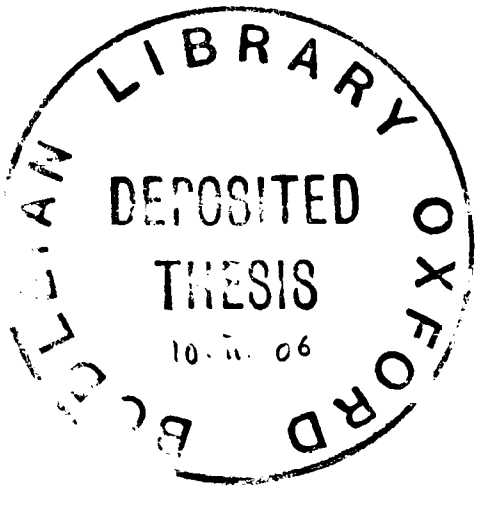
THE DERIVATIVE ACTION AS A CORPORATE GOVERNANCE TOOL:

A FUNCTIONAL AND FOCUSED APPROACH

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THESIS ABSTRACT

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This thesis of 98,273 words is concerned with one of company law's most thorny aspects: the derivative action. The thesis has both a positive and a normative dimension. It takes a position about the role that derivative action litigation should have in the corporate governance matrix. This is the realm of the normative, the domain of what some political philosophers call 'ideal theory'. However the analysis here aims not to be merely a philosophical flight of fantasy about how things ought to be, but rather aims to provide insight into current practice and to suggest substantive viable improvements. In view of this, this analysis can be used both to understand substantial and procedural rules governing the derivative action and judicial decisions in this area, and to suggest how problems should be resolved in the future, judicially and legislatively.

First, the thesis attempts a fundamental rethink of the content of the derivative action and its objectives. It attempts to clarify the nature of the action and the circumstances in which its application may be deemed propitious. The thesis then focuses on and examines the conditions that may produce a positive inducement to litigate. It expresses a view on what might be the optimal level of such litigation with a view to enhancing the potential effectiveness of the action. Crucially, it strongly links the actual viability of derivative actions to funding mechanisms, namely developing adequate means to fund derivative actions so as to make them worthwhile financially. Finally, the thesis argues that it is vital to clarify the interaction between the primary remedies available to shareholders.

More specifically, the thesis calls for action on three complementary levels, namely, conceptual—the adoption of a new framework in the guise of the Functional and Focused Model ('FFM') to govern derivative action litigation; strategic—the employment of appropriate incentives and fee rules which advance the premises behind the FFM; and, finally, maintaining doctrinal consistency – by clarifying the interaction between the derivative action and the unfair prejudice remedy.

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I was fortunate in having several articles, derived from chapters in this thesis, accepted for publication. I thankfully acknowledge the (often detailed) comments I received from the editors and anonymous referees of the following journals: Journal of Corporate Law Studies, European Business Organization Law Review, Modern Law Review, European Business Law Review, Journal of Business Law, International Company and Commercial Law Review and European Company and Financial Law Review. Most of these comments are reflected in the following chapters. In several

instances I have been persuaded by the responses to these articles to change my mind about several of the positions I took in them. Needless to say, my current views are described herein.

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Arad Reisberg.

Oxford, 27 May 2005

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■ Glossary of Terms

In this thesis, unless otherwise specified, 'firm', 'company', and 'corporation' are used interchangeably to refer to a non-charitable limited liability incorporated company. Similarly, the terms 'shareholder' and 'member' are used interchangeably.

The following abbreviations are also used:

(1) GENERAL ABBREVIATIONS

Chapter	ch
Civil Procedure (Amendment) Rules 2000 SI 2000/221 Rule 19.9	CPR 19.9
Civil Procedure Rules 2000	CPR
Companies Act 1985	CA 1985
Company	Co
Department of Trade and Industry	DTI
Insolvency Act 1986	IA 1986
Limited	Ltd
Note	n
Notes	nn
Paragraph	para
Paragraphs	paras
Part	pt
Public limited company	Plc
Rules of the Supreme Court	RSC
Schedule	sch
Section	s
Sections	ss
Special Litigation Committees	SLCs
United Kingdom	UK
United States	US

(2) ABBREVIATIONS OF NAMES OF PERIODICALS

Cambridge Law Journal	CLJ
Company Financial and Insolvency Law Review	CFILR
Company and Securities Law Journal	CSLJ
European Business Law Review	EBLR
European Business Organization Law Review	EBOLR
International and Comparative Law Quarterly	ICLQ
International Company and Commercial Law Review	ICCLR
Journal of Business Law	JBL
Journal of Corporate Law Studies	JCLS
Journal of Legal Studies	JLS
Lloyd's Maritime & Commercial Law Quarterly	LMCLQ
Law Quarterly Review	LQR
Legal Studies	LS
Modern Law Review	MLR
New Law Journal	NLJ
Oxford Journal of Legal Studies	OJLS

(3) ABBREVIATIONS OF LAW REFORM REPORTS

Law Commission *Shareholder Remedies* (Consultation Paper No 142 1996)	Consultation Paper
Law Commission *Shareholder Remedies* (Law Com Report No 246 1997)	Report
Company Law Review Steering Group *Modern Company Law for a Competitive Economy: Developing the Framework* (London DTI March 2000)	CLR *Developing the Framework*
Company Law Review Steering Group, *Completing the Structure* (DTI London November 2000)	CLR *Completing the Structure*
Company Law Review Steering Group *Final Report* (DTI London June 2001)	CLR *Final Report*

INTRODUCTION

1.1 Background

This thesis is concerned with one of company law's most thorny aspects: the derivative action. Whether and, if so, in what circumstances a shareholder should be able to bring an action on behalf of his company (ie a derivative action) is an important aspect of the current debate in the UK, and other jurisdictions, about corporate governance. Corporate governance is concerned with the relationship between the managers of a company and those who have a stake in the running of its affairs[1] and, although there is a debate about how far the concept of 'stakeholder' should extend, and for what purpose, it is indisputable that shareholders are stakeholders.[2] The mechanisms whereby stakeholders can oversee and control the managers (including the derivative action) form one facet of the relationship.[3] There is widespread agreement, however, that the derivative action under English law, as it presently stands, does not amount to an effective controlling mechanism.

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[1] DD Prentice 'Some Aspects of the Corporate Governance Debate' in DD Prentice and P Holland (eds) *Contemporary Issues in Corporate Governance* (Clarendon Press 1991) 2. Corporate governance is a term that lacks a single, universally accepted definition. Compare, for example, OECD's definition in *Principles of Corporate Governance* (OECD 1999) preface, with A Shleifer and R Vishny 'A Survey of Corporate Governance' (1997) 52 The Journal of Finance 737. On the basis of the broad definition above, the discussion in this thesis is *not* limited to internal corporate governance mechanisms for dealing with 'agency problems' (on which see ch 1 below) that arise within the corporate framework.

[2] See eg S Deakin E Ferran and R Nolan 'Shareholders' Rights and Remedies: An Overview' [1997] 2 CFILR 162, 163.

[3] See ch 1 below.

1.2 The Current Status of Derivative Actions

Lying deep at the heart of the company law structure, the derivative action, in its current form, is a subject which, to the uninitiated, is both complex and arcane. Its roots lie in case law principles established in the nineteenth century and which, in the opinions of many, no longer reflect the needs and reality of the modern corporate world. Consequent juridical development of the action and its governing concepts has been characterized by doctrinal confusion, and existing case law on the derivative action is confused, complex and often obscure.[4]

The need for reform is widely acknowledged and is long overdue. As a mechanism for shareholder control of corporate wrongs and thus as a tool of corporate governance, the derivative action has had much international attention given to it, particularly in the last decade or so. The English Law Commission conducted an extensive inquiry into shareholder remedies in the period between 1995 and 1997.[5] This resulted in recommendations to replace the existing derivative procedure with a new derivative action on a statutory basis.[6] As the Law Commission acknowledged, in an age of increasing globalization of investment

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[4] Law Commission *Shareholder Remedies* (Law Com Report No 246 1997) para 6.9.

[5] Law Commission *Shareholder Remedies* (Consultation Paper No 142 1996); Law Commission *Shareholder Remedies* (Law Com Report No 246 1997).

[6] Broadly speaking, the Company Law Review Steering Group has endorsed the recommendations of the Law Commission, and the recent White Paper, *Company Law Reform* Cm 6456 (London: DTI, March 2005) s 3.4, confirmed that the Bill will put derivative actions on a statutory footing.

and growing interest in corporate governance, greater transparency in the requirements for a derivative action is highly desirable.[7] It considered that the derivative procedure should be rationalized and modernized.[8] This is therefore an opportune time for a more fundamental rethink of the derivative action.

1.3 The Primary Objectives of the Thesis

The thesis has both a positive and a normative dimension. The thesis argues that we should consider not only those areas in which the action can be improved upon, but also its wider objectives. It therefore takes a position about what role derivative action litigation should have in the corporate governance matrix. This is the realm of the normative, the domain of what some political philosophers call 'ideal theory'. But that is not all. The analysis here aims not to be merely a philosophical flight of fantasy about how things ought to be, but rather aims to provide insight into current practice and to suggest substantive viable improvements. In other words, the arguments here fit current discussions of company law. In view of this, this analysis can be used as one method among others, both to understand substantial and procedural rules governing the derivative action and judicial decisions in this area, and to suggest how problems should be resolved in the future, judicially and legislatively.

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[7] Report para 6.9.

[8] Report para 6.12.

No attempt will be made in this work to cover all the complex issues which arise in relation to derivative action litigation,[9] nor to defend a set of detailed proposals.[10] Instead, an effort will be made to move and extend the discussion on derivative actions beyond its current scope, and in particular, to areas which are traditionally overlooked. First, the thesis attempts a fundamental rethink of the *content* of the derivative action and its objectives (an opportunity which was missed by the Law Commission's work). Secondly, the thesis focuses on and examines the conditions that may produce *positive incentives* to litigate in the first place. Thirdly, it strongly *links* the actual viability of derivative actions to funding mechanisms, namely developing adequate means to fund derivative actions so as to make them worthwhile financially. Finally, the thesis discusses what might be the *optimal level* of such litigation with a view to enhancing the potential effectiveness of the action, and what means might assist in achieving that level.

Given that the inadequacies of the present system are generally accepted to be substantial, it will also be necessary to consider whether any practical alternatives to the derivative action potentially exist and, if so, whether they might provide an acceptable replacement in any or all instances. Discussion of reforming the legal position of the derivative action will necessarily include comparative

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[9] So, for example, given the constraints of space, the thesis will not consider any questions relating to the derivative action and conflict of laws, on which see *Konamaneni v Rolls Royce Industrial Power (India) Ltd* [2002] 1 WLR 1269.

[10] At various crucial junctions, the thesis, nonetheless, will make reference to the Law Commission proposals (as well as the Company Law Review recommendations) and assess their effectiveness.

references to other legal systems. The importance of this aspect is compounded by the fact that numerous jurisdictions have already introduced statutory derivative actions.[11]

1.4 The New Proposed Framework Advanced by the Thesis

The theoretical inquiry advanced in this thesis is predicated on four interrelated suppositions, all of which are strongly reinforced by real-world observations:

First, as will be seen in Chapter 5, litigation is expensive, and its cost is a major obstacle in the path of a minority shareholder bringing a derivative action on behalf of the company. A rational shareholder will normally prefer to sell his shares rather than litigate. The expense of litigation, combined with the fact that any damages recovered (if any) accrue to the company, creates a powerful disincentive to commence litigation. If all shareholders share the same view, then no one is likely to step forward even in situations where litigation would be in the interests of the company (ie by increasing total share value). Secondly, allowing the common law derivative action to lurk 'dormant' in the hinterland of company law would be to ignore the possibility that the derivative action could be used as a legitimate corporate governance tool to redress the concerns which all scholars have with issues centred on management accountability and lack of shareholder

[11] Including, for example, Canada, Australia, New Zealand and, most recently, Israel.

voice. If the latter is the case and the derivative action, as the writer believes it to be originally conceived, presents a real opportunity for active corporate governance, then any recommendations which provide procedural clarity ought to be welcomed. Thirdly, in order to be socially desirable, policy prescriptions must identify the relevant welfare-enhancing determinants.[12] Finally, in order to be effective, legal reforms and regulatory measures must possess a *functional* capacity to affect the respective incentives that impact on the attainment of the social objectives of law enforcement.[13]

Intertwining these observations into a cohesive model of derivative actions, the thesis conceptualizes the derivative action mechanism and argues that action should be taken on three parallel levels: (1) *conceptual* (ie adoption of a new framework in the guise of the 'Functional and Focused Model' as set out below); (2) *strategic* (ie employment of appropriate incentives and fee rules which advance the premises behind the model); and (3) maintaining *doctrinal consistency* (ie clarification of the interaction between the derivative action and the unfair prejudice remedy).

At the *conceptual level*, the thesis develops a model to analyse and explain the use of the derivative action referred to as the ***Functional and Focused Model***

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12 See ch 4 under 4.1.

13 ibid.

('FFM'). Its starting premise is that litigation is a failsafe remedy, a safety net for instances when other mechanisms of accountability fail. Its challenge is to simplify procedures and establish a fair and balanced procedure for derivative action litigation. The FFM puts these constructive attributes into operation by validating principles to govern derivative actions and to tackle those difficulties that arise only in the context of these unique proceedings. Secondly, the *strategic* aspect of the FFM, which consists of a discussion of costs and fees as incentives to commence litigation, lends support to the central facet of the FFM and is subsequently put into operation. The focal interest of the theoretical inquiry is in gaining insight into how the derivative action shapes the incentives of private agents, namely shareholders and their attorneys, and how the latters' incentives, in turn, affect the fulfillment of the objectives of the derivative action. The final building block of the model concerns practical aspects of the law governing derivative actions. Chapter 7 will argue that it is vital to clarify the interaction and uneasy relationship between the unfair prejudice remedy under section 459 CA 1985 and the derivative action in order to *maintain doctrinal consistency*. This, in turn, may not only help preserve the derivative action and enhance its roles, but could potentially enhance the capabilities of other mechanisms of accountability, not least section 459, as members may be encouraged to bring this claim rather than the wide-ranging proceedings under section 459, and accordingly this will shift some of the burden from that section.

1.5 An Overview of the Thesis

The thesis is organized as follows. **Chapter 1** begins an inquiry into an indefinite, but fundamental, question that has received inadequate attention in the literature on corporate law theory in England: what purpose lies at the heart of the company's cause of action which justifies the use of derivative actions? As will be seen, shareholder litigation is neither the initial nor the primary protection for shareholders against managerial misconduct. A variety of other legal means, as well as social and market forces, also operate to hold corporate officials accountable. To the extent that these mechanisms effectively align the interests of managers and shareholders, there may be less need to resort to costly litigation as a means of protecting shareholder interests.

Building upon the discussion in the first chapter, **Chapter 2** inquires into the theoretical rationales and the social value behind derivative actions. The purpose is to determine whether some of the features inherent in the derivative action mechanism enhance or detract from the understanding of derivative action as a positive social force. The discussion suggests that the derivative action balances two competing sets of agency costs: litigation costs and management costs. It can minimize management costs when it (1) enforces directors' duties (the traditional view); (2) deters management wrongdoing through liability rules (arguably the primary benefit); (3) compensates for damages suffered by the company in money's worth (a controversial point); and (4) clarifies the scope of permissible

conduct through judicial decisions (a somewhat limited role in the UK). Crucial to the deterrence rationale is the fact that the deterrent value of derivative action is tied to the public's perception of the value of such litigation. The higher the public esteem of the derivative action, the greater will be its deterrent value. As it currently stands, the ambiguity of the derivative action's purpose and the linking of derivative actions to a failed objective weaken the social influence of the action in English law. On the other hand, the review below finds that the procedural requirements that foster court screening of the action's merits as well as the control of settlements are two important features of the derivative action which enhance its social meaning.

Chapter 3 adds another dimension to the question whether the possible benefits of the derivative action are outweighed by its costs. Conferring rights on minority shareholders to litigate in respect of wrongs to the company brings several problems to the fore. There are issues of standing, legal duties traditionally running in a straight line to the company; of policing the action, since litigious shareholders may not have the purest of intentions; and of corporate governance, requiring a fine balancing of shareholder rights and expectations against the prerogative of management to manage. The chapter examines and assesses how the aforementioned issues can be dealt with adequately. It argues that good intentions often make bad law. There is no doubt that some of the hurdles facing minority shareholders which make the derivative action cumbersome are there to perform a

vital function.[14] But these observations do not mean, however, that the baby should be thrown out with the bath water by denying shareholders *any* realistic access to a litigation remedy. In striking a proper balance, the chapter lays the foundations for the discussion in subsequent chapters. In particular, the chapter highlights the importance of two methods that are imposed in order to protect against abuse of these proceedings: (1) reallocating the responsibility to determine the merits of actions from the shareholder to courts; and (2) providing a screening mechanism to sift out cases that are without merit.

The existing knowledge of how derivative actions function and how the use of that mechanism in the general scheme of law enforcement may promote the deterrence of wrongdoing and compensation of harm, in other words the two primary objectives of the action identified in preceding discussion, falls short of providing an adequately coherent theoretical account on either descriptive or normative grounds. In an attempt to fill this gap, **Chapter 4** develops a model to analyse and explain the use of the derivative action referred to as the ***Functional and Focused Model*** ('FFM'). The model builds on the view of derivative action law laid out in Chapters 1, 2, and 3 and finalized in the first part of this chapter.

The strategic aspect of the FFM is then put forward in **Chapters 5 and 6**. An understanding of the economic effect of fees on the decision to commence litigation allows the development of rules to encourage those actions which

[14] Namely, to protect the company against the single aggrieved shareholder who through malice or misjudgment will waste the company's time and money.

advance the policy objectives behind the FFM. It is thus important to examine the critical role of costs and fees in initiating and maintaining derivative actions in the context of incentives to such litigation. **Chapter 5** argues that one of the major reasons why the action is employed in the US is due to adjustments in the usual cost rules, the most significant of which are the 'common fund' and 'substantial benefit' doctrines, and the recognition of contingency fee arrangements. The chapter closely examines the traditional way in which English law addresses the obstacle of funding, namely recognizing that the plaintiff should be indemnified for costs incurred in the proceeding. The analysis reveals serious flaws in the operation of indemnity costs orders. It concludes that it provides a less than adequate response to the formidable funding problem inherent in derivative actions as: (1) it provides almost no incentives to commence litigation since it will still be true that the plaintiff in derivative proceedings concerning a company of any size will have little or nothing to gain from their successful outcome; and (2) there is also little likelihood that this will sway shareholders to opt for the derivative action in lieu of section 459 Companies Act 1985 proceedings (the 'unfair prejudice remedy'). The question the chapter then raises is what fee formulas or financial mechanisms can be employed in order to bolster the distorted incentives of potential derivative action litigants.

Chapter 6 argues that good claims on behalf of the company ought not to fail because of financing problems. There is much therefore to be said for a policy that reduces this hurdle. Chapter 6 examines and assesses four possible strategies to

rectify the funding problem. The first two focus on short-term solutions and involve the company and the plaintiff shareholder, namely making a mandatory requirement for the company to pay the costs of the action and rewarding the shareholder with part of the proceeds of a successful action. The following two strategies concentrate on solutions in which the risk of litigation is shifted on to the plaintiff's attorney, namely by deploying conditional fee agreements and adopting US-style contingency fees in the limited context of derivative actions.

Finally, **Chapter 7** is concerned with an important practical aspect of the law governing derivative actions. As will be seen, shareholders, even in situations where they are adversely affected by the breach of the directors' duties, are more inclined to pursue the 'unfair prejudice' remedy available under section 459 Companies Act 1985. In many ways, this is a more flexible and useful remedy for the minority shareholder than derivative actions. The final chapter addresses the unclear interaction between the two remedies. The chapter argues that the derivative action has sufficient relevance to merit independent existence, in spite of the judiciary's willingness in recent times to apply section 459 to derivative-type actions because they wish to avoid the complexities associated with derivative action litigation. The chapter shows that the benefits of retaining the derivative action would outweigh the gains from dispensing with the derivative action in favour of a single form of action under section 459. Be that as it may, the presence of the unfair prejudice remedy and the unclear interaction between the two

remedies could, and should, be improved. In response, two strategies are examined and assessed.

1.6 A Final Note

This study makes two basic assumptions. First, it assumes that the readers of this work have a sound understanding of company law in general and of the area that relates to directors' duties in particular. Secondly, it is assumed that the readers are familiar with the works of the Law Commission and the Company Law Review Steering Group.[15]

The law is stated as known to the writer on 15 March 2005, with brief references to some later developments added at proof stage.[16]

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[15] Namely Law Commission *Shareholder Remedies* (Consultation Paper No 142 1996); Law Commission *Shareholder Remedies* (Law Com Report No 246 1997); Company Law Review Steering Group *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI London March 2000); *Completing the Structure* (DTI London November 2000); and the *Final Report* (DTI London June 2001).

[16] Such as the Government's White Paper *Company Law Reform* Cm 6456 (DTI London March 2005).

Shareholder Litigation and Corporate Governance

1.1 INTRODUCTION

This chapter is concerned with an indefinite but fundamental question that has received inadequate attention in the literature on corporate law theory in English law: what purpose lies at the heart of the company's cause of action which justifies the use of derivative actions?

As will be seen below, shareholder litigation is neither the initial nor the primary protection for shareholders against managerial misconduct. It cannot be viewed in isolation from a number of mechanisms which relate to corporate governance. A variety of social and market forces also operate to hold corporate officials accountable. These mechanisms and others, coupled with the regulatory authority of governmental agencies, constitute protections in the absence of private litigation. To the extent that these mechanisms effectively align the interests of managers and shareholders, there may be less need to resort to costly litigation as a means of protecting shareholder interests.[1] And so the question can also be formulated in the following manner: what role should be assigned to the derivative action that may, in turn, enhance the capabilities of these other mechanisms of accountability?[2]

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[1] S Deakin E Ferran and R Nolan 'Shareholders' Rights and Remedies: An Overview' (1997) 2 CFILR 162, 167.

[2] Although it is a pivotal concept in many fields, accountability remains an elusive concept – close to but different from responsibility. Accountability is best understood as a norm of governance,

The resolution of this question requires a distinction between two separate elements. First, the task is one of evaluating the respective merits of alternative mechanisms that may constitute an effective functional substitute for litigation. Secondly, building upon this initial evaluation, it is necessary to inquire into the theoretical rationales behind derivative actions. This introductory chapter is concerned with the first element. Chapter 2 will address the second.

The chapter proceeds as follows. Section 1.2 identifies the limitations of the traditional view of the derivative action. Subsequently it explicates the relation between the derivative action and two concepts, namely 'control' and 'agency costs'. Section 1.3 outlines some major techniques of accountability, which share the goal of reducing agency costs. Section 1.4 focuses on one such major alternative as it examines whether it is true that the market for corporate control may constitute an effective functional substitute for litigation. Section 1.5 concludes the chapter.

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stipulating particular modes of wielding power and of responses to power. See further A Licht 'Accountability and Corporate Governance' http://papers.ssrn.com/paper.taf?abstract_id=328401 (15 September 2002).

