Enforcement of a company's claims in english common law – derivative action

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ABSTRACT

The present article outlines a derivative action, highlights its essential features, and, to the extent necessary for its better understanding, the individual institutes of company law related to the derivative action. The main goal is to provide an understanding of individual institutes related to derivative action and to indicate solutions to problems that arise when filing an action. A derivative action is a special obligation-corporate institute with many particularities that appear in the obligational, corporate, and procedural fields. Special emphasis in the article is given to the examination of a derivative action and determining when an individual shareholder may, in accordance with the company law in the UK, bring an action in favour of the company. The answer can be found in the rule from the *Foss v. Harbottle case*, which will be presented in detail.

Keywords: derivative action, shareholders, public and private companies, *Foss v Harbottle*, Companies Act

Uveljavljanje terjatev gospodarske družbe v angleškem običajnem pravu – derivativna tožba

POVZETEK

V članku je opisana derivativna tožba, poudarjene so njene bistvene značilnosti in, kolikor je to potrebno za njeno boljše ra-

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zumevanje, posamezni instituti prava gospodarskih družb, povezani z derivativno tožbo. Glavni cilj je omogočiti razumevanje posameznih institutov v povezavi z derivativno tožbo, in nakazati rešitve za težave, ki se pojavljajo pri vložitvi tožbe. Derivativna tožba je poseben obligacijskopravni institut s številnimi posebnostmi, ki se pojavljajo na obligacijskem, korporacijskem in procesno pravnem področju. V članku je poseben poudarek namenjen preučitvi derivativne tožbe in določitvi, kdaj lahko posamezni delničar v skladu s pravom družb v Združenem kraljestvu vloži tožbo v korist družbe. Odgovor je mogoče najti v pravilu iz zadeve *Foss proti Harbottle*, ki bo podrobno predstavljen.

Ključne besede: derivativna tožba, delničarji, javne in zasebne družbe, *Foss proti Harbottle*, Zakon o gospodarskih družbah

1. Introduction

The term "partner" refers to the members (shareholders) of a limited liability company – *public* and *private companies* in English law and *corporations* in the US law, and, under some US laws, also to the partners in a *limited partnership*. *Derivative actions* are established in all capital companies. Their use is subject to strict conditions and to the practice of the courts, which, in the UK at least, is very reluctant to allow it.

In English law, the *derivative action* has long been called a "minority shareholder action" (Sullivan, 1985) and is considered a type of representative action brought by an individual shareholder on behalf of all the other shareholders. That a shareholder is, in fact, suing as a representative of the company and that the action necessarily has different characteristics from a normal representative action was only recognised by the English courts in the 1950s (Senčur, 1996: 690). In the US, it was much earlier.

Investment in companies – both public and private – has become the driving force behind innovation and economic expansion in the industrialised world. Any such investment represents an unconditional contract between those who run the company and those who manage capital. The trust that investors must have in those in charge is paramount to a healthy capital market. Today, under the impact of a not insignificant number of corporate failures and mismanagement, this trust is in an unenviable position. Moreover, the affected investors are demanding compensation from management because they are no longer prepared to accept such losses.

The shareholders' action[1] is a way of regulating corporate governance (Bohinc, 2001: 172).[2] However, the principles of corporate law make it difficult to compensate shareholders. In *the common law*, shareholder actions are limited and are complicated by complex rules and costly court procedures. Statutory *derivative actions* emerged in Canada in the 1970s as a legislative response by federal and provincial governments to a perceived deficiency in *common law*, which did not adequately protect the interests of shareholders and the public against unfair corporate governance (Kaplan, 2003: 444). Unfortunately, the statutory regulation of *derivative actions* has taken over the complexities of *common law* and has acquired new obstacles, as we will explain below.

2. On the concept of derivative action in the anglo-american legal system

2.1. The duty of the directors of a company

The Companies Act 2006 prescribes seven main duties of company directors in sections 171 to 177 (Companies Act, 2006). These duties are:

- the duty to act in accordance with the powers conferred;
- the duty to promote the company's performance;
- the duty to exercise independent judgement;
- the duty to exercise reasonable care, skill, and diligence;
- the duty to avoid conflicts of interest;
- the duty not to accept benefits from third parties;
- the duty to disclose an interest in a proposed transaction or arrangement.

The duties of directors may not be limited or waived, but com-

[1] The term "shareholder" refers to the partners or shareholders of limited liability companies – *public* and *private companies* in English law and, later in this chapter, *corporations* and *limited partnership* partners in US law.

[2] Corporations are divided under US law into public, public authority and private (profit and non-profit). In this article, they discuss the corporation in the narrow sense, which also means corporate law in the narrow sense. If we relate the latter to the Slovenian legal definition, it means company law. In American literature, it refers to business corporations, which includes a joint stock company, but according to Slovenian legal regulations, this would be classified as a capital company. However, corporations in this sense must be oriented primarily towards the interests of the shareholders who invested the founding capital.

panies may take out insurance to protect directors against costs in the event of breaches. Remedies for breaches of duty are not statutory but are consistent with common law and the principle of equity and include damages for loss of profits, restitution of unlawfully acquired benefits, and injunctive relief (Dosani, 2020).

2.2. Shareholders' actions

Shareholder actions[3] play an important role as a control mechanism in corporate law. Liability rules should be applied when the primary control mechanisms – the management board, the board of directors, and the shareholders – fail, but their breach is not sufficient to constitute grounds for replacing management. Where there is an imposition of personal liability on corporate officers and members of the board of directors for negligence and conflict of interest, it is the lawsuit that links the incentive of the board members to the interests of the shareholders (Romano, 1991: 55).

