the discussion in Ch 1. See also JC Coffee, above n 81, 1440.
\item[]{154} CA 1985, s 310(3)(a) was restated in CA 2006, s 233 (see below). In the absence of such insurance it is obviously extremely difficult to attract good directors to a public company and, indeed, such purchases are now commonplace. See BM Hannigan \textit{Company Law} (Butterworths 2003) 198 and the references cited therein. On the recommendations of the CLR on this issues (broadly the retention of these provisions) see CLR Final Report para 6.3; CLR \textit{Developing the Framework} para 3.74.
\end{itemize}
representatives against the consequences of wrongs done by those representatives to the company, it is important to remember that such insurance is not available in respect of wrongdoing intentionally aimed at the company and such insurance is, in fact, unlawful as contrary to public policy. Similarly, as well as or instead of buying insurance against liability for breach of duty, the CA 2006 permits the company, on a particular occasion, to indemnify the director against the costs of defending an action for breach of duty, but only if the director is found not liable. A consultative document from the DTI, published in December 2003, raised the possibility of relaxing the law so as to put directors and auditors into a more favourable position. However, eventually the Government relaxed the law on indemnification of directors only to the extent of permitting companies to indemnify directors in respect of most liabilities to third parties and to pay directors’ legal costs upfront, provided that the director repays if he is convicted in any criminal proceedings or judgment is given against him in any civil proceedings brought by the company or an associated company.

The sale of liability insurance raises a basic problem. The risk against which liability coverage protects its holders is having to pay legally mandated sanctions. And because the purpose of legal sanctions is, in significant part, to discourage and to punish unwanted behaviour, the fundamental issue arises whether liability insurance might undermine the effect of the law and thus be socially undesirable. See further S Shavell ‘On the Social Function and the Regulation of Liability Insurance’ (March 2000) Geneva Papers on Risk and Insurance Theory, available at <http://ssrn.com/abstract=224945>.

PL Davies, above n 90, 195–6. From a director’s point of view, it is also worth bearing in mind that insurance cover does not reduce the negative reputational implications of a liability claim. Although in the past liability claims brought by or on behalf of companies against their directors were rare, Hirt reports that there were about 25 reported cases concerning such liability claims in the main law reports between January 2002 and August 2003. These included at least two derivative actions, namely Bracken Partners Ltd v Gutteridge [2003] EWHC 1064 and Konamaneni v Rolls Royce Industrial Power (India) Ltd [2002] 1 WLR 1269. See HC Hirt ‘The Company’s Decision to Litigate against its Directors’ [2005] JBL 159.

CA 2006, s 232 restates CA 1985, s 309A, as inserted by the Companies (Audit, Investigations and Community Enterprise) Act 2004. It prohibits a company from exempting a director from, or indemnifying him against, any liability in connection with any negligence, default, breach of duty, or breach of trust by him in relation to the company. The prohibition on such exemptions dates back to the recommendations of the Greene Committee on Company Law (Cmd 2657, paras 46–47), which, in this respect, were implemented by s 152 of CA 1929, that later became CA 1985, s 310. Section 232(1) and (3) provide that any provision, whether in the company’s articles of association, in a contract or otherwise, attempting to exempt or indemnify a director in breach of this section is void. However, this is subject to three exceptions. Section 233 of CA 2006 permits the purchase of insurance, s 234 creates an exception for qualifying third party indemnity provisions, and thirdly, s 235 creates an exception for qualifying pension scheme indemnity provisions. Finally, s 232(4) makes it clear that nothing in this section prevents a company’s articles from making such provision as has previously been lawful for dealing with conflicts of interest.


More specifically, CA 2006, s 233 restates CA 1985, s 309A(5), as inserted by the Companies (Audit, Investigations and Community Enterprise) Act 2004. It permits a company to purchase and maintain insurance for its directors (so-called D & O liability insurance), or the directors of an associated company (defined in s 256 as, in effect, a company in the same group), against any liability attaching to them in connection with any negligence, default, breach of duty, or breach of trust.
5.4.3 Enhancing the social meaning of the derivative action

In Chapter 2 it was observed that the derivative action as currently structured and conducted does not achieve its full utility in controlling management behaviour. More specifically, ambiguity and tying the action to a failed objective currently weaken the social influence of the action in English law, whereas the procedural requirements that fostered court screening of the action’s merits as well as the control of settlements are two important features which enhance the social meaning of the action. This section briefly considers strategies that can be pursued to reverse the negative effects of those forces that weaken the social meaning of derivative actions, so that the action is more likely to be viewed as an instrument that affirms desirable norms in the corporate setting.

5.4.3.1 Reorienting the judiciary’s focus—confirming the public nature of derivative actions

Thus far we have seen that because the interests of the shareholders and the company may diverge, actions often seem to be concluded in a way which does not command public respect for the case brought or the process. The expressive value of the derivative action is thus diminished. The most apparent error English courts make in this respect is elevating the private effects of the case over deterrence in defining the mission of the derivative action. A useful step for more closely harnessing the derivative action to the corporate interest it represents is to invite early consideration by the court of the public character of derivative actions. Put simply, courts should reverse their orientation so that their examination of the derivative action emphasizes the public character of the norms raised by the derivative action. Useful guidance in implementing the purpose of this new emphasis will be provided in Part B of this chapter below. Before that it is perhaps useful to illustrate why the judiciary is capable of such a change. The most obvious thing to point out is that although judicial pronouncements and case law doctrines illustrate that judges are cautious about intervening in company affairs, this does not mean that a court will always stand aside. There are situations in which it

by them in relation to the company of which they are a director. In practice, policies of insurance contain a range of exclusions which, therefore, leave directors exposed to a range of liabilities. In any case, liabilities resulting from fraudulent and illegal conduct cannot be covered. It is also noteworthy that the wording of the section suggests that it does not permit a company to meet the cost of any excess which the policy may provide for. This will need to be paid personally by the director. See also the White Paper Company Law Reform (Cm 6456) (DTI March 2005) 3.3.

160 See Ch 2 above under 2.4.2.1 and 2.4.2.2.
161 See Ch 2 above under 2.4.3 and 2.4.4.
162 See, for example, the Court of Appeal’s refusal to endorse the public spirit of the claimants in bringing the action in Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] 1 Ch 204.
163 BR Cheffins, above n 95, 316.
is necessary to require judicial intervention in enforcing shareholder rights.\textsuperscript{164} One circumstance where the judiciary takes a different approach is where the conduct involved is fraudulent, dishonest, or otherwise tainted by self-interest.\textsuperscript{165} With cases involving such behaviour, the courts are less hesitant to intervene. This approach is consistent with the nature of the expertise that judges bring to company law cases. While judges may not have a background which leaves them well positioned to scrutinize conventional corporate policy-making, they are better situated when the conduct in question is deceitful, underhanded, or self-serving.\textsuperscript{166} Secondly, the judiciary is more likely to drop its cautious approach to company law matters when Parliament has legislated in relation to an area and has indicated that the court should be willing to step into the breach.\textsuperscript{167} Section 214 of Insolvency Act 1986 has prompted the judiciary to evaluate directors’ conduct more closely than has traditionally been required.\textsuperscript{168} Another legislative innovation which has caused the judiciary to take a more interventionist approach in evaluating the level of care, skill, and diligence used by directors is Parliament’s expansion of the power of the courts to disqualify individuals from serving as a director.\textsuperscript{169} Focusing on derivative actions alone, then, gives an inaccurate picture of judicial activism in the corporate field in the UK. The large number of unfair prejudice and disqualification cases provides plenty of examples of judges fashioning and developing the law to fit contemporary conditions.\textsuperscript{170}

Indeed, perhaps the boldest change has been with petitions under the unfair prejudice remedy, where the courts have on the whole shown greater willingness to step in to resolve internal company disputes. This approach has been generous and purposive, and in keeping with a current move to greater scrutiny of internal management.\textsuperscript{171} These are particularly important developments because, as will be seen in Chapter 8, there is no doubt that breaches of duty susceptible to the derivative action are now capable of constituting unfairly prejudicial conduct.\textsuperscript{172} So, the success of the unfair prejudice remedy has been as much due to a transformation in judicial attitudes as to its revised wording. There was perhaps something of an

\begin{footnotesize}
\textsuperscript{164} See, for example, C Baxter ‘The Role of the Judge in Enforcing Shareholder Rights’ [1983] CLJ 96, 110.

\textsuperscript{165} Essentially, the primary alleged claims in derivative actions. See Ch 2 above under 2.4.2.1.

\textsuperscript{166} BR Cheffins, above n 95, 316–17.

\textsuperscript{167} ibid 318.

\textsuperscript{168} ibid 319.


\textsuperscript{170} E Ferran, above n 122. See Ch 8 below.

\textsuperscript{171} See also B Hannigan ‘A Code of Conduct for the Quasi-Partnership’ (1988) 1 LMCLQ 60.

\textsuperscript{172} See Ch 8 below under 8.3.2.
\end{footnotesize}
awareness on the part of the judges that they were on trial, and that it was important not to be seen to kill off the remedy with the same zeal and thoroughness as had characterized their predecessors’ approach. In this respect, it is perhaps unfortunate that although the Law Commission’s recommendations, subsequently implemented by the Government with some amendments, hold out the possibility of greater levels of enforcement of directors’ duties, they both evidently approve of the policies which underlie the common law restrictive standing rules for individual shareholders. And if the court simply transfers 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 limited.

