Opinion

Derivative actions: a step too far?

James Palmer and Gary Milner-Moore of Herbert Smith LLP query the wisdom of the current company law reform proposals to amend the law on derivative actions.

The Company Law Reform Bill (CLRB) is introducing, among other things, a statutory regime for derivative actions (for background, see News brief “Company Law Reform Bill: is that it?”, www.practicallaw.com/2-201-6545). The government has emphasised that the new regime should not involve significant change from the existing approach but, if this is the intention, we query why the new sections are proposed at all.

Current position

The principle of “majority rule” is a cornerstone of English company law (Foss v Harbottle (1843) 2 Hare 461). In general, companies are not required to act merely at the behest of minority shareholders, even to pursue the company’s rights in relation to an alleged wrong. The logic of the rule has, we suggest, proved sound and has protected the majority of shareholders and directors from having their companies distracted into bringing unwelcome actions.

The theory is that there is no point in having claims brought which could be ratified by a shareholder vote (for example, for a breach of directors’ duties): rather, if the majority of shareholders want the claim to be brought where the board has not pursued it, they can convene a meeting either to change the board or to pass a resolution requiring the claim to be brought.

A related rule is that the company is the proper claimant for wrongs done to it, not individual shareholders. An aggrieved minority shareholder is left either to pursue any rights it may have under section 459 of the Companies Act 1985, in respect of any unfairly prejudicial conduct of the company, or to seek to bring a derivative action under one of the exceptions to Foss v Harbottle. A shareholder in a listed public company could, alternatively, sell out its shareholding.

The exceptions to Foss v Harbottle allow the shareholder to apply to court to continue a derivative action in the company’s name, in limited circumstances where the majority rule approach cannot work: in particular, where there is control of the company by the wrongdoers and there would be a fraud on the minority if the majority was allowed to hold sway. Claims can also be brought for ultra vires actions, for breaches which cannot be ratified by simple majority vote and where personal rights of the shareholder have been infringed.

The proposals

The CLRB proposes extending the scope of claims that could lead to derivative actions. In particular, it provides that a director’s negligence should be capable of challenge by this means. The extensions seem sensible if, but only if, the procedure for bringing a derivative action stays broadly as it is now. The CLRB also sets out a two-limb process for consideration by the court of whether or not to permit a claim to be continued (permission hearing), namely:

• Whether or not the claim must be refused and the factors for the court to consider (section 242(2), CLRB).
• If permission does not have to be refused, whether or not the court should exercise its discretion to refuse and the factors relevant to that decision (section 242(3), CLRB).

The directors’ views

One of the key issues is how far the court will defer to the directors. This balance was previously struck by the tests of wrongdoer control and fraud on the minority. A derivative action will be barred absolutely under the first limb if the court is satisfied that a person acting in accordance with the CLRB’s new director’s general duty to promote the success of the company would not seek to continue the claim. In practice, this test will rarely be satisfied. There is a great difference between establishing at a preliminary stage that a hypothetical
person “might not” pursue the claim and satisfying the court that he “would not”.

What matters more therefore is the second limb. One of the factors that the court must take into account is the importance that would be attached to continuing the claim by a hypothetical person acting in accordance with a director’s general duties. Evidence from the actual directors will no doubt be relevant. However, the ultimate assessment must, it seems, be that of the court. This will include assessment of the merits of the claim and evaluation of the likely commercial consequences for the company. Where there is an arguable case of breach, the courts may be tempted to grant permission so that any wrong can be remedied, even if the directors oppose this.

**Ratification and authorisation.** A company’s authorisation and/or ratification of a claim are currently an absolute bar to a derivative action. The likelihood of ratification (or, as regards a future act, the likelihood of authorisation) is also relevant. At first glance, the CLRB preserves this.

However, the principles governing ratification will be amended by section 216 of the CLRB (which, in the current draft, is largely incoherent). Ratification will generally require an ordinary resolution. Any members with “a personal interest, direct or indirect, in the ratification” will be disqualified from voting even if there is no question of abuse. This constitutes a fundamental change to company law and the principle of majority rule and transfers substantial influence to minorities. Almost any board decision can be challenged at least as far as a permission hearing, at which stage the court’s discretion will be determinative. In practice, this will require evidence from the directors justifying their chosen course. Since the court has a general discretion, most will prefer to provide this evidence rather than relying simply on abstract procedural objections.

There may well also be an additional administrative burden. Currently, no derivative action is available if the breach is ratifiable, irrespective of whether any resolution has been tabled. By contrast, the new law will depend on a factual enquiry into whether the breach is “likely to be ratified” and even then this is simply a factor for the court. Adjournment of the permission hearing for ratification is one possible solution and is, we suspect, likely to be adopted increasingly by the courts. For many companies, this will be an expensive formality giving leverage to minorities of itself.

A related discretionary factor is whether “the company has decided not to pursue the claim”. It is likely that the court will look at the circumstances and independence of decisions reached, but it is impossible to predict what weight will be given to them. There is no suggestion that they would operate as an absolute bar. Much will depend on how the case law develops.

**The general discretion**

A derivative action will therefore only rarely be subject to an absolute bar and the focus will be on the courts’ broad discretion. Although the CLRB lists factors for applying that discretion, there is no guidance on the weight to be attributed to them. For example, how important does an action need to be before permission is granted and what is the significance of this factor when weighed against others?

As the proposals seem to leave everything to the court’s discretion, in our view, the CLRB should be amended to preserve the traditional thresholds of fraud on the minority and wrongdoer control. That would make clear on the face of the statute that the new regime is not intended to sweep away the existing case law. Without this, the government’s suggestion that the proposals do not constitute a significant set of changes is hard to justify, whatever their intentions in providing “more modern, flexible and accessible criteria” for derivative actions. These sound like positive objectives but the manner in which they have been pursued means that we are likely to see significantly enhanced scope for minority shareholder litigation. This is of particular concern when set against the backdrop of the changes to directors’ duties. Is it worth it? We remain sceptical.

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