The effectiveness of shareholder suits as a control mechanism is hampered by the difficulties of *class actions*, since the costs of a civil action, although less than the total shareholder gain, are greater than the shareholder/plaintiff's proportionate gain (Romano, 1993: 29). To mitigate this problem, successful plaintiffs are reimbursed the costs of their lawyer/representative fees. However, a problem remains with the representative because of such an arrangement: the representative's interests do not necessarily coincide with the shareholder's interests. For example, a settlement payment in relation to a shareholder's claim may only be sufficient for the representative's fees. Critics of shareholder actions argue that most actions are unfounded and that only the plaintiff's representative benefits (Wood, 2004: 229). Proposals to reform shareholder actions are also given to reduce the filing of unfounded lawsuits.

Assessing the direct benefits of a lawsuit is not defined, as there may be indirect benefits not covered by contractual agreements, and legal theorists have investigated two additional hypotheses concerning the source of the benefits of a lawsuit, along with other benefits. The first suggests that corporations may voluntarily adjust management contracts in response to a lawsuit, thereby negating the need for substantial damages in court settlements.

[3] The article focuses on the UK legal system.

The second hypothesis is that a lawsuit can replace other control structures that supervise management, for example, an independent board of directors or a pooling of equity holders. From this perspective, the frequency of lawsuits should be influenced by the characteristics of other supervisory structures, as a weakness in the supervision of one institution may lead to a breach and, therefore, to a lawsuit as a settlement mechanism.

2.3. Derivative action in English *common law*

Previous generations of lawyers have translated the term "common law" as "obče pravo". Today's trend is to abandon such a translation, preferring to use the term in the original, i.e., not to translate it (Novak, 2004: 53).

When corporate law was beginning to develop, the English judiciary struggled to provide legal protection to aggrieved shareholders. The results were various (Watkins, 1999: 58-59).

There are three types of shareholder actions in *common law*:

- a private action against a company;
- a private action against members of the board of directors for breach of a duty to the shareholder personally; and
- a minority shareholder action as a form of typical action by a shareholder on behalf of all shareholders whose rights are violated in the same way (Senčur, 1996: 684).[4]

2.3.1. Minority shareholders' action

The principle that individual shareholders have no cause of action when an infringement has been committed against a company has its origins in the *Foss v Harbottle* case.[5] In it, two shareholders sued five members of the board of directors and two other persons on behalf of the company (Kaplan, 2003: 445) . They accused the members of the board of directors of fraudulent and illegal transactions. The court held that the plaintiffs did

[4] In the US law, individual and representative actions are referred to as direct actions as opposed to *derivative actions*. In this respect, a *derivative action* is therefore always also representative, whereas a direct action by a shareholder is only representative when the shareholder sues as a representative of shareholders who are in the same position.

[5] This rule states that the real plaintiff in a proceeding alleging a violation of the company's rights is, first and foremost, the company itself. Where the alleged infringement is an act which the shareholders can approve by a simple majority, no individual shareholder has a cause of action in respect of that act, because if the majority approves the act, *cadit quaestio*; but if the majority annuls the act, there is no cause of action.

not have active standing to file a lawsuit, as the impugned actions could have been approved by a vote of the shareholders, and the approval of the majority of the shareholders would have been a complete answer to the allegations of harm to the company.

The Foss v Harbottle rule consists of two principles (Morse, 1991: 436):

- the principle of the real plaintiff, based on the separate legal personality of the company, which implies that if a company has suffered a breach, this does not mean that the right of a member (shareholder) of that company has also been breached and, if it has not, the member has no cause of action; and

- the principle of internal governance or the majority principle, according to which it is for the majority to decide whether to initiate proceedings.

Under English company law, an individual member or shareholder brings an action in favour of the company in accordance with the *Foss v Harbottle* case, which plays an important role alongside the *Companies Act* and other *case law*.

The Court's decision in *Foss v Harbottle* established the rule that a company, under the direction of the members of its board of directors, is the only one with standing to bring an action for a breach committed against the company. The basis for this rule is the fact that legitimate control over the solvency of the company is vested in the board of directors elected by the shareholders, and the judiciary may not interfere with the "democratic will of a voluntary association" (Spotorno, 2018: 191). The exceptions to the *Foss v Harbottle* precedent relate to breaches that are outside the limits of the powers of the majority shareholders. These are acts outside the company's activities; transactions that require approval by a special majority; acts that are considered fraud of a minority; and the case in which individual violators obstruct the vote at a general meeting.

2.3.1.1. Foss v Harbottle rule and majority shareholder approval

The *Foss v Harbottle* rule provides that in the event of a breach to the detriment of a company, the only legitimate plaintiff is the company itself (the proper plaintiff principle).[6] The *Foss v Harbot-*

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tle case is also the foundation for the principle that the decision whether to bring an action against the offending member of the board of directors is normally taken by a majority of the shareholders at a general meeting (the majority principle or the principle of internal control). These rules, collectively referred to as the *Foss v Harbottle* rules, ensure that in the event of a breach, an individual shareholder cannot bring an action against a member of the board of directors on behalf of the company (Boyle, 2002: 1-23). However, case law has created exceptions to this rule.

