

SHAREHOLDER ACTIONS IN ENGLAND & WALES: NEW RULES BUT LITTLE ACTION

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In the light of the current economic crisis many shareholders in private companies are considering whether the directors of the companies in which they have invested can be held accountable for their actions.

In England and Wales there are two courses open to shareholders to seek redress: a minority prejudice action whereby a shareholder sues the majority shareholder or shareholders who control the company or a derivative action where the shareholder sues the company directors on behalf of the company.

It was thought that the imposition of broader duties on directors, combined with a procedure to allow shareholders to sue directors would lead to an explosion of shareholder litigation in England and Wales. As I set out below this has so far not happened.

The Companies Act 2006, was intended to increase shareholder engagement and to provide better regulation of corporate activities. A number of changes impact upon shareholders – the codification of directors' duties; changes to the derivative action procedure as well as the re-enacted rules on unfair prejudice.

Codification of Directors' Duties

Previously, these duties evolved through case law - sections 170 to 177 seek to codify them. Whilst sections 170 to 177 largely replicate the common law and equitable principles, there are some innovations, e.g. section 172 contains an express duty to promote the success of the company. It introduces a new concept of “enlightened shareholder value”. The directors are required to have regard to a number of factors when fulfilling this duty, including the interests of the company's employees and the impact of the company's operations on the community and the environment. This section has generated controversy, in particular the requirement to consider the impact on the environment. It is debatable whether these aims are always consistent with the primary role of a company in making money. It had been suggested that this new duty in conjunction with the new statutory derivative procedure (which I will come on to) could potentially invite more shareholder litigation by environmental activists and other pressure groups. I consider this further below.

Derivative Actions

A derivative action is an action by a shareholder against a director. Prior to the Companies Act 2006, derivative actions were often threatened but rarely actioned. Under the rule in *Foss v Harbottle*, the company was the proper claimant for any wrongs done to it, and companies were not required to act at the request of their shareholders even to pursue the company's rights in relation to an alleged wrong. In order to bring a derivative claim a shareholder had to fit his case into one of the exceptions to the rule in *Foss v Harbottle* namely: 1) that the company was controlled by the wrongdoers causing fraud on a minority; or 2) that the actions of the majority were *ultra vires*; or 3) that the personal rights of the

members had been infringed and that the breach could not be rectified by a simple majority vote.

The major problem with a derivative action under the old law was that the ratification of the conduct of the directors by the majority of the members was a bar to bringing a derivative action.

The New Rules

The new rules are found in sections 260 to 264 of the Act. Claims can be made in respect of acts or omissions, negligence, default or breach of duty by a director or a third party. They may be brought by any member regardless of membership status at the time of the alleged breach. Indeed, claims can be brought by a person in respect of breaches alleged to have occurred before shares were purchased.

The act provides that permission of the court is required to issue a derivative action, and this is a two-stage process:

First, the claimant applies for permission on a without notice basis to the court - the court considers the application without the input of the company. The court will consider the application on the papers first. If the claimant is unsuccessful, the application can then be renewed orally by the claimant. At this stage the shareholder needs only to establish that he has a prima facie case.

Second, if the claimant is successful at the first stage, the company will appear before the court to make representations, and the court will then decide whether the claim can proceed. This is the more important stage. The court will refuse permission under s263(2) if:

- A claim does not promote the success of the company; or
- The act or omission was authorised; or
- The act or omission has been or is likely to be ratified by the company.

In a ratification under section 239, no vote by either the director or member whose conduct amounts to negligence, default, breach of duty or trust, or any member connected with him will count. Where the wrongdoing has been authorised or ratified, then the court can disregard it if it has been authorised or ratified by way of the votes of the accused directors.

In considering whether to give permission the court must take into account under s263(3), in particular:

- (a) whether the member is acting in good faith in seeking to continue the claim;
- (b) the importance that a person acting in accordance with section 172 (duty to promote the success of the company) would attach to continuing it;
- (c) whether the relevant act or omission could be ratified by the company;
- (d) whether the company has decided not to pursue the claim;
- (e) whether the act or omission gives rise to a cause of action that the member could pursue in his own right (i.e. a personal action) rather than on behalf of the company.

In considering whether to give permission (or leave) the court shall have particular regard to any evidence before it as to the views of members of the company who have no personal interest, direct or indirect, in the matter. The claimant also needs to show he is acting in good faith.

Where a special interest group acquires a stake in the company solely for the purpose of bringing a claim in relation to that special interest (environmental, etc), the court might argue that the shareholder was not acting in good faith.

The Effect of the New Provisions

The new provisions appear to offer more protection for shareholders. The claims against directors can include negligence as well as breach of duty - previously, there was uncertainty at common law as to whether negligence claims were permissible. Claims by members that a particular corporate decision was negligently taken because directors failed to take into account the matters specified in their codified duties may be more likely.

There is no absolute bar on bringing a derivative action where the company has ratified (or could ratify) the action.

As stated above, at the time the Act was drafted, and when it first came into force, there was speculation about whether it would lead to a huge increase in shareholder litigation. However, since the relevant provisions came into force in October 2007, there have been very few reported cases under the new provisions. These cases are considered further below.

Recent Case Law

Concern had been raised that the changes to the derivative action regime could lead to increased tactical litigation against directors from activist shareholders.