5.4.3.2 Providing adequate incentives to shareholders

There is great value in providing ‘positive and ‘negative’ incentives—‘sticks and carrots’—for shareholders to take action on behalf of the company. The ‘stick’ currently exists in the form of the wide discretion provided to the court and the need to satisfy substantial procedural requirements prior to granting leave to bring an action. 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. Indeed, it has long been recognized that monitoring will only be effective if there are sufficient financial rewards to compensate for monitoring costs. So a way must be found to provide ‘carrots’ that would ensure that shareholders would have some hope of receiving a personal benefit if the action is successful, but more on this later.

B. Procedural and Substantive Aspects

5.4.4 Introduction

We are finally in a position to address the central issue of this chapter. The key characteristics discussed so far can be reduced to a number of practical recommendations to be included in the FFM. It should be clarified that although the FFM does not seek to make a comprehensive identification of all the matters governing derivative action litigation, it identifies key areas for review which are

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173 See, for example, LS Sealy ‘Shareholders’ Remedies in the Common Law World’ [1997] 2 CFILR 172, 176, 177.
174 See Ch 4 above under 4.3.
175 Especially breaches of the director’s duty of care which are excluded under common law from the scope of the derivative action. See Ch 4 above under 4.3.3.2 and below under 5.4.4.1.
176 Report para 6.13; CA 2006, Pt 11 discussed in Ch 4 above under 4.3.
177 PL Davies, above n 90, 250–1.
178 See CA 2006, Pt 11 discussed in Ch 4 above under 4.3.
germane for preserving the derivative action as a mechanism of accountability and address its major flaws. Combined together, the areas discussed below, namely (1) the nature of cases arising under the derivative action (section 5.4.4.1); (2) who may be qualified to bring a derivative action (5.4.4.2); and (3) formulating an expeditious screening mechanism (5.4.4.3), set guidelines for designing effective regulatory measures where derivative actions are used to enforce the law.

5.4.4.1 Nature of cases arising under the derivative action

A useful starting point is to ensure that the measures governing the derivative action should not restrict the use of the remedy to any particular type of company (ie will be available in respect of both public and private companies) and should not place any explicit limits on the type of conduct which can be the subject matter of litigation.¹⁸⁰

(a) Type of conduct

In theory, the types of causes of action which should be the subject of the derivative action should be as wide as possible so as to persuade shareholders, in appropriate circumstances, to utilize this remedy. A derivative claim is expressly confined under CA 2006, 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,¹⁸¹ provided the shareholders in general meeting had not actually ratified a ratifiable breach or had decided not sue in respect of it.¹⁸² But given the discussion above in relation to the problems associated with objectivity and the practicality of the general meeting to take such decisions,¹⁸³ coupled with the fact that the law is in considerable disarray as to what breaches may be ratifiable by shareholders,¹⁸⁴ there is no reason why ratification should be allowed to remain a deciding factor.¹⁸⁵ Instead, it is proposed, that shareholders should be able to apply for leave of the court irrespective of whether a breach is ratifiable or whether ratification has taken place.¹⁸⁶

¹⁸⁰ cf the Canadian statutory action, which was cited as a model for the Law Commission’s proposed framework (Consultation Paper 165). See generally BR Cheffins ‘Reforming the Derivative Action: The Canadian Experience and British Prospects’ [1997] 2 CFILR 227, 241–3.
¹⁸¹ See Ch 4 above under 4.3.3.2.
¹⁸² See CA 2006 s 263, discussed in Ch 4 above under 4.3.4.3 and 4.3.5.
¹⁸³ See Ch 3 above under 3.2.2.
¹⁸⁴ See discussion in Ch 3 above under 3.3.6.2.
handful of cases where a judge needs to take into account shareholder approval of impugned conduct in determining whether to grant leave.\textsuperscript{187} It must be of some significance then that the rigid approach taken to actual ratification has not been adopted in most Commonwealth and other legislation.\textsuperscript{188}

Turning to the type of causes of action which should be the subject of the derivative action, we noted that it is clear 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, especially breaches of the director’s duty of care,\textsuperscript{189} which are excluded currently from the scope of the common law derivative action.\textsuperscript{190} So, why this sudden change of heart? The Law Commission explained that there is no reason why directors should shelter behind the procedural rule of \textit{Foss}. It also observed that well-organized and competent companies run by directors who know and follow their respective duties have nothing to fear from this advance. And as for the common argument of increased litigation, this is dismissed as ‘overstated’.\textsuperscript{191}

But there is a much more fundamental question here: why has the law treated claims raising the duty of care until recently so dissimilarly from claims raising the ‘duty of loyalty'?\textsuperscript{192} The standard academic answer has been that judicial competence is lesser in the former case, and thus the prospect of judicial error is greater in cases where a conflict of interest is absent.\textsuperscript{193} Clearly, when a business decision proves erroneous, multiple explanations for that failure are possible. It could be that the decision-maker was negligent but, conversely, the truth may be that a risk that was accepted knowingly and prudently simply came to an unfortunate fruition.\textsuperscript{194} Or, it could be that a new and unforeseeable risk arose and matured after the time the business decision was irrevocably made. Because business decision-making involves unavoidable trade-offs between risk and return, some prudent decisions will prove disastrous. Examining these decisions with the 20/20 vision of judicial hindsight, courts may be unable to distinguish accurately

\textsuperscript{187} In which case the weight to be attached to ratification seemingly can range from none to a lot depending on the level of involvement of the defendants and whether they control the company. BR Cheffins, above n 180, 254–5 and the cases cited therein.
\textsuperscript{189} See Ch 4 above under 4.3.3.2.
\textsuperscript{190} cf Daniels v Daniels [1978] Ch 406, 414 with Pavlides v Jensen [1956] Ch 565. See now CA 2006, s 260(3) discussed above under 4.3.3.2.
\textsuperscript{191} Report paras 6.38–6.41.
\textsuperscript{192} The words ‘duty of loyalty’ in this context describe all the fiduciary duties to control management conflicts and limit the risk of managerial diversion of assets or information as used in R Kraakman PL Davies et al \textit{The Anatomy of Corporate Law: A Comparative and Functional Approach} (OUP 2004) 114.
lack of care from statistical bad luck. If this risk of judicial error is considerable, then to the extent the derivative action is relied upon to enforce the duty of care it may deter legitimate risk-taking by management and service on the board, rather than negligence.\textsuperscript{195}

In contrast, conflict situations involving self-serving behaviour are more likely to be culpable and at the expense of corporate interest. The possibility of non-culpable error is therefore much smaller. When a fiduciary fails to disclose a conflict of interest to disinterested directors, the chances are much greater that the fiduciary did so opportunistically, not innocently.\textsuperscript{196} Self-dealing is seldom unavoidable in the same manner as business risk. With the exception of remuneration decisions there usually is another party with whom the company could have transacted on similar terms. Conflicts of interest are something that courts have a long history of policing,\textsuperscript{197} and unlike the duty of care, they do not require courts to evaluate risk and return trade-offs with which they are uncomfortable\textsuperscript{198} and inexperienced.\textsuperscript{199} In fact, legal scholars substantially agree on the idea that judicial review of loyalty cases does not seem to entail costs outweighed by its benefits, because the task before the court is one for which it is well suited, so the costs of inquiry and error are sufficiently low.\textsuperscript{200} Further, in the case of duty of loyalty violations, the likelihood of detection is lower, and the magnitude of the expected gain is higher. Not only can self-dealing be concealed, but it tends to become self-perpetuating. Once a manager has engaged in one unfair self-dealing transaction, there is less social or moral inhibition to dissuade that manager from engaging in similar transactions. In addition, other managers may detect the self-dealing behaviour and emulate it. In short, unlike simple incompetence, self-dealing can be contagious and can corrupt the organizational culture. Given this greater likelihood that undetected self-dealing will lead to recidivism, the deterrent gains from a derivative action contesting breach of the duty of loyalty seem greater.\textsuperscript{201}

Whatever the case may be, if the experience in Canada and the US is anything to go by, the actions which claimants have sought to bring have typically been based on allegations of self-serving conduct carried out by the company’s

\textsuperscript{195} See Ch 2 above under 2.2.

\textsuperscript{196} For an illuminating account of the fiduciary obligation, see P Birks ‘The Content of Fiduciary Obligation’ (2000) 34 Israel Law Review 3.

\textsuperscript{197} See, for example, Aberden Rly Co v Blaikie Bros (1854) 1 Macq 461; Movitex Ltd v Bulpfield [1988] BCLC 104.

\textsuperscript{198} Pavlides v Jensen [1956] Ch 565, 576 per Danckwerts J.

\textsuperscript{199} JC Coffee, above n 194, 1427.


\textsuperscript{201} JC Coffee, above n 194, 1427–8.
A recent empirical study of shareholder litigation in Delaware confirmed these results. As Table 5–1 illustrates, more than 58% of the derivative action cases (128 out of 218) allege management self-dealing, that is, improper benefits to managers.

The researchers concluded that there is little indication that derivative actions are playing much role in policing duty of care issues relating to the ongoing management of companies, but instead show a dominant focus in Delaware in policing conflicts of interests. In this regard, derivative actions play a role in reducing management agency costs. This evidence, of course, is hardly applicable to the UK. However, at least it is not inconsistent with the theory presented above. But more importantly, the same pattern is evident in Canada, which has more in common with the UK from a structural viewpoint.