The theoretical rationale for the *Foss v Harbottle* rule: "Where the alleged infringement is an act which the shareholders can approve by a simple majority, no individual shareholder has a cause of action in respect of that act, because if the majority approves the act, *cadit quaestio*; but if the majority annuls the act, there is no cause of action." Since the decision to bring an action is in the hands of the majority of the shareholders, an individual shareholder cannot bring a *derivative action*. A shareholder can only bring a *derivative action* when it is determined that the breach cannot be authorised. From this axiom, it can be concluded that in the current regime, the approval rule[7] plays an important role in the filing of *derivative actions* (Wedderburn, 1967: 77). In fact, some of the analyses of the approval rule, or more specifically, of the circumstances in which offending members of the board of directors may be excused, suggest that it is important to understand and approach the circumstances of the Foss v Harbottle case critically (Hannigan, 2000: 493).

There are two links between the rule in the *Foss v Harbottle* case and the approval rule. The first is the majority principle. As explained by Jenkins L.J. in *Edwards v Halliwell* (Hirt, 2021), this principle makes it clear that in cases in which a simple majority of shareholders can authorise a breach, the *Foss v Harbottle* rule applies. Thus, a majority of shareholders may decide to bring an action (a "positive" decision on the process) or decide not to

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the company itself. Where the alleged infringement is an act which the shareholders can approve by a simple majority, no individual shareholder has a cause of action in respect of that act, because if the majority approves the act, *cadit quaestio*; but if the majority annuls the act, there is no cause of action.

[7] The approval is generally defined as the process by which management that is not in compliance with the company's rules is approved. The term approval is used to refer to a company's decision, by a simple majority (or in some cases a qualified majority) of shareholders at a general meeting, to relieve a director of their personal liability to the company arising out of misuse or violation of duty, which overrides the underlying breach. Therefore, once shareholder approval has been obtained, there is no longer any ground on which the company or a shareholder can bring proceedings on behalf of the company through a *derivative action* against the director who committed the breach.

bring an action for such breaches (a "negative" decision on the process). Actions that can be approved and actions that cannot be approved by a majority of shareholders are an essential part of the law dealing with the performance of the duties of members of the board of directors (Ferran, 1999: 146-147).

The second link is the decision to authorise the breach by a member of the board of directors, which includes the dismissal of that member. This decision constitutes an additional way of "negatively" deciding on legal proceedings and is equivalent to a shareholders' decision not to take legal action against a member of the board of directors. Approval differs from a decision not to commence proceedings in that, once the breach of duty of a member of the board of directors has been approved, the company no longer has a cause of action, as the breach has been remedied (Hannigan B., 2000: 503). With the approval of a majority of the shareholders, the cause of action ceases to exist, and the shareholders, their successors in title, or the liquidator can no longer sue the member of the board of directors for that breach at a later date. However, in the event of a repetition of the breach by the member of the board of directors, the company shall be obliged to bring an action.

In contrast, the decision of a majority of shareholders not to sue a member of the board of directors for breach of duty (which is binding on the individual shareholder who may wish to sue) does not bind the company in the future. As shareholders may later change their minds about bringing an action and subsequent shareholders or the liquidator may decide to bring an action (before the time limit), the member of the board of directors remains liable. The company's cause of action is thus only postponed. To understand the significance of the difference between majority approval and a decision not to sue, it is necessary to look at the established requirements[8] for *derivative actions*.

Given that the *Foss v Harbottle* rule is defined by reference to the approval rule, the question arises as to why it is necessary to have separate rules with respect to shareholder standing (Ferran, 1999: 143-144). A shareholder may not bring a *derivative action* simply because they have discovered a breach that cannot be authorised. Even where a shareholder discovers such a breach, there

[8] A shareholder wishing to bring a *derivative action* must therefore prove two elements: fraud by the minority and control of the company by the breachers.

are at least two ways under the *Companies Act* by which (usually) other shareholders can prevent a shareholder from bringing an action against a member of the board of directors. The first way is for a majority of shareholders to decide not to sue members of the board of directors, provided that those members are not directors of the company. The second way is a "veto by an independent body" of the company (usually a joint body of disinterested shareholders) opposing a lawsuit against the members of the board of directors. Both mechanisms, which prevent an individual shareholder from bringing a *derivative action*, are reflected in the established requirements for *derivative actions* (Ferran, 1999: 151).

Notwithstanding the fact that a shareholder who wishes to bring a *derivative action* proves the existence of fraud by a minority, control of the company by the breachers, or the existence of an *ultra vires* act, this does not mean that the shareholder has an individual and inalienable right to bring an action in favour of the company. It is necessary to distinguish between the impossibility of confirming that an act constitutes fraud by a minority or is unlawful and the possibility of deciding not to bring an action or to withdraw or settle an action. A shareholder shall not have the right to bring an action or to continue the proceedings if, for impartial reasons, a competent body of the company independent of the breaches so decides (Senčur, 1996: 688). It is difficult to explain why a breach is considered unauthorisable when the majority of shareholders can choose not to sue for that breach. In short, the currently established rules may prevent a shareholder from bringing a *derivative action* not only when there has been no approval by a majority of shareholders but also when approval is not possible (or the breach is deemed to be such).