1.2 SHAREHOLDER LITIGATION AND CORPORATE GOVERNANCE

1.2.1 Limitations of Traditional View

The derivative action's usual raison d'être is 'a form of pleading originally introduced on the ground of necessity alone in order to prevent a wrong going without redress'.[3] In this case, although the right remains the company's, it is appropriate to allow the individual shareholder to assert it on behalf of the company. The limited circumstances in which a derivative action may be brought are known as the 'exceptions to the rule in *Foss v Harbottle*'.[4] Under the common law, a derivative action is generally possible only if the applicant could invoke one of these exceptions.

The essence of the rule is that (1) the court will not ordinarily intervene if the matter is one that a company can ratify by its own internal procedure; and (2) the right to vindicate a wrong done to the company is vested in the company and prima facie the only proper plaintiff is the company itself.[5] The exceptions are intended to ensure that the company is not improperly prevented from averting or remedying a wrong done by a self-interested board, or by majority shareholders

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[3] *Smith v Croft (No 2)* [1988] Ch 114, 185.

[4] (1843) 2 Hare 461; 67 ER 189.

[5] These principles were applied in the case of *Foss v Harbottle* (ibid) and are often applied by the courts as 'the rule in *Foss v Harbottle*'. See KW Wedderburn 'Shareholders' Rights and the Rule in Foss v Harbottle' [1957] CLJ 194, 195–198. See also *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 210 where the Court of Appeal referred to the rule in *Foss* as embracing both the 'elementary' proper plaintiff principle and '... a related principle, that an individual shareholder cannot bring an action in the courts to complain of an irregularity ... if the irregularity is one which can be cured by a vote of the company in general meeting'.

acting improperly ('in fraud on the minority').[6] This rule has long been seen in a number of commonwealth jurisdictions as a significant barrier to effective shareholder enforcement.[7]

Put simply then, the rule is a logical consequence of the fact that a company is in law a separate person which shareholders have agreed should be managed by its directors. The exceptions to the rule are thus necessary to prevent the rule from becoming a cover for unreviewable abuse. The use of the derivative action ensures that the wrong is remedied on behalf of the company, albeit at the instigation of an individual shareholder. In English law it has been described as an exception to the 'elementary principle that A cannot, as a general rule, bring an action against B to recover damages or secure other relief on behalf of C for an injury done by B to C. C is the proper plaintiff because C is the party injured, and, therefore, the person in whom the cause of action is vested'.[8]

All this is hardly controversial. Anyone familiar with English company law will find an explication of the aforementioned view in almost every textbook on the subject.[9] However, the traditional view, envisaging both the necessity and the

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[6] CLR *Developing the Framework* 124.

[7] See eg A Beck and A Borrowdale *Guidebook to New Zealand Companies and Securities Law* (CCH 4th edn 1990) 232. The English Law Commission conceded that these exceptions are rigid, the law in this field is complex and obscure, and that this may well, in turn, deter minority shareholders from bringing such proceedings. Consultation Paper para 1.5.

[8] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] 1 Ch 204, 210. That an action under one of the exceptions to *Foss v Harbottle* is truly a derivative action, rather than one brought by the minority shareholder in his own right, was a late recognition in English law (*Wallersteiner v Moir (No 2)* [1975] QB 373).

[9] To name but few, PL Davies *Gower and Davies' Principles of Modern Company Law* (7th edn Sweet & Maxwell London 2003) ch 17 (hereafter '*Gower and Davies*'); B Hannigan *Company Law* (Butterworths London 2003) ch 16; LS Sealy *Cases and Materials in Company Law* (7th edn Butterworths London 2001) 478–516.

inevitability of vindicating a company's rights, is not entirely satisfactory because of theoretical as well as practical barriers.

First, this view explains *why* derivative actions are allowed, but not *what purpose* they serve. Put simply, it obscures the deeper concern of what can be achieved through the use of derivative actions.[10] Resolution of this question has remained beyond the ambit of academic discussion in English law.[11] But if the derivative action is to play any role in the corporate governance of English companies,[12] the question is what, if any, are the net benefits of these actions from a social or economic perspective for companies, shareholders and the business community overall.

Secondly, this traditional view of the derivative action, envisaging both the necessity and the inevitability of vindicating a company's rights, is troubling because litigation is sometimes infeasible and shareholders rarely initiate derivative actions in England, for well-documented reasons.[13] Further, shareholders often refrain from pursuing legal proceedings on behalf of the company because they lack funds, and they are hamstrung by the existing law from entering into

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[10] The writer distinguishes here between reasoning (ie the action is allowed in order to prevent a wrong going without redress) and a proper purpose in the wide sense of the word (ie what are the net benefits of these actions from, say, a social or economic viewpoint?). See also *Brady v Brady* [1989] AC 755 HL 779–780 (where the House of Lords noted that although in practice drawing a distinction between a reason and a purpose is not necessarily an easy task, a reason is not the same as purpose).

[11] Probably partly owing to the theoretical nature of the question, in the absence of any meaningful litigation.

[12] Even a modest one as envisaged by the Consultation Paper and the Report.

[13] These are addressed in chs 3 and 5 respectively.

imaginative arrangements whereby funds might be made available to them.[14] For these reasons it is arguably unsatisfactory to rely exclusively on litigation when its occurrence is somehow fortuitous.

Finally, commentators have recognized that other mechanisms which relate to corporate governance constitute a more powerful check to managerial misbehaviour. This view has been put forward in the last few decades by drawing attention, on the one hand, to the operation of a number of non-regulatory constraints on managers' discretion,[15] and, on the other hand, to the costs of legal intervention.[16]

Most notably, it has been suggested that the market for corporate control provides a more systematic and economical regulation. These virtues of the market have caused some to begin and to conclude their consideration of how to control management behaviour with market-based solutions.[17] The question is whether such market and social constraints prevent managers from engaging in wrongdoing to such a degree as to render legal intervention (such as by means of litigation) inefficient, considering its costs. Before it is possible to answer this, two concepts

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[14] See discussion in chs 5 and 6 below and A Reisberg 'Funding Derivative Actions: A Re-examination of Costs and Fees as Incentives to Commence Litigation' (2004) 4 JCLS 345.

[15] That is constraints which the market imposes either by means of inducing self-interested devotion to shareholders' interests or in the form of contractual arrangements. See generally H Butler and L Ribstein 'Opting out of Fiduciary Duties: A Response to the Anti-Contractarians' 65 (1990) Washington Law Review 1, 21–28.

[16] L Enriques 'The Law on Corporate Directors' Self-Dealing: A Comparative Analysis' 5 and accompanying text http://papers.ssrn.com/sol3/papers.cfm?abstract_id=135674 (13 July 2004).

[17] Most prominently, F Easterbrook and D Fischel 'Corporate Control Transactions' (1982) 91 Yale Law Journal 698, 701–702; KE Scott 'Corporation Law and the American Law Institute Corporate Governance Project' (1983) 35 Stanford Law Review 927, 938–939.

need to be explained first: 'control' and 'agency costs'.

1.2.2 Derivative Actions and Agency Costs

Derivative actions relate to a question of control – control of the corporate form. Alternatively, they relate to the steps being taken on behalf of shareholders to redress the imbalance in the modern company form between control exercised by directors and managers and that exercised by shareholders.

In 1932, Berle and Means published their treatise *The Modern Corporation and Private Property.*[18] This work proposed that those who own large public corporations do not control them and, conversely, those who control such corporations do not have significant ownership interests in them.[19] Berle and Means pointed out that shareholders in large public corporations had in effect exchanged control for liquidity.[20] They identified five major control types that apply to corporations.[21] While their work was confined to public corporations, the types of control identified are applicable to all companies:

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[18] Berle and Means *The Modern Corporation and Private Property* (rev ed Harcourt New York 1968).

[19] P Redmond (ed) *Companies & Securities Law Commentary and Materials* (LBC 1988) 181.

[20] See eg N Wolfson *The Modern Corporation: Free Markets versus Regulation* (Free Press 1984) ch 2, 20 et seq.

[21] See P Redmond (ed), above n 19, 182 for a discussion of these. Control could also arise on the basis of agreements or understandings between members, minority control through other members' apathy or inability to participate, and personal influence between shareholders. See, further MA Pickering 'Shareholders' Voting Rights and Company Control' (1965) 81 LQR 248, 269–272; KW Wedderburn 'Derivative Actions and Foss v Harbottle' (1981) 44 MLR 202, 205.

(1) ***Private ownership*** – this gives rise to control through complete ownership of the corporate form.

(2) ***Majority control*** – control that arises as a result of the ownership of a majority of the shares.

(3) ***Control through a legal device*** – the person who exercises the control does not own a majority of the issued shares but is nonetheless able to control the entity through, for example, the use of non-voting shares, or shares with weighted voting rights, etc.

(4) ***Minority control*** – this is where the particular group only holds a small number of shares but nevertheless is able to control the corporation. This can particularly be the case with public companies that have a large but scattered shareholder base such that a holder of perhaps as low a figure as 10% is able to exercise control.

(5) ***Management control*** – this occurs where the shares are widely held and there is no single group that has minority control. Often this is the case in public companies the majority of shares in which are held by institutions.

Members of a company do not in general 'control' the company and its operations. The reason for this is quite simply that the management and control of

the company is vested in its board of directors.[22] This proposition itself supports the view that the modern corporation is an abstraction devoid of physical form, existing only in contemplation of the law and therefore incapable of expressing its will without the mediation of natural persons.[23] On any view, companies are contractual structures where the board of directors and majority shareholders control and dominate the affairs. Because of this, the law imposes on the natural representatives of the non-natural corporate form fiduciary obligations that operate over and above and in addition to any contractual rights and remedies. This is because the non-natural company form is in need of protection extending beyond normal contractual remedies.[24] Where there is a breach of an obligation in favour of the company it follows naturally that it is the company that should be the person that takes the legal action. Indeed, that was the position in *Foss v Harbottle*,[25] where the court held that in the case of a breach of the duties owed to the company, the proper plaintiff was the company itself.

Shareholders have their own contractual remedies which manifest themselves in the positive controls that may be exercised by them in, for example, voting to remove directors who do not represent the will of the shareholders.[26] The difficulty is being able to win the proxy fight by getting sufficient numbers at the requisite

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[22] *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113, 134 *per* Greer LJ.

[23] P Redmond (ed), above n 19, 204.

[24] D McDonough 'Proposed New Statutory Derivative Action – Does it Go Far Enough?' (1996) 8 Bond Law Review 47, 49.

[25] (1843) 2 Hare 461; 67 ER 189.

[26] Under s 303 of CA 1985.

meeting.[27] If the numbers are not able to be mustered, the shareholders must revert to negative control measures, ie legal remedies, in order to redress the imbalance in control between the owners of the business and the directors/managers of the business.[28] This is sometimes referred to as the tension between control and accountability.[29]

In many public companies shares are very widely held[30] and it is often very difficult to remove directors or to bring about change. This is exacerbated by the growth of institutional investment holdings and the inability or lack of desire on the part of those institutions to seek to exercise control over the management of companies.[31] Therefore shareholders, particularly small shareholders, are to a very large extent, increasingly bound to rely on the aspects of negative control as opposed to positive control.[32]

At the same time, in large companies managers are given significant discretion in the running of the business. Indeed, this discretion is so broad that it effectively means management control of these companies. This control can lead managers to act in their own interests rather than in the interests of the shareholders. For example, they might divert corporate assets to themselves or set out to achieve

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[27] See below under 1.3.1.2.

[28] P Willcocks *Shareholders' Rights and Remedies* (Federation Press 1991) 16.

[29] I Ramsay 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 University of New South Wales Law Journal 149, 151.

[30] In the sense that they do not have a shareholder that owned, say, 10% or more of the equity.

[31] On which see ch 4 nn 77–87 and accompanying text.

[32] For more on this distinction, see E Herman *Corporate Control, Corporate Power* (1981) ch 4; PL Davies *Introduction to Company Law* (OUP 2002) ch 9.

goals which are more closely aligned to the promotion of their own interests rather than those of the shareholders.[33] The divergence of interests between managers and shareholders results in costs, usually described by economists as 'agency costs'.[34] These costs can be generally divided into two categories:[35]

(1) Monitoring costs incurred by shareholders to ensure that managers are acting in the interests of the shareholders.

(2) Bonding costs incurred by managers with the purpose of assuring shareholders that their interests are being pursued.[36]

Law can play an important role in reducing agency costs. Obvious examples are rules and procedures that enhance disclosure by agents or facilitate enforcement actions brought by principals against dishonest or negligent agents.[37] Indeed, research on corporate governance has identified a number of mechanisms or techniques of accountability intended to ensure that management acts in the best interests of shareholders. Agrawal and Knoeber, for example, investigated the effects on company's performance of several alternative mechanisms to control

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[33] PL Davies ibid,137.

[34] Agency costs or the 'agency problem', in the more general sense of the term, arise whenever the welfare of one party, termed the 'principal', depends upon actions taken by another party, termed the 'agent'. The problem lies in motivating the agent to act in the principal's interest rather than simply in the agent's own interest. See further R Kraakman PL Davies et al *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2004) 21–23; BR Cheffins *Company Law: Theory, Structure and Operation* (OUP 1997) 521–524.

[35] I Ramsay, above n 29, 151.

[36] M Jensen and W Meckling 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics 305; M Dooley and E Veasey 'The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared' (1989) 44 Business Lawyer 503, 527.

[37] R Kraakman et al, above n 34, ch 2; PL Davies, above n 32, 117–118; E Ferran *Company Law and Corporate Finance* (OUP 1999) 118.

manager–shareholder agency problems, including both structural and other internal and external control devices. Consistent with the notion that various control mechanisms can complement and substitute for one another, they found interdependencies in the effects of the various control devices on firm performance.[38] These results appear to be consistent with the notion that 'the firm chooses among alternative mechanisms for minimizing agency costs'.[39]

Put against this backdrop, '[t]he derivative suit is a monument to the problem of agency costs; it would make no sense to allow a shareholder to bypass the corporate management in bringing a suit against an officer if one could be confident that management always acted in the shareholders' interests'.[40] As we shall see in Chapter 2, derivative actions can reduce agency costs as they operate to deter mismanagement by imposing the threat of liability and therefore align the interests of managers and shareholders. Further, they can reduce one part of the agency costs, namely monitoring costs incurred by shareholders. Because shareholder co-ordination is not necessary in the case of the derivative action, it seems reasonable to believe that the availability of this action economizes on costs that otherwise would be necessarily incurred if shareholders were required to take collective action.

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[38] A Agrawal and C Knoeber 'Firm Performance and Mechanisms to Control Agency Problems between Managers and Shareholders' (1996) 31 Journal of Financial and Quantitative Analysis 377.

[39] C Himmelberg R Hubbard and D Palia 'Understanding the Determinants of Managerial Ownership and the Link between Ownership and Performance' (1999) 53 Journal of Financial Economics 353, 382.

[40] R Posner *Economic Analysis of Law* (4th edn Little Brown Boston 1992) 389.

1.3 ALTERNATIVE DEVICES TO CONTROL AGENCY COSTS

As we saw in the previous section, research on corporate governance has identified a number of mechanisms or techniques of accountability[41] intended to ensure that management teams act in the best interests of shareholders. Besides private litigation, these mechanisms are commonly subdivided, for descriptive purposes, into 'external' and 'internal' governance mechanisms. In order to understand what role should be assigned to shareholder litigation, it is necessary to consider first both the advantages and the limits of these mechanisms.[42]

What follows is a brief outline of two 'internal' governance mechanisms, namely the right to vote and the company's internal dispute-resolution machineries. Two major 'external' governance mechanisms are subsequently outlined: public enforcement and the role and importance of independent directors. It is worth emphasizing that the discussion here intends to be representative rather than exhaustive as it serves as a general background for the following chapters that will address more extensively some of the issues raised here.

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[41] For an in-depth analysis of the concept of 'accountability' and a new approach for discussing accountability and corporate governance, which builds on the study of social norms, see A Licht, above n 2.

[42] For an extensive survey on corporate governance see A Shleifer and R Vishny 'A Survey of Corporate Governance' (1997) 52 Journal of Finance 737. For theories associated with the development of corporate governance see CA Malin *Corporate Governance* (OUP 2004) ch 2.

1.3.1 Internal Mechanisms

The regulatory framework within which companies operate provides mechanisms for shareholders to exercise their 'voice' in order to bring pressure to bear on directors. This can be done, inter alia, by meetings, proxy contests or votes to remove directors from office. As will be seen below, however, it is simply not a part of the UK scene for these to be invoked in a co-ordinated manner as a means of ensuring accountability on the part of corporate management.[43]

1.3.1.1 *The right to vote*

It is arguable that a major enforcement mechanism available to shareholders other than litigation is the right to vote.[44] The assumption is that managers will act in the interests of shareholders because otherwise shareholders might vote for their removal. Voting in the general meeting of shareholders is a key shareholders' right and, naturally, central to corporate governance.[45] Yet in many cases shareholders will refrain from participating in general meetings and voting, even if it is made easy for them by electronic ways and means. This well-known phenomenon of 'rational apathy'[46] is common not only for private shareholders, but also for many institutional shareholders (unless one goes so far as to oblige them to vote by

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[43] DD Prentice 'Some Aspects of the Corporate Governance Debate' in DD Prentice and P Holland (eds) *Contemporary Issues in Corporate Governance* (Clarendon Press 1991) 25, 40–42.

[44] For a recent comparative analysis of the importance of voting rights in the corporate governance system of various jurisdictions see G Hertig 'Convergence of Substantive Law and Convergence of Enforcement: A Comparison' in J Gordon and M Roe (eds) *Convergence and Persistence in Corporate Governance* (Cambridge University Press 2004) 328, 336–338.

[45] E Ferran *Company Law and Corporate Finance* (OUP 1999) 118–122; BR Cheffins *Company Law*, above n 34, 17–18; PL Davies, above n 32, 255, 262–265; 'A Modern Regulatory Framework for Company Law in Europe' A Consultative Document of the High Level Group of Company Law Experts http://europa.eu.int/comm/internal_market/en/company/company (13 November 2003) (hereafter 'A Modern Regulatory Framework').

[46] On rational apathy, see RC Clark *Corporate Law* (Little Brown and Company 1986) 390–392.

law).[47] In companies with one or more principal shareholders, minority shareholders have no real influence even if they vote.[48] In groups of companies and particularly in multinational groups, the minority shareholders of the subsidiary and even those of the parent may simply not know where the real problems lie.[49] In such cases what is needed for shareholders is to first find out the facts and then to consider the appropriate course of action, which could be a shareholders' resolution or even an action to hold directors or others liable.[50]

However, it is now widely recognized that shareholder voting in large companies tends not to be a potent force. The reason is that it suffers from a collective action problem.[51] Voting in any case is not compulsory and for many shareholders there is a strong disincentive to vote. Attending a meeting in person may be expensive. The exercise of one's vote does not give one any privileges unless one has control or one's voice can be decisive. The act of becoming informed enough to vote intelligently requires an investment of time, which is a scarce resource. Yet a shareholder vote is unlikely to affect whether a proposal wins or loses. This is due to the level of concentration of ownership in the relatively dispersed UK market. The UK has an 'outsider' or 'arm's length' system

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[47] The option of mandtatory voting is analysed in GP Stapledon 'Institutional Investors: What are their Responsibilities as Shareholders?' in JE Parkinson et al (eds) *The Political Economy of the Company* (Hart Publishing Oxford 2000) 195, nn 145-155 and accompanying text. The recent White Paper will only continue to explore the proposal that institutional investors should be required to disclose how their voting rights have been exercised. White Paper *Company Law Reform* Cm 6456 (London DTI March 2005) 3.1).

[48] 'A Modern Regulatory Framework' 14.

[49] DD Prentice 'A Survey of the Law Relating to Corporate Groups in the United Kingdom' in E Wymeersch *Groups of Companies in the EEC* (Walter de Gruyter Berlin 1993); J Dine *The Governance of Corporate Groups* (Cambridge University Press 2000) ch 4.

[50] 'A Modern Regulatory Framework' 14.

[51] BR Cheffins *Company Law*, above n 34, 238–241; I Ramsay, above n 29, 153.

of ownership and control.[52] The 'outsider' typology is used to describe the situation that exists because share ownership is dispersed among a large number of institutional and individual shareholders[53] rather than being concentrated in the hands of small number of families, banks, or other firms.[54] **Table 1-1** below lists the incidence of block ownership in the larger companies of various nations; those with the highest score have the fewest companies with concentrated ownership, and hence their companies have the most diffuse ownership. Not surprisingly, the UK scored the highest.[55]

Table 1-1: Percentage of widely held[56] firms among twenty largest firms

Austria	0.05
Belgium	0.05
Italy	0.20
Norway	0.25
Sweden	0.25
Netherlands	0.30
Finland	0.35
Denmark	0.40
Germany	0.50
Canada	0.60
Switzerland	0.60
France	0.60
Australia	0.65
United States	0.80
Japan	0.90
United Kingdom	**1.00**

[52] C Mayer 'The City and Corporate Performance: Condemned or Exonerated?' (1997) 21 Cambridge Journal of Economics 291, 298–299.

[53] BR Cheffins 'Minority Shareholders and Corporate Governance' (2000) 21 Company Lawyer 41.

[54] Such as, for instance, is the case in some European countries, most notably Germany and France. For more on these differences, see E Nowak 'Investor Protection and Capital Market Regulation in Germany' in J Krahnen, R Schmidt (eds) *The German Financial System* (OUP 2004).

[55] The ownership data is from R La Porta et al 'Corporate Ownership around the World' (1999) 54 Journal of Finance 471, 492–493.

[56] In the sense that they do not have a shareholder that owned, say, 10% or more of the equity.

A similar pattern is evident when smaller companies are taken into account. As of 1996, just over 20% of the companies listed on the London Stock Exchange had a shareholder other than an institutional investor that owned 20% or more of the shares.[57]

The result of the relatively dispersed UK capital market is that the cost and futility of becoming informed leads most 'small' shareholders to choose rational apathy. They do not take the time to consider particular proposals, and instead adopt a crude rule of thumb such as 'vote with management'.[58] Collective action theory also tells us, critics argue, that shareholders will not make economically motivated proposals or actively oppose manager proposals unless the potential gains are much larger than the cost of the effort.[59] A shareholder bears most of the cost of a proxy campaign, but receives only a pro rata share of the gains from success, while other shareholders free-ride on his efforts. Free-rider problems work in tandem with the rational apathy of the free riders to discourage shareholder proposals from being made.[60]

Theoretically, agency costs between managers and shareholders may be reduced if shareholders increase control by forming voting coalitions.[61] However, voting coalitions are usually temporary and are customarily forged with a specific

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[57] M Faccio and L Lang 'The Separation of Ownership and Control: An Analysis of Ultimate Ownership in Western European Corporations' (unpublished working paper, 2000) Table 2.

[58] B Black 'Shareholder Passivity Reexamined' (1990) 89 Michigan Law Review 520, 527–528.

[59] ibid.

[60] ibid.