<table>
<thead>
<tr>
<th>Allegations in complaint</th>
<th>Public entity defendant</th>
<th>Private entity defendant</th>
<th>Total number of cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self-dealing and benefits to managers</td>
<td>97</td>
<td>31</td>
<td>128</td>
</tr>
<tr>
<td>Duty of care&lt;sup&gt;a&lt;/sup&gt;</td>
<td>31</td>
<td>1</td>
<td>32</td>
</tr>
<tr>
<td>Oppression to minority</td>
<td>2</td>
<td>19</td>
<td>21</td>
</tr>
<tr>
<td>Charter amendment</td>
<td>7</td>
<td>0</td>
<td>7</td>
</tr>
<tr>
<td>Misleading statement</td>
<td>5</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Other allegations</td>
<td>15</td>
<td>10</td>
<td>25</td>
</tr>
<tr>
<td>Total non-acquisition cases</td>
<td>157</td>
<td>61</td>
<td>218</td>
</tr>
</tbody>
</table>

Source: RB Thompson and RS Thomas ‘Shareholder Litigation: Reexamining the Balance between Litigation Agency Costs and Management Agency Costs’ Vanderbilt University Working Paper Number 02–10 (2002), available at <http://ssrn.com/abstract_id=336162>. This was the largest empirical study of shareholder litigation in the US and consisted of more than 1,000 corporate duty cases filed in the Delaware Chancery Court in 1999 and 2000. Arguably, Delaware is the best forum to study shareholder litigation because it has the most active of any state courts in the US with arguably the strongest corporate law judges.

<sup>a</sup>In these derivative actions, the claimants are claiming that managers have not kept adequate financial records, or have failed to supervise properly the operation of the company.

<sup>202</sup>For Canada see BR Cheffins, above n 180, 241–3 and the evidence therein; for the US, see JA MacKerron ‘Shareholder Derivative Litigation and the Nexus of Contracts Corporation (1992) 40 Kansas Law Review 679, 685.

<sup>203</sup>Interestingly, Table 5–1 also reveals that the third largest category (about 10% of the cases) include claims of self-dealing, almost all involving closely held companies (19 out of 21 cases). This seems to confirm the premise that derivative actions retain an important role in policing management in closely held corporations. See below under (c). For an interesting recent comparative legal analysis on English and American laws on the issue of judicial discretion in minority protection litigation involving a private company or closely held corporation, see J Abugu ‘A Comparative Analysis of the Extent of Judicial Discretion in Minority Protection Litigation: The UK and the US’ (2007) 18 ICCLR 181.

<sup>204</sup>The evidence in Canada also indicates that even when the derivative action procedure were extended to include breaches of directors’ duties of care and skill, there would not be an abundance of cases in the area. BR Cheffins, above n 180, 243.
(b) Multiple derivative actions

The modern tendency is for companies to have subsidiaries and associated undertakings. This tendency gives rise to the issue of whether a shareholder in a parent company may bring a derivative action on behalf of a subsidiary or associated company within the group. Logically 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.\(^{205}\) It is therefore easier to refer to all these actions as ‘multiple’ derivative actions. Such an action may be appropriate where a shareholder in one company (A) can show that the directors of company A and of a subsidiary (B) or related company (C) (which may not be a direct subsidiary or a direct investment of company A), have wrongly prevented the enforcement of a cause of action vested in subsidiary B or related company C.\(^{206}\)

The idea of a multiple derivative action has been first recognized and developed in the US since at least the latter part of the nineteenth century, particularly where the plaintiff is a shareholder in a group structure based on wholly owned subsidiaries.\(^{207}\) The Law Commission noted that double derivative actions are available in Canada under the Canada Business Corporations Act 1985\(^{208}\) and multiple derivative actions are available in New Zealand.\(^{209}\) However, it rejects the idea on the grounds that it was not persuaded that it would be helpful or practical to include such a provision and that situations calling for its use are likely to be extremely rare.\(^{210}\) The CA 2006 is regrettably therefore silent on this issue.

However, like others,\(^{211}\) the writer takes a different view here and believes that 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.\(^{212}\) In the US, it has been rationalized in the following terms:\(^{213}\)

\(^{205}\) For the reverse situation, where a shareholder complains about the conduct of a parent company, see the cases set out in Consultation Paper paras 9.9–9.13.

\(^{206}\) Consultation Paper para 16.51.

\(^{207}\) See, for example, *Goldstein v Groesbeck* 142 F 2d 422 (2d Cir 1944); *Kaufman v Wolfson* 1 AD 2d 555, 151 NYS 2d 530 (1st Dept 1956).

\(^{208}\) Consultation Paper Appendix F para 2.6.

\(^{209}\) Consultation Paper Appendix F para 4.3.

\(^{210}\) Report para 6.110.

\(^{211}\) Including the CLR *Developing the Framework* para 4.133; AJ Boyle, above n 185, 85–6.

\(^{212}\) As was illustrated recently in relation to the unfair prejudice petitions in *Gross v Rackind* [2004] EWCA Civ 815 (Israel), where a shareholder in a parent company was allowed to bring a derivative action on behalf of a subsidiary, although he held *no shares* in the subsidiary, on the grounds that denying the right to bring such an action would diminish the effectiveness of the derivative action as a supervisory tool of the organs of the company. This is an interesting development as the Israeli Companies Act 1999 is *silent* with respect to multiple derivative actions.

\(^{213}\) *Brown v Tenney* 532 NE 2d 230, 233 (Ill 1988). cf Civil Case 1931/00 (22 August 2002) (Israel), where a shareholder in a parent company was allowed to bring a derivative action on behalf of a subsidiary, although he held *no shares* in the subsidiary, on the grounds that denying the right to bring such an action would diminish the effectiveness of the derivative action as a supervisory tool of the organs of the company. This is an interesting development as the Israeli Companies Act 1999 is *silent* with respect to multiple derivative actions.
Without triple or double derivative suits a shareholder of record in the holding company would... be without remedy, even where, as here, the holding company is the wrong-doer. The additional layer in the corporate structure would prevent the righting of many wrongs and would insulate the wrongdoer from judicial intervention. *The law, however, cannot be deceived by specious and illusory devices, disguises, or circuitry of action.* (author’s emphasis)

This, indeed, seems to sit well with the derivative action’s usual *raison d’être.*

Further, allowing multiple derivative actions is justified in the case of a corporate group where a blind eye has been shown by the board towards abuse by directors and managers at a lower level in the group hierarchy. Similarly, not allowing multiple actions will severely limit the use of the remedy even where serious fraud and abuse have occurred, which in many cases will not involve the board of the parent company. It would seem then that the observations made by the trial judge in *Gross v Rackind* with respect to the use of the unfair prejudice remedy in similar circumstances appear to be equally applicable to derivative actions.

(c) Types of companies

It has already been indicated several times in the text that the derivative action should be available to all types of companies. The Law Commission did not recommend that any special adjustments should be made to take into account the distinctions between closely held companies and publicly quoted companies and Pt 11 of CA 2006 contains no such distinction. For the reasons set out above, it is submitted that this is, indeed, the right approach. The same position exists in Canada. The pattern emerging there is that most of the decisions have involved closely held companies. The same pattern is evident in New Zealand and Israel. By contrast, in the US, public companies are involved more frequently

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214 Smith *v* Croft (No 2) [1988] Ch 114, 185.
215 AJ Boyle, above n 185, 86.
216 As Boyle notes, breach of duty of care and skill may be very difficult to establish against members of the parent company’s board who fail to detect more serious breaches of duty at lower levels of this group hierarchy: ibid. This problem is magnified in a large multinational group structure, on which see I Lynch Fannon ‘A Transatlantic Case: The Derivative Action as a Corporate Governance Tool’ (2005) 27 Dublin University Law Journal 1.
217 [2003] EWHC 3298 (Ch); [2004] EWCA Civ 815.
218 Judge Weeks observed that ‘[i]t would seem to me strange if a commercial re-organisation had deprived the shareholders of the protection of section 459’; [2003] EWHC 3298, [9]. An interesting question is whether the application of the derivative action in those circumstances needs to be limited to quasi-partnerships. Beyond a quasi-partnership group of companies, it would be difficult to ignore the *Salomon* principle to find the affairs of one company in a group being the affairs of another. See Adams *v* Cape Industries plc [1990] Ch 433 and discussion in R Goddard and H Hirt ‘Section 459 and Corporate Groups’ [2005] JBL 247.
219 BR Cheffins, above n 180, 241–3 and the evidence therein.
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in derivative action litigation than are smaller ones, the most likely explanation for the different pattern is the existence of institutional distinctions which affect the incentives of those who will potentially bring derivative actions. In the UK, the pattern emerging is similar to that in Canada, New Zealand and Israel. Derivative actions against public companies in the UK are, indeed, rare. This is hardly surprising. Closely held companies in the UK which, although relatively less significant in economic terms, make up the vast majority of companies, and thus also the majority of companies involved in litigation arising from intra-corporate disputes.

5.4.4.2 Who may be qualified to bring a derivative action?

At common law, only an individual who is a member of a company can obtain standing to commence a derivative action. Usually, a former shareholder, a creditor, and an employee cannot litigate such proceedings. No changes have been made when the Law Commission’s proposals were implemented.

This is not the case elsewhere. Under the Israeli Companies Act 1999 any shareholder or director is entitled to bring a derivative action. In addition, a creditor of the company is also allowed to bring a derivative action on behalf of the company, if a forbidden distribution by the company has been made. In Singapore, a ‘complainant’ includes ‘any other person who, in the discretion of the Court, is a proper person to make an application’. This is similar to the position in Canada although the Canadian definition is slightly broader.

