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Companies Act 2006 Derivative claims and recent case law

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Background

In putting the rights of shareholders to sue directors on behalf of the company (a "derivative claim") on a statutory basis, the Companies Act 2006 (the "Act") both codified and extended the existing common law right under Foss v Harbottle for a shareholder to bring a claim against a director (where they were not acting in good faith) in the company's name. A claim may now be brought in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director (section 260).

At the time of implementation the impact of the new statutory derivative claim regime and the potential proliferation of such claims was the subject of speculation only. Indeed the Law Commission, in recommending the requirements of a new statutory procedure, had intended that the criteria for determining whether a shareholder has a meritorious claim be more modern, flexible and accessible. Three years have since passed and yet there remain very few reported derivative action cases.

This briefing note sets out recent key cases and attempts to identify why so few actions have materialised notwithstanding the perceived breadth of directors' duties set out in the Act in respect of which a director may fall foul. In doing so, this note considers whether the two stage procedure to commence a derivative claim has perhaps proved to be too high a hurdle for claimants.

Bringing a derivative claim and the two stage procedure

A minority shareholder must apply to the Court for permission to bring an action in the name of the company. Whilst the Court may be bound to refuse permission (e.g. where the acts of the directors have been authorised or ratified), the Act (section 263) provides sufficient scope for the Court to exercise a wide discretion as to whether or not to permit the action. One critical innovation made by the Act is that a simple majority of shareholders may no longer ratify the conduct of the board, which might otherwise bar any derivative claim by a minority shareholder. Instead, the votes of anyone connected with the director(s) who are the subject of the claim, shall be disregarded.

There is a two stage procedure for bringing a derivative claim, the first hurdle of which in requesting the Court's permission to make the application is to show that the application is being brought in good faith (the "Good Faith Test"). This criteria should filter out any claims being brought by persons trying to bring a claim with an ulterior purpose beyond that of scrutinising the acts of directors, such as where a pressure group may acquire shares in a company for the sole purpose of bringing an action, perhaps to gain publicity and/or damage that company's reputation in the eyes of the public.

The formal two stage derivative claim procedure (section 261) that applies to the bona fide shareholder's application, is as follows:

Stage 1 The applicant must present its evidence and show that it has a prima facie case, with neither the company nor its directors being required to submit any evidence at this stage. Aside from the application of the Good Faith Test, the Court's criteria for analysing an application is set out in section 263 and, inter alia, requires it to consider itself to be a hypothetical director of the company and whether or not he would, in accordance with his section 172, seek to continue the claim ("The Hypothetical Director Test").

Stage 2 If the prima facie case has been shown in Stage 1 to the satisfaction of the Court, then it will only then request that the respondent company provides evidence on which to defend the action, whether by contesting the shareholder's right to bring the action or by presenting evidence to counter the claim. Subject to the evidence then presented, the Court will decide whether or not the application may proceed.

Early opinion on the new procedure was that the Stage 1 test would be relatively easy to achieve and that the progress of an application to Stage 2 would be little hindered by the Court. The following three cases reveal that the mere formality of progressing through Stage 1 has not been the Court's view.

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Recent case law

Franbar Holdings Ltd v Patel and ors (2008)

Leaving the facts of this case to one side, the High Court in Franbar refused an application for permission to continue a derivative claim. William Trower QC presiding stated that in coming to any conclusion as to whether a hypothetical director would, in accordance with section 172, seek to continue the claim it was necessary to consider the following: a) the prospects of success, (b) the ability of the company to make a recovery, (c) the disruption that would be caused to the company by the commencement or continuation of the proceedings and (d) the cost of such proceedings.

In his application of these tests, the judge concluded that the parallel unfair prejudice petition under section 994 and a separate shareholders' action weighed in the balance against his grant of permission to continue the derivative action. He held that a hypothetical director would view pursuing a derivative claim as less important in accordance with section 172, certainly until the other proceedings had been resolved. In that respect the judge did leave the door open for a derivative action in the future, presumably when the hypothetical director may attach greater weight to the importance of a derivative claim.

Mission Capital v Sinclair (2008)

The court refused Sinclair an application for permission to continue a derivative claim. In this case the claimants, the former executive directors sought to bring a derivative claim against Mission Capital. Mission Capital had terminated the applicants' employment and required them to resign on the grounds that they had failed to meet the financial forecasts and submit financial information to the board. Mission Capital obtained an injunction excluding the applicants from the company premises and requiring them to deliver some documents.

