

Derivative claims under UK company law and some related provisions of German law

by Frank Wooldridge and Liam Davies

INTRODUCTORY REMARKS

The bringing of derivative claims by the shareholders of an English or Welsh company used to be restricted by reason of the application of the common law rule in *Foss v Harbottle* [1843] 2 Hare 461 (the position was the same in Scotland). According to this rule, which was subject to exceptions, an individual shareholder could not bring an action on the company's behalf against a director who was in breach of his duties to the company. It was only possible to bring such a claim if the wrongdoing was not ratifiable or treated as such. Where an unratifiable wrong could be identified, a derivative action by an individual shareholder might not take place where the majority of the shareholders in general meeting decided not to sue the wrongdoing director(s), provided that the defaulting director(s) did not control the company (*Taylor v National Union of Mineworkers* (1985) BCLC 237).

The position was similar where an independent organ of the company expressed itself opposed to litigation against the wrongdoing director(s) (see *Smith v Croft (No 2)* 1988 Ch 114). The former position in relation to derivative actions before the introduction of the new procedure in Part 11 of the Companies Act 2006, which came into force on October 1, 2007, is very well explained by H C Hirt in his excellent article, "Ratification of breaches of directors duties: the implications of the reforms proposed regarding the availability of derivative actions" (24 *Company Lawyer* (2004) 197.) The rules governing ratification appear to be somewhat complex and uncertain in their effects: see E Ferran, *Company Law and Corporate Finance*, OUP, 1999, p143 in this sense.

The Law Commission made important proposals for the amendment of the law relating to the derivative action in its final report *Shareholder Remedies* (no 246, 1997) which recommended that there should be a "new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue

an action" and that the leave of the court should be required to continue a derivative action. The Company Law Reform Steering Group made a similar recommendation regarding a simplified procedure for such actions. This recommendation was adopted in sections 260-264 of Part 11 of the Companies Act 2006. This Act also provided that such derivative claims could be brought in relation to a cause of action vested in the company and seeking relief on its behalf only with the permission of the court. The 2006 Act further provides that derivative claims may be brought by way of a petition under section 994, which is concerned with unfairly prejudicial conduct of the company's affairs. The effect of section 996(2)(c) is to enable the court to order a derivative claim if a petition under section 994 is brought on the grounds that the company's affairs are being or have been conducted in a manner prejudicial to the interests of the members generally, or some part thereof, is successful. It seems unlikely that much use will be made of this procedure except where it appears unclear to the plaintiff presenting the petition that a derivative claim might be available.

The present article will specifically concern itself with sections 260-269 of Part 11 of the Companies Act 2006. It should be noted however that section 370 of the Act provides for a statutory claim to enforce directors' liabilities in the event of the contravention of certain provisions governing political donations and expenditure.

The provisions of the Act relating to derivative actions in Scotland included in sections 265-269 of the Companies Act 2006 are generally identical, or almost the same as those applicable to England and Wales or Northern Ireland contained in sections 260-264 thereof. However they do differ from the latter provisions in certain procedural aspects.

AMBIT OF THE DERIVATIVE CLAIM UNDER PART 11 OF THE ACT (GENERAL STATUTORY CLAIM)

A shareholder wishing to bring such a derivative claim has to seek the consent of the court to continue it (see Companies Act 2006, s 261, or s 266 for the position in Scotland; this power of the court should prevent any great increase in the number of derivative claims which was feared in the House of Lords). The court is no longer bound by the rule in *Foss v Harbottle* in reaching its decision, but it has to consider certain matters which were relevant to this rule in deciding whether it is in the interests of the company for the action to be brought (see Gower and Davies, *Principles of Modern Company Law*, 8th ed, P L Davies, Sweet and Maxwell, 2008, p 615, in this sense). The company must be made a defendant to the claim in accordance with rule 19.9(3) of the Civil Procedure Rules.

The derivative claims which may be brought under Part 11 of the Companies Act 2006 are claims arising from a proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company. The cause of action may be against a director or another person (Companies Act 2006, ss 260(3) and 265(3) and (4) (applicable to Scotland)); such a person will have been involved with the director's alleged breach of duties, but he or she may be sued separately (or together with the director).