²²¹ R Thompson and R Thomas, above Table 5.1, Source; BR Cheffins, above n 180, 242 and 258–9.
²²² For an ‘entrepreneur’ US lawyer seeking to maximize his expected return, publicly quoted companies, for distinctive reasons which exist in the US, are more promising candidates than are closely held companies. See MP Dooley and EN Veasey (1989) ‘The Role of the Board in Derivative Litigation’ 44 Business Lawyer 503, 541–2.
²²³ Since Prudential Assurance in the early 1980s there have been very few cases involving public companies. To be sure, raw numbers of derivative actions filed are not very instructive because settlements are unreported; nonetheless, out of 80 or so cases in LexisNexis involving some derivative action type claims in the past 10 years, the writer could find very few examples, none of which includes companies the size of Prudential. In any case, since Prudential Assurance very few derivative actions were successfully initiated—for rare illustrations, see Knight v Frost [1999] 1 BCLC 364 and Clark v Cutland [2003] EWCA Civ 810 discussed in Ch 8 below under 8.3.1 and 8.4.2.
²²⁴ At the end of 2005 public companies constitute only 0.5% of the register. See DTI Companies in 2005–2006, Table A2.
²²⁵ A former member can, nevertheless, bring a derivative action in relation to wrongs done to the company before he became a member. See, for example, 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).
²²⁶ Consultation Paper paras 20.32–20.33. See CA 2006, s 260, discussed in Ch 4 above under 4.3.3.
²²⁷ Under s 194 (A) of the Companies Act 1999.
²²⁸ With respect to the problematic standing of creditors to initiate derivative action, see Ch 3 above n 150 and accompanying text.
²²⁹ Companies Act 1999 s 204.
³⁰ Companies Act (c 50), s 216A(1).
According to s 238 of the Canada Business Corporations Act 1985 ‘complainants’ include past and present shareholders as well as past and present directors or officers. In New Zealand, only current shareholders and directors are included in the pool of potential applicants. The Australian provisions confer standing on a member, a former member, and a person entitled to be registered as member of the company or of a related company, as well as an officer or former officer of the company. There is no catch-all class in the derivative actions of these jurisdictions and the respective lists of persons who can apply to bring a derivative action appear exhaustive.

A wide grant of standing would seem to accord with the deterrence objective of the derivative action as set out by the FFM. Certainly, if the directors and management know or believe that their actions can be challenged by a larger class of interested stakeholders, they will, in theory, be deterred from acting without care and/or without regard for their duties. The Law Commission, however, is unconvinced of the merits of a wide grant of power, and, indeed, there are practical problems associated with too wide a grant.

First, former shareholders and directors are more likely to be acting in their own interests rather than in the company’s interests, given that they are no longer directly associated with the company. Secondly, it may not be appropriate to allow a person to become a claimant where he is no longer entitled to receive a share in a possible future compensation. On the other hand, allowing former members to take action acknowledges the fact that these former members may have been compelled to leave the company in view of the potential dispute leading to a court battle on behalf of the company. Certainly, there is justification for not granting standing to debenture holders as arguably they did not bargain for it and this could also be providing them with the means to interfere with management. Although the other prerequisites to the bringing of the action should and are meant to take care of the obviously unmeritorious cases, there may be cases that slip through the net, notwithstanding and in spite of an improper motive. In such ‘borderline’ cases, there will probably be a need for more vigilant supervision of the conduct of the proceedings.

Whatever the case may be, the impact of widening the classes of people may not be significant. First, even in jurisdictions which allow for wider classes of people, evidence suggests that the vast majority of derivative actions are invoked by current shareholders. Secondly, in Canada, where the applications were

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231 Under s 236(1) of the Australian Corporations Act 2001.
232 PKM Choo, above n 220, 71.
233 ‘...since there is bound to be a current member who (if the wrong has not been ratified) could maintain proceedings’: Consultation Paper para 20.33.
234 See Ch 2 above under 2.3.2.2.
236 This is clearly evident in Israel and in Canada. A Reisberg, above n 220, 251; BR Cheffins, above n 180, 239 and the cases cited therein.
made by former shareholders\(^{237}\) or former directors\(^{238}\); these were denied primarily because the court felt that such applicants lacked ‘sufficient interest’ in the outcome of the derivative action. This was notwithstanding the fact that these classes of applicants have a prima facie right conferred by legislation to bring the application.\(^{239}\) Given these findings, it is proposed that under the FFM, a member and present (but not past) directors should be entitled to bring a derivative action.\(^{240}\)

5.4.4.3 Formulating an expeditious screening mechanism

We arrive now at the central facet of the FFM, namely formulating judicial screening of the action. In Chapter 3 two common checks which are relevant to the grant of leave were examined.\(^{241}\) The argument was not that the policy premise they reflect is not a sound one, but: (1) it is questionable whether as they are currently structured they provide the court with the necessary tools to determine the merits of the case in question, as they function as rhetorical devices rather than substantive standards; and (2) it is desirable to distinguish sharply between the issue whether the allegations in the statement of claim, if true, disclose the legal liability to the company and the logically separate issue of whether the claimant has standing to enforce any liability.\(^{242}\)

(a) The proposed rule: identifying those actions that appear likely to increase corporate value

The proposed rule addresses the procedural complexity of derivative actions and seeks to replace overbroad restrictions to a claimant’s standing to sue with more specifically focused checks to discourage non-meritorious litigation. Accordingly, instead of asking ‘is the plaintiff being improperly prevented from bringing these proceedings on behalf of the company?’,\(^{243}\) the central inquiry should focus on identifying and precluding those actions that appear likely to decrease corporate value.

\(^{237}\) Jacobs Farms Ltd v Jacobs (1992) OJ No 813 (Ont Gen Div).

\(^{238}\) Schafer v International Capital Corporation [1997] 5 WWR 99 (Sask QB).

\(^{239}\) In Jacobs Farms Ltd v Jacobs (1992) OJ No 813 (Ont Gen Div) Blair J opined that ‘it could not have been the intention of the Legislature . . . to clothe every former shareholder and every former director with the status of a complainant for the purposes of bringing a derivative action’. Baynton J (Schafer v International Capital Corporation [1997] 5 WWR 99, 104) explained the necessity for this ‘sufficient interest rule’ on the grounds that such a rule is required to distinguish between applicants who have a bona fide potential financial stake through the corporation in the outcome of the derivative action and applicants who seek leave for an improper purpose.

\(^{240}\) There seems no reason not to permit the board to decide in favour of litigation, if that would normally fall within its grant of management powers. See Ch 3 above under 3.2.2.

\(^{241}\) Namely, the ‘good faith’ and ‘in the interest of the company’. See Ch 3 above under 3.4.2.4 and 3.4.2.5.

\(^{242}\) See Ch 3 above under 3.4.2. Because of the complicated nature of these proceedings some scholars have suggested that it might not be necessary for the claimant to even make out a prima facie case at the preliminary stage—see R Keane Company Law in Ireland (3rd edn Butterworths 2000) 319–20. Some proper checks are nonetheless essential.

\(^{243}\) Smith v Croft (No 2) [1988] Ch 114, 185.
At first glance, the above rule might appear to be doomed by the difficulty of the task that the courts must perform in valuing the benefits of the derivative action. Derivative action litigation is already hard to value in terms of the benefits.\textsuperscript{244} Assessing its costs and benefits from an ex ante perspective would seem to be harder still. On closer inspection, however, assessing the value of derivative actions divides readily into component tasks that fall well within the scope of judicial competence.\textsuperscript{245}

As an initial matter, there are two independent grounds for allowing the action to proceed: generation of net recoveries or deterrence of misconduct.\textsuperscript{246} The court should thus conduct an inquiry based on these two alternative decision rules: judges should ask whether the litigation is likely to yield any recovery net of litigation costs, and whether the action is a plausible deterrent.

(b) How will the inquiry operate?
Consider first the rule that courts would allow the action to proceed on the basis that litigation is likely to yield recovery net of litigation costs. This exercise would entail a detailed ex ante cost-benefit analysis which requires balancing the expected value of recovery against the legal costs of continuing the action in each case.\textsuperscript{247} This inquiry would not be burdensome for the court to administer.\textsuperscript{248} An action without deterrent value only benefits the company through net recovery,\textsuperscript{249} while its costs include, for instance, both litigation expenses and increases in insurance or salary costs that are associated with directors’ liability.\textsuperscript{250}

New tools could be developed in due course to assist the court in estimating the value of actions, such as adopting a ‘cost-effectiveness’ test. Where the undertaking of a procedure or its costs are challenged, the courts should ask how the expected costs (in time and monetary worth) of undertaking a derivative action

\textsuperscript{244} Consultation Paper para 14.1.
\textsuperscript{245} See Ch 3 above under 3.3.3. Moreover, this involves precisely the same type of evaluation which is performed when determining whether to refuse permission if directors acting in accordance with the duty to promote the success of the company (s 172) would not have pursued the action (CA 2006, s 263, discussed in Ch 4 above under 4.3.4.1 and 4.3.5), albeit with a more convenient, focused, and efficient standard.
\textsuperscript{246} A derivative action increases corporate value in these two circumstances. See Ch 2 above under 2.3.
\textsuperscript{247} cf s 165(1)(b) of the New Zealand Companies Act 1993, which requires the court to take into account when considering leave ‘the costs of the proceedings in relation to the relief likely to be obtained’.
\textsuperscript{248} In Joy v North 692 F 2d 880, 892 (2d Cir 1982) Judge Winter framed a similar test in the following terms: ‘Where the court determines that the likely recoverable damages discounted by the probability of a finding of liability are less than the costs to the corporation in continuing the action, it should dismiss the case’: ibid. Much of the attraction of the Joy test lies in Judge Winter’s painstaking inventory of the ex post costs and benefits associated with the derivative action, very much in the form provided in Ch 2 above under 2.2 which could be used by the court in this exercise.
\textsuperscript{249} That is, any form of recovery, including, for example, the return of the company’s property.
compare with the value of its expected benefits (i.e., the expected recovery for the company or the general deterrence). The notion of efficiency employed here may be labelled *transaction cost efficiency*. A method is efficient then, given a particular amount of resources dedicated towards implementation, when it can put into operation the set of substantive goals to a greater degree than would be possible for any other feasible method. This would certainly be in line with current case law, the Law Commission proposals, and, of course, consistent with our underlying premise that litigation is a fail-safe remedy, a safety net for instances when other mechanisms of accountability fail.