2.3.1.2. The meaning of the Foss v Harbottle rule and the shareholder vote

The importance of the *Foss v Harbottle* rule has increased markedly in practice due to the following principle: "unless the articles of association or the memorandum of association provide otherwise, a shareholder is not disqualified from voting or from using the power of the vote to pass a resolution/decision by reason of the circumstances of the interest they have in the subject matter of the vote" (Sealy, 2001: 143-144). This principle was established in the *North-West Transportation Co Ltd v Beatty* case. In that case, the Privy Council held that "every shareholder has the right to vote on any such question even if they have a personal interest which is contrary to or different from that of the company". Therefore, as shareholders, members of the board of directors can, in fact, use their vote to prevent legal proceedings against themselves as members of the board of directors.

Voting has always been considered a membership right belonging to the shareholder's interest in the company and "may be used by the holder for their own selfish interests, even if these are contrary to the interests of the company" (Hirt, 2021). Jonathan Parker J. confirmed this principle in the *Re Astec (BSR) Plc* case: "The main proposition is that, in general, a shareholder's right to vote is a property right which the shareholder may exercise at any time when it is in their interest to do so. They are not bound to vote for what others consider to be in the interests of the general body of shareholders or of the company as a whole" (Hannigan, 2000: 583).

Members of the board of directors have the right to vote as shareholders at general meetings on matters in which they have an interest, and this includes voting on the approval of their breaches. In this way, the members of the board of directors, as shareholders, have the opportunity to act as judges in their own process. The principle that a shareholder cannot vote on those decisions for which the articles so provide and, in those cases, cannot vote to approve their own breach, as raised in the *North-West Transportation* case, is clearly the reason for the distinction (made by the judges) between breaches that can be and those that cannot be approved (Hollington, 1999: 10).

There is no principle in the UK corporate law stipulating that shareholders with an interest in a particular case may not vote. If voting is viewed as a corporate (membership) right and taking into account the fact that shareholders are not fiduciaries of their shares for the company or other shareholders, it can be generally concluded that, in UK corporate law, shareholders are not subject to a "fiduciary duty" (Hollington, 1999: 10). However, there are suggestions that shareholders may use their votes "in good faith for the benefit of the company as a whole" (Wedderburn, 1981: 208-209). However, any suggestion that there is any "fiduciary duty" to which shareholders would be subject when voting should be carefully considered. Moreover, it is difficult to define what exactly the alleged voting restriction requires. However, it could be argued that a "fiduciary duty" exists where shareholders vote to amend the articles of association, but even this responsibility remains vaguely defined (Boros, 1995: 203-209).

The imposition of such a "fiduciary duty" on shareholders voting on approval could be an advance for the UK law. In the CLRSG main consultation papers,[9] it was suggested that the validity of the approval decision or the decision not to take action against breachers should depend on whether the necessary majority was reached without the support of the breacher(s) or those under their influence (Davies, 2010: 221).

The current law provides that shareholders may use their voting rights to pursue their interests, even when voting on approval, even if their interests conflict with those of the company. Therefore, another mechanism is needed to limit the power of the majority to vote on the approval of a breach of duty. In contrast, case law has limited the power of the majority to vote on approval by developing categories of breaches which cannot be approved. The 2006 Companies Act (Companies Act, 2006) limits the majority's decision-making power by Article 994, which subjects the decision of supervisors to bring an action (as shareholders and members of the board of directors) to a fairness standard. The so-called "equitable remedies" under Article 994 provide a mechanism to control the decision-making power of the majority and thereby prevent a dispute that might arise between the minority and the majority over a decision on a legal proceeding. At least in theory, the remedy provided by Article 994 can protect minority shareholders by subjecting the use of shareholders' decision-making power to a fairness standard to be tested by the courts and by allowing aggrieved shareholders to exit the company if the standard is breached. Under this article, the courts are allowed to review the majority's decision regarding the initiation of legal proceedings. At the same time, it also allows the court to assess whether the majority's decision not to take legal action against the breachers has unfairly affected the interests of minority shareholders in the event that the shareholders do not decide to take legal action.

[9] *Company Law Review Steering Grou*

Shareholders are not usually subject to a “fiduciary duty” or any other restriction when voting. The lack of such restrictions is a reason that the failure or prevention to bring legal proceedings against breachers may have an unfair impact on the interests of other shareholders. It appears that a claim under Article 994 of the *Companies Act* in respect of the right of a majority to vote on the commencement of proceedings can only succeed if the offending members of the board of directors are also majority or controlling shareholders (or are in a position to influence the majority shareholders). In such circumstances, it is the suspected shareholders who make decisions; therefore, the shareholders may succeed by alleging that the supervisors acted in bad faith or with improper intentions. If they do succeed in this claim, the fact that the supervisors failed to react to the breaches of duty by the members of the board of directors or to prevent legal proceedings against them may be considered unfair conduct that affected the subsequent process.

In contrast, a majority of shareholders may freely decide to take legal action where the offending members of the board of directors and the majority or controlling shareholders are not the same persons (and those shareholders are not influenced by the breachers), and the breachers are not in a position of power in the company. In such circumstances, it seems unlikely that a court would assess the appropriateness of the use (or non-use) of the majority’s decision-making power to proceed against the breachers. Therefore, it appears that Article 994 of the *Companies Act* protects the minority only in the most obvious cases of abuse of the majority’s decision-making power.[10] In other words, Article 994 only covers abuses of decision-making power that arise because of the problem of “control over the breacher”.