[61] R Crespi-Cladera and L Renneboog 'United We Stand: Corporate Monitoring by Shareholder Coalitions in the UK', http://papers.ssrn.com/sol3/papers.cfm?abstract_id=276656 14 (27 July 2002).

aim (ie the removal of incumbent management).[62] In any case, a number of studies found that companies' operating performance and valuations were not affected by shareholder proposals, and shareholder proposals did not appear to engender corporate governance policy changes.[63]

Overall, then, several factors combine to ensure that shareholders in the UK are rarely poised to vote and take a hand in the running of the company. The most prominent factors include: (1) the costs of becoming informed so as to vote intelligently; (2) the minimal impact of the vote; (3) the possibility that other shareholders may take a free ride on the efforts; (4) the uncertainty of outcome in the UK 'arm's length' system of ownership and control; and finally (5) the *de minimis* incremental gain that will flow to a shareholder even should the action he supports be successful. Instead, shareholders in the UK choose apathy, tend to maintain their distance, and give executives a free hand to manage by relying more on the market and spreading their risks by investing in a number of companies.[64] It remains to be seen whether the measures proposed by the Government recently to enable shareholders to have a constructive dialogue and increase their engagement with the company in which they hold shares will bear any impact on this.[65]

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[62] ibid; PIRC Annual Proxy Voting Report 2003, http://www.pirc.co.uk/pubserv.htm; J Karpoff P Malatesta and R Walkling 'Corporate Governance and Shareholder Initiatives: Empirical Evidence' (1996) 42 Journal of Financial Economics 365.

[63] Above n 61.

[64] DD Prentice, above n 43, 30; BR Cheffins 'Minority Shareholders and Corporate Governance' (2000) 21 Company Lawyer 41; BR Cheffins *Company Law*, above n 34, 238–241.

[65] For example, shareholders of quoted companies will have a new right, if a certain specified minority so request, to require an independent scrutiny of any polled vote. White Paper *Company Law Reform* Cm 6456 (London DTI March 2005) 3.1.

1.3.1.2 *The company's internal dispute-resolution machinery*

A natural enforcement mechanism available to shareholders other than litigation is the company's internal dispute-resolution machinery.[66] However, as will be seen in Chapter 3, this machinery cannot always provide the right forum. For example, it fails to give a satisfactory solution when the perpetrators of the fraud are in control of the company. To illustrate this point, this section focuses on one of the major company's internal dispute-resolution mechanisms, namely addressing questions to directors at the Annual General Meeting ('AGM').[67]

Theoretically, the AGM, particularly the opportunity to ask questions, offers the only forum for effective individual shareholder activism. Even though the outcome of voting on resolutions is de facto determined beforehand by the proxy voting system (mainly by institutional shareholder votes),[68] the prospect of facing embarrassing questions can act as a mild deterrent to management considering self-interested action.[69] Further, the AGM is perhaps 'the sole occasion when company

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[66] See in this respect Drury's thesis that in a long-term relationship providing a forum for the dispute (such as the general meeting) is in many cases ultimately going to be more effective in promoting the continuance of that relationship than allowing an individual shareholder unlimited access to what might be described as the 'discrete transaction oriented dispute-solving machinery' of the courts. R Drury 'The Relative Nature of a Shareholder's Right to Enforce the Company Contract' (1986) CLJ 219, 223.

[67] On resolutions and addressing questions in AGM generally see PL Davies, above n 32, 137–138; *Gower and Davies*, above n 9, 350–353; LS Sealy *Cases and Materials in Company Law* (7th edn Butterworths London 2001) 178–188.

[68] R Pennington *Pennington's Company Law* (8th edn Butterworths London 2001) 769. The PIRC publishes an annual report (http://www.pirc.co.uk/pubserv.htm) which analyses the proxy voting returns for over 500 company meetings. On proxy voting generally, see B Hannigan, above n 9, 489; LS Sealy *Cases and Materials in Company Law* (7th edn Butterworths London 2001) 197–198; *Gower and Davies* 360–363.

[69] *Gower and Davies*, above n 9, ch 15.

directors are immediately accountable to their shareholders'.[70] The AGM provides a forum for frank and honest debate over allegations that might have negative reputational effects for the company at a later stage.[71]

However, management's discretion over the 'business and conduct' of general meetings, especially relating to controlling access rights and controlling the 'question and answer' time, limits the extent to which individual shareholders can use the AGM to participate in corporate governance.[72] Some companies may go to great lengths to anticipate likely activist attacks and, by inspecting the register, distinguish among the individuals attending the meeting those who are likely to be part of these attacks. There appears, therefore, to be some trepidation on the part of board members regarding the role of shareholder questions at the AGM and this may be behind some of the pressure from industry to reform the AGM in a way that would minimize the role of debate in an open forum, using the 'question-and-answer' technique.[73]

Discussion of the reform of the AGM centres on the failure of shareholders to use this forum to any significant degree as a corporate control mechanism.[74] When all is going well, institutional shareholders, who have privileged access to

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[70] R Hussey 'Shareholders' Questions at the AGM' Bristol Business School, University of West England, Report Prepared for Deloitte & Touche (1995) 5.

[71] ibid.

[72] A similar problem arise in the context of submitting shareholder resolutions under ss 376 and 377 CA 1985, where the current system works decidedly in favour of management and against individual investors. See also the Australian case in *NRMA v Parker* (1986) 11 ACLR 1.

[73] J Cook and S Deakin 'Empirical Evidence on Corporate Control' (December 1999) ESRC Centre for Business Research, University of Cambridge 42.

[74] ibid 43.

company directors and management through private meetings, tend not to attend AGMs. Instead, they tend to leave the AGM to the pressure groups and querulous individual shareholders.[75] The current statutory law relating to the conduct of general meetings 'ignore[s] the potential value of a statutory right to ask questions'.[76] Yet this appears to be the area identified as possibly the greatest source of value of the AGM, both as a tool in the service of accountability and as a means by which individual investors can gain insights not offered in the company reports.[77]

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75 *Gower and Davies*, above n 9, 338–339. See generally, G Stapledon *Institutional Shareholders and Corporate Governance* (Clarendon Press 1996).

76 See previous edition of PL Davies *Gower's Principles of Modern Company Law* (6th edn Sweet & Maxwell London 1997) 583.

77 J Cook and S Deakin, above n 73. The Government's *White Paper Modernising Company Law* (Cm 5553, July 2002) para 2.18 and White Paper *Company Law Reform* Cm 6456 (London: DTI, March 2005) 3.1–3.2 may go some way to remedy this. For example, the Government proposes that companies should be able to allow members directly to demand a poll in advance of a meeting and vote on that poll without needing to attend or appoint a proxy.

On the vast potential for electronic communication technologies to facilitate access to company information and to overcome, to some extent, the collective action problems related to the AGM, see *Modern Company Law For a Competitive Economy* (Final Report 2001) paras 7.1 and 7.7 endorsed by the Government in the White Paper *Company Law Reform* Cm 6456 (ibid) 3.1; E Ferran 'The Role of the Shareholder in Internal Corporate Governance: Enabling Shareholders to Make Better-Informed Decisions' (2003) 4 EBOLR 491, 512-514; E Boros 'Corporate Governance in Cyberspace: Who Stand to Gain What from the Virtual Meeting' (2003) 3 JCLS 149 (detailing UK, Australian and US reforms).

1.3.2 External Mechanisms for Reducing Agency Costs

1.3.2.1 *Public enforcement*

The performance of company directors is increasingly subject to legal regulation and self-regulation. For example, there is a growing recognition that there is a role for a watchdog empowered to take action on behalf of shareholders by investigations, inspections and the institution of civil and criminal proceedings.[78] There are those who argue that the UK assigns its public bodies a significant deterrent role, both in investigating conflicted transactions and by means of the broad use of public suits and criminal sanctions to deter illicit self-dealing.[79] Further, there are also corporate regulators such as the Stock Exchange and the Panel on Takeovers and Mergers.[80] These bodies play an important role in deterring mismanagement and thereby reducing agency costs by enforcing corporate laws and the Stock Exchange Listing Rules.[81]

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[78] For justifications for state intervention in company affairs see BR Cheffins *Company Law*, above n 34, chs 3 and 4. On specific powers of regulation such as investigations, inspections and the institution of civil and criminal proceedings see *Company Investigations – How They Work*, available from the DTI website: http://www.dti.gov.uk/cld/inv_htw.htm; B Hannigan *Annotated Guide to the Companies Act* (Butterworths London 2001) 859–896; B Hannigan, above n 9, 73 and more specifically ch 19.

[79] R Kraakman et al, above n 34, ch 5. By contrast, Japan and especially the US prefer to encourage private litigation through doctrines that supports derivative and shareholders' class action (ibid). However, it should be noted that the level of activity reported each year detailing action taken against companies and directors investigating conflicted transactions by the DTI is relatively low. DTI *Companies in 2001–02* (2002) Tables 1–3, 10–11 (indicating 183 and 158 completed investigations in 2000–01 and 2001–02 respectively out of 4010 and 4433 respectively requests for such investigations).

[80] On the aims of takeover regulation see B Pettet *Company Law* (Longman Harlow 2001) ch 21.

[81] ibid and see further *Gower and Davies*, above n 9, ch 28 and more specifically 711 et seq.

Yet it is impractical to rely exclusively on public enforcement. First, limits on funding and resources of corporate regulators means that they cannot, of necessity, pursue all breaches of the law. For example, the Government has never been willing to shoulder the cost of making the DTI a day-to-day supervisor of company affairs, nor is the DTI likely to be capable of doing that job.[82] Further, although there are, for example, provisions for the appointment of inspectors to investigate the affairs of the company, these are *ad hoc* and have not led to the systematic examination of corporate governance by the regulatory authorities.[83] Secondly, there is no reason to believe that the priorities established by a corporate regulator for enforcement are necessarily the correct ones or are identical to those of each and every corporation. This dictates a role for private enforcement.[84] Thirdly, there are several theoretical problems associated with government regulation of company participants, such as restricting personal freedom and autonomy of parties, lack of familiarity with the marketplace or difficulties associated with the introduction and implementation of regulatory measures (ie interest groups may have too large an influence on the law-making process).[85] Finally, when the legal system assigns an enforcement role to private enforcers (ie through litigation) there is less need to rely on public agencies and in turn the tendency of such public agencies to

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[82] For a detailed account of these issue see, BR Cheffins *Company Law,* above n 34, chs 3 and 4.

[83] DD Prentice, above n 43, 42. It could be argued that there is no need to have many cases in order to achieve high levels of deterrence. For example, the use of few 'test cases' may be sufficient to deter potential abuse by directors who are situated similarly at other companies. See further ch 2 under 2.3.3.1.

[84] I Ramsay, above n 29, 152.

[85] These issues are explored in detail in BR Cheffins *Company Law,* above n 34, ch 4.

determine, sometimes arbitrarily or for political reasons, not to enforce rights or duties it had previously guarded, is likely to be higher.[86]

1.3.2.2 *Non-executive directors*

Another way in which agency costs can be reduced is by increasing the role and importance of independent directors (also known as non-executive directors, hereafter 'NEDs'). The thrust of the argument is that NEDs are an effective means of ensuring management accountability to shareholders. It is generally thought that their presence contributes value to the company, or more specifically, to shareholder value, through various roles they perform including: (1) reviewing the performance of the board and of the executive;[87] (2) their monitoring role afforded by their independence from management; (3) in taking the lead where potential conflicts of interest arise;[88] (4) their power to express views and take decisions in line with shareholder interests; and (5) through their contributions to strategy formulation.[89]

Recent reports of the Cadbury[90] and Greenbury[91] Committees and the Hampel Review, while stressing the importance of greater reporting to

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[86] On why private enforcement serves a fail-safe function and ensures greater stability in the application of law see, American Law Institute Principles of Corporate Governance and Structure: Restatement and Recommendations (Tentative Draft No 1 1982) 220–221.

[87] Report of the Committee On the Financial Aspects of Corporate Governance (Gee London 1992) para 4.5.

[88] ibid para 4.6.

[89] Report of the Committee on Corporate Governance (Gee London 1998) para 3.8 (hereinafter the Hampel Report); J Cook and S Deakin, above n 74, 7.

[90] Report of the Committee On the Financial Aspects of Corporate Governance (Gee London 1992).

[91] Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury (Gee London 1995).

shareholders, have placed their main emphasis on a larger role for NEDs of the board in monitoring the performance of the company, including that of the executive directors.[92] Likewise, it is believed that '... non-executive directors play a central role in corporate governance in UK companies. From the point of view of UK productivity and competitiveness, the progressive strengthening of the role of non-executive directors is strongly desirable'. [93] The new revised Combined Code[94] provides the first quasi-official description of their functions.[95] Building on the review undertaken by Higgs, it emphasizes that NEDs should not only monitor management but also contribute to the development of strategy.[96] A core element of the Combined Code is its recommendation that the board be composed of at least half independent NEDs.[97] Another is the separation of the positions of board chairman and chief executive officer ('CEO').[98] The effect of both elements taken together is a functional distinction between management (executive directors) and

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[92] The High Level Group of Company Law in Europe has recently envisaged a similar role for 'independent, non-executive and supervisory directors'. A Modern Regulatory Framework, above n 45, 14. On the evolution and growth of NEDs in the UK see JE Parkinson 'Evolution and Policy in Company Law: the Non-Executive Director' in JE Parkinson et al (eds) *The Political Economy of the Company* (Hart Publishing Oxford 2000) 233.

[93] D Higgs *Review of the Role and Effectiveness of Non-Executive Directors* Consultation Paper 7 June 2002 and Report from January 2003, 3 www.dti.gov.uk/cld/non_exec_review (hereafter 'Higgs').

[94] Which was published on 23 July 2003 and applies for reporting years beginning on or after 1 November 2003.

[95] Combined Code para A.1.

[96] ibid and Higgs, above n 93, para 6.1 et seq.

[97] Combined Code para A.3.2. Independence primarily means that there are no 'relationships or circumstances which are likely to affect, or could appear to affect, the director's judgment' (para A.3.1). It will be seen whether the new approach can provide 'for the first time, a widely accepted definition of independence' (Higgs, above n 93, para. 9.12). As Barnard noted, 'no definition will cover every situation and ... traditional measures of independence ... cannot capture those situations where even those directors who appear to be independent may not be because of social ties, a desire to be a team player or simple passivity.' J Barnard, 'The Hampel Committee Report: A Transatlantic Critique' (1998) Company Lawyer 110, 114–115. The CLR (*Developing the Framework*, para 3.148) conceded that independence cannot be legislated for since 'the quality required is a state of mind and character and relevant experience, rather than some formal indication of independence'.

[98] ibid para A.2.1.

control (NEDs led by the chairman). As all directors have the same powers, NEDs can also take the initiative in management decisions, and they are not restricted to post-decision approval as is the German supervisory board.[99]

By comparison, in the US the presence of NEDs (known in the US as 'independent' directors) on company boards is considered to be a key form of corporate governance control. There appears to be an increasing recognition across jurisdictions of NEDs with expertise in corporate governance as a new professional category.[100] According to Shepherd, this trend follows from increased institutional investor power and activism.[101] There is further evidence that indicates a closer relation of CEO turnover to performance in firms where non-executive directors dominate the board.[102] It also appears that NEDs of poorly performing companies lose their reputations and are frequently unable to find replacement positions.[103]

At the same time, there has been considerable debate over the effectiveness of NEDs.[104] In a nutshell, the major concerns include the following. First, there are

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[99] K Hopt and P Leyens 'Board Models in Europe – Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy' (January 2004) http://ssrn.com/abstract=487944 (12 March 2004).

[100] For a recent study of the risk of actual liability outside directors of public companies face in Australia, Canada, Britain and the US, and three civil law countries (France, Germany and Japan), see BS Black BR Cheffins and M Klausner 'Liability Risk for Outside Directors: A Cross-Border Analysis' (2004) Stanford Law and Economics Olin Working Paper No 285 http://ssrn.com/abstract=557070 (12 January 2005).

[101] B Shepherd 'The Growing Clout of Independent Directors' (1999) 13 Global Finance 52.

[102] M Weisbach 'Outside Directors and CEO Turnover' (1988) 20 Journal of Financial Economics 431.

[103] S Gilson 'Bankruptcy, Boards, Banks and Blockholders' (1990) 27 Journal of Financial Economics 355; S Kaplan and D Reishus 'Outside Directorships and Corporate Performance' (1990) 27 Journal of Financial Economics 389.

[104] For a recent summary of the debate see K Hopt and P Leyens, above n 99.

those who submit that the balance of research in the UK indicates that the link between board composition and either firm performance or board control over the CEO and executive management is either not significant, or at least not straightforward.[105] Supporting this view, another study found no evidence of disciplining by NEDs.[106] Further, Agrawal and Knoeber found evidence of a negative relationship between the percentage of outsiders on the board and firm performance. They suggest that outsiders may be added to boards for cosmetic reasons and that therefore additional outsiders reduce firm performance.[107]

Secondly, there are concerns as to the costs of running companies as the role of independent directors is expanded. For example, some argue that these directors increase the cost of running companies because of their lack of familiarity with the business[108] and there are concerns as to the costs of implementing the recent changes with respect to their expanded role (ie an army of human resources may be expected to be used in the appointment and training process envisaged by the Higgs Report).[109] Further, one may wonder what the costs of this change in boardroom atmosphere will be, as well as the opportunity costs and other costs associated with lengthier meetings. On the one hand, a too confrontational boardroom, in which it

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[105] J Cook and S Deakin, above n 73, 7; and, pre-Higgs, A Cosh and A Hughes 'The Changing Anatomy of Corporate Control and the Market for Executives in the United Kingdom' (1997) 24 Journal of Law and Society 111.

[106] J Franks and C Mayer 'Governance as a Source of Managerial Discipline' Prepared for the Company Law Review, Committee E on Corporate Governance (First draft January 14, 2000; Revised April 10, 2000) 18.

[107] A Agrawal and C Knoeber, above n 38.

[108] D Fischel 'The Corporate Governance Movement' (1982) 35 Vanderbilt Law Review 1259, 1282–1284; V Brudney 'The Independent Director – Heavenly City or Potemkin Village?' (1982) 95 Harvard Law Review 597.

[109] B Hannigan, above n 9, 155.

is more likely that the question of whether the CEO should be replaced will be raised, may well lessen the CEO's incentive to provide sufficient and prompt information to the board in an attempt to try and save her chair.[110] On the other hand, if it is true that what prevents NEDs from acting as shareholder champions is an excessively cozy 'boardroom atmosphere,' then a diverse set of NEDs may make it more likely that tough questions will be asked.[111] There is likewise some empirical evidence to suggest that the appointment of independent directors does result in an increased share price and therefore is perceived by some to be a positive development by shareholders.[112]

A third group doubt whether in the absence of a close link between the NEDs and the directors these approaches can bring about real changes.[113] A related argument is that because NEDs are expected to assume many roles,[114] the outcome of such hyperactivity will be that CEOs of public companies will have much less freedom to serve their own interests (which is, of course, good), but also much less freedom (and less time) to make innovative and profit-generating business decisions (which is, of course, bad).[115] Further, as the role of the NED is expanded,

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[110] J Coffee 'What Caused Enron? A Capsule Social and Economic History of the 1990's' in B Kogut and P Cornelius (eds), *Corporate Governance and Capital Flows in a Global Economy* (OUP 2003) 29.

[111] L Enriques 'Bad Apples, Bad Oranges: A Comment from Old Europe on Post-Enron Corporate Governance Reforms' (2003) 38 Wake Forest Law Review 911, 929–930 and the evidence therein.

[112] S Rosenstein and J Wyatt 'Outside Directors, Board Independence and Shareholder Wealth' (1990) 26 Journal of Financial Economics 175.

[113] See the 6th edition of PL Davies *Gower's Principles of Modern Company Law* (6th edn Sweet & Maxwell London 1997) 67.

[114] See eg Higgs, above n 93, 27–29.

[115] Cheffins effectively highlights the trade-off between board's increased monitoring and innovation. BR Cheffins *Company Law,* above n 34, 624–625.

the potential legal liabilities may also expand and the risk, or perceived risk, attached to the post may create some reluctance to accept such posts, unless the financial rewards provide sufficient inducement.[116]

Overall then, there are mixed views on how effective the presence of NEDs on a board is as a mechanism to control agency costs.[117] Similarly, the evidence as to whether increasing the role and importance of NEDs represents a positive focused disciplinary mechanism is equivocal.[118] In any case, it is questionable whether their role may provide the same protection mechanisms that in the end achieve functionally similar results as litigation.

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[116] B Hannigan, above n 9, 155–156.

[117] E Ferran *Company Law and Corporate Finance* (OUP 1999) 122. Enriques, after reviewing the pros and cons of NEDs, formulates a pessimistic view that 'one may wonder how better corporate governance will become if we are to rely on non-executive directors' sainthood in order to prevent executive directors' sins'. L Enriques, above n 111, 932.

[118] Surveys indicate that NED representation is on the rise (from 44% in 1980/81 to 50% in 1995/96). A Cosh and A Hughes, above n 104. NED representation is also spreading to European countries, particularly France, Germany and the Netherlands. See B Shepherd, above n 100.

1.4 DERVATIVE ACTIONS VERSUS MARKET FORCES

The foregoing discussion suggests that there are serious limitations and constraints on the effectiveness of various tools that may work to reduce agency costs and thus align the interests of shareholders and managers. This is hardly a revelation. We have already mentioned that various control mechanisms can complement and substitute for one another to compensate for that. In fact, different mechanisms for dealing with agency cost problems may be used in different legal systems.[119] For example, it has been suggested that although the US and the UK have similar legal systems that share a common origin, their common history may be less important than the fact that they have developed quite different mechanisms for dealing with the same 'agency cost' problems that in the end achieve functionally similar results.[120]

To illustrate, assume that there has been a materially false financial statement by company X in both the US and the UK. The issuance of a materially false financial statement may cause a significant drop in the company's share price upon its discovery in both nations. In the US, this may elicit a derivative action; in

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[119] It is beyond the scope of this work to investigate in depth the reasons behind this. See generally E Glaeser and A Shlefier 'The Rise of the Regulatory State' 61 (2003) Journal of Economic Literature 401; R Kraakman et al, above n 34, 225.

[120] J Coffee 'Privatization and Corporate Governance: The Lessons from Securities Market Failure' (1999) 25 Journal of Corporation Law 1. For a recent account of these issues see R Kraakman et al, above n 34, ch 5.

the UK, institutional investors may protest to the board and demand corrective action. However, in both countries, responsible senior management may lose their jobs. Similarly, in both countries, a chief executive officer whose company's share price and earnings under-perform the industry averages for a given number of successive quarters is likely to find himself out of office. The mechanism of his removal (a board *coup d'état* or a hostile takeover) may, however, differ between the two countries.[121]

The question is then whether it is also true that an important mechanism such as the market for corporate control and the derivative action can complement and/or substitute for one another. This is an important question, not least because it can be argued that the effective absence of litigation remedies in the UK available to minority shareholders suggests that the combination of other mechanisms (eg high disclosure standards) and an active, unconstrained takeover market may constitute an alternative effective functional substitute for litigation (or other remedies that are more available in the US). Also, to the extent that this mechanism effectively aligns the interests of managers and shareholders, there may be less need to resort to costly litigation as a means of protecting shareholder interests.[122] The purpose of the following two sections is thus twofold: first, to examine from a theoretical perspective whether the slack created by the limited derivative action litigation in the UK may be taken up by a more active market in corporate control; and subsequently, to evaluate whether the way the UK market for corporate control

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[121] Coffee ibid.

[122] S Deakin E Ferran and R Nolan, above n 1, 167.

works in the real world is also consistent with the theory that it can substitute for derivative actions in practical terms.