Turning to the deterrence benefit, to allow an action to proceed on this rationale, courts need only make an up-or-down judgment about the *likelihood* of deterrence. This rationale should be employed when the court believes that the prospects of the litigation will substantially enhance the prospects of deterrence in the light of matters of *public policy*. The public policy calculus will include a

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252 Essentially, what it means is that a method of implementing a set of substantive goals is efficient in this way when the resources it consumes in the process of implementation are lower than would be consumed by adopting any other feasible method of implementation. This draws on, but is not coterminous with, the insights provided by the branch of economics which goes by the same name. See the contributions to O Williamson and S Masten *Transaction Cost Economics* (Edward Elgar 1995). Specifically concerning the definition of efficiency, P Milgrom and J Roberts *Economics, Organization & Management* (Prentice-Hall 1992) 22–30 is particularly helpful.

253 It is obvious that to attain transaction cost efficiency should be a (procedural) goal of every part of a defensible legal system. This is how efficiency is employed here, i.e., to determine whether the law attains its substantive goals in the cheapest feasible way. See further R Mokal ‘Consistency of Principle in Corporate Insolvency’ (December 2001) 39, available at <http://ssrn.com/abstract=303722>.

254 *Barrett v Duckett* [1995] 1 BCLC 243, 250 per Gibson LJ.

255 Requiring the court to consider whether a remedy is available as an alternative to the claim: Report para 6.70 and Draft Rules 50.9 and 50.10 in Appendix B. See also CA 2006, s 263 (discussed in Ch 4 above under 4.3.5), under which if the claim could be pursued as a personal claim, rather than as a derivative claim, that fact might influence the court to refuse permission.

256 cf *New Zealand Companies Act* 1993, s 165(1)(b) (‘the likelihood of proceeding succeeding’) and CA 2006, s 263(2)(a) (discussed in Ch 4 above under 4.3.4.2 and 4.3.5).

257 For example, when a judgment is forward-looking in the sense that future protection and avoidance of continuing abuse deserves judicial consideration. Thus a judgment establishing an important precedent or principle that will be of continuing value to all shareholders merits continuance. See also *Bosch v Meeker Cooperative Light & Power* 101 NW 2d 423, 427 (1960).

258 This point was usefully framed in *Zapata Corp v Maldonado* 430 A 2d 778, 789 (Del 1981) (‘The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation’s best interests’). Perhaps the best example is where a derivative action holds an entire board of experienced directors liable for breach of duty. See *Smith v Van Gorkom* 488 A 2d 858 (Del 1988). Arguably we all benefited from the ‘public good’ provided by Mr Moir’s plight in *Wallersteiner v Moir* (No 2) [1975] QB 373. There is also ample evidence from the US to support this point. *Rosenfeld v Black* 445 F 2d 1337 (2d Cir 1971) set a standard of conduct which reverberated throughout the mutual fund industry. The case held that an adviser to a mutual fund occupied a fiduciary relationship to it and could not sell that position for a profit. The profit in that situation amounted to pennies per share. But the point here is that the case set a standard of conduct for an entire industry. The same could be said of many other notable cases: *Perlman v Feldmann* 219 F 2d 173 (2d Cir 1955); *Moses v Burgin* 445 F 2d 369 (1st Cir 1971); *Fogel*
fuller consideration of the action’s prospective impact both on the company and the climate within which it operates as well as on ‘corporate UK’. The court may, for instance, weigh the probable benefits to all similar companies through proscribing the challenged conduct and consider as well whether its proscription and any concomitant deterrence will likely occur in some other proceedings. While carrying out this exercise, the court could be expected to include within their finding the policy reasons for holding that the action be allowed to proceed on a deterrence rationale and why the particular case is likely to substantially enhance the prospects of deterrence. The rationale is threefold:

1. It will facilitate the emergence of a consistent policy on when to allow the action to proceed based on this rationale;
2. The court will gradually feel more comfortable with the deterrence rationale as cases accumulate; and
3. It will encourage compliance with the law and with proper standards of behaviour. Misbehaviour will be discouraged before it occurs as lawyers will be able to advise boards of directors about their responsibilities and the potential liabilities which they can incur. The desire to avoid suits

v Chestnutt 533 F 2d 731 (2d Cir 1975), to name a few. None of those derivative actions involved large recoveries for the companies for whom they were brought. And certainly if you calculated the recoveries on a share-by-share basis, they would have been tiny. But they were of immeasurable importance to the integrity of corporate governance by setting standards for corporate actors. See further SM Grossman ‘Commentary: The Social Meaning of Shareholder Suits’ (1999) 65 Brooklyn Law Review 47.

259 Professor Cox, for example, through an elegant description of the role of the derivative action in reducing systematic risk, advances an economic analysis as a justification for a deterrence rationale. The thrust of the argument is that managerial misconduct contributes to systematic risk and therefore to the cost of each company’s capital. Reduction in managerial misconduct through the deterrence force of derivative actions can therefore have a positive effect on an overall allocation of resources. J Cox ‘Compensation, Deterrence and the Market as Boundaries for Derivative Suit Procedures’ (1983) 52 George Washington Law Review 745, 746–55.

260 Such an approach was employed in Diamond v Oreamuno 301 NYS 2d 78, 84–5 (1969), where the court believed there would be little prosecution of corporate fiduciaries for insider trading by either investors or the SEC.

261 cf Item Software (UK) Ltd v Fassihi [2004] EWCA Civ 1244, [62]–[68] per Arden LJJ who put forward in clear terms the policy reasons for holding that a director’s duty of loyalty requires him to disclose his misconduct. Arguably, there are also improvements that could be made in the settlement process. If the derivative actions are to serve a social purpose, it is important that these settlements (involving serious corporate wrongdoing) be made publicly available. The court should require that the briefs in support of the settlement discuss the legal and factual issues in the case. The disclosure of that information would not only go far in meeting the concerns about the private nature of these cases and their settlements, but would add greatly to the deterrent effect.

262 Although most decisions are fact-specific, process-oriented, and invariably judgmental narratives of the directors’ behaviour, scholars in the US found that the social force of the opinions lie not only in their results but also in the guidance lawyers pass on to their clients from the courts’ narratives of acceptable and unacceptable conduct: DD DeMott ‘Puzzles and Parables: Defining Good Faith in the MBO Context’ (1990) 25 Wake Forest Law Review 15, 29–31; EB Rock ‘Saints and Sinners: How Does Delaware Corporate Law Work?’ (1997) 44 University of California Law Review 1009, 1094–8. This point is well illustrated in relation to the UK wrongful trading provisions,
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provides a lever for influencing the conduct of senior management and the board.263

As regards the operation of the deterrence inquiry, the following points can be made. Although the decision about the likelihood of deterrence can not be made with mathematical precision, it is expected that courts will learn over time that some types of action, even if uneconomic in the sense that they fail to recover their immediate costs, ultimately result in beneficial deterrence of harmful misconduct.264 Presumably, a court in evaluating an action’s deterrence prospects will look chiefly to the penalties that it imposes on wrongdoers and the probability that shareholders could detect similar misconduct.265 For example, misconduct involving breaches of fiduciary duties by managers, or self-dealing that is widely known or can be discovered by close analysis of the public record,266 are presumptively subject to detection and therefore to deterrence, provided that the action imposes genuine penalties on the directors at fault.267 By contrast, it might be possible to determine early on that some actions (such as actions targeting misconduct that shareholders are inherently unlikely to detect or that impose no obvious costs on defending directors) would probably justify dismissal. For example, much serious misconduct by directors (such as bribery and insider dealing) is often inherently unlikely to be detected by shareholders acting alone. Derivative actions involving these forms of wrongdoing usually ‘piggyback’ on governmental or internal corporate investigation.268 In these cases, the deterrence inquiry must ask whether the additional sanction imposed by a derivative action, beyond the penalties that wrongdoers face from the original investigation, substantially enhances the prospects of deterrence. When this seems unlikely, as when derivative actions piggyback on criminal or DBERR investigations, the action can only be justified by positive net corporate recoveries (the alternative rule in the inquiry). Conversely, actions against serious misconduct may well deter future misconduct (and hence merit continuation on a deterrence ground) when

which arguably operate on the minds of directors who will have been warned about the dangers of liability they face once the company becomes insolvent. Above under 5.4.2.4.

263 The lawyer, when confronted by broad standards, will emphasize in his advice the positive affirmations of the director’s conduct, preferring the certain over the speculative course: R Calnan ‘Directors’ Duties: Companies in Financial Difficulties’ lecture delivered at the Faculty of Laws, UCL (28 January 2005).

264 And even if judges estimate the deterrence benefit of an action solely in terms of the harmfulness of managerial misconduct, as one might suspect will often be the case, introducing deterrence into the judicial calculus is a step in the right direction.