According to sections 260(5) and 265(7) of the Act, directors for the purpose of Part 11 include former and shadow directors. Shadow directors are defined in section 251(1) of the Companies Act as persons with whose directions or instructions the directors of the company are accustomed to act. Former directors remain subject to two of the seven general duties imposed on directors by sections 171-177 of the Act (Companies Act 2006, s 170 (2)). These are to avoid conflicts of interest as regards the exploitation of any property, information or opportunity of which they become aware at a time when they were directors; and the duty not to accept benefits from third parties as regards things done or omitted by them before they ceased to be directors. The position of shadow directors is somewhat uncertain (see Gower and Davies, pp 485-87). According to section 260(4) of the Act it is immaterial whether the cause of action arose before or after the person seeking to bring or continue the derivative claim became a member of the company. Section 265(5), which applies to Scotland, is in similar terms. However former members of the company are not permitted to bring derivative claims. Nevertheless sections 260 (5)(c), and 265(7)(e) which are in identical terms provide that references to a member of a company include a person who is not a member but to whom shares have been transferred or transmitted by operation of law.

THE COURT'S DISCRETION WHETHER TO APPROVE THE CONTINUANCE OF THE DERIVATIVE CLAIM

As already indicated the court has to approve the continuation of the claim (see Companies Act 2006, ss 261 and 266 (applicable to Scotland)). It must refuse to do so in certain situations, ie where the actual breach of duty has been authorised or ratified by the company, or where the proposed breach of duty has been ratified by it (Companies Act 2006, ss 263 (2) (b) and (c) and 268 (1)(b) and (c)(applicable to Scotland)). The court must also refuse to permit the continuance of the claim where a person acting in accordance with his duty to promote the interests of the company would not seek to continue it (Companies Act 2006, s 263(2)(a) and 268(1)(a) (applicable to Scotland); and see also the judgment of David Donaldson QC (sitting as a Deputy High Court Judge) in *Langley Ward Ltd v Trevor & Anor* [2011] EWHC 1893 (Ch)). The court has to be satisfied of the latter situation, and does not appear bound by the views of the shareholder who initiates proceedings.

If the above negative requirements are satisfied the court has to take further considerations into account before deciding whether to permit the derivative claim to continue (Companies Act 2006 ss 263(3) and 268(2) (applicable to Scotland)). These considerations do not appear to be exhaustive. The court must consider the importance that a person acting in accordance with section 172 (duty to promote success of the company) would attach to continuing the action. This test is similar to the preliminary negative test already mentioned. The court is further required to take into account whether the shareholder seeking to continue the action is acting in good faith. In its earlier jurisprudence on derivative actions, it has usually not permitted such an action to continue where the claim has been brought for an ulterior purpose – *Barrett v Duckett* [1995] 1 BCLC 243 and *Portfolios of Distinction v Laird* [2004] 2 BCLC 741 – or where there is another satisfactory remedy, for example placing the company in liquidation. In the case of *Franbar Holdings v Patel* (2009) 1 BCLC I, the existence of an alternative remedy under section 994 of the Companies Act 2006 was an important factor in the court's decision to refuse permission to continue a derivative claim (see Mayson, French and Ryan, *Company Law*, 26th ed, OUP 2009 at p 553 for a short discussion of this case. It has been referred to in a number of subsequent decisions including the Opinion of Lord Glennie in the *Petition of A M Wishart* [2009] CSOH 20 given in the Outer House of the Scottish Court of Session, as well as in certain English cases).

This principle was also stated in the judgments of Lewison J in *Iesini & Ors v Westrip Holdings Ltd & Ors* [2009] EWHC 2526 (Ch) and Newey J in *Kleanthous v Paphitis & Ors* [2011] EWHC 2287 (Ch). The court is also required to take into account whether the act or omission constituting the breach of duty could be or would be likely to be ratified by the company (Companies Act

2006, ss 263 (3) (d) and 268 (2) (d) (Scotland)). In the case of a proposed breach of duty, it has to determine whether the act or omission could be, and in the circumstances would be likely to be ratified by the company (Companies Act 2006, ss 263 (3) (c) and 268 (2) (c) (Scotland)). The court has to take account in appropriate cases of whether the breach of duty is likely to be ratified by the company, and not merely whether it is ratifiable. The concept of ratifiable wrongs has given rise to controversy in the past (see the discussion in Gower and Davies, pp 586-8). According to certain decisions and text-writers, certain breaches of the law are non-ratifiable. Others have held the view that any breach can be ratified if the ratification is carried out by means of the votes of disinterested members. It is noteworthy that sections 239 (3) and (4) of the Companies Act 2006 require the ratification of any conduct by a company director which amounts to negligence, default, breach of duty or breach of trust in relation to the company to be by the votes of persons other than the relevant director or any member connected with him. However, section 239 (7) provides that section 239 does not affect any rule of law as to acts which cannot be ratified by the company.