1.4.1 The Market in Corporate Control – an Effective Functional Substitute for Litigation?

The ability of market forces as opposed to litigation (or the law more generally) to curb managers' wrongdoing cannot be tested in the abstract, but rather should be tested country by country.[123] This requires an examination of the factors that influence corporate governance features most significantly, such as the degree of development and effectiveness of the market for corporate control in the UK.[124] There are a number of market mechanisms that, depending upon the circumstances, operate as well to align the interests of shareholders and managers.[125] These include the product market, the capital market, the market for corporate control, and the labour market for managers. The focus here is on the market for corporate control.

The modern economic theory of the corporation accords a central role to the market for corporate control in enhancing managerial efficiency and

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[123] B Black and R Kraakman 'A Self-Enforcing Model of Corporate Law' 109 (1996) Harvard Law Review 1911, 1914 (observing that 'effective corporate law is context-specific, even if problems it must address are universal').

[124] Including ownership concentration, courts' expertise in corporate law and the effectiveness of the judicial system or the activism of institutional investors. Some of these important features will be examined in subsequent chapters. See further L Enriques, above n 17.

[125] E Ferran *Company Law and Corporate Finance* (OUP 1999) 118–122; BR Cheffins *Company Law*, above n 34, 5–14; I Ramsay 'Company Law and the Economics of Federalism' (1990) 19 Federal Law Review 169, 181–184.

accountability.[126] In many ways, the market for corporate control is thought to be the evolutionary endpoint of stock market development.[127] The theory is straightforward – it is the *threat* of a bid that provides management with an incentive to maximize shareholder-return since, if successful, this will make their company bid-proof because they have ensured shareholder loyalty. Similarly, market forces will cause managements to seek to prove that they are honest and efficient. This will encourage investment in the company, ward off a takeover and improve their own marketability.[128] Conversely, takeovers can improve efficiency by transferring assets to those who can manage them more productively. Consequently, more effective managers emerge who can raise the firm's profitability and share price. Further, even if current managers are not replaced, an active market for corporate control presents a credible threat that inefficient managers will be replaced and thus ensures that the incumbent management actively seeks to maximize shareholder value and thereby raises corporate performance.[129]

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[126] See eg F Easterbrook and D Fischel *The Economic Structure of Corporate Law* (Harvard University Press Reprint edn 1996); E Fama and M Jensen 'Separation of Ownership and Control' (1983) 26 Journal of Law and Economics 301. For a detailed discussion of the theory of the market for corporate control, see C Bradley 'Corporate Control: Markets and Rules' (1990) 53 MLR 170.

[127] BR Cheffins *Company Law*, above n 34, 119–121; A Singh A Singh and B Weisse 'Corporate Governance, Competition, the New International Financial Architecture and Large Corporations in Emerging Markets' Paper presented in University of Cambridge (4 July 2002) 19 (with permission from authors) (hereafter 'Singh Singh and Weisse').

[128] E Ferran 'Corporate Law, Codes and Social Norms – Finding the Right Regulatory Combination and Institutional Structure' (2001) 1 JCLS 381; K Hopt 'Modern Company and Capital Market Problems: Improving European Corporate Governance after Enron' (2003) 3 JCLS 221.

[129] Singh Singh and Weisse, above n 127, 19.

It would be useful, at this point, to examine the UK market by reference to the parallel market that exists in the US. As will be seen, the enforcement mechanisms of the US and the UK may be very different. This, in turn, may shed light on some of the unique features of the UK market.

In the UK, in theory at least, market forces can be quite potent. Miller observes that the UK has a more robust and less regulated takeover market than the US, while the US is more permissive towards derivative litigation.[130] Though this is hardly a new observation, Miller argues that these differences can be viewed as partly reflecting alternative approaches to controlling agency costs in the Berle-Means corporation.[131] In UK, agency costs are controlled by the threat or reality of a hostile takeover bid in which incumbent managers are replaced if they fail to maximize the value of a firm's assets. In the US, where hostile takeovers have been severely restricted, the derivative action has attained greater prominence as a management control device.

Although there is some plausibility to the theory that the systems reflect alternative approaches to the same public policy problem (ie they are both techniques of accountability) this view is not entirely satisfactory.[132] As it has evolved in the US, the derivative action is not an effective means for ensuring managerial competence. Derivative actions based on alleged mismanagement are

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[130] For example, the federal principles which generate strong pressures for anti-takeover legislation at the state level in the US are not present in the UK. Moreover, compared to the US, there are few formal legal constraints on takeovers in the UK. See eg G Miller 'Special Symposium Issue: Political Structure and Corporate Governance: Some Points of Contrast between the United States and England' (1998) Columbia Business Law Review 51 (hereafter 'G Miller "Special Symposium"'). See also R Kraakman et al, above n 34, ch 5.

[131] G Miller 'Special Symposium' ibid 52.

[132] ibid.

extraordinarily difficult to win. The derivative action is most effective in dealing with cases of self-dealing or illegality, but these are not, or at least are not usually, the sorts of managerial behaviour against which the hostile takeover is directed. It follows that the derivative action and the hostile takeover *are not substitutes* for one another in a public policy sense.[133]

Further, several prominent commentators in the US concede that the market for corporate control may be inadequate to deal with one-time defalcations by managers.[134] In particular, it is argued that the most significant weakness in the market for corporate control solution as a deterrent to managerial misbehaviour lies in its ineffectiveness against so-called 'one shot' breaches of fiduciary duties by managers. Yet this is one of the major objects of derivative actions.[135] Directors and officers who have a chance to achieve unprecedented wealth through a single misdeed have less concern for their continued association with the company which provided them with that once-in-a-lifetime opportunity.[136] Therefore the takeover is generally considered more effective in displacing managers who have *systematically* underemployed or misemployed the company's resources. The conclusion is that the markets for control and managements in the US both function

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[133] ibid.

[134] F Easterbrook and D Fischel, above n 17, 701; L Bebchuk 'The Case for Facilitating Competing Tender Offers: A Reply and Extension' (1982) 35 Stanford Law Review 23; M Roe 'The Institutions of Corporate Governance' Discussion Paper No 488 08/2004 http://www.law.harvard.edu/programs/olin_center/ (18 April 2004).

[135] As will be seen below in ch 2.

[136] J Cox 'Compensation, Deterrence and the Market as Boundaries for Derivative Suit Procedures' (1983) 52 George Washington Law Review 745, 753–754.

best in those situations in which the derivative action normally *does not apply*: ordinary daily decision-making.[137] For these reasons, even the most fervent proponents of market-based solutions in the US believe that the derivative action has a role to play in redressing and deterring managerial misbehaviour.[138]

An alternative theory might be that the distinctions between the UK and the US stem from political differences. Yet, at least at first glance, this seems somewhat puzzling. We might assume, based on a review of US takeover law, that incumbent corporate managers are calling the shots. Such a view, however, cannot easily explain the relative vibrancy of derivative litigation in the US as compared with the UK.[139] Incumbent managers do not like derivative litigation because they are often the defendants; and even if they are not defendants, the derivative action threatens their authority to manage the company.[140] A political explanation of the evidence must therefore be based on a more complex theory than one based solely on the power of incumbent management.

A more satisfying account can be provided when differences in the systems' structure are taken into account.[141] In the US, where corporate law is dominated by state governments, the political forces aligned against hostile takeovers are quite potent, generating legislation and judicial decisions that have suppressed takeover activity. In the UK, with its more unitary system, the political forces play out

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[137] ibid, 754.

[138] F Easterbrook and D Fischel, above n 17, 701–702; KE Scott, above n 17, 938–939.

[139] G Miller 'Special Symposium', above n 130, 52.

[140] ibid.

[141] ibid, 53.

differently, and the system accordingly generates rules more accommodating to unfriendly takeovers.[142]

Given the more concentrated character of the British financial community (both in terms of institutional ownership and physical location in the City of London), reputational effects may matter more in the UK than in the US.[143] With respect to derivative litigation, the differences stem largely from the political influence of the organized bar. Because the English system until recently did not recognize any form of contingency fees,[144] there is little support from the organized bar to push for liberalization in the rules governing derivative litigation. Thus incumbent managers, who are generally hostile to derivative litigation, exercise a great deal of control over the scope of the remedy.

In fact, it can be argued that if we focus on enforcement, it is clear that the differences between the US and the UK are probably as great as between the US and France (a nation generally thought to enforce its investor protection laws only weakly).[145] In the US, class and derivative actions are permitted, and plaintiffs' attorneys may charge contingent fees, which are usually awarded by the court based on a percentage of the recovery that the attorney obtains for the class. Under the standard 'American Rule' each side bears its own legal fees (which means that

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[142] ibid. For general background and a stimulating account on the relationship and differences between the two legal systems see PS Atiyah and RS Summers *Form and Substance in Anglo-American Law: A Comparative Study of Legal Reasoning, Legal Theory and Legal Institutions* (Clarendon Press 1987).

[143] J Coffee, above n 120.

[144] See the extensive discussion below in ch 6 on the introduction of conditional fees in the UK and the incentive structures this may create.

[145] J Coffee, above n 120.

the plaintiff's attorney faces only the loss of time and expenses invested in the action if the action is unsuccessful and is not generally liable for the winner's legal expenses).[146] The recognition of contingency fees and the 'common fund' doctrine[147] permitting attorney compensation out of the amounts generated for the benefit of the corporation have created a strong interest group within the organized bar that favours a relatively liberal scope for the remedy. Because the organized bar is usually quite influential in the design of corporate rules, it has been able to ensure a relatively wide-ranging derivative remedy despite the remedy's unpopularity among corporate managers.

In the UK, the reverse is generally true. Class actions and contingent fees[148] are not authorized, and the losing side must normally compensate the winning side for its costs, which, in turn, may constitute a prohibitive deterrent to litigation.[149] As a result, while a highly entrepreneurial system of private enforcement has evolved in the US that largely overcomes the collective action problems that dissuade individual investors from suing, nothing comparable exists in the UK. This is not to say that the US system is optimal. For one, litigation could in principle result in over-deterrence.[150] On the other hand, absent similar enforcement mechanisms, minority shareholders will predictably remain passive,

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[146] ibid. See further ch 5 under 5.2.2.

[147] See ch 5 under 5.2.2.

[148] That is, US style contingent fees. On conditional fees see ch 6 under 6.3.1.

[149] J Coffee, above n 120.

[150] As will be seen in ch 2 under 2.3.3.2.

even if they learn that they have been defrauded.[151] Differing political dynamics again help to explain differences in legal institutions.[152]

With these observations in mind, let us examine now whether the way in which the market for corporate control in the UK works in the real world is also consistent with our observations so far that it *cannot* substitute for derivative actions.

1.4.2 Flaws in the Operation of the Market for Corporate Control

Potentially, the market may offer a more attractive substitute for the derivative action as an alternative technique of accountability. As will be seen, while these market forces can operate to reduce 'agency costs' they are, nonetheless, imperfect and subject to limitations. For example, the product market in which a company operates may not be competitive, with the result that the company can be operating inefficiently without this inefficiency being disciplined by the market.[153] More importantly, a critical school has developed a multifaceted critique that has increasingly questioned the above textbook version of the market for corporate control.[154] Likewise, recent research has suggested that extra-legal mechanisms for controlling managerial power are less effective than they might be.[155] A number of other studies have cast doubt on the disciplinary hypothesis of the market for

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[151] J Coffee, above n 120.

[152] G Miller 'Special Symposium', above n 130, 53.

[153] I Ramsay, above n 29, 154 and the references therein.

[154] Singh Singh and Weisse, above n 127, 20.

[155] S Deakin E Ferran and R Nolan, above n 1, 167–169; JE Parkinson *Corporate Power and Responsibility – Issues in the Theory of Company Law* (Clarendon Press Oxford 1993) 132.

control. It is the purpose of the reminder of this chapter to consolidate these views and to briefly highlight some of the flaws and limitations of the market.

First, a number of analysts have pointed out that in the real world the market for corporate control has an inherent flaw in its operation: it is far easier for a larger company to take over a small one than the other way around.[156] In principle, it is possible that a small company may take over a larger and less efficient company, though the incidence of this is very small,[157] and in a takeover battle it is the absolute size that counts rather than the relative efficiency.[158] Therefore the development of an active market for corporate control may encourage managers to 'empire-build' not only to increase their monopoly power but also to progressively shield themselves from takeover by becoming larger.[159]

Secondly, takeovers are a very expensive way of changing management.[160] There are substantial costs associated with takeovers in countries like the US and the UK which hinder the efficiency of the takeover mechanism.[161] Either mounting a takeover or defending against one involves substantial transactions costs.[162] These costs, particularly when the bid is unsuccessful, may simply be dead-weight

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[156] A Singh *Take-overs, Their relevance to the Stock Market and the Theory of the Firm*, Cambridge University Press (1971); A Singh 'Corporate Takeovers' in J Eatwell M Milgate and P Newman (eds) *The New Palgrave Dictionary of Money and Finance* (Macmillan London 1992) 480–486.

[157] A Hughes 'Merger and Economics Performance in the UK: A Survey of the Empirical Evidence 1950–1990' in J Fairburn and J A Kay (eds) *Mergers and Merger Policy* (2nd edn OUP 1991).

[158] Singh Singh and Weisse, above n 127, 20.

[159] ibid.

[160] See generally A Peacock and G Bannock *Corporate Take-overs and the Public Interest* (Aberdeen University Press 1991).

[161] Singh Singh and Weisse, above n 127, 20.

[162] This last point is well-illustrated in Table 2.4 in DD Prentice, above n 43, 37.

costs to the respective companies that do not produce any countervailing advantages. Likewise, because hostile takeovers involve substantial costs, it is highly probable that, so to speak, 'small' unfair self-dealing, in the absence of other means of reaction, will go undetected or at least unpunished.[163] Likewise, the efficient operation of the takeover mechanism requires that enormous amounts of information are widely available.[164] Specifically, market participants require information on the profitability of corporations under their existing management; nonetheless, it has been noted that such information is not easily available even in countries like the UK.[165]

Thirdly, there is no evidence that corporate governance necessarily improves after takeovers. This is for the simple reason that most takeovers are not disciplinary, and in many of them the acquiring company is motivated by empire-building considerations.[166] Research has found recently that takeover markets in the UK, and hostile takeovers in particular, are not significantly related to poor performance.[167] In addition, the research found no significant relation between managerial disciplining and large outside share blocks held by financial institutions, individuals, families and non-executive directors.[168] This has led some to conclude that takeovers represent a poorly focused disciplinary mechanism.[169]

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[163] L Enriques, above n 17.

[164] Singh Singh and Weisse, above n 127, 20.

[165] ibid.

[166] ibid.

[167] J Franks and C Mayer, above n 106.

[168] ibid.

[169] ibid.

Fourthly, it has been argued that takeovers can be used as a device to avoid honouring implicit contracts developed between workers and the former management.[170] This abandonment of implicit contracts can be argued to be socially harmful in that it discourages the accumulation of firm-specific human capital by workers.[171]

Fifthly, the market for corporate control may have little or no application to private companies.[172] Yet private companies, although relatively less significant in economic terms, constitute the vast bulk of companies in the UK.[173] This inevitably limits the application of the market for corporate control. Similarly, the threat of takeover is irrelevant where the company is, to all intents and purposes, bid-proof.[174]

Finally, there may be other forces that hinder this market. First, defensive tactics employed by managers of companies which are potential takeover targets are said to have a limiting effect on the openness of the market.[175] Secondly and more generally, the market for corporate control can vary significantly and, for

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[170] Singh Singh and Weisse, above n 127, 20–21.

[171] A Shleifer and L Summers 'Breach of Trust in Hostile Takeovers' in A Auerbach (ed) *Corporate Takeovers: Causes and Consequences* (University of Chicago 1988).

[172] Singh Singh and Weisse, above n 127, 21.

[173] At the end of 2001, there were 12,400 public companies (0.8% of the register) and 1,491,500 private companies (99.2% of the register). DTI *Companies in 2001–02*, Table A2.

[174] For example, with a weighted voting structure or where the first indication of trouble wipes out the value of the company. DD Prentice, above n 43, 38.

[175] In general, takeover defensive tactics are rather restricted in England. See S Deakin and G Slinger 'Hostile Takeovers, Corporate Law and the Thoery of the Firm' (1997) 24 Journal of Law & Society 124. Therefore such defences as are available to directors and managers of English companies are mostly in the form of marketplace tactics such as buying and selling assets, entering into contracts that might make a firm an undesirable target, and so on. See G Miller 'Special Symposium', above n 129, 52.

various reasons, may apply only within a limited range.[176] For example, numerous companies are *not* the subject of capital market disciplines.[177] If a company is in a position to meet its funding requirements by using cash generated internally by the retention of profits, management will have a reduced incentive to run the business in manner which matches the expectations of the market.[178] Similarly, the experience in the US suggests that companies in which the degree of inefficiency is not extreme enough to create a sufficient reduction in the share price to cause a takeover, and companies in which the degree of inefficiency is so extreme as to preclude a takeover because it is such a risky undertaking, fall outside this range and the market for corporate control may only weakly discipline these companies.[179]

In short, it has been illustrated that the market for control has some serious flaws in its operation, and its effectiveness can depend on variables including the company's size and organizational complexity, shareholding structure, the amount of information which is widely available or defensive tactics employed by managers of companies which are potential takeover targets. Likewise, many takeovers are not disciplinary, and in many of them the acquiring company is motivated by empire-building. This is not to suggest that the market for control may not have an important role in the corporate governance system of an open and

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[176] I Ramsay, above n 29, 154 and the evidence therein.

[177] J Parkinson, above n 155, 118.

[178] BR Cheffins *Company Law*, above n 34, 120.

[179] J Coffee 'Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance' (1984) 84 Columbia Law Review 1145, 1203–1204.

competitive economy such as the UK. It certainly has a vital place.[180] However, it is perhaps easy to overestimate the beneficial effect upon management performance of the *threat* of the takeover bid.[181] Similarly, takeovers are a costly and imperfect way to discipline errant managers. Finally, and more importantly for the discussion which follows, whether their role can be said to deal with the *same* 'agency cost' problems that in the end achieve functionally similar results as derivative actions is a different question altogether.

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[180] E Ferran *Company Law and Corporate Finance* (OUP 1999) 122; E Ferran, above n 128; K Hopt, above n 128.

[181] *Gower and Davies*, above n 9, 750 and the references therein.

1.5 CONCLUSION

There are three key conclusions that this initial discussion seems to point to. First, it needs to be acknowledged that shareholder litigation is neither the initial nor the primary protection for shareholders against managerial misconduct. It cannot be viewed in isolation from a number of mechanisms which relate to corporate governance. These include structural as well as internal and external control devices for minimizing agency costs. Secondly, a brief examination of some major control devices has revealed that there are flaws and constraints in their effectiveness. The point here is not that these mechanisms are not important but rather that they are imperfect and that the disciplinary framework they impose is far from complete. Their effectiveness varies from industry to industry, from firm to firm and from time to time. Thirdly, in focusing on one major control mechanism, namely the market for corporate control, it was illustrated that the derivative action and the hostile takeover *are not* substitutes for one another in a public policy sense. This is for two reasons, one theoretical and the other practical. First, the market for control functions best in those situations in which the derivative action normally *does not apply*: ordinary daily decision-making. Secondly, the market for control has some serious flaws in its operation, and its effectiveness is subject to variables. It follows that an unconstrained takeover market may not constitute an effective functional substitute for litigation and it would be unsafe to rely solely on markets as a substitute for other forms of control.

Although this is hardly a revelation, it seems consistent with the notion that various control mechanisms can complement and substitute for one another. This, in turn, suggests that the derivative action may have a role in minimizing agency costs. In relation to litigation, the crucial question then becomes: in what way or ways can the derivative action provide a supplementary mechanism to these other mechanisms of accountability? It is the purpose of the following chapter to inquire into these important issues.

The Choice of Rationales and the Social Meaning of Derivative Actions

2.1 INTRODUCTION

This chapter aims to analyse the theoretical rationales behind derivative actions, and to ask how they relate to our understanding of the social value and roles of the derivative action as a corporate governance tool.[1]

The discussion is organized as follows. An initial analysis of the merits and demerits of the derivative action is presented in Section 2.2. Section 2.3 analyses the roles derivative actions may assume in enforcing corporate accountability. The question addressed is whether their purpose is primarily to deter misconduct or simply to compensate the company for the wrongdoing. As part of this, the possible benefits and limitations of these rationales will be explored. Finally, Section 2.4 examines the public image, or expressive value, of the derivative action. The purpose is to determine if some of the features inherent in the derivative action procedure enhance or detract from the understanding of derivative action as a positive social force.

A final word before we proceed. Some of the themes in Sections 2.3 and 2.4 are drawn from derivative actions theory found in American literature. The writer believes it is imperative to pay attention to American developments (as well as

1 For an earlier version of this chapter entitled 'The Choice of Objectives and the Social Meaning of Derivative Actions' see (2005) 6 EBOLR 227.

developments in other common law jurisdictions). The derivative action in the US has become a very sophisticated procedure and there is a rich and vast literature on the subject.[2] The aim is therefore twofold: first, to indicate, in the light of research from the US, where the discussion in the UK should be conducted, and secondly, to examine what can be learnt from the experience in the US. The theoretical foundations outlined in this chapter will then be analysed to develop the conceptual framework in which derivative actions in English law may be accommodated.[3]

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[2] A note of caution must be sounded when making direct comparisons with shareholders' litigation in the US. The derivative action in the US is a sophisticated mechanism with several distinctive features. The differences can be explained in terms of the impact of existing legal rules, policy issues and reliance on alternative enforcement mechanisms. That said, the US legal system has nevertheless had to address somewhat similar problems (ie the floodgates argument) and has had to resort to various restrictive rules, some of which have similar theoretical suppositions to the English common law; thus ratification will sometimes shut down a derivative action. Other rules are technical bars designed to discourage derivative actions, such as the requirement for a minority derivative litigant to give security. See B Pettet *Company Law* (Longman Harlow 2001) 239. The focus here is on theoretical issues, and there is no reason to assume that the same incentive structures do not present themselves in the UK, although the same level of activity is not present.

The analysis in this chapter focuses principally on Delaware as the paradigm. See further RJ Gilson 'Globalizing Corporate Governance: Convergence of Form or Function' 49 (2001) American Journal of Comparative Law 329, 350 ('The aggregated choices of a majority of publicly traded U.S. corporations have resulted in a convergence on the Delaware General Corporation Law as a de facto national corporate law').

[3] See ch 4, where we assess whether, as a matter of policy, there is any viable role for derivative action in English law in light of the rationales identified here.

2.2 MERITS AND DEMERITS OF DERIVATIVE ACTIONS

In the previous chapter we saw that shareholder litigation is neither the initial nor the primary protection for shareholders against managerial misconduct. A variety of social and market forces also operate to hold corporate officials accountable. Yet no single technique of accountability is likely to be optimal under all circumstances. Each has its characteristic and well-known limitations. As a result, shareholders are best served by an overlapping system of protections, one of which is by means of derivative actions. At the same time, it should not be assumed that derivative actions are an unqualified good. There are valid reasons why *litigation* would leave the company worse off than before.[4] In a nutshell, the common, partly overlapping, objections include the following:

(1) There is the danger that a company will be burdened with an action that it does not want. As Templeman LJ stated in *Prudential Assurance Co Ltd v Newman Industries* Ltd *(No 2)*[5] the company in that case might have felt that 'it might be killed by kindness'. For example, while winning the legal arguments and obtaining an enforceable remedy, the company may suffer collateral harm which outweighs the gain from litigation. This may include also non-monetary harm, ie litigation may produce unwanted publicity, which in turn may affect the long-term reputation of the company, which

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[4] Some of the issues raised below are not exclusive to derivative actions, but have a more general application to claims by companies against wrongdoing managers. On the problems presented by the uneasy position of shareholders in derivative action see ch 3 under 3.2.2.1.