Sinclair counterclaimed and brought a derivate claim against Mission Capital and the non-executive directors along with the replacement director. The question the court had to consider was whether to allow the claim for a derivative action. Sinclair managed to pass the first stage as they could show that they had a prima facie case for permission to be granted as it was thought that a hypothetical director would continue the claim (section 263(2)(a)). A key consideration here was to ensure that the derivative claim did not duplicate the counterclaim also being made in the case and therefore serve no real purpose. The Court then turned to the second limb of the test as provided for in section 263(3). Although the judge could not be satisfied that a hypothetical director would not continue the claim, he considered that the director would not attach much importance to it. One of the reasons for this is because the damage the company would suffer from the wrongful dismissals was speculative. Secondly, the judge took the view that the claimants could recover what they sought by way of an unfair prejudice petition under section 994.

Stimpson v Southern Landlords (2009)

The company signed a merger agreement with another company which resulted in the assets of the former company being transferred to the other company. The claimant was a founding member and president of the first company.

The application to pursue a case under a derivative action was refused. Leaning heavily on the judgment in Franbar, the judge reiterated that it was important to note that section 263(3) does not provide an exhaustive list of matters to be taken into account. In this instance, if the claim succeeded then the employees who had been transferred as a result of the merger may face redundancy. Such an injustice was a factor that could be considered against the continuation of the claim.

It was also noted that the claimant had other avenues open to him which he failed to pursue. He could have argued his point at board meetings or tried to set up a general meeting. The judge believed that the claimant brought the action as he did "not want to see the first (company)…lose its identity or to lose control of it". The judge went as far as to say that he considered motivation of this sort to be "a negative factor".

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Pipeline derivative actions

Despite, the above cases failing to produce positive results for the applicant shareholder it would be remarkable in the current economic climate not to find determined activist shareholders making derivative claim applications and refining the quality of those applications in light of the above. Two known derivative claims are already in the pipeline. One, against Lloyds TSB relating to their decision to merge with an ailing HBOS, where the shareholder activist group Lloyds Action Now may join forces with the UK Shareholders' association.

The other is proposed to be brought by minority shareholder Mark Bruce-Smith against the directors of Caffyns plc for an alleged breach of duty to shareholders in respect of the underperformance of that company. A summary of Mr Bruce-Smith's letter sent to Caffyns plc ordinary shareholders is provided below and perhaps reflects the feelings of many shareholders suffering the ill affects of the global economic downturn:

"Much of Caffyns' woes have been self-inflicted by a management that was ill prepared, slow to react and lacking in ideas for the future. We should not allow ourselves to be duped by any board attempts to hide behind the recession." How a Court may unravel a director's negligent decision from the turmoil in the global economy at large may prove the litmus test for the Court's attitude to derivative claims under the new statutory regime or, just as likely, we may see many derivate actions failing to pass the Hypothetical Director Test, where distinguishing poor decision making from "ambient" poor performance of the subject market is, at best, difficult.

Overview

The recent case law appears to show the high threshold that claimants need to meet at Stage 1 of the statutory procedure to pursue a derivative claim. It may be that disaffected minority shareholders should try to pursue other avenues of accountability and/or recourse against the company or its directors before bringing a derivative claim under the Act, such as that of the section 994 unfair prejudice petition recommended by the judge in Mission Capital. Recent enhancements to minority shareholders' rights, also under the Act, may similarly provide a more proactive avenue of recourse in which directors' acts can be scrutinised and the individuals, ultimately, called to account. Such scrutiny may also have the added preventative dimension in respect of future proposals.

Whether or not that proves to be the case, any director of a company that does not regularly refresh themselves of their statutory duties under the Act may be exposing themselves and the company to potential minority shareholder actions. Indeed the overarching duty that a director must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of the members as a whole (set out in section 172), should be a director's mantra.

The changes may hit companies in the pocket also as every successful derivative claim application may result in increased insurance premiums as the potential liability for directors rises.

It is interesting of itself, that a flurry of derivative claims have not materialised since the new procedures were implemented. Only time will tell whether the global economic downturn will stimulate minority shareholders to pursue more such actions, or, in the alternative, cash strapped investors may well shy away from the expense and emotional burden of an action in favour of leaning on the enhanced minority shareholder rights.

It may transpire that the use of the derivative action procedure may find itself forming part of a wider strategy for effecting change. For example, the hope of Bruce-Smith's team is for the board of Caffyns to step down voluntarily or under pressure from non-executive directors, indicating that a shareholder may take the view that the threat alone of a derivative action may be sufficient to achieve their aim of regime change in the boardroom.

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