The court also held in *Franbar Holdings v Patel* that the latter provision means that court must inquire whether the ratification has the effect of improperly preventing a claimant from bringing a claim on behalf of the company. This could occur when it had been obtained by the votes of a member who was associated with the director to be sued, but who was not connected with him for the purposes of section 239 (4). “Connected persons” are defined (in a complex manner) for the present purpose in section 252 of the Act. The approach in this case appears to favour the theory as to ratification according to which it must take place as the result of the votes of disinterested members, rather than the one according to which certain acts are unratifiable.

The court is also required to take account of whether the company has decided not to pursue the claim through the medium of a board resolution or a resolution of the shareholders (Companies Act 2006, ss 263 (3) (c) and 268 (2) (c) (Scotland)). If such a decision has been made by a resolution which was not significantly influenced by persons acting in breach of their duties, the derivative claim would appear unlikely to be allowed to continue. Furthermore, the court is also required to consider whether the act or omission in respect of which the claim is made gives rise to a personal action as opposed to a derivative one on behalf of the company. Such personal actions are not frequently available to members and the position with regard to costs is more favourable in derivative claims.

It follows from *Wallensteiner v Moir (No 2)* [1975] QB 373 that when permission is given to bring a derivative claim, the company is normally responsible for the costs of that claim, even if the claim is unsuccessful. (Now see Civil

Procedure Rules, r 19.9, which provides that the court may order the company to indemnify the claimant against any liability for costs incurred in the application for permission, or in the derivative claim or both). The court will normally consider the obligation of the company to pay on a continuing basis when the litigation proceeds and may be reluctant to give the claimant an unconditional right to payment. In *A M Wishart v Castlecroft Securities Ltd and others* [2009] CSIH 65, the Court of Session found that the company was liable to pay all legal expenses incurred by the petitioner in respect of the derivative proceedings so far as these expenses were incurred from the date of the court’s judgment on the application under section 266 of the Companies Act 2006 for leave to raise proceedings until the procedural hearing of the claim. It also found that the petitioner should be indemnified against all awards of expenses made against him in connection with the proceedings until the hearing unless the court ordered otherwise on an application being made by the company prior to the hearing in the event of a material change in circumstances. The Court of Session reserved to the petitioner the right to apply in the petition for a similar order in respect of later stages of the derivative proceedings. An English court may be expected to adopt a similar approach.

Particular regard must be paid by the court to the evidence given of the views of other shareholders in the matter. This factor may be of considerable significance in deciding whether to permit the continuance of the derivative claim. However, the shareholders in the company may be apathetic or be hampered by lack of adequate information. The position is rather different in relation in the statutory derivative claim for unauthorised expenditure, where the shareholders have the right to all information concerning the subject matter of the litigation in the company’s possession once proceedings have been initiated (Companies Act 2006, s 373). No such right is available in relation to the general statutory claim under sections 260-269.

SPECIAL TYPES OF DERIVATIVE CLAIM

If those who are empowered to initiate litigation on behalf of the company fear that a derivative claim may be brought against it, they may endeavour to prevent this by initiating a claim on behalf of the company which they have no intention of seriously pursuing. In such an event, sections 262 (2) and 267 (2) (Scotland) of the Companies Act 2006, allow a shareholder in the company to apply to the court for permission to continue the proceedings as a derivative claim if the following factors are present (in Northern Ireland leave is substituted for permission). These are (a) that the manner in which the company commenced or continued the proceedings amounts to an abuse of the process of the court, (b) the company has failed to prosecute the claim diligently, (c) it is appropriate for the member to continue the claim as a derivative claim.

As is the case when application is made to continue an initial derivative claim (see Companies Act 2006, ss 261 (2) and 266 (3) (Scotland)) if it appears to the court that the application and evidence filed by the applicant in support of it does not disclose a prima facie case for giving permission or leave, the court is required by section 262 (3) (s 267 (3) in Scotland) to dismiss the application and make any consequential order it thinks appropriate.

Sections 264 and 269 of the Companies Act 2006 provide for a shareholder to apply to take over an existing derivative claim. These provisions are intended to prevent directors from frustrating litigation by inducing a sympathetic shareholder to commence a derivative claim, which he will not pursue effectively (see Gower and Davies, pp 621-22 for a further explanation of these provisions).