[5] [1982] 1 Ch 204, 221.

will deter further investment. Overall then, litigation may simply not be worth the expense.[6]

(2) There may be doubts about whether a verdict in favour of the company will be obtained, either because of disputes about the law or because of difficulties proving the events said to constitute a breach of duty. In addition, the defendants may not be in a position to meet the judgment even if litigation is successful.[7]

(3) There are also hidden costs beyond the direct costs of litigation.[8] Litigation can disrupt the decision-making process and thereby impose unforeseen and undetected costs. For example, management must take time away from daily business operations to prepare for the action. That time costs the company not only in salaries, but also in lost revenues because (a) management is often too busy to oversee operations as effectively as in the absence of litigation; and (b) the impact of distraction of key personnel by continued litigation. Litigation may therefore consume an undue amount of management time, and the senior management time spent on litigation might be more profitably be used elsewhere (ie seeking

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[6] DD Prentice '*Wallerseiner v Moir*: A Decade Later' [1987] The Conveyancer 167, 168; BR Cheffins 'Reforming the Derivative Action: The Canadian Experience and British Prospects' [1997] 2 CFILR 227, 230; PL Davies *Gower and Davies' Principles of Modern Company Law* (7th edn Sweet & Maxwell London 2003) 443.

[7] *Gower and Davies* ibid.

[8] *Joy v North* 692 F 2d 880, 892 (2d Cir 1982); P Banta 'Note: The New Indiana Business Corporation Law: 'Reckless' Statue or New Standard' (1987) Columbia Business Law Review 233, 236.

appropriate opportunities for investments). There will therefore be cases where a company's interests will be best served by foregoing litigation in favour of alternative courses of action (eg relying on the threat to terminate relations with an employee to force a settlement).[9]

(4) Derivative actions generate agency costs of their own. For example, the increased risk of litigation might deter individuals from becoming directors.[10] Accordingly, the use of derivative actions can raise the expenses that companies must incur in order to attract managers. In theory, a manager's net return from his job must equal some 'reservation' level for him to be willing to work for the company.[11] Hence, if managers face a risk of action, a company must either supply them with adequate liability insurance[12] or raise their salaries[13] by an offsetting amount to induce them to maintain their position.[14]

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[9] BR Cheffins, above n 6, 230.

[10] This relates to a wider issue, namely the problem of fixing appropriate level of duty. Arguably, the preferred strategy should not be to institute a mechanism that prevents wrongs from being remedied. See further R Kraakman PL Davies et al *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2004) 2.2.1.

[11] This is the net return that the manager could obtain from the best alternative place of employment.

[12] See in this context s 310 CA 1985 discussed in ch 4 under 4.4.2.5.

[13] Some express doubts that salaries will arise to compensate managers for corrupt gains that they are denied by the threat of suit. For the grounds for such scepticism see R Kraakman H Park and S Shavell 'When Are Shareholders Suits in Shareholder Interests?' (1994) 82 Georgetown Law Journal 1733, 1738 and 1748.

[14] The action, even if ultimately won by defendants, may be seen by board members not only as taking time, but also putting them in the uncomfortable position of having to submit to questions testing their ability to remember past events accurately and articulate answers with clarity. There is also the risk of generating unfavourable publicity which harms the directors' reputation. RH

(5) Litigation agency costs may also arise in other forms. As we saw, a derivative action is a legal oddity. A self-appointed shareholder (and that litigant's attorneys) champions the claims on behalf of the company. The small actual return to any one shareholder means that the incentives of the protagonist plaintiff may diverge from those of the company as a whole. This, in turn, may result in incurring further agency costs. Because of his small stake in the company, the complaining shareholder has very little incentive to consider the affect of the action on the company as a whole.[15] Thus derivative actions create a risk of strategic behaviour by minorities. One salient example is the possibility for 'gold-digging' claims against the company which are settled on terms advantageous to the plaintiff shareholder and the defendants but which do not reflect the value of the company's right or are not in the interests of the company.[16]

(6) A common argument made opposing derivative action is that it deters legitimate risk-taking on part of managers. Imposing liability may discourage entrepreneurial risk-taking and adversely affect profit maximization. Fear of liability makes directors more risk averse. Arguably, this is possibly the greatest cost of derivative

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Mundheim 'Commentary: The Social Meaning of Shareholder Suits' (1999) 65 Brooklyn Law Review 55, 56–57.

[15] More on this important point in ch 3 under 3.2.2.1.

[16] In order to reduce the possibilities for 'gold-digging' settlements are controlled by the court. See below under 2.4.4.

action litigation.[17] Those hired to run corporations are hired to take calculated risks in pursuit of profits. Since shareholders are protected from risk volatility by diversified portfolios, in the long run they gain from management taking a risk.[18] Directors, on the other hand, are not well situated to absorb losses from decisions that turn out unprofitably.[19] First, business decisions rarely involve black-and-white issues; instead, they typically involve prudential judgments among a number of plausible alternatives. Given the vagaries of business, moreover, even carefully made choices among such alternatives may turn out badly.[20] Secondly, directors at most serve only a handful of firms, and if they are personally liable for some portion of the losses their only option is to avoid the risks, and such aversion to risk hurts shareholders.[21]

(7) Arguably, after-the-fact litigation is an imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years

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[17] P Banta, above n 8, 236.

[18] Because potential profit often corresponds to the potential risk, it is arguably very much in the interest of shareholders that the law does not create an incentive for overly cautious corporate decisions. Some opportunities offer great profits as the risk of very substantial losses, while the alternatives offer less risk of loss but also less potential profit. *Joy v North* 692 F 2d 880, 886 (2d Cir 1982).

[19] Coffee, for example, argues that directors are 'poor cost avoiders' with respect to corporate losses flowing from negligent decision-making and hence can be rendered excessively risk averse in the long run. JC Coffee 'Litigation and Corporate Governance: An Essay on Steering between Scylla and Charybdis' (1984) 52 George Washington Law Review 789, 801–803.

[20] JJ Hanks 'Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification' (1988) 43 Business Law Review 1207, 1232.

[21] P Banta, above n 8, 237.

later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.[22]

(8) Finally, immeasurable costs are incurred because of the oppressive effect litigation has on morale. This may result in the departure of key personnel. Even in the absence of an action or the immediate threat of one, a general fear of litigation can cause boards to incur costs that would not otherwise be necessary. Directors' concern about possible legal liability for decisions serves only to reduce risk-taking and the attractiveness of board positions, while only adding expensive paper trails. In order to avoid liability, directors will keep longer paper trails and hire more experts than they need to make decisions, and probably more than the law requires. In the absence of certainty, too much is safer than too little.[23]

It is clear then that there are valid reasons why litigation would leave the company worse off than before. The litigation decision involves a commercial judgment based on an assessment of the arguments for and against the initiation of litigation (risks, expenses and possible benefits) and may be regarded as an 'investment decision' for the company. Overall, then, the decision not to sue a

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[22] *Joy v North* 692 F 2d 880, 886 (2d Cir 1982).

[23] P Banta, above n **8**, 237.

director will not always be an easy one and a negative decision is not necessarily a sign that the company is being too lax towards its directors.[24] On the other hand, whatever the nature of a derivative claim, it is generally thought that the action may entail possible benefits in several ways. These benefits are usefully summarized in **Table 2-1.**

Table 2-1

Roles of Derivative Actions				
Role	Deterrence	Compensation	Filling gaps (ancillary role)	Enforcement of directors' duties (traditional view)
Possible Benefits	Deterrence of unwanted managerial behaviour	Recovery[25]	Fills gaps in incomplete contracts between shareholders and managers	Holding directors accountable
Takes effect	Ex ante Ex post	Ex post	Ex post	Ex post

The purpose of **Table 2-1** is simply to emphasize the various ways in which derivative actions can be used as an instrument of corporate governance, not to offer a new formalistic schema that displaces rather than aids functional understanding. In the left-hand side of the table we find the two main purposes that

[24] *Gower and Davies,* above n 6, 443.

[25] As is explained below under 2.3.2.2, this includes both recovery in the sense of financial recovery and the return of the company's property.

the derivative action is usually said to serve in corporate governance, namely deterrence and compensation. The argument that the primary role of shareholder derivative actions is the reduction of agency costs assumes that such actions deter mismanagement. The assumption is that liability rules enforced by derivative actions play a fundamental role in aligning the interests of managers and shareholders.[26] In addition, most analyses assume as well that the purpose of the action is simply to compensate the company and its shareholders for the harm caused. In the following section we closely examine these rationales.

The purpose of the bottom row in **Table 2-1** is merely to highlight the fact that three of the possible roles of derivative action take full effect ex post, that is only after the action is brought. For instance, the financial benefit of compensation (ie recovery), by its very nature, can only be realized after the derivative action is brought. By contrast, deterrence works both ex ante and ex post. As will be seen, deterrence involves both ex ante expectations of wrongdoers (regarding the probability and the magnitude of the threat of expected liability should they decide to engage in wrongdoing) as well as actual ex post liability for the total harm they cause.[27]

Two additional roles of derivative actions are presented in **Table 2-1** for the sake of completeness. First, on the right-hand side we find the traditional view of

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26 On why the threat of personal liability provides directors with an incentive to comply with applicable standards of conduct, see JE Parkinson *Corporate Power and Responsibility – Issues in the Theory of Company Law* (Clarendon Press Oxford 1993) 132–135.

27 See 2.3.3.1 below.

derivative actions, namely, enforcement of directors' duties. As will be seen in Chapter 3, a corollary objective of derivative actions is to ensure that directors pay heed to their legal duties. Although directors' duties are owed formally to the company and not to individual shareholders, it is essentially shareholders' interests that are protected by the imposition of these duties.[28] The imposition of duties sets limits to the directors' exercise of corporate powers and attempts to control the exercise of managerial discretion and self-interested behaviour. The effectiveness of such duties and controls depends on there being realistic enforcement, or at least the prospect thereof. But, as will be seen in Chapter 3, there are difficulties with this because, circuitously, the directors owe these duties to the company and the company's decision to call the directors to account is made for it by the board. For these reasons, duty-based controls therefore depend very much on viable shareholder enforcement.[29]

A fourth role should be mentioned briefly: the gap-filling role (third column). An additional potential social benefit from derivative action litigation is ancillary to its role as a governance device: legal rules are public goods.[30] In theory, litigation can reduce legal uncertainty. The absence of clear legal rules is costly.[31] For one thing, it leads to variance in assessments of the legal standard and thus to

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[28] The main fiduciary duty owed by directors is the duty to act bona fide in the interests of the company and these interests have time and again been equated with the interests of the shareholders a whole. See eg *Allen v Gold Reefs of West Africa Ltd* (1900) 1 Ch 671.

[29] See further ch 3 under 3.2.1.

30 RR Romano 'The Shareholder Suit: Litigation without Foundation' (1991) 7 Journal of Law, Economics and Organization 55, 85; F Easterbrook and D Fischel *The Economic Structure of Corporate Law* (Harvard University Press Reprint edn 1996) 34–35. For a discussion of precedent as a public good in general see R Posner *Economic Analysis of Law* (5th edn Aspen 1998) 567.

31 E Kamar 'Shareholder Litigation under Indeterminate Corporate Law (1999) 66 University of Chicago Law Review 887, 889.

divergences of behaviour from the social optimum. Some corporate fiduciaries may overestimate the legal constraints and forgo efficient transactions, while others may underestimate the very same constraints and carry out inefficient transactions. Further, legal indeterminacy creates liability risk, which risk-averse fiduciaries are in a poor position to bear. Exposing corporate fiduciaries to this risk makes their services more costly and less productive to shareholders.

It is generally thought that much of the company's contract is informal and confused. The complete contingent claims contract, which seeks to predetermine all the future behaviour of the company and the substantive rights and duties of corporate actors, is particularly impossible and financially undesirable. Gaps are inevitably left in the company's contract.[32] The long-term nature of the contract and its consequential incompleteness entail an unusually high degree of legislative and judicial intervention. Beyond mere gap-filling, the informational problems enjoyed by shareholders inherent in the long-term corporate relationship demand and justify some judicial control of the parties' express bargain.[33] One mechanism for filling these gaps is through judicial construction. The judiciary may be involved in a process of ex post construction of the company's contract. [34]

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[32] RR Drury 'The Relative Nature of a Shareholder's Right to Enforce the Company Contract [1986] CLJ 219, 246; DD Prentice 'The Theory of the Firm: Minority Shareholder Oppression: Sections 459–461 of the Companies Act 1985' (1988) 8 OJLS 55; I Macneil 'Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory' (2001) 1 JCLS 107.

[33] CA Riley 'Contracting out of Company Law: Section 459 of the Companies Act 1985 and the Role of the Courts' (1992) 55 MLR 782.

[34] ibid.

For example, contractual gaps may be addressed by duties imposed by the courts.[35] By virtue of case law precedents a director must act with care, skill and diligence, must act in the best interests of the company, must not put himself in a position where his personal interest conflicts with the company's and must account for any personal profits made while acting on behalf of the company.[36] As decided cases accumulate, the interpretation and proper application of fiduciary standards, for example, become clearer, allowing directors and officers to estimate legal outcomes more accurately and thus to behave more closely to the social optimum.[37] All companies benefit from a judicial decision clarifying the scope of permissible conduct. The benefit of clarification is not simply deterrence of future managerial conduct, but rather, given the contractual setting of the company, identification of a rule around which the parties, namely managers and shareholders, can transact.[38] It may well be that the law in this area is fostering efficient outcomes by playing a 'gap filling' role.[39]

The scenario described so far, has, nonetheless, a serious limitation in practice: it presupposes a rich seam of modern judicial precedent on which to build this gap-filling role. But it has been observed that the UK does not have nor, despite proposed reforms to the derivative action, is it likely in future to have a large number of actions producing a rich seam of modern judicial precedent on

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[35] BR Cheffins *Company Law: Theory, Structure and Operation* (OUP 1997) 134.

[36] ibid. See generally, *Gower and Davies*, above n 6, ch 16.

37 E Kamar, above n 31, 890.

[38] R Romano 'The Shareholder Suit: Litigation Without Foundation?' (1991) 7 Journal of Law Economics and Organization 55, 83.

[39] BR Cheffins *Company Law*, above n 35, 134.

which to draw in order to remove uncertainty about precisely what is required of directors in particular circumstances.[40] This may suggest then that this role may have somewhat limited scope in the UK.

2.3 THE CHOICE OF RATIONALES: DETERRENCE VERSUS COMPENSATION

2.3.1 The Primary Purposes of Derivative Actions in the US

Arguably, any legal rule that imposes duties on potential wrongdoers and delivers compensation to injured victims would seem to have the features of general deterrence, particular compensation and consequential social benefits as presented above. The question is then which of these purposes of the derivative action is, or should be, the primary justification?

The argument that the primary role of shareholder derivative actions is the reduction of agency costs assumes that such actions deter mismanagement. If a net economic benefit to the company were a prerequisite to derivative proceedings, fraud which did not exceed a certain level would never be pursued.[41] The assumption is that liability rules enforced by derivative actions play a fundamental role in aligning the interests of managers and investors. In this respect, it is thought

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40 E Ferran 'Company Law Reform in the UK' (2001) 5 Singapore Journal of International and Comparative Law 516; JC Coffee 'Privatization and Corporate Governance: the Lessons from Securities Market Failure' (1999) 25 Journal of Corporation Law I (noting the sharp contrast between the UK and US in shareholder enforcement). The recent White Paper acknowledged that it is unlikely that putting derivative actions on a statutory footing will affect the low number of cases brought. White Paper *Company Law Reform* Cm 6456 (London: DTI, March 2005) Annex A, 277.

41 S Watson and O Morgan 'A Matter of Balance: The Statutory Derivative Action In New Zealand' (1998) 19 Company Lawyer 236, 237; Farrar Russell and Hampton, *Company Law and Securities Regulation in New Zealand* (1985) 187.

that derivative action has a prophylactic effect which is salutary.[42] In addition, most analyses assume as well that the purpose of the action is simply to compensate the company and its shareholders for the harm caused. Of course, either deterrence or compensation can be taken to extremes.[43]

On a first blush, it could be argued that neither mission conflicts with the other, since to hold a person accountable to those harmed by his misdeeds provides a powerful disincentive for others to similarly conduct themselves.[44] Circumstances might arise, nonetheless, where the costs to the company of continuing litigation are likely to equal or exceed the expected recovery.[45] If the basic rationale were compensation, there would seem little justification for permitting such an action to continue in the company's name. Conversely, from a deterrence perspective, if the underlying conduct involved illegal, fraudulent or predatory behaviour, the long-term 'generic' collective interests of shareholders might well justify the continuation of such an action.[46] A basic tension then exists between these two rationales and no facile answer is offered in this chapter to reconcile them.[47]

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[42] See also Consultancy Report, Review of the Hong Kong Companies Ordinance (March 1997) 149, 152.

[43] Coffee and Schwartz, for instance, have eloquently called for a balance and have embodied such a balance in their work. J Coffee and D Schwartz 'The Survival of the Derivative Suit: An Evaluation and a Proposal For Legislative Reform' (1981) 81 Columbia Law Review 261.

[44] J Cox 'The Social Meaning of Shareholder Suits' (1999) 65 Brooklyn Law Review 3, 8 (hereafter 'Cox, "the Social Meaning"').

[45] American Law Institute *Principles of Corporate Governance and Structure: Analysis and Recommendations* (Tentative Draft No 1 1982) pt I, 233.

[46] See below under 2.3.3.1.

[47] For a careful consideration of how the distinction between instances in which an enhanced sanction designed to deter might best be imposed in contrast to the more frequent instances in which a compensatory sanction will fulfill desirable deterrence objectives, see RD Cooter 'Punitive Damages, Social Norms, and Economic Analysis' (1997) 60 Law & Contemporary Problems 73.

It is interesting to note that the American Law Institute ('ALI') looked to balance the competing rationales[48] and, while recognizing the need for compensation, also suggested that there is 'generic benefit' to the shareholder who holds a portfolio of shares in that there is enhanced deterrence against wrongdoing even though the costs in a specific action may exceed the return to the company.[49] ALI suggests that the termination of an action on the grounds that it does not produce a net benefit would ultimately increase average agency costs.[50] The commentary accompanying the ALI's proposals justifies the use of the derivative action even if no gain accrues to a specific company, because of the social benefits[51] that flow from deterrence as well as the enforcement of regulatory provisions.[52] Overall, then, the ALI philosophy is that deterrence predominates when a compensatory purpose is lacking.[53]

Two questions arise in response: (1) is this view tenable? and (2) what are the reasons put forward for this view? In order to answer this, it is useful to examine now the benefits and limitations of these two rationales. **Table 2-2** below summarizes the major points.

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[48] s 7.10 of the American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* (Proposed Final Draft 1992).

[49] ibid 601.

[50] ibid.

[51] On the social benefits see below under 2.4.

[52] The American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* (Council Draft No 3 1983) 232–236.

[53] J Cox 'Compensation, Deterrence and the Market as Boundaries for Derivative Suit Procedures' (1983) 52 George Washington Law Review 745, 762.

Table 2-2 Deterrence versus compensation—benefits and limitations

	Compensation	Deterrence
Rationale	The action may confer **monetary benefits**, as companies may recover damages from wrongdoing directors	**'Generic benefit'** to the shareholder who holds a portfolio of shares: enhanced deterrence against wrongdoing
Decision Rule **(ie on what basis should the action be allowed to proceed)**	Does the expected recovery exceed the expected litigation costs that the company will bear?	In the absence of recovery, would the public benefits outweigh its private benefits?
Sanctions	**Recovery** (ie financial penalties and the return of the company's property)	Mainly intangible **non-monetary sanctions** (ie threats of financial penalties, loss of reputational capital and social stigma)
Limitations	▪ Change in composition of shareholders ▪ Injury to the company is not the same as the injury suffered by shareholders ▪ The wealth effects of derivative actions are negligible ▪ More easily and less wastefully achieved through means other than litigation ▪ Non tangible relief	▪ Its level is very difficult to estimate ▪ May impose costs well in excess of the original injury ▪ May not always impose an adequate sanction ▪ Paradox of timing of the action – ex post ▪ Requires shareholders' commitment to a policy of action
Possible Value	**Relatively low**	**Arguably high**

2.3.2 COMPENSATION

2.3.2.1 *The rationale and decision rule*

Let us begin by looking at the left-hand side of **Table 2-2**. There are those who would restrict the derivative action to a compensatory function. Proponents of a compensatory derivative action consider that, if a cost-benefit analysis concludes that the damages suffered by the company could not be rectified in money or money's worth, then the interests of the company and the shareholders are better served if leave to bring proceedings is refused. If compensation is to be the fundamental justification for the action then a simple decision rule should exist for when the action should be allowed to proceed: does the expected recovery exceed the expected litigation costs that the company will bear (including the plaintiff's attorney fees)?[54]

2.3.2.2 *Limitations*

A compensatory rationale brings to the fore various difficulties.[55] As can be seen in the third row of **Table 2-2**, a compensatory rationale has at least five critical shortcomings. First, the change in composition of shareholders means that shareholders at the time of injury who subsequently dispose of their shares prior to a court order for recovery do not obtain compensation, while incoming

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[54] J Coffee 'New Myths and Old Realties: The American Law Institute Faces the Derivative Action' (1993) 48 Business Lawyer 1407, 1428.

[55] D Fischel and M Bradley 'The Role of Liability Rules and The Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis' (1986) 71 Cornell Law Review 261, 292; J Coffee and D Schwartz, above n 43, 302–309.

shareholders receive a windfall gain.[56] When the recovery is on behalf of a publicly traded company this necessarily enriches any shareholder who became such after the action was commenced. In the public company, share ownership changes daily so that those who own their shares when the impacts of the defendant's wrongdoing occurred will not be the same owners when damages are recovered. Arguably, the post-wrongdoing set of shareholders are not unjustly enriched because theoretically a portion of their purchase price reflected the expected value of the derivative action being brought on behalf of their company. Nevertheless, it is difficult to see how the post-wrongdoing set of shareholders have been injured by the defendant's wrongdoing; they are instead recovering on a purchased chose in action.[57]

Secondly, the injury to the company resulting from, for instance, a breach of directors' duties is not necessarily the same as the injury suffered by shareholders.[58] For example, even if an efficient securities market translates an injury suffered by the company into a decline in share value, it may be that the loss of the shareholders will exceed that of the company because the events will be perceived by the marketplace as creating a risk of repetition.[59]

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[56] J Coffee and D Schwartz, above n 43, 302–309; American Law Institute *Principles of Corporate Governance and Structure: Analysis and Recommendations* (Tentative Draft No 1 1982) pt I, 233. As Ramsay rightly notes, this problem was evident in the decision of the House of Lords in *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134. I Ramsay 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 University of New South Wales Law Journal 149, 156.

[57] J Cox, above n 53.

[58] J Coffee and D Schwartz, above n 43, 304. This point is also essentially recognized by the Consultation Paper para 16.4 and is linked to the so called 'reflective loss rule' on which see below, ch 6 under 6.2.2.3.

