Corporate Legal Alert

Derivative claims: a case for cautious optimism

The provisions in the Companies Act 2006 which potentially make it easier for shareholders to bring “derivative claims” alleging wrongdoing by directors have been in force for just over a year. So far, two cases of shareholders trying to use the procedure have been reported and both have failed at an early stage.

Background

A derivative claim is a claim brought by a shareholder on behalf of the company in respect of actual or potential loss to the company caused by a director’s action or inaction. The new statutory provisions allow derivative claims to be brought in more circumstances than would have been allowed previously. In particular, the shareholder does not need to show “fraud on the minority” (i.e. that the director has committed a non-ratifiable breach of duty) or “wrongdoer control” (i.e. that the director controls the majority of the company’s shares). This widening of the scope of the derivative claim is tempered by new procedural hurdles to be overcome by a shareholder wanting to bring a claim. First, the court must be satisfied that the shareholder has established a “prima facie” case for being given permission to proceed (“Stage 1”). If the shareholder succeeds at this stage, the court will then consider evidence from the company before

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deciding whether permission to continue the claim should be granted ("Stage 2"). The Companies Act 2006 sets out two factors which, if present, mean the court must deny permission (the “mandatory factors”). In addition it sets out six factors to which the court should have regard when exercising its discretion to deny permission (the “discretionary factors”).

Facts

In *Mission Capital PLC v Sinclair & another*, the shareholders bringing the claim (Mr Sinclair and his daughter) had both been executive directors. Their employment and directorship had been terminated by the board for alleged failure to provide financial information and meet financial forecasts. They claimed that the termination of their contracts was a wrongful repudiation of those contracts by the company, and that the non-executives who carried out the termination were in breach of their fiduciary duties to the company because their motive was in fact to further the interests of other commercial ventures with which one of the non-executive directors was associated.

In *Franbar Holdings Ltd v Patel & others*, the shareholder bringing the claim (Franbar) had a 25% stake in the company; the remainder of the shares were held by Casualty Plus. Franbar alleged that the directors of the company that had been appointed by Casualty Plus had diverted business opportunities away from the company to Casualty Plus, had wrongly suspended one of Franbar’s nominated directors and had failed to provide adequate financial information.

Decisions

In both cases the court found that neither of the mandatory factors was present. It therefore went on to consider the discretionary factors, and the two that proved decisive were the same in each case.

One of these discretionary factors is the importance that a person acting in accordance with a director’s duty to promote the success of the company would attach to continuing the claim – would an objective hypothetical director think it would promote the success of the company to pursue the complaint raised by the shareholder? In each case, the court found that such a person would not attach much importance to continuing the claim. In *Franbar* this was because of, amongst other things, the claim’s chances of success, the costs involved and the likelihood of recovery of any damages actually awarded. In *Mission Capital* the court thought that the more likely course would be to replace the former directors rather than bring a claim against those whose acts caused their removal.

The other discretionary factor that was decisive in each case was whether the alleged wrongdoing gave rise to a cause of action that the shareholder could pursue in his own right rather than on behalf of the company. In each case the court found that the
applicants had alternative means of recourse in their own right. Franbar had already brought an unfair prejudice claim under s994 Companies Act 2006 as well as a claim for breach of its shareholders agreement with Casualty Plus. Although the Sinclairs had not brought a s994 claim, the court thought that the relief they were seeking could be pursued under s994 and therefore denied permission to continue the derivative claim.

Commentary

The new derivative claims procedure allows the company to stay out of the action until Stage 2, the legislative intention being that companies should not have to go to the trouble and expense of getting involved if the shareholder cannot show a prima facie case. In both the reported cases, however, the company agreed that Stage 1 and Stage 2 could be considered together rather than waiting to see if the court decided that the shareholder had a prima facie case for permission before getting involved. This is not surprising. It is likely that it will only be in very clear cases that a court will feel able to use either the mandatory factors or the discretionary factors to knock out a claim without any evidence being given by the company. In addition, in both the reported cases the derivative claim was only one part of the proceedings, there were other claims and counterclaims in existence. The company was therefore already an active participant in the proceedings and had, for instance, already instructed lawyers and incurred costs in relation to the other, non-derivative-claim based claims.

As the two reported cases indicate, the mandatory factors will not often be found. The first mandatory factor is that a person acting in accordance with a director's duty to promote the success of the company would not seek to continue the claim. This is a high threshold and it will be difficult for the court to say that the hypothetical director would not (rather than might not) seek to continue it. The other mandatory factor is that the alleged wrongdoing has been authorised or ratified by the shareholders. If this is the case any derivative claim is clearly doomed to failure and would presumably therefore not be brought. The only situation where this factor is likely to be relevant in practice is where a claim is brought and authorisation or ratification occurs after the bringing of the claim but before the court considers the factors.

There has been nervousness that the new derivative claims procedure will make it easier for shareholders to bring claims against directors. One of the reasons for this, as mentioned earlier, is that a claim can be brought against a director for simple breach of duty, there is no need to prove fraud on the minority. As readers will be aware, the duties of directors have, to a large extent, been codified in the Companies Act 2006. Four of the newly stated duties came into force in October 2007 and three came into force in October 2008. The four that came into force in 2007 (duty to act within powers, duty to exercise independent judgement, duty to promote the success of the company and duty to exercise reasonable care, skill and diligence) are arguably more open to subjective judgement than those that came into force in 2008 (duty to avoid conflicts of interest, duty not to accept benefits from third parties and duty to
declare interests in proposed transactions with the company). These last three duties are arguably more capable of objective assessment – “did the director fail to disclose an interest in a transaction” may well be an easier question to answer than “did the director act in the way that he considered in good faith was most likely to promote the success of the company”.

There was no detailed discussion in either case of the duty or duties that the directors were alleged to have breached, which is not surprising since the purpose of the permission process is to give the court an opportunity to assess whether the derivative claim should proceed further, not to decide the merits. However, companies and directors will take a certain amount of comfort from the attitude the courts have displayed in these two cases. Although in both cases the company has had to get involved in the application procedure, it was involved in the wider proceedings in any event, and in fact it was the existence of the wider proceedings that helped the derivative claim applications to fail. What the new procedure has done, in effect, is replace the old technical bars to a derivative claim with a more qualitative assessment of whether a claim should be allowed to proceed. Bearing in mind that the effect of allowing a claim to proceed is, as the court made clear in *Fransbar*, to override the rights of the company’s directors to consider whether or not to take proceedings to enforce the company’s rights, the courts have so far shown a commendably practical and realistic approach.

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