Therefore, where the breachers control the company, the court may decide that the majority has acted unjustly by not bringing or by preventing proceedings against the breachers. With regard to the “control of the breachers” requirement, in practice, such claims seem to make sense mainly for companies with a small number of shareholders, where some of the shareholders are also members of the board of directors (especially for quasi-partner-

[10] The shareholder must attempt to persuade the company to bring the action; and the English courts recognise that it is absurd to require directors who are also the breachers to bring an action, or to call a general meeting to decide whether to bring an action, where the breachers have effective control over the company.

ships). In summary, Article 994 of the *Companies Act* does not generally provide an adequate legal answer to the problems arising from the decision-making power of the majority to bring an action against breachers.

Under the *Companies Act*, an individual shareholder may not bring a *derivative action* for an authorisable breach by a member of the board of directors, meaning a breach that can theoretically be authorised by a simple majority of shareholders (Yılmaztekin, 2019: 132). The possibility of approval constitutes an obstacle to a *derivative action*; in some cases, approval itself is an obstacle. Thus, where there is a possibility of approval of a breach, an individual shareholder is prevented from suing on behalf of the company even though the approval of a majority of shareholders has not taken place. The main reason that the possibility of approval constitutes a greater obstacle to *derivative actions* than approval is to avoid the costs of unsuccessful court proceedings.

Theoretically, the possibility of approval seems reasonable, as it can be assumed that a majority of shareholders will either approve of the breach (in which case there is no breach and thus no cause of action) or oppose the breach (in which case the company will bring an action) (Hirt, 2021). However, this argument presupposes joint decision-making. Shareholders generally do not have the possibility to scrutinise breaches of duty of the members of the board of directors that can be approved at a shareholders' meeting; thus, the theoretical argument of the possibility of approval as an obstacle fails.

The current law is based on the presumption that joint decision-making is an appropriate mechanism for proceedings against members of the board of directors. The fact that the possibility of approval is an obstacle to *derivative actions* is considered to be one of the main substantive weaknesses of the current established requirements. The possibility of approval does not ensure that the breach is actually presented to the shareholders at the general meeting and that the shareholders collectively consider approving the breach.

2.3.1.3. Exceptions to the Foss v Harbottle rule

Although the statutory regulation of *derivative actions* has superseded the exceptions to the *Foss v Harbottle* precedent, the rule itself has endured and remains a ground on which courts are prepared to dismiss an action or a claim for damages for lack of legal interest on the basis that the claim does not allege any offence against the shareholder (Bamigboye, 2016).

The *common law* limitations on shareholders' actions are also an addition to the idea of limited liability, which was first made possible by an English law in the mid-19th century (Kaplan, 2003: 445). Limited liability was introduced primarily in response to the concerns of wealthy investors whose assets were exposed to suits against the joint stock company, which was the dominant form of corporate entity in England at the time. In the *Salomon v Salomon & Co. Ltd* case, the House of Lords confirmed that the creation of a limited liability company creates a distinct legal identity; therefore, the members cannot be sued for the liabilities of the company (Eales, 1996: 20).

A special feature of a limited liability company is that the assets of the company are owned by the company and not by its members. Although the damage to the limited liability company may be reflected in a decrease in the value of the shares, the shareholder's loss is only a consequence of the loss of the company. Therefore, a shareholder cannot sue for losses that are primarily losses of the company. This limited liability rule has been consistently applied by the courts since the *Salomon v Salomon* case (Raaijmakers, 2004: 376).

The third major limitation on shareholder suits is the general legal principle that members of the board of directors owe their duties to the company as a legal entity and not to existing or potential shareholders. This was the decision of the House of Lords in the *Percival v Wright case* (Campbell, 2007: 36), in which members of the board of directors bought shares from shareholders without disclosing that negotiations for the sale of the shares were underway. This caused the value of the shares to rise. The members of the board of directors were not found guilty of breach of their duties to the company.

Although there was a disregard of the *Percival v Wright* precedent, this was, in fact, an exception to a precedent that remains applicable in modern corporate law. In addition, it has been suggested that family companies and special relationships of trust and dependence between the member(s) of the board of directors and the shareholder(s) should be counted among the exceptions. The general rule remains the same as it was at the end of the 19th century: the members of the board of directors and the management have a duty of care to the company, not to its shareholders (Kaplan, 2003: 447).

The *Foss v Harbottle* rule does not apply in cases in which:

- the act is *ultra vires* or illegal, because even a majority of the shareholders cannot approve such a transaction;

- the act can only be validly performed or authorised by a special resolution of the general meeting, since a simple majority cannot approve the act even in these cases;

- the personal rights of the shareholder have been violated by the act;

- the act constitutes fraud by a minority, and the offenders control the company. (Farrar, 1991: 445)[11]

The most notable exceptions to *Foss v Harbottle* are cases of fraud against a minority by management. An action for fraud against a minority can only be brought as a *derivative action*, which has developed through case law, and its underlying values are rooted in the principle of equity. The plaintiff must satisfy the principle of equity, under which they come before the court innocent. The court does not address frivolous lawsuits motivated by a false cause. This was the case in *Nurcombe v Nurcombe* (Sterling, 1985: 478), where the court dismissed the claim of the plaintiff because she had benefited from the breach that was the subject of the action. Sterling ridiculed the motive for the action, saying: "What the plaintiff is really saying in this suit is: Even though I shared the defendant's unfairly acquired gains, I want the court to order that the defendant pay the corporation its share and mine so that I will have the opportunity to profit more because of my status as a shareholder." (Sterling, 1985: 478)