[59] J Coffee and D Schwartz, above n 43, 304.

Thirdly, various empirical studies in the US have concluded that in the typical derivative action, while the total amount of recovery may be significant, it is generally *de minimis* on a per share basis.[60] Put differently, these studies point out that the wealth effects of derivative actions are negligible.[61] Accordingly, if all the derivative action accomplishes is the refund of a few cents per share to thousands of individual shareholders, the argument goes, it is difficult to conclude that such a result justifies the considerable drain on judicial time and court resources that the litigation of this complex form of action creates.[62] Although this fact causes little difficulty from the standpoint of deterrence, it is difficult to justify the costs imposed by such litigation on the company and the judicial system as a whole if the primary goal is compensation.[63]

Fourthly, a related problem is strongly reinforced by real-world observations: not all derivative actions lead to a tangible relief.[64] It is not unusual, for example,

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[60] R Romano 'The Shareholder Suit: Litigation Without Foundation' (1991) 7 Journal of Law, Economics and Organization 55, 62; S Bhagat and R Romano 'Event Studies and the Law: Empirical Studies of Corporate Law' (2002) 4 American Law & Economics Review 380, 407.

[61] The real problem with any study finding a negligible benefit is that it cannot measure the deterrent or compensatory capacity of the derivative action in the abstract but only under a specific set of legal rules. Unfortunately, no parallel empirical research exists on the wealth effects of derivative actions in the UK (possibly as the data is so scarce). Ultimately, empirical research cannot prove that the derivative action can or cannot work. See further Coffee 'New Myths', above n 54, 1436–1437. Further, the same critique could be made of criminal law. The fines imposed by a criminal court often may fall bellow the state's cost of prosecution. Nonetheless, criminal prosecutions continue, either because society believes in a general deterrence or because it enjoys retribution.

[62] J Coffee and D Schwartz, above n 43, 304.

[63] American Law Institute *Principles of Corporate Governance and Structure: Analysis and Recommendations* (Tentative Draft No I 1982) pt I, 233–234.

[64] This, in turn, raises another problem. When derivative litigation results in an intangible or therapeutic relief only (even if shareholder litigation results in deterrence benefits), there should be little reason for individual shareholders to sue. See ch 5 under 5.2.2.

that the remedy is proprietary, where, for example, the directors' conduct involves misappropriating the company's assets.[65]

These four problems—the constant changes in the composition of shareholders, the fact that the injury to the company is not the same as the injury suffered by shareholders, the *de minimis* recovery on a per share basis, and the non-tangible relief—are emphasized here not to challenge the desirability of securing full compensation for wrongs done to the company, but rather to indicate that a compensatory rationale cannot fully justify the derivative action or, indeed, explain the high costs incurred in the process of litigation, as discussed in Section 2.2 above.[66]

Still a fifth and more theoretical objection to the use of a compensatory rationale as a leading principle is simply that compensation might be more easily and less wastefully achieved through means other than litigation.[67] A variety of insurance systems could in principle be authorized to protect shareholders from the risk that their company would be injured because of self-dealing or other abuses. More simply, shareholders, can, and to some large extent do, protect themselves from such risks through portfolio diversification in order that their single company

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[65] In which case a tracing order against and a charge over the misappropriated assets will be most suitable. See eg *Clark v Cutland and others* [2003] EWCA Civ 810 (un unfair prejudice petition, in which the High Court held that it can make the type of order that it could make in a derivative action and grant a tracing order, as there was a derivative action in the background with which the petition had been consolidated). For liability to account for property that had been misappropriated, see generally *Cook v Deeks* [1916] 1 AC 554 (PC); *Daniels v Daniels* [1978] Ch 406.

[66] J Coffee and D Schwartz, above n 43, 305. Support for this view can be found in landmark cases such as *Diamond v Oreamuno*, 301 NYS 2d 78, 81 (1969); *City of Riverside v Rivera* 106 S Ct 2686 (1986).

[67] American Law Institute *Principles of Corporate Governance and Structure: Analysis and Recommendations* (Tentative Draft No 1 1982) pt I, 234.

exposure to loss is small.[68] Yet such insurance systems for shareholders would not seem to satisfy the community's desire to punish wilful abuses on the part of those who undertook to serve it [ie the community], and indeed, unless subject to limitation, they might even give rise to the moral hazard of encouraging abuses.[69]

2.3.3 Deterrence

2.3.3.1 *The rationale and decision rule*

In the previous section we saw that compensation has some serious limitations. While these limitations do not imply that compensation is an illusory goal altogether, they do indicate that a compensatory rationale cannot fully justify the derivative action. On this view, the goal of deterrence may be seen as a key element (subject to its own costs as discussed below) in reducing the agency costs inherent in the management of companies.[70] As can be seen in the second row of the right-hand side of **Table 2-2**, if deterrence is to be the fundamental justification for derivative actions, a simple decision rule should exist for when the action should be allowed to proceed: in the absence of recovery, would the public benefits from litigation outweigh its private benefits?

While a simple rule exists to decide when the action should be allowed to proceed, it is virtually impossible to identify a general deterrent effect. This is because the precise effect of deterrence is virtually incalculable or at least not

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[68] ibid.

[69] ibid.

[70] I Ramsay, above n 56, 156.

readily quantifiable.[71] Two major factors combine to create this effect. First, evidence here is virtually non-existent, because general deterrence is not easily or readily susceptible to empirical testing. We cannot estimate the number of offences and thereby estimate the probability of detection, which is essential for measuring such an effect.[72] For example, it is hard to test empirically because it requires an examination not of the share price of the subject company, but of the share price of all companies affected by the action or companies whose managers believe themselves to be affected.[73] Secondly, the deterrence factor lies in the subjective, subconscious reactions of directors and thus is almost untraceable.[74]

The difficulty stems also from the fact that the case for a deterrence rationale rests on an unknown and probably unknowable variable: the gains to shareholders resulting from *future* misconduct that is deterred.[75] Although these gains cannot be quantified reliably, it is easy to understate them. In part, this is because a successful derivative action is likely to produce a positive externality: it will deter misconduct in other companies.[76] As a result, even if the deterrent benefits to the company in

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[71] A similar problem exists with director disqualification procedures (see below ch 4 under 4.4.2.2): since the costs, and to an even greater extent the benefits, are not readily quantifiable, it must remain a matter of speculation whether expanding the scope for director disqualification in the UK has yielded a net social benefit. See BR Cheffins *Company Law*, above n 35, 553.

[72] R Romano 'The Shareholder Suit: Litigation without Foundation?' (1991) 7 Journal of Law, Economics and Organization 55, 84–85.

[73] J Coffee 'Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions' 86 (1986) Columbia Law Review 669, 673.

[74] Coffee ibid; V Janjigian and P Bolster, 'The Elimination of Director Liability and Stockholder Returns: An Empirical Investigation' (1990) 13 Journal of Financial Research 53.

[75] J Coffee, above n 54, 1428.

[76] In this respect, Shavell explains that the social benefits of litigation could exceed the private benefits in some instances. An illustration would be where the action generates some beneficial deterrent effects that cause others to desist from a course of conduct that would impose externalities

whose name the action is brought do not exceed the company's direct and indirect litigation costs, its shareholders still may benefit.[77] In addition, arguably, a credible threat of an action, particularly one that can get beyond a motion to dismiss, has an important consequence. The desire to avoid actions, and certainly the desire to be able to construct very good defences, provides a lever for influencing the conduct of senior management and the board.[78] Likewise, when the deterrence question is focused upon a threatened harm to shareholders themselves, there is a basis to permit some recovery out of prophylactic considerations to remind the directors that their ultimate responsibilities are to the shareholders.[79]

As can be seen, deterrence operates on two levels—first, the company which is subject to litigation, and secondly the 'family of companies' as a whole. With respect to the latter, because shareholders generally do not own shares in a single company but hold diversified portfolios, they benefit if a derivative action deters potential defendants who are situated similarly at other companies, even if it involves a net loss to the company in whose name the action is brought.[80] It is important to understand this, because in some circumstances the benefit of a

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on society. S Shavell 'The Social versus the Private Incentive to Bring Suit in a Costly Legal System' (1982) JLS 333.

77 For example, a recent study in the US has shown that the impact of recent decisions in derivative cases (such as Caremark, Disney and Oracle) goes well beyond the outcome of the cases themselves – these decisions changed the rules for future legal practice by forcing companies to accept better conduct and procedures. See further R Thompson R Blakey and R Thomas 'The Public and Private Faces of Derivative Lawsuits' Vanderbilt Law and Economics Research Paper No 04-14, http://ssrn.com/abstract=555813 (14 August 2004).

78 In other words, education of the board and senior management may well be an ancillary benefit when assessing the impact of these actions. See also RH Mundheim 'Commentary: The Social Meaning of Shareholder Suits' (1999) 65 Brooklyn Law Review 55, 57.

79 Particularly when the shareholder-focused model of company law currently prevails in English law. See ch 4 under 4.4.1.2, and J Cox, above n 53, 764.

80 Cox ibid.

derivative action may accrue less to the shareholders of the subject company and more to shareholders generally in the form of increased deterrence of managerial abuse. As a result, shareholders as a class could benefit even though a particular company's share declined because the company was compelled to incur litigation expenses in excess of the specific benefits it received.[81]

Why would there be such a benefit? The logic is the same as in the case of criminal enforcement. Both the derivative action and criminal enforcement depend on an *external enforcer*—the public prosecution or the plaintiff shareholder (private enforcer).[82] The idea is that the conviction of a company's director presumably deters not only other officers of the same company but also other directors of other companies.[83] One obvious difference between these two enforcement mechanisms is that the criminal law can threaten imprisonment sanctions, while a derivative action can employ only *the threats of financial penalties, loss of reputational capital and social stigma.*[84] And although these intangible non-monetary sanctions, namely loss of reputation and social stigma, are even harder to estimate, only a fool ignores them.[85] Another major distinction is that public enforcers are not motivated by the pecuniary profits they may gain from litigation, but rather by policy goals and institutional incentives. Indeed, criminal law enforcement is based almost

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[81] J Coffee, above n 73, 673.

[82] J Coffee, above n 54, 1428–1429.

[83] Consider, for example, the US case in *Rosenfeld v Black* 445 F 2d 1337 (2d Cir 1971). The case held that an adviser to a mutual fund occupied a fiduciary relationship to it and could not sell that position for a profit. The profit in that situation amounted to pennies per share. But the point here is that the case set a standard of conduct which reverberated throughout the mutual fund industry. The same could be said of many other notable cases. See ch 4 (part II) n 85.

[84] J Coffee, above n 54, 1429.

[85] J Coffee, above n 54, 1436–1437.

exclusively on sanctions that do not directly benefit law enforcement authorities. At the same time, when enforcement is entrusted to individual plaintiffs, it is more difficult to combine lenient sanctions with frequent enforcement. Unlike paid prosecutors, private plaintiffs will bring an action only if they expect to collect damages high enough to recover their expenses. The central difficulty then lies in the fact that the amount of damages that optimally deters defendants' misconduct *will not necessarily* prompt the proper level of litigation by plaintiffs. A discussion on how to overcome this difficulty is deferred until Chapter 6, when we examine how to design adequate models of funding that would, in turn, induce shareholders to sue in appropriate circumstances.

2.3.3.2 *Limitations*

If the observations made so far suggest that deterrence should provide the primary rationale for the derivative action, it must be acknowledged, as the fourth row in **Table 2-2** indicates, that this rationale is subject to its own limitations. First, the derivative action cannot always impose an adequate sanction. Because wrongdoers usually will be asked to make restitution, merely compensatory damages may not invariably amount to an effective sanction.[86]

Secondly, deterrence may have a chilling effect on the willingness of company's directors to take risks, which is especially troublesome in the case of outside directors whose services may be discouraged. One criticism is that the net result of liability rules enforced by derivative actions may not be that directors are

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[86] Comment 'The Dilemma of the Double Derivative Suit' (1989) 83 Northwestern University Law Review 729, 755. On the deterrent effects of markets and the limitations of liability regimes in promoting managerial efficiency see JE Parkinson, above n 26, 132–135.

deterred from acting negligently, but only that they are deterred from acting without expensive paper trails and excessive expert advice.[87] While some costs are to be expected, they should be minimized. When the marginal cost of additional liability, including all the costs discussed above, is equal to the agency costs avoided, the system is efficient. Those who reject the deterrence rationale believe that this balance is not achieved. The argument runs along the lines that enforcement of liability rules through derivative litigation is inappropriate, as the costs of litigation may impose costs on the company well in excess of the original injury allegedly committed by the directors.[88]

In short, deterrence may have a high cost. This last problem with the deterrence rationale is mitigated to a considerable extent once shareholders are recognized as having a generic interest as a class in an effective system of corporate accountability.[89] As explained above, because over the long run the shareholder invests in a portfolio of companies rather than a single security, the shareholder may benefit from enforcement costs in a single case even though these costs may exceed the ultimate recovery to the individual company. In any case, these problems probably affect only a minority of cases and do not imply that the derivative action cannot generally produce the necessary measure of deterrence in other cases.[90]

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[87] P Banta, above n 8, 237.

[88] P Banta, above n 8, 236–237. It should be noted that proof of this is as elusive as proving the contrary. D Fischel and M Bradley 'The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis' (1986) 71 Cornell Law Review 261, 292.

[89] American Law Institute *Principles of Corporate Governance and Structure: Analysis and Recommendations* (Tentative Draft No 1 1982) pt I, 235.

[90] ibid 235–236.

Crucial to the foregoing discussion is one further difficulty. A shareholder's interest in bringing the action may diverge from the company's interest in either direction.[91] On the one hand, a shareholder may rationally decide not to sue when willingness to do so would raise corporate value. This can occur because, even though action is discouraged by an expected recovery that is small relative to litigation costs, the prospect of action would have served to deter misconduct. On the other hand, a shareholder may elect to bring a derivative action when this will be likely to lower corporate value. The reason, in essence, is that the expected recovery from managers that motivates actions may be only an apparent gain to the company: it will be offset, at least in part, by increases in liability insurance premiums, indemnification payments made by the company on the managers' behalf and managerial compensation.[92] For these reasons, under a broad class of regimes for allocating the costs and benefits of derivative actions (including the English rule which allocates costs to shareholders pro rata), shareholder incentives to sue may be either excessive or insufficient, relative to the criterion of maximizing corporate value.[93] Although in theory the shareholders' goal is assumed to be the maximization of corporate value, their incentives whether or not to bring a derivative action may not advance corporate value. As a logical matter, a variety of legal strategies might ameliorate the misalignment of the shareholder incentives to bring action that have been identified here. A discussion of such possible strategies is deferred to Chapter 6.

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[91] R Kraakman H Park and S Shavell, 'When Are Shareholders Suits in Shareholder Interests?' (1994) 82 Georgetown Law Journal 1733, 1736.

[92] ibid.

[93] ibid.

2.3.3.3 *How does deterrence operate?*

We have yet to deal with a basic and important question: how does deterrence operate? It is the purpose of this section to examine this briefly. By way of disclaimer, it should be clarified that the present inquiry concerns itself neither with the level of investment that will be necessary to obtain optimal deterrence, nor with the magnitude of expected liability given any level of investment in a derivative action.[94] Instead, the inquiry that follows is concerned with generating unambiguous statements about classic deterrence theory. These statements will then be analysed in our discussion in Chapter 4.

Classic deterrence theory treats the severity of sanctions and the frequency of enforcement as alternative policy tools for regulating behaviour.[95] Legal sanctions force individuals contemplating undesirable behaviour to weigh their potential liability against their private benefit from that behaviour. They will engage in the controlled activity only to the extent that their private benefit exceeds their expected liability.[96] In principle, numerous combinations of sanctions and enforcement levels can achieve the same deterrent effect. Monetary sanctions, for

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[94] It is also beyond the scope of this chapter to examine the theory of deterrence in relation to civil actions generally. See generally S Shavell 'A Note on Optimal Deterrence when Individuals Choose among Harmful Acts' (1989) NBET Working Paper Series http://www.nber.org/papers/W3061; M Smith 'Deterrence and Origin of Legal System: Evidence From 1950 – 2000' Dice Center Working Paper No 2003-9 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=414365 (12 September 2004).

[95] E Kamar, above n 31, 996; GS Becker 'Crime and Punishment: An Economic Approach' (1968) 76 Journal of Political Economy 169. See also JE Parkinson, above n 26, 355–356. On the economic theory of deterrence see previous edition of R Posner *Economic Analysis of Law* (3rd edn 1986) 205–212.

[96] A director, having to decide whether to enter a self-dealing transaction, will compare the expected benefits he receives from the transaction with the expected costs imposed on him by the legal system, in the case that judicial intervention is successfully triggered. See further RC Cooter and BJ Freedman 'The Fiduciary Relationship: Its Economics Character and Legal Consequences' (1991) 66 New York University Law Review 1045, 1052.

example, can be as low as a few pence or as high as the entire personal wealth of defendants. The rate of law enforcement can vary from bringing to court a few wrongdoers to bringing to court as many as can be detected.[97]

Deterrence of wrongdoing is ordinarily obtained by imposing on potential wrongdoers a threat of ex post liability for the full cost of harm caused to victims by their wrongdoing.[98] The argument is that the threat of liability for the full cost of harm caused by wrongdoing (ie compensatory damages) is the optimal measure of damages where the wrongdoer is found liable with certainty.[99] Imposing such a threat leads companies to internalize ex ante the social cost of their contemplated behaviour and make optimal investments as a precaution to reduce the risk of harm. Deterrence, it follows, implicates wrongdoers' ex ante expectations regarding the probability and the magnitude of the threat of ex post liability (ie expected liability), should they decide to engage in wrongdoing. The magnitude of ex ante expected liability from derivative actions is a function of several independent variables,[100] including (1) the probability of detecting the wrongdoer's behaviour so as to bring a action on behalf of the company; (2) the probability of holding the wrongdoer liable by obtaining a favourable judgment or a favourable settlement that is approved by the courts; and, finally (3) the magnitude of average damages

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[97] E Kamar, above n 31, 897.

[98] The themes in this section are drawn from G Halfteck 'The Effects of Incentives to Invest and the Level of Investment in Class Action Law Enforcement on the Magnitude of Liability for Harm', Discussion Paper No 452 (12/2003) http://www.law.harvard.edu/programs/olin_center/ (15 March 2004) (hereafter 'G Halfteck').

[99] See generally A Polinsky and S Shavell 'Punitive Damages: An Economic Analysis' (1998) 111 Harvard Law Review 869, 878–887. Where wrongdoers may escape liability for harm for which they are responsible, however, the optimal threat of liability should exceed the social cost of harm generated by their conduct (ie compensatory damages) by an award of punitive damages—such that, on average, they will pay for the harm caused. ibid 873–876, 887–900.

[100] G Halfteck, above n 98, 14.

awarded to the company (whether by means of judgment or a settlement). The exact properties are highly context-specific and are therefore not specifically discernable.[101]

Where liability is a viable possibility regardless of whether the alleged wrongdoer has acted wrongfully, the deterrent effects of such a threat of liability are said to be inefficient because such liability creates an ex ante inducement to invest in precautions even though such investment is not socially efficient.[102] Where the magnitude of expected liability is equal to (or even slightly less than)[103] the full social cost of harm caused by the wrongdoer's conduct, the wrongdoer is optimally deterred from engaging in a contemplated wrongdoing. Optimal deterrence is therefore obtained where wrongdoers face a threat of ex post liability for the total harm they cause, neither more nor less. In fact, where wrongdoers face a threat of liability that exceeds or falls short of the measure of compensatory damages, potential wrongdoers will be over-deterred and under-deterred, respectively.[104] Competing considerations need to be balanced. On the one hand, the availability of legal recourse is essential if management's obligations to its shareholders are to constitute more than a precatory body of law. Some judicial mechanism for the enforcement of fiduciary duties must therefore exist that is independent of management's control. On the other hand, few corporate transactions are not susceptible to differences of opinion. Nor are courts infallible.

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[101] G Halfteck, above n 98, 54–55.

[102] G Halfteck ibid 13.

[103] Attorney's fees that are incurred by the wrongdoer should also be counted in the cost that is internalized by the wrongdoer, so they can be added to obtain optimal deterrence.

[104] G Halfteck, above n 98, 13.

Thus corporate directors might have reason to view their position as exposed and vulnerable if every transaction or alleged omission subjected them to the prospect of significant liability at the behest of a single shareholder.[105]

What is clear, however, is that those who start from the a priori view that corporate wrongdoing is not sufficiently deterred at present may want to argue for increasing the focus on managerial liability.[106] There will be cases, as occur in the US, Canada and Australia, where derivative action proceedings prove justified as a mode of redressing serious corporate abuse.[107] Similarly, those that believe corporate behaviour is over-deterred should favour increasing corporate criminal liability to avoid more costly measures.[108] Obviously, those whose function is to represent the interests of large public companies, such as the CBI and leading firms of City solicitors, will resist any changes in the law that might encourage an 'active' market in civil litigation by minority shareholders.[109] It will be contended that the 'burden' of self-regulation, the investigatory powers of the DTI and the criminal law are all sufficient to cope with any fraud or mismanagement that may occur in public companies.[110] The counter-intuitive nature of many of these conclusions raises interesting questions about whether it makes sense to regulate the business arena, and at what cost, but these are questions beyond the scope of this work.

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[105] Above under 2.2.

[106] A Boyle *Minority Shareholders' Remedies* (Cambridge University Press 2002) 13.

[107] ibid.

[108] On the limitations of corporate criminal liability see JE Parkinson, above n 27, 354-361.

[109] A Boyle, above n 106, 13.

[110] ibid.

2.4 UNDERSTANDING THE SOCIAL MEANING OF DERIVATIVE ACTIONS

2.4.1 Introduction

Crucial to the foregoing discussion is one further issue. This section explicates the public image, or expressive value, of the derivative action. The purpose is to determine whether some of the features inherent in the derivative action procedure enhance or detract from derivative action being understood as a positive social force. The premise driving this inquiry is an understanding that the higher the public esteem of the derivative action, the greater will be its deterrent value.[111] To illustrate why this premise is correct, consider the following study by social psychologist Robert Cialdini.[112]

Cialdini placed flyers under the windshield wipers of cars and observed how their drivers disposed of the flyers upon returning to their cars. In the case of one group of drivers, an associate of Cialdini would pass by the driver, pick up some litter, and discard the litter in a refuse container. Very few of the drivers in this group threw the flyer on the street. In contrast, over one-third of the drivers who did not witness the responsible behaviour of the passer-by discarded the flyer onto the street. The study reflects the well-documented tendency of individuals to make

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[111] The discussion draws on Cox 'The Social Meaning', above n 44.

[112] RB Cialdini et al (1991) 'Focus Theory of Normative Conduct' 24 Advances in Experimental Social Psychology 201, 221–23; CR Sunstein 'Social Norms and Social Roles' (1996) 96 Columbia Law Review 903, 905.

social choices by reference to the conduct of others.[113] The relevance of the littering study to the derivative action turns on whether the initiation, maintainance and dismissal of a derivative action are like the conduct of Cialdini's responsible associate. Can the action cause corporate managers (Cialdini's drivers) not involved in the action to conform their future behaviour to the normative standards invoked by the action's plaintiff (Cialdini's associates), so that managers will place the shareholders' and investors' interests where they should be rather than irresponsibly discarding them?[114]

In this section, the question asked is whether the derivative action itself can be viewed as a responsible actor so that, much as in the case of the passer-by, the action's existence deters misconduct by others. The continued existence of the derivative action is easier to justify if it has such an effect. Simply stated, so far we considered the deterrent value of private litigation in terms of the sanctions it provides. Here a new consideration is added, namely, the social opprobrium that attaches to the action's defendants as a consequence of being pursued in a derivative action. In this respect, it is vital to consider to what extent certain procedural and substantive features of derivative action contribute positively or negatively to their social meaning.