265 One may be sceptical of complaints that lacked specific allegations of misconduct, since the wrongdoing in these complaints would be presumably difficult to detect or deter a second time.

266 Such as through provisions which require detailed disclosure of direct and indirect self-dealing transactions. See, for example, CA 1985, s 317, restated with changes in CA 2006, ss 182–183, 185 and 187.


268 As well illustrated in the case involving Allied Irish Banks plc, above under 5.4.2.3.
high damages are expected or when public enforcement proceedings is likely to follow in the wake of the litigation.²⁶⁹

(c) What should be the relationship between the compensation and deterrence rationales?

Pursued dogmatically, either rationale can lead to absurd results, as illustrated below. Rather than follow either principle to the limits of its logic, the sounder course is to compromise by treating the compensation rationale as primarily a limit on the deterrence justification.²⁷⁰ Alone, a deterrence rationale can justify a company expending almost any sum to bring a wrongdoer to account, whereas a compensation rationale gives the defendant a strategic incentive to threaten to conduct a prolonged and expensive defence. For example, assume a director has misappropriated £500,000 in a complicated fraud. Ex ante, a compensation rationale could justify expenditures of up to £499,999 to recover that sum; any greater expenditures, however, would not produce a net recovery. In the latter situation, shareholders would be better off if the wrong is not rectified than if more money is wasted. This logic implies that as long as it is expensive for the company to win a litigated recovery against the director, these expenses may justify a corporate termination of the action, even though the fiduciary breach was serious. However, if we posit that the corporate expenditures in the litigation will discourage other potential wrongdoers, then it follows that such expenditures reduce the average agency cost that shareholders must incur in order to hold their management accountable, even if they do not produce a compensatory benefit. In theory then, the fully diversified shareholder may benefit even if £300,000 is expended to recover £200,000.²⁷¹

At some point, which cannot easily be identified, the deterrence rationale must be rejected. The problem with the deterrence rationale is that it is open-ended and speculative. One does not know whether expenditures of, say, £800,000 or even more would also produce a deterrence benefit in excess of the costs incurred. Nor can one begin to estimate the marginal deterrence benefit, if any, of each additional successful derivative action. To see why, suppose that directors have a 15% probability of discovering a self-dealing opportunity in each year, but that such self-dealing could be deterred by the threat of a derivative action. An optimal litigation policy would always dictate a derivative action against self-dealing directors in order to deter misconduct without cost and absolutely. However, the company which is sensitive to effects on its reputation would only allow the action to proceed if the present value of future deterrence gains exceeds the net cost of an action (including damage to reputation lasting well into the future). Because these future gains might not be realized for many years and would have to be

²⁶⁹ R Kraakman H Park et al, above n 250, 1762–3.
²⁷¹ ibid.
discounted accordingly, the company would prefer not to sue today unless the corporate losses from self-dealing were very large.\footnote{272} Finally, the greatest problem with a single-minded focus on deterrence is that not all (and probably not most) shareholders are fully diversified.\footnote{273} These shareholders lose, rather than gain, when the corporate recovery falls below the company’s expenditures in a derivative action, even if a deterrence surplus is created that benefits the other, fully diversified shareholders.\footnote{274} For all these reasons, a deterrence rationale should be constrained by a compensatory ceiling.\footnote{275} Clearly at some point a disproportion between the expected costs and the expected recovery should justify dismissal, even if the action is a legally meritorious one (also in the sense of the public good it may entail).\footnote{276} One cannot define with precision where this point lies and, because of this indeterminacy, one must rely upon judicial discretion. As a result, the FFM does not attempt any precise balancing formula between the two rationales but instead contemplates case-by-case judicial balancing.\footnote{277}

(d) An illustration of the proposed inquiry
As Table 5–2 illustrates, it is possible to predict that most cases will congregate along more or less four ‘prototype’ scenarios.

(e) An assessment of the benefits of the proposed inquiry
As a practical matter, the merits of an inquiry as proposed above seem to turn on how accurately courts or potential litigants can estimate the value of actions. There is no doubt that attempting to screen value-decreasing cases at the outset of litigation is likely to be less conclusive than screening at later points in the litigation. Indeed, there will be cases which the court considers at the outset to be

\footnote{272}{R Kraakman H Park et al, above n 260, 1756.}
\footnote{273}{Although shareholders have the ability to diversify their portfolios so as to minimize the risk of any single investment, most investors are not fully diversified because they hold assets other than marketable securities, such as real estate, insurance, pensions, or small business holdings. As a result, they may wish to hold an undiversified securities portfolio to wrap around their other investment assets in order to achieve full diversification on an overall level. This theme was developed in JC Coffee ‘Market Failure and the Economic Case for a Mandatory Disclosure System’ (1984) 70 Virginia Law Review 717, 748–9.}
\footnote{274}{JC Coffee, above n 273.}
\footnote{275}{ibid.}
\footnote{276}{A ceiling is an important limitation, since there is no economic reason to compel a company to act as a ‘guinea-pig’ for other companies when the net costs the action imposes on the company whose managers are sued clearly outweighs its financial returns from the action. In fact, it could be argued that since the initiation of litigation is in many ways an ‘investment decision’ for the company (see Ch 2 above under 2.2) any director advising shareholders to take action when the litigation costs are likely to be high and yield little or no recovery may be acting negligently.}
\footnote{277}{The notions of compensation and deterrence must each be interpreted in the context of each case, as the costs and benefits of a litigation remedy vary with the context. The public company characteristics may, for example, introduce several considerations not necessarily present in the similar factual setting of a small company harmed by its dominant shareholder (say of the type involved in Nurcombe v Nurcombe [1985] 1 WLR 370). cf American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (Tentative Draft No 3 1984) Pt VII.}
arguable, but not likely to succeed, which ultimately bring a reward. That is the very nature, however, of a legal screen.³⁷⁸ The choice is not between a more or less accurate measure of value, but between what is currently an almost inaccessible criterion to evaluate the merits of derivative actions at an early stage³⁷⁹ and

³⁷⁸ Perhaps the real difficulty in proposing to screen derivative actions based on their contributions to corporate value lies less in the logic of screening than in the issue of who screens: boards or courts? Here, the arguments on both sides track the familiar debate discussed in Ch 3 above under 3.3. On the one hand, screening by independent directors is likely to be cheaper and better informed as to the facts than screening by judges; on the other hand, screening by courts is likely to be better informed about the law and less prone to structural bias than screening by boards. See also R Kraakman H Park et al, above n 250, 1768.

³⁷⁹ See Ch 3 above under 3.4.2 and CA 2006, Pt 11, discussed in Ch 4 above under 4.3 and 4.4.

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Table 5-2. FFM: identifying those actions that appear likely to increase corporate value

<table>
<thead>
<tr>
<th>'Prototype' scenarios</th>
<th>Compensation</th>
<th>Deterrence</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1 'The optimal scenario'</strong></td>
<td>√</td>
<td>√</td>
<td>The action should clearly proceed</td>
</tr>
<tr>
<td>Litigation is likely to yield recovery and is likely to deter misconduct (eg judgment establishing an important precedent)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2 'Borderline scenario A'</strong></td>
<td>√</td>
<td>–</td>
<td>The action should proceed upon finding that the action is likely to yield a positive recovery net of litigation costs</td>
</tr>
<tr>
<td>Very little expected deterrence, but the prospect of the action is likely to yield X recovery</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>3 'Borderline scenario B'</strong></td>
<td>–</td>
<td>√</td>
<td>The action should proceed upon finding that it is likely to enhance substantially the prospects of deterrence. However, at some point a disproportion between the expected costs and the expected recovery should justify dismissal (the compensatory ceiling)⁴</td>
</tr>
<tr>
<td>Very little expected recovery, but the prospect of the action is likely to deter Y misconduct</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>4 'The non-benefit scenario'</strong></td>
<td>–</td>
<td>–</td>
<td>The action should clearly be dismissed</td>
</tr>
<tr>
<td>Litigation is unlikely to yield any recovery, and is unlikely to deter misconduct</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note that even the US cases cited in n 258 above, which were primarily justified in the sense of the public good deterrence entailed, still involved some recoveries for the companies for whom they were brought.
a standard which provides a convenient, focused and efficient method by which to judge whether to allow the action to proceed. It follows that where the strength of claimant’s cases indicates a real possibility of ultimately increasing corporate value, there is little justification for not allowing the action to proceed.

Another advantage of the proposed inquiry is that it does not involve the courts in any untoward involvement in the business affairs of the company, nor will it be costly. In fact, in most cases, the deterrent benefit will be obtained without any cost at all. If the case can be justified by positive net corporate recoveries (that is, the alternative rule in the inquiry) permission to continue should be granted anyway, so that any potential deterrence benefits that might be obtained would follow without extra cost. But the real novelty in the proposed two-rationale inquiry concerns the substantive standard at the core of the test: the derivative action ought to be judged on the basis of the value it creates for companies, and not solely on the basis of an ad hoc ‘necessity in order to prevent a wrong going without redress’.²⁸⁰ It is in this sense that the ‘functional’ and ‘focused’ elements of the FFM come under the spotlight. The derivative action should be allowed to proceed only if it serves one of these prime objectives. The FFM highlights the functional logic behind the derivative action: a derivative action would be allowed to proceed only if it serves a substantive goal. This goal, in turn, justifies the existence of this law enforcement by demonstrating why it is worthwhile having it. This perspective enables us to clarify the statement made above: although a derivative action is undoubtedly a procedural device, it cannot solely be justified on a procedural basis.²⁸¹ A set of substantive goals should be exogenously specified (ie deterrence of misconduct or generation of net recoveries) if the derivative action is to turn into an effective controlling mechanism in corporate governance.²⁸² In principle, then, the maintenance of public standards should be seen rather as being something of value in its own right,²⁸³ as this inquiry may not exclude cases with obvious deterrent value simply because their expected recovery is small as explained above.

