

# Company Law

## Shareholder remedies: the final report

by Tony Boyle

The Law Commission's final Report on Shareholder Remedies (Law Com 246, Cm 3769, October 1997) completes the task begun by their Consultation Paper (No. 142) of 1996. The central feature of the Law Commission's proposed reform of shareholder remedies is a new statutory derivative action. The present commentator examined the impact of this remedy on public listed companies on the basis of the proposals and arguments presented in the Consultation Paper (*Amicus Curiae*, Issue 3, November 1997). The present comment looks at changes made in the final report and considers some wider implications of this important development in shareholder remedies.

### ENFORCEMENT OF DIRECTORS' DUTIES

The final report affirms that the new derivative action it proposes is confined to the enforcement of directors' duties by minority shareholders. In that sense it is an inclusive remedy extending to the whole range of directors' duties. In certain respects, however, it has a narrower range than the traditional 'common law' derivative action. The final report closes the door in respect of proceedings against wrongdoing majority shareholders. The Consultation Paper left open the possibility of using the new remedy against managers and officers who were not directors but on a more restrictive basis than in the case of proceedings against directors – essentially re-introducing the old concept of 'fraud on a minority'. The final report has wisely rejected this dual approach, but has adopted the questionable solution of excluding managers and officers from the new remedy. This may have significant implications for the successful deployment of the new remedy in the case of a public listed company, which is itself the top holding company of a large group. The final report also rejects any provision for multiple derivative actions (left open in the Consultation Paper). This will add to the problem, very obviously, where groups of companies are involved.

Confining the new derivative action to proceedings against directors still allows

for those involved in their breaches of duty to be joined as defendants (e.g. where the remedies of tracing and constructive trusts are resorted to). The final report also establishes that 'director' includes 'shadow' and 'de facto' directors. The final report, on the other hand, establishes that minority shareholders may not intervene or commence proceedings against third parties (e.g. in tort) even if the board of directors breached their duty in refusing to take such proceedings. This still leaves the possibility of a derivative claim against the board itself for their possible breach of duty.

Where the company has a claim for breach of duty, the final report proposes that where the company fails diligently to pursue proceedings a shareholder may apply to continue, as a derivative action, proceedings commenced by the company. To do so it must be shown that the claim is capable of being pursued as a derivative action; the company has failed to prosecute the claim diligently; and the manner in which the company has commenced and continued the action amounts to an abuse of the process of the court.

### IMPLEMENTATION OF REFORMS

An important innovation in the final report is to limit new legislation (a proposed s. 458A in the *Companies Act 1985*) to the basic essentials of the new remedy. The detailed procedure for the application for leave to bring a derivative action is to be spelt out in rules of court (para. 6.16). This will clearly have the added advantage that it will shield the details of the proposed procedure from adverse attack when the main legislative provision is examined in Parliament. It may also allow judges to be more flexible in the application of the new procedure.

### APPLICATION FOR LEAVE

The final report emphasises that this will be subject to strict judicial control and what are called 'issues relevant to the grant of leave' (good faith, interests of the company etc.) largely confirm what was

contained in the Consultation Paper. There is, however, some clarification in respect of shareholder ratification. This remains (like the other issues) 'only a factor to which the court has regard'; but it is made clear that the fact that a wrong is ratifiable will not hinder a shareholder commencing proceedings (para. 6.84), actual ratification will still bar proceedings. But, in considering whether or not to grant leave, the court may adjourn proceedings to allow a meeting to be called for the purpose of ratification. The court may also use its discretion to refuse leave where it is clear that a wrong will be ratified and no purpose will be served in ordering this holding of a meeting. A new factor introduced by the final report allows the court to take into account the fact that the company, in a general meeting, has resolved not to pursue the cause of action. The report points out that this is not the same as ratification which has the effect of curing the wrong; but that it will bind the minority if made in good faith in what the majority consider is the benefit of the company (para. 6.87).

This hardening of policy (as between the Consultation Paper and the report) will be practice largely to take away the apparent availability of the new remedy to enforce the full range of director's duties – even though in principle they are all within its ambit. Actions for negligence (or for breaches of conflict of interest and duty) may, in rare situations, obtain leave. If, in the case of listed public companies, the institutional investors can be persuaded to refuse ratification (or oppose a resolution to suppress proceedings), then the new remedy may prove slightly more viable than its common law predecessor.

The real gain of the proposed remedy will, however, be in the area of fraudulent breaches of directors' duties that are not subject to ratification. Here it will provide a better approach than the existing law in 'wrongdoer control'. This will be particularly evident in the case of public listed companies where 'de facto' control now causes such problems.

On one important matter the Consultation Paper and the final report have very little to say. It is briefly assumed that the existing system for funding derivative suits (costs indemnity orders) is working perfectly well and should be left to itself. This is open to question. In the case of listed public companies the financial and informational barriers still remain formidable. Yet it is the case of such companies that the need to remove barriers to derivative litigation is most apparent. A recent development across the whole area of civil litigation seems to come too late for the final report. The Lord Chancellor's recent proposal to replace legal aid with a new system of conditional fees raises very interesting possibilities. The Lord Chancellor's department has told this commentator that the system will include any civil proceedings the object of which is the recovery of money judgment. It will therefore include derivative proceedings. If this new system can be 'married' with the indemnity order already established, bright prospects (depending on your point of view) may be in prospect for the derivative action.

**CONCLUSION**

The Law Commission's aim in this report was above all to clarify the confusion in the existing law. The final report observes (para. 6.9) that:

*'... the introduction of a clear set of rules for the derivative action [based on Canadian and other Commonwealth models] in this country would follow the lead given in other jurisdictions. In an age of increasing globalisation of investment and growing international interest in corporate governance, greater transparency in the requirements of a derivative action is in our view highly desirable'.*

That cannot be doubted. However, it seems strange to this commentator (see *Amicus Curiae*, Issue 3, November 1997) for the Law Commission not even to refer to the applicable law in the leading member states of the European Union (especially Germany and France). Comparative law cannot surely be confined to the Commonwealth. Another surprising omission is any treatment of the conflict of laws in this area. The EU as an arena for civil litigation should have been borne in mind. The law of the EU

(which our courts must already apply) has an interesting provision in respect of jurisdiction over corporate proceedings and shareholders' actions. As to choice of law in derivative proceedings, the scant English authority deserved at least some attention. As with the refusal to consider substantive company law (most notably as regard to directors' duties) this can only be justified in terms of the narrow remit set by the Lord Chancellor's Department and the DTI. The Law Commission did not see itself as free to travel even slightly beyond this remit set out at the commencement of the final report (see paras. 1.1 and 1.3). 

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