However, it could be argued that anomalies were committed,, because the rule on improper motive was followed to the letter. The case of *Barrett v Duckett* (Stephenson, 2020) provides a good example of this hypothesis. Mrs Barrett, a 50 per cent minority shareholder (minority because she did not control the casting vote of the chairman), brought a *derivative action* against her son-in-law. The son-in-law was then in control of a company established by Mrs Barrett's late husband. Ostensibly, she brought the

[11] According to Farrar, the rule does not apply even in cases in which a shareholder may sue when justice so requires.

action for misappropriation of the company's assets, for diverting the company's business and profits to another company with which he had a business relationship, and for obtaining a substantial sum of unauthorised fees. As a result of his actions, his once-successful company became insolvent. Fearing for the welfare of her daughter, Mrs Barrett sued her son-in-law for reparation and damages. Despite the fact that her daughter was a member of the board of directors and had allegedly benefited from the misappropriated funds, Mrs Barrett did not bring a claim against her daughter. Although the company clearly had a *prima facie* right to compensation for these infringements, the court of appeal, contrary to the main civil court, dismissed Mrs Barrett's claim. This was on the ground that Mrs Barrett did not have legal standing to pursue the action. Since her primary motive was not to correct corporate breaches but to protect her family's personal and financial interests, she was not a credible plaintiff and thus did not come to court innocent, despite the destruction of the family business and thus, indirectly, her and her daughter's financial security. Mrs Barrett was dissatisfied with the court proceedings and spent a great deal of money, bearing all the costs of the unsuccessful action herself. Although an "improper" motive may be a good justification for dismissing a claim if it is deliberately harmful, it seems that courts sometimes use the principle of equity to find an excuse to dismiss a claim. As Watkins comments (Watkins, 1999: 47): "Corporate law seems to have a perverse delight in putting as many obstacles in the way of the minority plaintiff as possible."

In the *Barrett v Duckett* case, the court suggested that a *derivative action* should only be brought when the minority shareholder has no other remedy. The court suggested that it would be better to bring a private action under Article 459[12] of the *Companies Act* (Mäntysaari, 2005: 230). In addition, given the insolvency of the company, Gibson LJ (The law commission, 1997: 47). considers that the independent liquidator should decide whether the remaining money of the company should be used to pursue the litigation, given that Mrs Barrett was left with no available funds. Where a minority shareholder brings a *derivative action*, it is a

[12] Paragraph 1 of Article 459 of the Companies Act 1985 provides: *"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 which is unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial."*

legal claim for the remedy and restitution of the breaches suffered by the company. Thus, if the money is recovered, it belongs to the company and not to the minority shareholder, despite the fact that the latter will incur costs as a result of the action. Such a situation seems manifestly unfair. In the *Wallersteiner v Moir (No. 2*) case (The law commission, 1997: 52), the court acquitted the almost bankrupt Moir of the costs of the proceedings, which were borne by the state budget. The attempt, approved by the majority of the courts, was to impose on the company the legal costs incurred by the plaintiff in bringing the action in good faith on behalf of the company, although it would have made much more sense for the board of directors to bear the costs. The legality of their judgement rests on the fact that, if the action succeeded, the company would benefit as well as, albeit indirectly, the individual. At the time of this innovation in case law, it was hoped that this would encourage shareholders to bring *derivative actions*, whereas the traditional, inflexible approach was to reduce the number of such actions. Nevertheless, Sugarman considers that maintaining an interest in litigation is too high a price to pay for the potential flaws in the orthodox approach (Sugarman, 1997: 226).

However, until then, there were limits to the application of this liberal rule. In the *Smith v Croft* case, Stephenson suggested that (among other qualifications) costs could only be recovered in cases of "legal necessity" in which the plaintiff was unable to fund the action themselves (Stephenson, 2020). The limitation set out in the above case was not, however, adhered to by the court in the *Jaybird Group Ltd v Greenwood* case (Jaybird Group Ltd v Greenwood: 1986). Nevertheless, the rule remains that minority shareholders should not rely entirely on the rule from the *Wallersteiner* case to ensure the recovery of their legal costs. In the *McDonald v Horn* case (The law commission, 1997: 53), which concerned a pension fund but is similar to a *derivative action* by a minority shareholder, further restrictions were proposed, namely that the claim should not be allowed until the independent party had investigated the plaintiff's claim. Nevertheless, in this case, Vinelott obtained permission for a new method of payment of court costs: the non-refundable payment of court costs. As this method was adopted before the trial, it allowed the beneficiaries of the pension fund to sue at the expense of the fund, irrespective of the verdict. Nevertheless, there is uncertainty as to the legal costs, which shows the reluctance of the judiciary to fairly support the *derivative action* of minority shareholders.

Rule from the *Wallersteiner* case is preserved in rule 12A R.S.C. Ord.15 (The law commission, 1997: 5), which aims to combine a claim for compensation and a means of deciding whether the plaintiff has a legal interest in bringing a *derivative action*. This was achieved by confirming that both prerequisites must be clarified at the preliminary hearing before the commencement of the judicial proceedings. Because of R.S.C. Ord.15 r12A, the court has the discretion to determine the prerequisites under which it will allow a claim for damages to be brought. It is also appropriate to settle a claim for damages at preliminary hearings, as even preliminary proceedings can be lengthy and can cost as much as a smaller court proceeding.

The *Prudential Assurance Co. Ltd. v Newman Industries Ltd. (No. 2)* case (Stephenson, 2020) initially required that the appropriateness of the *derivative action* be proved in the preliminary proceedings. In this case, the Court of Appeal required that it be proved:

a) that the company has the right to file a claim; and

b) that the claim falls within the framework of the exceptions of the precedent of *Foss v Harbottle*.