THE GERMAN RULES GOVERNING ACTIONS AGAINST BOARD MEMBERS

The German legal provisions contained in paragraphs 147 and 148 of the *Aktiengesetz* do not mention a derivative claim (*actio pro socio* or *abgeleitet Forderung*), but provide for a number of remedies which may have a similar result, except that they cannot be used by individual shareholders except where their shareholding exceeds a specific amount. Paragraphs 147 and 148, which contain quite complex provisions, provide for the bringing of actions against members of the supervisory or executive boards, or the founders of the company, who have caused damage to it. Paragraph 149 is largely concerned with the giving of publicity to actions under paragraph 148. There are no corresponding provisions in relation to a private company and it is a matter of controversy whether and under what conditions an individual shareholder in such a company may bring an action against any of its managers.

Paragraphs 147(1) and (2) of the *Aktiengesetz* stipulate that the general meeting may, acting by a simple majority vote, appoint special representatives for the purpose of bringing a claim for damages against board members or founders of a public company in respect of wrongful acts done by them. According to paragraph 136 of the *Aktiengesetz*, persons allegedly participating in a wrongful act may not take part in the vote.

A claim for damages under the above provisions must be brought within six months of the meeting which decided to take the action. The special representatives have to be members of one of the company's two boards or founders of the company. However, they may be other persons if the holders of at least one tenth of the share capital or €1 million thereof so request and the court deems such an appointment appropriate. The court costs are dealt with in paragraph 147(2) sentence 3, which provides that if the court grants the motion, the company has to bear the court costs. The special representatives appointed by the court may request the company to reimburse reasonable cash expenses and remuneration for their services. The court

decides upon such expenses and remuneration and an immediate appeal may be made against the decision, but any further appeal is precluded.

The above requirements have been regarded as somewhat unduly restrictive and a new paragraph 148 was incorporated into the *Aktiengesetz* in 2005, which provides for an action for damages by shareholders against members of the boards or founders complying with less stringent requirements. However, an individual shareholder is not permitted to bring such an action irrespective of the amount of his shareholding. As in the United Kingdom, there is a preliminary procedure before an action against a member of one of the boards or a founder may be brought. Paragraph 148 (1) of the *Aktiengesetz* allows the holders of shares amounting to one hundredth part of the capital of the company or amounting to €100,000 thereof to bring an action against members of the supervisory or executive board or the founders in their own name if four conditions are fulfilled. It was thought necessary to impose the latter requirements to discourage unmeritorious litigation becoming encouraged by the somewhat permissive character of the provisions.

The shareholders must show that they, or in the case of a universal succession of title, their predecessors in title, purchased their shares before the alleged breach of duty or wrongful act came to their attention by being given publicity. Such publicity may occur in the financial press, on the radio or television, or on the internet. Furthermore, the shareholders must show that the company was required to bring an action against the alleged wrongdoers within a specified period of time, and that facts exist which give rise to the suspicion that the company suffered damage through dishonesty or a serious breach of duty on the part of members of either board or the founders. Finally the shareholders must also demonstrate that there are no predominant reasons concerning the welfare of the company which militate against an action by them. The action must be brought in the *Landgericht* in the district where the company is situated.

The above preliminary procedure reminds one of the rules governing the bringing of a derivative action contained in sections 261 and 266 of the United Kingdom Companies Act 2006. However the latter procedure involves the consideration of different factors. If a German *Landgericht* permits the bringing of an action for damages such action must, according to paragraph 148(4) *Aktiengesetz*, be brought before the same court within three months of permission being given for it. The competent court is the *Landgericht* in the district in which the company is situated. By paragraph 148(3) sentence 2 *Aktiengesetz*, the company may itself take over the claim for damages at any time in which case the shareholder's proceedings for permission to bring the action, or for damages, cease. Instead of bringing a new action the company is permitted by the second sentence of paragraph 148(3) to continue an existing action by shareholders. Whether the original

action ceases or continues, the shareholders who brought it are joined as parties to the company's action.

The costs of court proceedings under paragraph 148 of the *Aktiengesetz* are dealt with by the complex provisions of paragraph 6 thereof. According to the first sentence of this paragraph, the costs of the application to commence such proceedings must be borne by the applicant, if such application is unsuccessful. However, if the application fails because of considerations, which should have been communicated before such application but which were not so communicated, the company is required by the second sentence of paragraph 148(6) to pay the costs of such application. The third sentence thereof provides that the burden of costs is also determined in any final judgment. According to paragraph 148(6) sentence 4, if the company brings proceedings itself, or if it adopts litigation against it by the shareholders, it bears the costs of such litigation. Furthermore it may only withdraw such an action in accordance with the special rules contained in paragraph 93(3) sentences 3 and 4 of the *Aktiengesetz*. Sentence 5 of paragraph 148(6) provides that if the action is unsuccessful the company must reimburse the unsuccessful litigant for his costs, unless he obtained permission to bring the action by means of deliberately or negligently incorrect statements. The final sentence of paragraph 148(6) provides that if there are several shareholders involved in the action against the company, they are entitled to the costs of one attorney unless more than one such person is essential for the proceedings.