Turning to the ‘focused’ element, there are two dimensions here: first, litigation should be focused on those areas or instances in which other mechanisms of accountability fail. For example, recall that the most significant weakness in the

²⁸⁰ Smith v Croft (No 2) [1988] Ch 114, 185.
²⁸¹ See also C Hale ‘What’s Right with the Rule in Foss v Harbottle?’ [1997] 2 CFILR 219, 222.
²⁸² In order to appreciate this point fully, it is useful to consider the difference between the English and Australian approaches here. Broadly speaking, the picture that consistently comes through from Australian derivative action cases shows a willingness to get to the substantial issue, undistracted by consideration of locus standi or procedure. Sealy describes the difference between the English and Australian approaches as the difference between ‘Why should we?’ and ‘Why not?’: LS Sealy ‘The Rule in Foss v Harbottle: The Australian Experience’ (1989) 10 Company Lawyer 52. The novelty in the proposed test above is that it answers both questions, namely why should we (ie in order to promote deterrence or compensate the company for the harm caused), but also why and when we should not use this remedy (ie when these objectives are absent).
market for corporate control solution as a deterrence to managerial misbehaviour lies in its ineffectiveness against so-called ‘one shot’ breaches of fiduciary duties by managers as well as in relation to private companies. Yet this is one of the major objects of derivative actions.²⁸⁴ The derivative action should therefore have a role to play in redressing and deterring this type of managerial misbehaviour. The second dimension of the ‘focused’ element lies in the notion that litigation should be focused by the type of issues the court should look into when deciding whether the action should proceed as set out by the proposed inquiry above and as illustrated next.

(f) Shareholder standing
Having by this stage established whether the company has a valid claim to proceed with, the court can turn to deal with the standing of the particular shareholder who wishes to pursue the action. To reiterate, the Law Commission Report acknowledges the unique position of the shareholder in that ‘the applicant may benefit commercially if he succeeds in the derivative action, and thus has an ulterior motive²⁸⁵ in bringing it. But nonetheless, the court may consider that he is an appropriate person to bring the action and that the action ought to be brought’.²⁸⁶ Although slightly inaccurate, this recognizes the prevalent inherent duality which seems to exist within the majority of minority claims.²⁸⁷ It is inevitable that while the individual shareholder sues to uphold the right of the company, he also therewith attempts simultaneously to protect indirectly his personal interests. But as explained earlier, as a general rule, a derivative claim is equivalent to a claim by the company itself and as a result, the conduct of the shareholder should take a backseat role in the court’s assessment of whether the derivative action should go forward.²⁸⁸ In this way, the assessment on the merits of the case could concentrate

²⁸⁴ See Ch 1 above under 1.4.1.
²⁸⁵ The use of the term ‘ulterior motive’ is arguably inappropriate. ‘Ulterior’ is inaccurate because apart from situations when a shareholder is abusing the derivative action jurisdiction which exists to do justice to the company (Barrett v Duckett [1995] 1 BCLC 243), as is explained in Ch 7 below under 7.2.2.2, it is both expected and hoped that a shareholder will assume the role of initiator (unless, of course, there is someone else who is expected to assume the risk of litigation, ie lawyers). Likewise, ‘motive’ is a concept which is notoriously difficult to apply, often being mixed and difficult to prove. Moreover, the idea of denying someone an otherwise valid claim solely on the basis of an improper motive is contrary to other, arguably analogous, areas of company law. See J Payne ‘Clean Hands in Derivative Actions’ [2002] CLJ 76, 82.
²⁸⁶ Report para 6.76; now reflected as one of the factors the court must take into in considering whether to give permission (or leave). See CA 2006, s 263(3)(a) (whether the member is acting in good faith in seeking to continue the claim) discussed in Ch 4 above under 4.3.5.4.
²⁸⁷ In some situations it may be difficult to determine whether an action should be personal or derivative in from. A classic example is Marx v Estates and General Investments Ltd [1976] 1 WLR 380. Note also the rule against ‘reflective loss’. Painting with a broad brush, this rule proscribes a shareholder from recovering for damage which is merely a reflection of the company’s damage. See discussion in Ch 7 below under 7.2.2.3.
²⁸⁸ The rationale is that if the wrongdoer’s duty is owed to the company and the right to enforce that claim belongs to the company and not to the shareholder, why should any conduct by a shareholder destroy the company’s right of action? See further J Payne, above n 285, 77 and 81.
on whether the claim should be allowed to proceed on the grounds set out above (which highlights again the focused nature of the FFM).²⁸⁹

However, it is inescapable that in some cases the claimant will be in an acute conflict of interest in pursuing the derivative action.²⁹⁰ Although that might not (and should not normally) be a fatal obstacle to the grant of permission to continue the action, it is certainly a matter that requires the most careful scrutiny.²⁹¹

This question can only be decided on the circumstances of each case (in light of factors such as the shareholder’s behaviour or relationship with the wrongdoers). The writer thus takes the view that it would be unwise to employ any strict formula to decide this question.²⁹² Instead, the court should use its general discretion and powers to prevent a particular shareholder to pursue the action on behalf of the company.²⁹³ For example, if the court believes that the shareholder is acting only in his own self-interest it may well be legitimate to prevent him from taking an action.²⁹⁴ In such cases, the conduct of the shareholder should have personal consequences for him, but should not have consequences for the company.²⁹⁵ It follows that it is possible for the court to accept that the company may have a valid claim, but to deny the right to this shareholder to pursue that claim on behalf of the company because of some aspect of that shareholder’s position.²⁹⁶

(g) Access to information
A critical issue that must be remedied 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 asymmetry of

²⁸⁹ For a similar approach, see s 165 of the New Zealand Companies Act 1993. There seems to be no bar for a shareholder to bring a derivative action, provided the requirements under s 165 are satisfied. These focus on issues such as costs of the proceedings, the likelihood of the proceedings succeeding, and the company’s interest and not the shareholder’s standing.
²⁹⁰ For example, having received money unlawfully from the company.
²⁹² See Ch 3 above under 3.4.2.1, 3.4.2.2 and 3.4.2.4. cf Report para 6.76.
²⁹⁴ For example, when a shareholder buys shares in a company and decides to bring a derivative action against its directors (assuming there are adequate grounds for this action on the basis of the directors’ behaviour) when its purpose is not to protect the company but to tie up management time and to provide a substantial distraction to the company’s business in the hope of providing an advantage to a third company in which he is involved. J Payne, above n 285, 81–2.
²⁹⁵ The neatness of this proposition hides the fact, nonetheless, that in some cases when the company is very small (as in Nurcombe), imposing consequences on the claimant shareholder will inevitably have an impact on the company itself. J Payne, above n 285, 85–6.
²⁹⁶ As in Barrett v Duckett [1995] 1 BCLC 243. In Portfolios of Distinction Ltd v Laird [2004] EWHC 2071, the court held that the best way forward was to appoint an independent receiver over the company, as there were serious questions about the claimant’s good faith in purporting to act for the benefit of the company.
information between management and shareholders or between large and small shareholders.²⁹⁷ The rationale is threefold:

(1) there must be instances when litigation could be prevented by allowing the shareholder a right to inspect records;²⁹⁸

(2) the very existence of such a right might act as a deterrent and thereby encourage good management;²⁹⁹ and

(3) shareholders must be allowed to judge accurately the strength of the potential claim.³⁰⁰ Without the necessary access to information, then, many shareholder actions, in both public and private companies, will in practice be prohibited from the outset.

The question of whether a shareholder in a derivative action should be entitled to early disclosure of the company’s documents was considered by the CLR.³⁰¹ The CLR acknowledged that the logic of a derivative process is that the shareholder suing in the right of the company and for its direct benefit should be entitled to the information that would be available to the company. It also acknowledged that the CPR provide inadequately for early disclosure. Nonetheless, while as a matter of logic the CLR agreed that it might be argued that a potential claimant in a derivative action should have pre-trial access to the company’s papers, in practice, the CLR believed, like the Law Commission,³⁰² that disclosure should be a matter to be governed by the court once the proceedings have commenced, and granted only when the court is satisfied that there is a serious issue to be tried.³⁰³

It is hard to agree with this. First, the logic behind this is erroneous: how can the court be satisfied that there is a serious issue to be tried if the shareholder is initially prevented from gathering information to establish exactly that? Secondly, as a matter of policy this serves only as another disincentive for a shareholder to bring a derivative action, if he is denied access to relevant information when he is suspicious about wrongdoing. Finally, given the suspicion English courts have

²⁹⁷ Case law confers on shareholders only scant corporate rights to ‘internal’ company documents: *Arrow Trading and Investments v Edwardian Group Ltd* [2004] EWHC 1319 and discussion in Ch 3 above under 3.2.3.2.


³⁰⁰ See also E Ferran *Company Law and Corporate Finance* (OUP 1999) 123.

³⁰¹ CLR *Developing the Framework* 131–2.

³⁰² The Law Commission considered and rejected the case for pre-action discovery of documents in such cases, but suggested that this issue might be considered in the context of a pre-action protocol. Report paras 7.13–7.16.