The factual situation in the *Prudential* case was supported by Knox (Stephenson, 2020: 20) with the precedent of *Smith v Croft (No. 2)*. Thereby, he took the view that it was for the independent body of the company to determine whether the action was in the company's best interests. However, it can reasonably be assumed that a requirement for a preliminary hearing is not the right route to a successful claim. The interpretation of the exceptions and rules set out in the *Foss v Harbottle* precedent can be unclear and controversial, making an independent action difficult to pursue. It can be argued that the requirement of pre-trial proof of the adequacy of the action served to incorporate the "interests of justice" as another exception to the *Foss v Harbottle* precedent. This proposed additional step, first mentioned in the *Heyting v Dupont* (Boyle, 1964: 479) case, would have allowed judges the freedom to decide on remedies in cases in which the alleged breacher does not fall into any of the previously established categories. Such flexibility is certainly desirable as it would allow courts to decide on the jurisdiction in *derivative actions*. It is very likely that this would encourage more reasoned and less contrived judgements in *derivative actions*. It would limit the cases in which a judge is forced to extend the boundaries of other precedents in order to justify a ruling. The allegedly indifferent and undiscovered judicial tendency to find an excuse to dismiss a claim would thus be reduced.

Despite the desire for judicial protection, proving the appropriateness of bringing a claim at a preliminary hearing is uneconomic in terms of cost and duration. A full judicial procedure would be necessary to regulate the validity of the instance of justified exceptions. This would, in turn, lead to higher costs for *derivative actions* and increase the duration of the proceedings. In the face of such obstacles, it is to be expected that plaintiffs would be no more encouraged to bring claims than by the existing case law. Clearly, such a situation could not be condoned, although the current system is also worryingly inadequate. Considering the potential benefits of a broader equitable exception than the *Foss v Harbottle* precedent, we conclude that the time for reform has indeed come.

Moreover, under Article 264 of the *Companies Act*, one board member may bring a claim to take over a derivative action taken by another member if, for example, the latter has failed to exercise due diligence in the action.

Since the *Companies Act* came into force, there have been very few known cases of derivative actions; two of them have been concluded at first instance, namely *Mission Capital Plc v Sinclair* and *Partner and Franbar Holdings Ltd v Patel and Partners* (Mayer Brown, 2009: 2).

2.3. Problems with derivative actions in English law

When a company suffers damage as a result of either the active conduct or the passive acceptance of a majority of shareholders, it is likely that the opposing minority will also suffer the negative consequences of the damage caused. For example, if the company is expropriated and the company is entitled to compensation, the share capital of the company is reduced and the shareholder's benefits (dividends) may be reduced accordingly. The primary loss is suffered by the company, which is why the loss event is called a "corporate loss", but this does not exclude indirect loss to the minority (in the sense of damage to or destruction of their stakes). Therefore, a *derivative action* allows the minority to sue the breachers (usually the members of the management board or the board of directors) on its own behalf and on behalf of the other uninvolved shareholders. Lord Denning wrote in the *Wallersteiner v Moir (No.2)* case (Watkins, 1999: 44): "The form of action is always A. B. (the minority shareholder) on their behalf and on behalf of the other shareholders against the breachers and the company." In addition, a shareholder may use a *derivative action* even if the damage had been done prior to their membership in the company. The prevailing covert duality of such actions, is interesting. While the individual sues ostensibly to defend the rights of the corporation, they also seek to protect their own (personal) interests. As a result, it can be concluded that in many cases, personal interests and the interests of the corporation are closely linked. Thus, it is logical to conclude that the choice of procedure is the source of confusion and debate.

In the *Edwards v Halliwell* case (Panico, 2004: 78), it was said that the *Foss v Harbottle* rule is disregarded when the conduct of the majority shareholder is wholly outside the company's business capacity, meaning outside the company's activities according to the provisions of the memorandum of association. In such a case, proceedings are allowed which have as their object the declaration that such business is unauthorised. At the time of the *Halliwell* case, the exception was justified by the fact that "There is no doubt that the transaction would have been approved by any majority" (Boyle, 2002: 6).

2.4. Legal and procedural problems associated with derivative actions

The legal and procedural difficulties associated with *derivative action* in the English legal order became apparent in the "unfortunate" *Prudential Assurance* action (Stephenson, 2020). The facts of this case were complex but mainly arose from a legal transaction between two closely related companies. A minority shareholder of one of the companies brought an action against the other company and two members of its board of directors. The minority shareholder attempted a private action, a representative action for personal loss, and a representative action against the company on behalf of all shareholders.

Vinelott refused a request to eliminate the pleadings in the *Prudential Assurance v Newman Industries (No. 1)* case (Law commission, Shareholder remedies, 1997: 33). Vinelott also refused the defendants' request for a preliminary ruling on whether the conditions for a *derivative action* had been met. At the next trial, the same judge granted the claim on the basis of evidence of fraud and conspiracy against the shareholders. As the shareholders were claiming damages both personally and on behalf of the company, the court had to consider the possibility of double recovery for a single breach. Vinelott agreed with the plaintiff's counsel that there was a risk that the company for whose benefit the action was won would either abandon the action or treat the proceeds in a manner that would be detrimental to the shareholders. Vinelott also found that the recovery would not benefit those shareholders who sold their shares after the loss and before the recovery. He concluded that the solution was to issue a declaration of private and *derivative actions* but simultaneously hold the private actions and require that no legal proceedings proceed without the court's permission (presumably until it is known if the company complies with the judgement) (Hopt, 1985: 266).