Publicity concerning the claim for damages is dealt with in paragraph 149(1). The first sentence of this paragraph stipulates that the request to bring the claim and the result thereof must be published in the company's journals without delay after such request has been granted. If the company is listed, its journals must include the *Bundesanzeiger* (Federal Legal Gazette) and may include another journal or the internet. The details which have to be published are set out in paragraph 149(2) *Aktiengesetz*. Paragraph 149(3) requires that any agreement designed to avoid litigation is subject to the foregoing provisions.

The new German rules contained in paragraphs 148 and 149 of the *Aktiengesetz*, like those contained in paragraph 147 thereof appear rather detailed and complex, and it remains to be seen how much use will be made of them. It should be remembered that German shareholders in a public company are given extensive rights to information by paragraph 131 *Aktiengesetz*, but that such rights may only be exercised in the general meeting. The use of the right to be informed may facilitate the disclosure of breaches of duty by the executive directors, and members of the supervisory board, and hence the bringing of actions against them.

CONCLUDING REMARKS

In the United Kingdom and in Germany, legal rules are in force which attempt to limit the number of derivative

claims and actions by shareholders against members of the boards of companies. These rules provide for a preliminary procedure in relation to such actions. The English and Scottish preliminary procedures operate in two stages, in the first of which the court only considers the application and the evidence provided by the applicant (see Companies Act 2006, ss 261 (which applies to England & Wales) and 266 (which applies to Scotland)). Unless the application is dismissed there is then a hearing in which the company is entitled to take part, and the court hears the evidence produced by it. In deciding whether to grant leave, the court has to consider the factors set out in sections 263(2)-(4) and 268(2) and (3) of the Companies Act 2006. The latter provisions apply to Scotland.

One of the important factors is how a hypothetical person acting in good faith (including a director) would approach the question of continuing with the claim. His Honour Judge Pelling QC found in the recent case of *Stimpson v Southern Private Landlords' Association* [2009] EWHC 2072 (Ch), (2009) HL1321871 that, for several reasons, a hypothetical director would not seek to continue with the claim and added that even if he was wrong about this matter there were others reasons against it. A detailed analysis of the new procedure and the manner in which it should be employed appears in pages 6-11 of the recent judgment of the Court of Session in *A M Wishart v Castlecroft Securities and Others*.

The need for a preliminary procedure in relation to derivative claims was already recognised by the Court of Appeal in *Prudential Assurance Co v Newman Industries* [1984] Ch 204 in which the danger of the protraction of the procedure was recognised. (See also *Smith v Croft (No 2)* [1988] Ch 114, in which the court tried as a preliminary issue whether the company was entitled to the relief sought and whether the action fell within the proper boundaries of the rule in *Foss v Harbottle*). It is evident that the new legal rules represent an abandonment of the limitations imposed on derivative claims by the rule in *Foss v Harbottle*. It remains to be seen how they will be applied by the courts. In the meantime, boards of directors may wish to review their director's and officer's liability insurance policies to ensure that the defence of derivative claims is an insured risk.

The German rules contained in paragraph 148(1) of the *Aktiengesetz* which govern the exercise of the court's discretion to permit an action by shareholders together holding at least one hundredth of the share capital or €100,000 thereof are not so detailed as those contained in sections 263 and 268 of the Companies Act 2006, which seem to have been influenced by the fear of a large number of unmeritorious actions, brought sometimes by pressure groups. The German provisions contained in paragraph 148(1) sentence 2 of the *Aktiengesetz* stipulate that if the *Landgericht* admits a claim, the substantive action must be brought within three months. However, if the dispute is of an acrimonious nature, appeals may result in its further protraction.

Paragraph 148(6) of the *Aktiengesetz* contains detailed provisions governing the costs of an action against members of one of the two boards or founders of a public company. (As indicated above, the question of costs was considered by the Court of Session in *A M Wishart v Castlecroft Securities Limited*).

It is interesting to note that there appear to be no rules of European Community Law governing shareholders remedies; the enactment of such rules would seem likely to

give rise to controversy because there is considerable variation in such rules in the different Member States. 

Dr Frank Wooldridge

Liam Davies

Solicitor, Marriott Davies Yapp LLP