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[113] For articles discussing the extensive literature on this point, see DM Kahan 'Social Influence, Social Meaning, and Deterrence' (1997) 83 Vanderbilt Law Review 349, 352–361; J Scholtz 'Enforcement Policy and Corporate Misconduct: The Changing Perspective of Deterrence Theory' (1997) 60 Law & Contemporary Problems 253.

[114] Cox 'The Social Meaning', above n 44, 5.

2.4.2 Construction and Deconstruction

Whether and to what extent a derivative action has a reputational impact upon its defendants is proportional to the expressive value enjoyed by *all* derivative actions. That is, the message of the individual derivative action is affected by the company it keeps with other derivative actions.[115] To be sure, the substance of the claim against a manager has much to do with the sting he will feel from the action's charges. A charge that directors were grossly negligent in approving compensation and perquisites for the company's senior managers takes on a very different cast when coupled with charges of cronyism or even self-dealing. Even a complaint that a manager failed to disclose adverse confidential information regarding the company takes on quite a different meaning when it is also alleged that he gained privately through insider trading.[116] Although an action's substantive charges have a reputational impact that depends on the nature of the complaint, the charges are weakened if the medium through which they are asserted lacks a credible reputation. Charges of usurping corporate opportunities, for example, will fail to convey the social condemnation for such misconduct if the charges are not seen as credible. The derivative action, if commonly understood to be frivolous, will not affirm the social norms the action's defendants allegedly violated. The defendants will instead be seen as the objects of bad luck, not derision. Thus the procedural

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[115] Cox 'The Social Meaning', above n 44, 5–6.

[116] ibid 6.

context in which corporate norms are developed and affirmed are of the utmost significance if those norms are to discipline managers.[117]

The following discussion examines to what extent features of derivative action are consistent with the process of establishing and affirming norms for business organizations. As discussed below, some features of derivative actions are destructive to their role in managing norms for corporate law, whereas other features contribute positively toward that role and in turn enhance the action's social meaning.[118]

2.4.2.1 Ambiguity of the action's objective

We should recall that compensation of the injured and deterrence of misconduct are the joint purposes of derivative actions. However, in the corporate setting, derivative actions are usually perceived as addressing purely private injuries, even though the goal of deterrence might be advanced by the successful prosecution of the action. Simply stated, the resolution of a private dispute is the prevailing objective of a derivative action and deterrence its valuable by-product. Thus the public role of the derivative action is muted and indeed obfuscated by the characterization of its objective as simply doing justice to those harmed by the

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[117] ibid. Arguably, in the same fashion, in an environment where the derivative action is seen as an instrument that affirms desirable norms in the corporate setting, one derivative action litigant may persuade other litigants in other companies to litigate.

[118] Cox explains (above n 44, 8) that the inspiration for organizing the following analysis is Professor Lessig's insights on techniques for constructing social meaning. Lessig isolated the ways the expressive value of an event, such as the imposition of a sanction, can be influenced. The four ways he poses, and around which the following discussion is organized, are ambiguity, tying, inhibition and ritual. L Lessig 'The Regulation of Social Meaning' 62 (1995) University of Chicago Law Review 943, 1009–1034.

defendant's misconduct.[119] In the end, derivative actions have only a private existence so that in the public's eye they are just another commercial dispute.

We arrive now at the thrust of the argument. Arguably, the courts' preoccupation with the private nature rather than the deterrent aspects of derivative actions leads to *ambiguity* in the action's expression of social values. Few shareholder actions entail breaches of a private contract between the plaintiffs and the action's defendants. Instead, most actions are based on breaches of fiduciary obligations or, more specifically, fraud embodied in the common law.[120] In other words, at common law a shareholder can only enforce the company's claim if the breach of duty was a 'fraud' and the wrongdoers were 'in control'.[121] Fraud in this context means 'fraud in the wider equitable sense of that term'.[122] Essentially, the term encompasses situations such as '... where the majority are endeavouring directly or indirectly to appropriate to themselves money, property or advantages which belong to the company or in which other shareholders are entitled to participate ...'.[123] Therefore attempts by the majority to sell worthless assets to the

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[119] The latter objective is well illustrated in the reasoning of *Nurcombe v Nurcombe* [1985] 1 WLR 370, 378 *per* Browne-Wilkinson LJ.

[120] Take, for example, *Atwool v Merryweather* (1867) LR 5 Eq 464n. The plaintiff claimed rescission of a contract entered into by directors and the return of money and shares paid to them in consideration for the sale, claiming that they had made a concealed profit. The court held that the directors had acted fraudulently and upheld the plaintiff's claim. Seemingly, the nature of the dispute here is solely private. The nature of offence committed, however, is anything but—finding that directors acted fraudulently may well have public effects such as disqualification in accordance with s 4 of the Company Directors Disqualification Act 1986. This process involves the public imposition of very high level of disapproval by the judicial system. See also B Pettet *Company Law* (Longman Harlow 2001) 452.

[121] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 211.

[122] *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2, 12 *per* Sir Robert Megarry V-C, discussing the judgment of Templeman J in *Daniels v Daniels* [1978] Ch 406.

[123] *Burland v Earle* [1902] AC 83 (PC) 93, *per* Lord Davey.

company,[124] to divert business from the company to themselves in breach of fiduciary duty[125] or to compromise litigation against bodies in which the majority are interested on terms prejudicial to the company[126] have all been held to amount to 'fraud' in this context, entitling minority shareholders to bring a derivative actions.[127] The term has also been applied to the negligent decision of directors, who were also the majority shareholders, to sell company assets to one of their number at an undervalue,[128] and to acts of a controlling shareholder which had the effect of stultifying the purpose for which the company was formed.[129]

It is clear then that in most derivative actions the norm invoked has a *substantial*, if not *exclusive*, *public source and importance*. Indeed, as will be seen in Chapter 4,[130] the corporate group, rather than what Wigram V-C described in *Foss* as the 'private partnership', has become 'the quintessential model of corporate business activity in the late twentieth century'.[131] In this context, corporate activity (and in particular the exercising of directors' discretion in business decision-

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[124] *Atwool v Merryweather* (1867) LR 5 Eq 464n.

[125] See eg *Cook v Deeks* [1916] 1 AC 554 (PC).

[126] *Menier v Hooper's Telegraph Works* (1874) 9 Ch App 350; *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2.

[127] A purported ratification of wrongful acts might itself, in some circumstances, constitute a fraud on the minority.

[128] *Daniels v Daniels* [1978] Ch 406; cf *Pavlides v Jensen* [1956] Ch 565.

[129] *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2.

[130] Under 4.2.2.

[131] S Bottomley 'Shareholders' Derivative Actions and Public Interest Suits: Two Versions of the Same Story?' (1992) 15 University of New South Wales Law Journal 127, 141–142.

making) has become more of a 'public' concern, which should therefore be subject to greater judicial scrutiny in order to protect individual members' rights.[132]

In theory, therefore, derivative actions provide a *public link* to the norm by requiring resolution in court, where potentially a public voice, the court, addresses the facts of each case through the lens of the applicable norm. Because 'fraud' and 'control' are both private matters[133] whereas deterrence is of public concern, the more squarely the courts place the objectives of derivative actions in the private sphere, the weaker the public perception will be that such actions are reflections of society's condemnation of the misconduct underlying the charges of the action. To the extent that actions are perceived as addressing purely private injuries, instead of being understood to address violations of the public interest in ways that cause private harms, the public perception will be that derivative actions are but a subset of the standard commercial dispute between two warring financial interests.[134] Moreover, attracting judicial attention to the public potential of the derivative action is strongly supported by the traditional raison d'être of the derivative action.[135] Standing to bring a derivative action is conferred when it is necessary to avoid the injustice of a serious wrong to the company going unredressed.[136] Such an approach invites early consideration of the public character of derivative

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[132] ibid. For judicial recognition (in Canada) of the public role of management, and the corresponding need for strict standards of conduct see *Canadian Aero Service Ltd v O'Malley* [1973] 40 DLR 3d 371, 374 *per* Laskin J.

[133] In the sense that their existence can only be construed on the facts of each case.

[134] Cox 'The Social Meaning', above n 44, 12–13.

[135] For example, the fact that a member may bring a derivative action in relation to wrongs which were done to the company before he became a member (*Seaton v Grant* (1867) LR 2 Ch App 459), illustrates that compensation cannot be the sole rationale ('true injury' is not required).

[136] *Smith v Croft (No 2)* [1988] Ch 114, 185.

actions.[137] Moreover, once private disputes are brought into a public courtroom, a limited public interest must be recognized as attaching to the process by which they are resolved. This public interest does not require that every cause of action be litigated to the hilt at whatever cost to the company and its shareholders, but it does necessitate that courts conduct their business in a seemly fashion. If a court is told that bribery is a profitable (albeit illegal) means of doing business and that the company has no plans to discontinue these practices, that court is morally compromised if it thereupon dismisses the action.[138]

2.4.2.2 Tying derivative actions to a failed objective

Social scientists have long stressed the importance of 'framing' in evaluative decisions. The anchor point that is set forth has a significant impact on the judgment made about a proposition. The anchor not only fixes the point at which inquiry begins, but it is also frequently the standard for judging the merits of an idea, argument or social institution.[139] In this respect, the public perception of the derivative action and its social meaning has been affected by such framing. Complementing the courts' cynical view of derivative actions[140] chiefly as private matters, the debate surrounding derivative actions in the UK continues to judge

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[137] See also Lord Wedderburn 'The Social Responsibility of Companies' (1985) 15 Melbourne University Law Review 4, 24: '[fiduciary duty] is imposed in private law, but with a *public* function. It is a vehicle of a social purpose' (emphasis in original). See generally JE Parkinson, above n 27, ch 7.

[138] J Coffee 'Litigation and Corporate Governance: An Essay on Steering between Scylla and Charybdis' (1983) 52 George Washington Law Review 789.

[139] Cox 'The Social Meaning', above n 44, 13.

[140] Perhaps best illustrated by Templeman LJ in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* where the derivative action procedure was referred to as 'lamentable litigation' with its 'horrendous costs' and that the company in that case might have felt that 'it might be killed by kindness' [1982] 1 Ch 204, 220–222.

their social value in terms of how often they are pursued[141] and how they compare to the alternatives.[142] By finding (unsurprisingly), as they do, that derivative actions fail in their mission, the studies support a negative view of their social value.

Against this benchmark, the derivative action has fared badly in terms of the public perception of its theoretical value. Tying the measure of the derivative action's social value to this benchmark will most certainly condemn it to failure. Certainly this is the case with derivative actions in English law. The prevailing view is one that lends itself to measures of success and failure and frequency of proceeding as opposed to a theoretical or an abstract benefit (ie deterrence). The preoccupation with success or failure is understandable since this is measurable but, as we saw above, deterrence is not. Derivative actions are thus tied to a measurement, ie the number of actions brought per year, that most surely is an indication of their failure, not their success. However, as will be seen, the success of any replacement for the current obsolete procedure would best be judged not by the quantity of the case law generated under the new procedure, but by whether the rules governing the circumstances in which such an action may be brought are made more comprehensible and accessible so that, in exceptional circumstances, the commencement of a derivative action is regarded as a remedy worth pursuing instead of being ruled out at an early stage of a dispute as being far too difficult even to contemplate.[143]

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[141] In which case, they fare rather badly as these actions are rarity. See eg E Ferran 'Company Law Reform in the UK' (2001) 5 Singapore Journal of International and Comparative Law 516.

[142] A recurring theme in the literature is that s 459 petition ('unfair prejudice') is, and is likely to remain, a far more attractive and convenient remedy for shareholders. Examples abound. For a recent explication of this view see eg J Payne 'Shareholders' Remedies Reassessed' (2004) 67 MLR 500, 501–502; J Payne and DD Prentice 'The Corporate Opportunity Doctrine' [2004] 120 LQR 198, 202.

[143] S Deakin E Ferran and R Nolan 'Shareholders' Rights and Remedies: An Overview' [1997] 2 CFILR 162, 165. See ch 4 under 4.4.2.4.

2.4.3 Applying the right inhibitions

The social meaning of an act can be shaped by the inhibitions imposed around it. By inhibiting certain behaviour, the occurrence of which would otherwise create or reinforce a disfavoured social meaning, we shape our perception of the act itself.[144] Similarly, some procedural requirements provide important inhibitions that should contribute positively to the view of derivative actions being seen as important social mechanisms.

The most important inhibition that can be used to nurture positive deterrent effects flowing from derivative actions are pre-trial procedures that lead to the dismissal of baseless suits.[145] CPR Rule 19.9 (3) expressly requires the court's approval for the continuance of a derivative action.[146] The court's early involvement in the facts supporting the derivative action complaint provides an important pre-trial screening mechanism by which the action's merits may be assessed.[147] Screening the merits of the action provides an important bulwark against the continuation of strike suits past the leave to proceed. The pleading requirement has a positive winnowing effect so that derivative actions that meet

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[144] Cox 'The Social Meaning', above n 44, 20; L Lessig 'The Regulation of Social Meaning' 62 (1995) University of Chicago Law Review 943, 1013 and 1032. Professor Lessig illustrates this point by stating that segregated neighbourhoods would be reinforced if real estate brokers were permitted to disclose the racial composition of a neighbourhood. In the US, the Fair Housing Act bars such disclosure and thus reduces the likelihood that the selection of a new home will be made on the basis of racial considerations.

[145] Cox 'The Social Meaning', above n 44, 20.

[146] It has been held that the mandatory requirement for permission under CPR r 19.9 cannot be dismissed as a mere technicality and reflects the real and important principles that the Court of Appeal re-affirmed in *Barrett v Duckett* and underlines the need for the court to retain control over all the stages of a derivative action. See *Portfolios of Distinction Ltd v Laird* [2004] EWHC 2071.

[147] In its contemporary formulation, however, the courts' discretion fails as an efficient screening mechanism, as is illustrated in ch 3 under 3.4.2.2 and 3.4.2.3.

these pre-trial demands enjoy greater merit than if these requirements did not exist.[148] The approval of the court acknowledges that the company was right to have initiated the action in the first place. Secondly, and equally importantly, upon satisfying the court's requirement, the derivative action can more easily be understood to reflect a public condemnation of the conduct that is the subject of the action. It is only through satisfying the court's requirements that the plaintiff *earns the right* to bring the action (a procedure which otherwise does not exist in ordinary civil cases). To the extent that, following the pre-trial procedures, meritorious cases tend to survive, the continued prosecution of a suit can be expected to have a greater public value than if there were no pre-trial procedures. This is because on average there would be a higher likelihood that a derivative action complaint addressed actual misconduct. It thus appears that socially desirable inhibitions may exist that contribute to derivative actions serving as a valuable deterrent to misbehaviour by corporate managers.[149]

2.4.4 Procedural requirements and settlements

The fourth technique for shaping social meaning is through rituals that induce actions that are likely either to support or to weaken a particular social meaning.[150] The most visible and important rituals for the derivative action are the procedural requirements that accompany the initiation and settlement of the action.

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[148] Cox 'The Social Meaning', above n 44, 24.

[149] See further A Reisberg 'Judicial Control of Derivative Actions' (2005) 8 ICCLR 335.

[150] One example is singing the national anthem at sporting events. Cox 'The Social Meaning', above n 45, 28; L Lessig 'The Regulation of Social Meaning' 62 (1995) University of Chicago Law Review 943, 1013–1014, 1032–1034.

In addition to the court's approval, which confers some sort of a public status on the action's plaintiff, strength in the settlement process enables the derivative action to secure its position as a mechanism for vindicating public norms. As seen earlier, because of his small stake in the company, the complaining shareholder has very little incentive to consider the effect of the action on the company.[151] Thus derivative actions create a risk of strategic behaviour by minorities. They open the possibility for 'gold-digging' claims against the company which are settled on terms advantageous to the plaintiff shareholder and the defendants but which do not reflect the value of the company's rights or are not in the interests of the company. This is the reason, for example, why an order for an indemnity in respect to costs that may be awarded to a shareholder to help him maintain a derivative action also requires the plaintiff to refer back to the court for approval of any offer of settlement of the action.[152] This, in turn, may reduce the possibilities for 'gold-digging' claims against the company which are settled on terms advantageous to the plaintiff shareholder and the defendants but which do not reflect the value of the company's right or are not in the interests of the company. This procedure is analogous to that in the US system for class and derivative actions, which does not otherwise exist in the procedure under English law.[153] Settlement is thus an important ritual in the life and image of the derivative action. If properly understood, it is a ritual that should raise the public image of the action.[154]

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[151] JD Wilson 'Attorney Fees and the Decision to Commence Litigation: Analysis, Comparison and an Application to the Shareholder's Derivative Action' (1985) Windsor Yearbook of Access to Justice 142, 179–180.

[152] CPR r 19.9 (3).

[153] A Marks and W Rees 'Shareholders' Actions' (1991) 2 ICCLR 39, 41.

[154] See A Reisberg, above n 149.

2.5 CONCLUSION

The foregoing discussion suggests that there is a role for derivative actions in reducing agency costs. Generally speaking, the derivative action balances two competing sets of agency costs: litigation costs and management costs. It generates litigation costs, for example, when it consumes an undue amount of management time, a time that might be more profitably be used seeking appropriate opportunities for investments. At the same time, it can minimize management costs when it (1) enforces directors' duties (the traditional view); (2) deters management wrongdoing by aligning the interests of managers through liability rules (arguably the primary benefit); (3) compensates for damages suffered by the company in money's worth (a controversial point); and (4) clarifies the scope of permissible conduct through judicial decisions (a somewhat limited role in the UK).

Crucial to the deterrence rationale is the fact that the deterrent value of derivative action is tied to the public's perception of the value of such litigation. The higher the public esteem of the derivative action, the greater will be its deterrent value. As it currently stands, the ambiguity of the purpose of the action and tying derivative actions to a failed objective weaken the social influence of the derivative action in English law. On the other hand, the above review found that the procedural requirements that fostered court screening of the action's merits as well as the control of settlements are two important features of the derivative action which enhance its social meaning. In Chapters 4 and 5, we shall consider strategies that can be pursued to reverse the negative effects of those forces that weaken the

social meaning of derivative actions so that the action is more likely to be viewed as an instrument that affirms desirable norms in the corporate setting.

Ultimately, the question that this chapter raises is whether the possible benefits of the derivative action are outweighed by its costs. Before it is possible to answer this, an additional dimension must be explored first. Policy considerations are of prime importance in this respect. If it were true, for example, that a shareholder is rarely allowed to sue on behalf the company, as seems to be the underlying policy of English courts, the conclusion might follow that the action had little deterrent effect and could rarely achieve compensatory or other purposes. In such an event, regardless of its costs, the benefits of litigation would seem too minimal to justify substantial reliance on it. Before the theoretical objectives identified here may play any role in the UK, it needs to be examined whether these issues can, under the current law, be dealt with adequately. The next chapter begins such an inquiry.

Policy Premises: Old Myths and New Realities

3.1 INTRODUCTION

Minority shareholders face particular difficulties where they seek redress against wrongdoing directors. Both the defective state of the existing common law and the detailed design of the new proposed statutory derivative action cause problems. This state of affairs seems to reflect an implicit acceptance both by the judiciary and the Law Commission that is somehow undesirable that companies should be exposed to civil litigation by minority shareholders.[1]

This type of thinking is rarely (if ever) made explicit; nonetheless, it is likely to continue being the primary *policy impediment* to enhancing the potential utility of derivative actions.[2] No assessment of the derivative action can thus proceed very far without having to face the current policy assumptions which underline the restrictive standing rules for individual shareholders.

The chapter proceeds as follows. Section 3.2 discusses the problems with conferring rights on minority shareholders to litigate in respect of wrongs to the company. Subsequently, two policy responses are analysed. First, Section 3.3

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[1] For explication of these views see AJ Boyle, *Minority Shareholders' Remedies* (Cambridge University Press 2002) 12–13. For an earlier draft of this chapter entitled 'Theoretical Reflections on Derivative Actions: The Representative Problem' see (2006) European Company and Financial Law Review (forthcoming).

[2] PL Davies *Introduction to Company Law* (OUP 2002) 250.

examines and assesses the competence of three bodies which may assess the merits of a derivative action: a committee of independent directors; an 'independent organ' of the company; and the courts. It concludes that courts should discharge the task of deciding this critical question. Section 3.4 explains that once a gate-keeper is put in place, the focus should be on establishing an expeditious means for screening and dismissing non-meritorious cases. It evaluates how well (or rather, badly) current legal screens work. Section 3.5 draws some conclusions.

3.2 THE NATURE OF THE PROBLEM WITH CONFERRING RIGHTS ON SHAREHOLDERS TO LITIGATE

3.2.1 Introduction

Conferring rights on minority shareholders to litigate in respect of wrongs to the company brings several issues to the fore. There are issues of standing, legal duties traditionally running in a straight line to the company;[3] of policing the action, since litigious shareholders may not have the purest of intentions; and of corporate governance, requiring a fine balancing of shareholder rights and expectations against the prerogative of management to manage.[4]

At common law, the shareholder's access to litigation to pursue actions rightly belonging to the company is very restricted. One of the cardinal principles of company law is embodied in the rule in *Foss v Harbottle*[5]—if a company suffers a wrong, then, because it is a separate legal entity from its incorporators, prima facie it is the company that should seek redress for that wrong. Also, if the alleged wrong is one that is capable of being approved or ratified by a majority of the shareholders, then no individual shareholder can maintain an action in respect of

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[3] *Percival v Wright* [1902] 2 Ch 241; in special circumstances, directors may owe duties to individual shareholders: *Peskin v Anderson* [2001] 1 BCLC 372.

[4] In most companies (both listed and unlisted) in the UK, powers of management and control are vested in the board of directors. See Art 70 of Table A CA 1985. This is by no means unique. See eg, s 198A(1) of the Australian Corporations Act 2001; s 128 of New Zealand Companies Act 1993.

[5] (1843) 2 Hare 461; 67 ER 189.

that wrong.[6] Additionally, if an independent organ of the company considers that it is not in the interests of the company to pursue a derivative action, the court may prevent the action from proceeding.[7]

The rule in itself is logical and can be said to achieve what is socially and economically desirable. For one, it reduces the scope for wasteful litigation.[8] The rule also obliterates the potential for duplicated litigation. A wrong that has an adverse impact on a company's financial position committed against the company could potentially also be detrimental for a number of stakeholder groups. In addition to the company's shareholders, who could suffer loss because the value of their equity may be decreased as a result of the wrongdoing, the company's creditors and employees may also have cause for complaint. In the case of the company's creditors, they may worry that there is a higher chance that the company would default on repayment. The employees, on the other hand, may find their jobs in jeopardy.[9] If all such persons are allowed to sue, the company could be 'killed by kindness' by litigation,[10] the court system will be overly burdened and the defendants will have to face a multiplicity of suits.