The defendants appealed against the decision of the first instance court. The second instance proceedings lasted forty-five days, and the reasoning behind the Court of Appeal's decision was so extensive that only two of the seven chapters were published. The Court of Appeal ruled that the claims in the action were erroneous and held that the action was brought only because of the fear that the conditions for a *derivative action* would not be met. Following this decision, the Court of Appeal refused to rule on whether the claim was properly framed in light of the fact that the parties were constrained by Vinelott's decision to proceed to judgement. Somewhat obliquely, the Court of Appeal reacted to the first instance court's decision by denying the minority fraud conviction and ruling that the shareholders' claims were barred due to the *Foss v Harbottle* precedent (Kaplan, 2003: 448). Due to the length and expense of the *Prudential Assurance* litigation, the Court of Appeal set the following for future cases.

Before filing a claim, a plaintiff must establish a *prima facie* case showing that:

1. that the company is entitled to the damages claimed;

2. that the claim is within the exception to the *Foss v Harbottle* precedent (Mäntysaari, 2005: 172).

Subsequent decisions in English law have followed this complementary judicial pronouncement, requiring shareholders, upon objection by the defendants, to assert the above requirements before proceeding with a *derivative action*. These preliminary hearings soon developed into complex and costly court proceedings. The problems in limiting the scope of the exceptions to the *Foss v Harbottle* rule and the procedural complications created by the tripartite nature of the plaintiff, the company and the defendants made any major *derivative action* difficult (Mäntysaari, 2005: 172).

3. Conclusion

For too long, *derivative action in the UK common law* has been abandoned among the values of the past, clinging to outdated principles of case law while attempting unsuccessfully to develop its own concepts to fit modern dilemmas. The result is an overly complex, vague, and artificial legal interpretation, which is reflected in judgements that extend the boundaries of legal rationality.

The liberalised additions to the minority shareholder protection clause concerning *derivative actions* are reflected in a penetration into traditional territory and a reduction in the degree of appropriateness. Judicial incompetence, obstinacy, and restraint in allowing the dual nature of the minority shareholder *derivative action* is reflected in the suppression of a potentially effective reform: the adaptation of the *derivative action* to Article 459 of the *Companies Act*. The report of the Parliamentary Law Commission on the possible reform of shareholders' remedies failed to improve the actions for damages with courage, zeal, and radicalism, even though the report of the Parliamentary Law Commission was a step in the right direction. Looking at the approaches of other *common law* systems, the commission's proposals do indeed appear to be a poor and confused mix of ideas from different sources, which is exceptionally unoriginal. We must hope that the commission's adequate but insufficient proposals do not set a limit to the extent to which the law and the judiciary will support *derivative action* reforms. There is still much work to be done in reforming the use and structure of the action to ensure that it achieves the highest possible level of success.

In a *derivative action*, all shareholders have a partial and indirect interest in the damage suffered by the corporation as well as in bringing the action on behalf of the company.

The identity of the defendants in a *derivative action* depends on the nature of the claim of the shareholder/plaintiff. Although *derivative actions* typically involve claims for breach of duty against current or former members of the management board or the board of directors, officers or majority shareholders, the scope of potential defendants is not limited to persons with a fiduciary duty to the company (Christian, 1999). Thus, a *derivative action* may be a claim against a third party on behalf of the company.

A *derivative action* is a complex form of civil action. Its complexity is due to many factors. The most important is the fact that the corporation, and not the shareholder/plaintiff, is really the party. The consequence of this is that the company is a necessary party to the proceedings. In addition, if the relevant jurisdiction requires that the company be represented by a lawyer in the action, the non-lawyer shareholder cannot proceed with the *derivative action*.

As a result, much depends on whether the court characterises a particular claim as one in which the shareholder must use a *derivative action* or as one that the plaintiff brings as an individual by way of direct action. In such a case, as in many others, the court's decision on the relevant law is important as it determines which jurisdiction will be applied. In addition, when a *derivative action* is brought in federal court, the court must determine whether federal or state law should be applied to resolve certain issues. Shareholder claims for individual damages may be pursued through a class action in which the shareholder is the lead plaintiff on behalf of the class.

Another factor complicating *derivative actions* arises from doctrines that allow the corporation itself, through its shareholders or members of its board of directors, to determine whether a *derivative action* is in the best interests of the company. Many jurisdictions provide that the plaintiff must require the members of the board of directors to bring the action except in the case the action is void. In addition, some jurisdictions also require that the request be made by the shareholders, except when this would be ineffective, while other jurisdictions require the plaintiff to make the request through the members of the board of directors. Where filing through the members of the board of directors is deemed ineffective, under several statutes and precedents, the board of directors has the power to convene a special "action committee" composed of the members of the board of directors. Such a committee then decides whether the corporation would benefit from the action. Jurisdictions differ in determining the circumstances in which the board of directors may convene such a committee and the degree of deference to be shown by the court following its decision.

Most *derivative actions* are dismissed, or disputes are settled out of court or in court, and there is little evidence of a court deciding on the merits. Many jurisdictions require that the court accept an acceptable settlement, waiver or compromise and that shareholders who are not parties to the proceedings receive an agreement on a possible resolution of the dispute.

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