However, to date, these concerns appear to have been unfounded. There have been very few reported cases of a derivative claim having been brought under the 2006 Act. In one of the first reported decisions, *Franbar Holdings Ltd v Patel and ors* (2008), the High Court refused an application under section 261 of the 2006 Act for permission to continue a derivative claim.

Following a series of disputes between Franbar Holdings Ltd (F Ltd) (the holder of 25% of the shares in Medicentres (UK) Ltd (M Ltd)) and Casualty Plus Ltd (C Ltd) (the holder of 75% of the shares in M Ltd), F Ltd issued three sets of proceedings:

- (i) A claim against C Ltd for breach of the shareholders' agreement between the parties.
- (ii) A petition under section 994 of the 2006 Act by F Ltd against C Ltd seeking an order that C Ltd purchase F Ltd's shares in M Ltd.
- (iii) A claim by F Ltd against the directors nominated by C Ltd and M Ltd, which F Ltd sought permission to continue as a derivative claim as it sought a remedy on behalf of M Ltd.

The court refused permission to continue the derivative claim. The judge stated that a person acting in accordance with the duty to promote the success of the company would be

unlikely to attach very much importance to continuing the derivative claim (section 263(3)(b)). The hypothetical director acting in accordance with section 172 would take into account a wide range of considerations when assessing the importance of continuing the claim. These would include matters such as the prospects of success of the claim, the ability of the company to recover any award of damages, the disruption which would be caused to the company's business by having to concentrate on the proceedings, the cost, and any damage to the company's reputation and business if the proceedings were to fail. A director would often be in the position of having to make what was no more than a partially informed decision on continuation without a clear idea of how the proceedings might turn out. The judge considered that the hypothetical director would be inclined to regard pursuing the derivative claim as less important given that several of the complaints were more naturally formulated as breaches of the shareholders' agreement or were acts of unfair prejudice which were already the subject of proceedings.

The other reported case is *Mission Capital v Sinclair* (also 2008). In this case the applicants constituted a minority on the board of Mission Capital. Three non-executive directors were in the majority. The board purported to terminate the applicants' employment and required them to resign from the board. Mission Capital obtained an interim injunction excluding the applicants from its premises and requiring delivery up of certain documents. The applicants both counterclaimed and brought a separate derivative claim against the non-executive directors and their replacement director. In their counterclaim, the applicants argued that their employment contracts were still subsisting and that their purported resignations were invalid. They claimed injunctive relief equating to specific performance of their service contracts and reinstatement to the board. By the derivative claim, they argued that Mission Capital would suffer damage from their wrongful dismissal and the replacement director would act improperly. They claimed the same heads of relief as in the counterclaim.

On the application for permission to continue the derivative claim, the judge looked at the question whether a notional director, under section 263(2)(a), would seek to continue the claim. The debate focussed on whether the derivative action was purely duplicative of the counterclaim. The judge accepted that it was arguable that the derivative claim might succeed where the counterclaim failed and that Mission Capital would be able to claim damages against the directors for the damage it had suffered as a result of the applicants' wrongful dismissal, which would not be available to the applicants as shareholders.

However, he then went on to consider how to exercise his discretion under s. 263(3). He refused permission. He held that although he could not be satisfied that the notional s.172 director would not continue the claim, he did not believe that he would attach that much importance to it. He stated: "*Would a company which had wrongfully dismissed a director normally take action against those responsible for the damage that it has suffered? It would depend, but I suspect that the action it would take in preference would be to replace the directors. Moreover, on the evidence before me the damage...[Mission Capital] will suffer is somewhat speculative - another reason why the section 172 director would not attach great weight to it*".

A second ground was that he was not satisfied that there was anything sought by the applicants which they could not recover by means of an unfair prejudice petition under s. 994 of the 2006 Act.

Unfair Prejudice Petitions

While derivative actions are proving difficult, claims by minority shareholders for unfair prejudice have been unaffected by the 2006 Act.

Sections 994-996 largely replicate the provisions in the 1986 Act and provide as follows:

“A member of a company may apply to the court by petition for an order under this Part on the ground.. that the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of members generally or of some part of its members (including at least himself).”

Both petitioner and respondent will be shareholders and typical grounds for unfair Prejudice will include:

- (i) breach of a legal bargain between the shareholders (such as a shareholders agreement or the company's articles of association);
- (ii) breach of fiduciary duty (by a director who is also a shareholder);
- (iii) breach of an equitable agreement or understanding.

The court has a wide discretion in relation to remedies but the usual order will be that the respondent purchases the petitioner's shares at a value that takes account of the unfair prejudice suffered. (Usually a plainly reasonable offer to buy out the minority shareholder at an appropriate price will provide a defence to a claim based on alleged unfair prejudice precisely because excluding a shareholder from the company's affairs is only unfair if it is exclusion without a reasonable offer – see *O'Neill v Phillips* (1999)).

Practical Tips

Directors should consider how they will deal with shareholder requests for board papers in relation to particular (probably contentious) matters (where the shareholders may be trying to use the information to launch a derivative claim).

It would also be helpful to review the directors' and officers' liability insurance policies to ensure the defence of derivative claims is covered. In the light of concerns about increased liability for directors (albeit that these fears have not yet materialised), the costs of these insurance policies may rise (at least until it becomes clearer how derivative claims under the 2006 Act will be dealt with by the courts).

Conclusion

The story so far is that we have a change in the nature of directors duties – “enlightened shareholder value” and the need to work in the long term interest of the shareholders – but no obvious effect on minority prejudice actions and no reported derivative actions allowed to date.