³⁰³ Above n 301, 132.
generally shown towards shareholders who come before the court, it is highly unlikely that the court will consider granting disclosure orders favourably.

It is possible that the lack of effective means of information-gathering by shareholders could be overcome by less direct means, as is well illustrated in Japan. The surge of derivative action litigation in Japan in recent years has been partly explained by the fact that, in many cases, derivative actions ‘piggyback’ on government enforcement, often in the form of criminal prosecution.\textsuperscript{304} Before the 1990s, shareholders who wished to sue faced an uphill battle in gathering information about defendants’ conduct.\textsuperscript{305} But beginning in the early 1990s prosecutors began to pursue aggressively individual wrongdoers in the corporate context.\textsuperscript{306} With increased criminal enforcement and public announcements of state-gathered evidence, potential shareholder-claimants were able to gather more information about corporate activities, and specifically management misdeeds, than they had in the past. In effect, prosecutorial and investigative powers became a substitute for the lack of effective means of information-gathering by shareholders.\textsuperscript{307}

Nonetheless, the effort to streamline litigation must address informational problems more directly, as the following anecdotal examples illustrate.\textsuperscript{308} First, South African legislation, in the limited context of the statutory derivative action, provides as a first step for the appointment by the court of a curator ad litem, whose role is to investigate the shareholder’s complaint and advise the court whether the litigation should be allowed to proceed.\textsuperscript{309} The curator is given unrestricted access to the company’s books and records. Secondly, s 319 of the Australian Corporations Law 2001 provides a mechanism, subject to a number of limits, to enable access to documents. It empowers the court, on application by a shareholder acting in good faith and for a proper purpose, to order that the applicant be allowed to inspect the company’s records, not personally, but through a lawyer or registered company auditor acting on his behalf, on such terms as the court thinks fit. Finally, according to German law, the right to obtain information can be exercised through a formal procedure known as the special audit (Sonderprüfung).\textsuperscript{310} This means that a shareholder or a minority of shareholders

\textsuperscript{304} Additional factors, mainly in the form of financial incentives, are discussed in Ch 6 below under 6.2.1.

\textsuperscript{305} Information disclosure is not terribly abundant; shareholder rights to view corporate records are predicated on the holder having at least 3% of the shares; cause must be shown to appoint an outside inspector; and pre-trial discovery is non-existent. MD West ‘Why Shareholders Sue: The Evidence from Japan’ Michigan Law and Economics Research Paper No 00–010 (November 2000), available at <http://ssrn.com/abstract=251012>.

\textsuperscript{306} After the bursting of the Japanese real estate and stock market bubble that characterized the late 1980s, and with an influx of foreign business.

\textsuperscript{307} See evidence in MD West, above n 305.

\textsuperscript{308} In most jurisdictions rights of discovery prior to initiation of litigation are either very limited or non-existent. D Faber ‘Reform of Shareholders’ Remedies’ in B Rider (ed) Developments in European Company Law (Kluwer Law 1998) Vol 1 119, 127.

\textsuperscript{309} Under Companies Act 1973 s 266.

\textsuperscript{310} KL Hopt ‘Shareholder Rights and Remedies: A View from Germany and the Continent’ [1997] 2 CFILR 261, 264.
can require a special audit on a particular matter to be conducted by a person, usually an auditor, who is appointed by the court for this special purpose.

In short, it is proposed that the court should make use of its jurisdiction under s 261 of CA 2006 and allow such access in appropriate cases.³¹¹ Clearly there must be safeguards to avoid abuse and care must be taken to ensure that persons such as business competitors do not acquire shares in order to exploit such a right of access. However, subject to these restraints, such a right would provide protection for shareholders, avoid many misunderstandings and encourage boards to manage their companies in a regular and proper manner. Paradoxically, this may even lead to fewer shareholder disputes being litigated.³¹² Time will tell whether the powers granted to the court under s 261 of CA 2006 will be enough in this respect.³¹³ Current case law generally confers on shareholders only scant corporate rights to ‘internal’ company documents³¹⁴ 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.

(h) Notice to the company

Finally, a procedure should be enacted which requires a limited period of notice to be given to the company if a shareholder is to maintain the action, albeit that notice may be waived in urgent cases.³¹⁵ This is to provide the company with the opportunity to vindicate its own rights.³¹⁶ The cause of action rightly belongs to the company, and it should therefore have the first option of pursuing its own rights. It is possible that the directors may decide themselves that the company should shoulder the responsibility for the action, thus making the derivative action unnecessary. Alternatively, the directors may be able to take such steps to correct or remedy the situation that formed the basis for the derivative action, which may satisfy the prospective claimant’s concerns.³¹⁷ Indeed, notice to the

³¹¹ See CA 2006, s 261(3) discussed in n 313 below. Another way that could be followed is along the lines of a new Delaware legislation liberalizing the ability of shareholders to obtain books and records of the company ‘if they have a targeted, proper purpose’ to see what is going on. See SB 127, 142nd Gen Assembly (Del 2003) (amending Del Code Ann Tit 8, s 220).
³¹³ 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. See discussion in Ch 3 above under 3.2.3.2 and Ch 4 above under 4.3.4.1.
³¹⁵ It is to be hoped 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 para 6.49 of the Report), although at the time of writing, this does not form part of the Act.
³¹⁶ BR Cheffins, above n 180, 245–7.
³¹⁷ Including internal sanctions such as dismissal or demotion of a defendant employee: Consultation Paper 156–7.
company is now a common precondition to the grant of leave for a shareholder to pursue statutory derivative actions in numerous jurisdictions, although the precise period differs.³¹⁸

The requirement should allow the court to make such interim order as it thinks fit where the complainant establishes that it would not be expedient to give notice as required. This envisages situations where the directors are hostile, under the domination of the wrongdoers, or where timeous litigation is of the essence.³¹⁹ The position is broadly similar in the US, where a shareholder must first provide the board with a ‘demand’ to sue. A judge, however, can waive the demand requirement when it is futile to expect the directors to make a reasoned and unbiased decision on the matter, for example, because the alleged wrongdoers comprise or control a majority of the board. A complex and unclear jurisprudence has in turn developed on the issue of excusing demand.³²⁰ If carefully construed, however, this should not be allowed to be the case in English law. The Canadian approach could be followed, where unlike the ‘demand’ requirement in the US, the notice need not specify each and every cause of action; it is enough that the notice contains some information to determine the nature of the shareholder’s claim.³²¹ After all, the notice is not intended to be a form of pleading.

5.4.4.4 Funding derivative actions: a re-examination of costs and fees as incentives to commence litigation

There is an additional crucial tailpiece to the discussion so far. As will be seen in Chapter 6 below, the treatment of fees has a direct impact on the frequency of litigation. The more advantageous the fee rule is to the prospective claimant the greater the employment of litigation. An understanding of the economic effect of fees on the decision to commence litigation allows the development of rules to encourage those actions which advance the policy objectives behind the FFM. The following two chapters address this aspect of the FFM.

5.4.4.5 Maintaining doctrinal consistency

The final building block of the FFM concerns practical aspects of the law governing derivative actions. Chapter 8 will argue that it is vital to clarify the interaction

³¹⁸ This varies between no minimum notice period specified (in Canada, under CBCA’s 239 (2) (a), to 45 days under Israeli law). The Law Commission put that figure at 28 days (Consultation Paper 147). For arguments in favour of a longer period, see J Poole and P Roberts ‘Shareholder Remedies—Corporate Wrongs and the Derivative Action’ [1999] JBL 99, 104.
³¹⁹ cf Australian Corporations Act 2001, s 237(2)(e) and Report paras 6.58–6.59 and Draft Rule 50.4(3) Appendix B.
and uneasy relationship between the unfair prejudice remedy under the unfair prejudice remedy and the derivative action in order to maintain doctrinal consistency, but more on this later.

5.5 Conclusion

This seems an appropriate point at which to consolidate the discussion in the first five chapters. The Functional and Focused Model (FFM) for derivative action litigation presented here builds on the view of derivative action law laid out in Chapters 1, 2, 3, 4, and 5 and finalized in the preceding sections of this chapter. The FFM is a descriptive and analytic device. By focusing on what makes derivative action procedure special, it helps illuminate the structure of the derivative action. Its ultimate aim is to reformulate the application, structure, and incentives to bring the action, in order for it to be both effective and reliable as well as address modern dilemmas. The premise driving this FFM is an understanding that to allow the common law derivative action to lurk ‘dormant’ in the hinterland of company law would be to ignore the possibility that the derivative action could be used as a legitimate corporate governance tool to redress the concerns which all scholars have with issues centred on management accountability and lack of shareholder voice. If the latter is the case and the derivative action, as the writer believes it to be originally conceived, presents a real opportunity for active corporate governance, then any recommendations which provide procedural and substantive clarity ought to be welcomed.

On the whole, the FFM seems to have accomplished a threefold objective: first, the FFM responds to and, indeed, fills the critical shortcoming of the academic literature on derivative actions by providing a theoretical structure of derivative action as a law enforcement mechanism in the corporate governance context.

Secondly, the FFM advances a conceptually inclusive analytic framework and offers insights that, taken together, provide the requisite underpinnings for policy analyses of derivative action. Thirdly, the FFM sets guidelines for designing effective regulatory measures where derivative actions may be used to enforce the law.

The foundations of the FFM which were put together in this chapter are meant to provide a procedure for analysing and justifying this body of law. It is time now to turn to the second (strategic) part of the FFM, namely resolving the issues relating to the costs and fees of derivative actions and providing positive inducements to litigate.