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[6] The majority rule principle is based on the doctrine of separate corporate personality and on the early partnership principle that courts would not interfere between partners except to dissolve the partnership. See *Carlen v Drury* (1812) 1 V & B 154, 158: 'This Court is not to be required on every occasion to take the management of every playhouse and brewhouse in the Kingdom' *per* Lord Eldon LC. See further KW Wedderburn 'Shareholders' Rights and the Rule in Foss v Harbottle' [1957] CLJ 194, 196.

[7] *Smith v Croft (No 2)* [1988] Ch 114.

[8] *MacDougall v Gardiner* (1875) 1 ChD 13, 25 *per* Mellish LJ.

[9] BR Cheffins 'Reforming the Derivative Action: The Canadian Experience and British Prospects' [1997] 2 CFILR 227, 229–231.

[10] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] 1 Ch 257, 263.

The other advantage of the rule lies in the fact that it allows management to decide whether to sue or not, without being second-guessed. As we saw in Chapter 2, litigation may not always be in a company's best interests and opinions will undoubtedly differ as to what is best for the company. Since deciding whether or not to sue is often a commercial decision, involving as it does a cost-benefit analysis with a necessary consideration of the potential damage to corporate reputation, it should therefore be a decision which management is qualified and competent to make.[11] The rule also restricts the scope for tactical or vexatious litigation, ie legal proceedings used as a strategic ploy to gain some personal advantage, such as a good price for the litigant shareholder's shares, or to pursue a personal vendetta against the directors.

Difficulties, however, arise when a majority of the directors are themselves engaged in conduct detrimental to the company. It is unlikely that the board will take steps to ensure that the company sues the wrongdoers. While it is possible for a majority of shareholders in general meeting to act, this will not be done if the directors themselves are also the controlling shareholders,[12] or it may be unlikely in widely dispersed companies. In such situations, the position for dissenting minority shareholders is particularly bleak, especially if there is no ready market for their

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[11] BR Cheffins 'Reforming the Derivative Action: The Canadian Experience and British Prospects' [1997] 2 CFILR 227, 230 and the references therein; PL Davies 'Director's Fiduciary Duties and Individual Shareholders' in McKendrick (ed) *Commercial Aspects of Trusts and Fiduciary Obligations* (Oxford 1992) 86–87 and 90–99; LS Sealy 'Power of the General Meeting to Intervene' [1989] CLJ 26, 27.

[12] It is also possible that some shareholders able to exercise decisive votes may have been offered an inducement (such as an indemnity) to vote in favour of the wrongdoers. See *Atwool v Merryweather* (1867) LR 5 Eq 464. Moreover, in a general meeting of a large public company directors alleged to be liable to the company might be able to determine the outcome of a resolution in their own favour by the use of proxy votes. See *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257; [1980] 2 All ER 841, 871 et seq and Ch 1 under 1.3.1.1.

shares or if they faced restrictions on the transfer of shares.[13] In companies with a dispersed shareholding, difficulties associated with collective decision-making will in most cases prevent an action from going to court. One could say that the minority shareholder has reached a legal cul-de-sac.[14] Therefore, if the rule is enforced in every situation, there will be manifest injustice as wrongdoers go unpunished and managerial wrongdoing is not redressed.[15] Investors will be at the mercy of the majority who are advancing their own interests at the expense of the company.[16]

The initial conclusion is that duty-based controls therefore depend very much on some other viable enforcer.[17] Essentially then, the scope of directors' duties and the ways in which those duties can be enforced are interrelated issues which must be considered together.[18] Reciprocity is a key here. The common law recognized these problems and allowed a shareholder to take action in the company's name if he could establish two elements: first, that the wrong was one that could not be validly ratified by the majority because it was a fraud on the minority,[19] and secondly that the perpetrators of the fraud were in control of the

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[13] PKM Choo 'The Statutory Derivative Action in Singapore – A Critical Examination' (2001) 13 Bond Law Review 64, 66.

[14] ibid.

[15] *Nurcombe v Nurcombe* [1985] 1 WLR 370, 378 *per* Browne-Wilkinson LJ.

[16] ibid 432.

[17] JE Parkinson *Corporate Power and Responsibility – Issues in the Theory of Company Law* (Oxford Clarendon Press 1993) 239.

[18] S Deakin E Ferran and R Nolan 'Shareholders' Rights and Remedies: An Overview' [1997] 2 CFILR 162, 165.

[19] Although it is common to refer to the circumstances which are most frequently found to justify the derivative action as being a 'fraud on the minority', any fraud has, in truth, been practised on the

company. This gave rise to the common law derivative action. Unfortunately, the existing English authorities on the question of what exactly amounted to a fraud on the minority have been conflicting and difficult,[20] which, in turn, has limited the remedy's reach. Be that as it may, there is an underlying paradox here. As will be seen below, it is almost a maxim of English courts to treat those shareholders who are allowed to take an action in the company's name with suspicion and some uneasiness with respect to their *suitability* and indeed their *appropriateness* to assume the role of instigator of proceedings.[21]

3.2.2 The Policy Problem: Can a Shareholder Adequately Represent the Company?

In relation to litigation decisions, the crucial question is: who has the power to take these decisions and what, if any, limitations should be placed on their power?[22] There seems no reason not to permit the board to decide in favour of litigation, if that would normally fall within its grant of management powers.[23] One might be skeptical about how often a board will decide to sue one of its members, but this in itself does not mean that the board cannot litigate if it chooses to do so.[24] In any case, the board which decides to sue may no longer contain the wrongdoing directors because there has been a change of management.[25] More likely perhaps,

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company and the award will be in the company's name. This distinction should be carefully observed. See eg C Hale 'What's Right with the Rule in Foss v Harbottle?' [1997] 2 CFILR 219, 221; LS Sealy *Cases and Materials in Company Law* (7th edn Butterworths London 2001) 498.

[20] See discussion in Consultation Paper para 4.9. See also K Wedderburn 'Derivative Actions and Foss v Harbottle' (1981) 44 MLR 202, 211–212, who finds the meaning of fraud in the context of derivative actions 'replete with uncertainty' in conception, requiring 'intellectual gymnastics of Olympic quality' in application and 'wrong in law and policy'.

[21] One only has to look to the Court of Appeal's decision in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 to discern the judiciary's attitude to minority shareholders.

the management of the company may have passed upon insolvency into the hands of a liquidator, who decides to sue the former directors.[26]

More problematic are decisions *not* to sue the wrongdoers. The presence of the wrongdoer on the board, even if he does not vote on the issue, casts a cloud over any such decision by the board.[27] Here, the common law rule that the company has the right to the unbiased advice of all its directors seems to express itself in the common law principle that, if that is not available because one or more of them has an interest in the transaction in question, then the decision reverts to the shareholders in general meeting,[28] even though there is a general and exclusive grant of management powers to the board in the articles.[29] But while the general meeting may have the residual power to litigate in such situations, reliance upon the collective body of shareholders is problematic for two major reasons, one theoretical, the other practical. First, recall that one of the two principles arising from the rule in *Foss v Harbottle* is that the court should not be intervening where

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[22] PL Davies, above n 2, 193.

[23] Above n. 11 and accompanying text.

[24] *John Shaw & So (Salford) Ltd v Shaw* [1935] 2 KB 113 CA; PL Davies, above n 2, 193.

[25] As was the case in *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378 HL.

[26] See IA 1986 s 212 which permits a liquidator to initiate a summary procedure by which the court inquires into the alleged breaches of duty by directors and orders them to restore property or make payment to the company.

[27] PL Davies, above n 2, 193.

[28] *Movitex v Bulfield* [1988] BCLC 104. But cf *Breckland Group v London and Suffolk* [1989] BCLC 100.

[29] As Davies notes (above n 2, 193) this point is not entirely clear, but unless the proposition is accepted, the rule in *Foss v Harbottle* does not make much sense, for that rule says that the individual should not normally be permitted to enforce the company's right but should ask the shareholders collectively whether they wish to do so.

the shareholders in general meeting can vote to ratify a breach of duty by a director. Where ratification is effective then, it will inevitably have an effect on a minority shareholder's action.[30] It is not always clear, however, when ratification will be effective. The law is in considerable disarray as to what breaches may be ratified by shareholders.[31] It is unclear what are the exact circumstances in which ratification may bar a derivative action, and it is impossible to reconcile all the decided cases with any simple set of propositions.[32] This has certainly produced a large amount of academic discussion.[33] Another problem with ratification by shareholders in general meeting is that those who are responsible for the alleged wrongdoing may control the voting power of the general meeting at which the ratification took place.[34] It is not surprising therefore that it has been suggested that this requirement reveals the same faith in the abilities of shareholders in a general meeting to be

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[30] This process, like many of those found in company law, seems to have originated in trust law. In simple terms, ratification has been explained as the process by which 'those to whom duties are owed may release those who owe the duties from their legal obligations ... prospectively or retrospectively'. See J Payne 'A Re-Examination of Ratification' (1999) 58 CLJ 604, 606; C Hirt 'Ratification of Breaches of Directors' Duties: The Implications of the Reform Proposal Regarding the Availability of Derivative Actions' (2004) 25 Company Lawyer 197.

[31] See eg *Rolled Steel Products (Holdings) Ltd v British Steel Corp* [1986] Ch 246, 296 *per* Slade LJ. English law, nonetheless, has recognized a category of non-ratifiable wrongs, either because the wrong is not done to the company but to the shareholders in their personal capacity or because the company itself is not 'legally competent' to deal with the question. J Payne, above n 30, 614.

[32] For example, commentators have not been able satisfactorily to distinguish between cases such as *Regal (Hastings) Ltd v Gulliver* [1942] 1 All ER 378 (where it was suggested that shareholders could ratify the breach of duty by directors) and *Cook v Deeks* [1916] AC 554 (the breach of duty by directors was held not to be ratifiable).

[33] On the limits of ratification see J Payne, above n 30, 614; B Hannigan 'Limitations on a Shareholder's Right to Vote – Effective Ratification Revisited' [2000] JBL 493.

[34] This is due to the well-established concept in English law that shareholders hold their vote as a piece of property. Based upon this principle it is clear that a shareholder may ratify a wrong which he committed in another capacity, such as a breach of duty as a director. *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589.

making proper decisions as did the judgment in *Foss v Harbottle*, as it reflects scepticism about the effectiveness of derivative litigation.[35]

Turning secondly to the practical problem, while the general meeting may have the residual power to litigate in such situations, this is unlikely because (1) in the case of closely held companies the majority shareholders are likely themselves to be the directors; and (2) in the case of public widely held companies, to garner the support required to launch such actions would be a Herculean task in itself. With respect to (1) the problem is obvious. Wrongdoing directors may simply do nothing. Who is to force them to take an action when they simply decide to take the matter no further? Even if we assume for a moment that shareholders are to consider whether to institute proceedings (while interested shareholders are not entitled to vote on resolutions to enforce the company's rights against the wrongdoers),[36] someone other than the wrongdoing directors needs to summon a meeting of the shareholders. Such provisions are contained in the Companies Act, but they require a relatively large proportion of the shareholders to trigger them.[37] Without some way around this, we seem to have reached an impasse. Turning to (2), we saw in Chapter 1 that shareholders suffer a collective action problem when voting which undermines their effectiveness as a decision-making body.[38] A

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[35] I Ramsay 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 University of New South Wales Law Journal 149, 169; D DeMott 'Demand in Derivative Actions: Problems of Interpretation and Function' (1986) 19 Davis Law Review 461, 475–476.

[36] As was proposed by the CLR *Completing the Structure,* paras 5.85–5.86. This would reverse the decision in *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589 and deal with one of the major weaknesses in the rules relating to the enforcement of directors' duties.

[37] PL Davies, above n 2, 136–137, 249.

[38] Under 1.3.1.1.

rational shareholder in a public company will not expand the time and effort to evaluate whether a derivative action is in the interests of the company because the shareholder's vote would have only a small effect on the outcome and the small shareholding means that any gains by reason of the derivative action being successful will only be small.[39] Even if a shareholder cannot assess the merits of a proposed derivative action, the shareholder may not abstain from voting but may vote in accordance with a recommendation from the directors that the action be discontinued,[40] even if the shareholder recognizes that some of these proposals may not be in his interests.[41]

Overall, then, it is easy to see why the collective body of shareholders may be an inappropriate decision-making body for assessing the merits of a derivative action. But this leaves a fundamental contradiction from which it appears impossible to escape: on the one hand, leaving the decision to sue with the shareholder as a whole, even if interested shareholders are excluded from voting, runs the risk that the shareholders' collective action problem will lead to less than the optimal amount of litigation. On the other hand, giving an unfettered right to bring a derivative action to any individual shareholder creates the risk that a shareholder who has only a small stake in the company will bring the action, not

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[39] KE Scott 'Corporation Law and the American Law Institute Corporate Governance Project' (1983) 35 Stanford Law Review 927, 945.

[40] I Ramsay, above n 35, 170.

[41] L Bebchuk 'Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments' (1989) 102 Harvard Law Review 1820, 1839 (observing that there is empirical evidence confirming this view).

because it is thought to be in the best interests of the company, but to promote some personal objective.[42] So, is there a way around this?

The way chosen to mediate between these two competing considerations in English law is to shift *decision-making* on suits against wrongdoing directors into the hands of *any individual shareholder*,[43] but in order to counteract the potential risk of abuse by the individual shareholder two qualifications have been introduced: (1) the action is allowed to proceed only in very restricted circumstances;[44] and (2) the court is brought in to adjudicate.[45] The action initiated by the individual may proceed only if the court permits it to do so and on the terms set by the courts.[46]

At least two points must be made now. First, although this seems trivial, it is important to bear in mind that if the action is to have any prospect of working as a remedy, the two interrelated issues, namely shareholder enforcement and the way in which courts discharge the discretion entrusted to them, must co-exist.[47] But as

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[42] Or as Davies puts it, this might be thought to be an example of minority oppression of the majority. PL Davies, above n 2, 249.

[43] An intermediate solution adopted in Part XA of the CA 1985 (introduced by the Political Parties, Elections and Referendums Act 2000) is to give the right of suit to any group of shareholders representing 5% or more of the company's issued capital, irrespective of the majority's views. This is an approach to allocation of litigation rights which is used in German law. However, as Davies and Hannigan note, it is unusual in British law and is unlikely to prove of any practical significance. PL Davies, above n 2, 250; B Hannigan *Company Law* (Butterworths London 2003) 458. cf art 16 of the EU Draft Fifth Directive (providing that members holding shares of a nominal value of 10% of issued share capital, or such lower percentage as national legislation may provide, may require proceedings to be brought on behalf of the company). See DTI Consultative Document *Amended Proposal for a Fifth Directive on the Harmonisation of Company Law in the EEC* (1990) art 16.

[44] Above, nn 5–7 and accompanying text.

[45] Davies uses the term 'trustee' to refer to the courts' role here, though the writer prefer not to use this well-established concept in the law of trusts here. PL Davies, above n 2, 250.

[46] CPR r 19.9.

[47] See also JE Parkinson, above n 17, 241.

will be seen below, because of various constraints, minority shareholder litigation is unlikely to lead to an adequate level of enforcement. Secondly, it is clear that shifting the decision to the court does not alter the basic problem. Doctrinally, the real bite is that the court is faced with an awkward dilemma: leaving a wrong without redress or running the risk that individuals will bring derivative actions without the purest intentions in mind. So how should the court go about this?

At a policy level, there is, of course, more than one way to respond to this.[48] In English law, the shareholder must run several miles and clear numerous hurdles just to obtain the court's permission to bring an action on behalf of the company in the first place.[49] In fact, it is now very difficult to get such an action beyond the threshold stage, and the odds are heavily stacked in favour of a successful application to strike out. The action has been formulated and applied in a more and more restrictive way, so that the chances of a corporate litigant to get even a hearing, still less a ruling, on the merits are so slim that he would probably not think it worthwhile to take the issue to court.[50] Paradoxically then, although a derivative action depends on shareholder enforcement, the shareholder's unique position in the company has led the court to see much merit in the arguments *against* enforcement by individual shareholders of the company's right on the grounds that the company needs to be protected against malicious or misguided

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[48] Contrast, for example, the different attitudes of judges in England and Australia. See LS Sealy 'Shareholders' Remedies in the Common Law World' [1997] 2 CFILR 172, 179–180.

[49] A Walters 'Division of Powers: Mitchell & Hobbs (UK) Ltd v Mill' (1996) 17 Company Lawyer 314.

[50] For example, in 1987, Sealy observed that eight out of ten cases reported in *Butterworths Company Law Cases,* involving a *Foss v Harbottle* type point, were decided unfavourably to the plaintiff. LS Sealy 'Problems of Standing, Pleading and Proof in Corporate Litigation' in BG Pettet (ed) *Company Law in Change* (London 1987) 1; LS Sealy, above n 48, 179.

minority shareholders. It is therefore worth looking a little more closely at the expressed (and sometimes unexpressed) rationales behind this approach. There are at least five major issues at play here.

3.2.2.1 Perverse incentives

As a matter of policy, questions may be raised in respect to the appropriateness of shareholders to represent the company. These questions relate to at least three core principles of company law: the separate legal personality, the concept of majority rule and the idea that a vote is a piece of property. The shareholders, while being asked to act on behalf of the company in this regard, are in a peculiar position in relation to the company which may make it impossible for them to remain wholly independent[51] when deciding whether or not to bring an action.[52]

As alluded to earlier, an individual shareholder who brings an action on behalf of the company may have poor incentives to maximize shareholders' wealth.[53] Because of his small stake in the venture, the complaining shareholder has very little incentive to consider the effect of the action on other shareholders, the supposed beneficiaries, who ultimately bear the costs.[54] It could be argued that shareholders have money invested in the company and so the decision whether or not to bring an action in relation to directors' wrongdoing will often have an

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[51] In fact, minorities could become the oppressors of the majority in so far as they could impede the carrying on of the proper business of the company, and English law as it stands provides no formal means of dealing with this. Other jurisdictions, such as France, even go so far as to allow a company to sue a minority shareholder in damages for being obstructive. LS Sealy, above n 48, 173.

[52] J Payne, above n 30, 607 and 609.

[53] D Fischel and M Bradley 'The Role of Liability Rules and The Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis' (1986) 71 Cornell Law Review 261, 271.

[54] ibid.

economic impact on them. This may often be supposed to sharpen their concern to protect the company since if the company prospers then, generally speaking, the shareholders will also prosper. However, there may well be circumstances in which their economic interests conflict with those of the company, where, for example, the directors have wrongfully paid a dividend to the shareholders out of the capital of the company.[55] Further, one should recall that the shareholders may also be the wrongdoing directors, and may use their shares to validate their own wrongdoing to the company.[56]

3.2.3.2 Access to information

Information is the lifeblood of litigation. Litigants battle to learn information, to conceal information and to spin information so that it might better persuade judges, and opponents, to accept their view of the facts and law. Indeed, it is probably no exaggeration to claim that litigation is all about the process of learning information, the cost of learning information, and the optimal response to information.[57] However, one of the most difficult things to achieve in any litigation is to gather the facts. In derivative action litigation there is an added concern. Information asymmetries accompany managerial misconduct: directors know the frequency and amount of harm caused by their misconduct, whereas shareholders do not.[58]

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[55] Or where the claimant was in an acute conflict of interest in pursuing the derivative action, having received money from one of the defendants. See *Portfolios of Distinction Ltd v Laird and others* [2004] EWHC 2071 discussed in A Reisberg 'Judicial Control of Derivative Actions' (2005) 8 ICCLR 335.

[56] *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589.

[57] See further JA Grundfest and PH Huang 'The Unexpected Value of Litigation' Minnesota Legal Studies Research Paper No 04-18. http://ssrn.com/abstract=585803 (12 July 2004).

[58] Information asymmetries may, in fact, prevent the company from successfully challenging the transaction before the court, by causing courts to judge erroneously in favour of the defendant. RC Cooter and BJ Freedman 'The Fiduciary Relationship: Its Economics Character and Legal

Assuming that the shareholders have become aware of possible irregularities or instances of incompetence—say, anecdotally, through press speculation or as a result of 'whistleblowing'—they will then face the task of obtaining more detailed information to enable them to evaluate the merits of litigation and to begin to put together adequate evidence to support the allegation of wrongdoing.[59] This can be critical in a derivative action as the majority of information is probably in the hands of the controllers of the company. Those are the persons who would normally be the focus of the litigation. Under English law, however, a shareholder has only very limited rights to inspect company documents.[60] These include the statutory registers, the minute books and directors' service agreements.[61] Disputes often arise when shareholders become concerned at what has been taking place within a company but are denied access to information.[62] If the shareholder is not a director or officer he has no right therefore to inspect the company's files, including its accounting records. Similarly, the case law confers on shareholders only scant corporate rights to 'internal' company documents.[63] In this respect, minority shareholders not only suffer from serious informational disadvantages compared to

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Consequences' (1991) 66 New York University Law Review 1045, 1070; KB Davis 'Judicial Review of Fiduciary Decision Making – Some Theoretical Perspectives' (1985) 80 NW University Law Review 1, 27–28.

[59] An illustration of this problem can be found in Lord Denning's graphic account of the difficulties encountered by Mr Moir in *Wallersteiner v Moir (No 2)* [1975] QB 372. See also JE Parkinson, above n 17, 244–245; GR Sullivan 'Restating the Scope of the Derivative Action' [1985] CLJ 236.

[60] See eg *Re DPR Futures Ltd* [1989] BCLC 634. But compare s 319 of the Australian Corporations Law discussed in D Faber 'Reform of Shareholders' Remedies' in *Developments in European Company Law* (Kluwer Law 1998) Vol 1 119, 127.

[61] See CA 1985 s 318 (service contracts), s 356 (register of members), s 383 (minute books), s 408 (register of charges).

[62] L Kosmin 'Minority Shareholders' Remedies: A Practitioner Perspective' [1997] 2 CFILR 201, 218.

[63] *Arrow Trading and Investments v Edwardian Group Ltd* [2004] EWHC 1319.

the board but this, in turn, may also not allow them to judge accurately whether or not an action should be instituted or to evaluate the strength of the potential claim.[64]

3.2.3.3 Expertise

A related problem is that the lack of expertise and access to relevant information will frequently make it difficult for shareholders to determine which management actions are inconsistent with maximizing the value of the company.[65] Further, managers, not small shareholders or plaintiffs' attorneys, direct the company's affairs.[66] What looks like a hasty decision by company managers may simply reflect their knowledge of the subject and their desire to avoid the expense of hiring outside experts.[67] For example, a seemingly self-interested decision to accelerate the exercise of share options may well be the most efficient method of awarding an increase in compensation.

3.2.3.4 Shareholders' long-term commitment to a policy of suit

There are other, equally serious, impediments here. Assume that shareholders could without cost commit themselves to sue derivatively on behalf of the company when an action would deter misconduct. Informed shareholders with only investments at stake would then willingly commit themselves in advance to sue when and only when an action would result in an increase in corporate value. It is doubtful, however, whether shareholders could make such a commitment without leadership

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[64] E Ferran *Company Law and Corporate Finance* (OUP 1999) 123.

[65] See discussion in ch 2 under 2.2.

[66] Art 70 of Table A CA 1985.

[67] D Fischel and M Bradley, above n 53, 273.

from the board of directors or a low-cost way to bind all shareholders to the new litigation policy. Likewise, as a legal matter, shareholders cannot commit their successors in an active trading market to a litigation policy.[68] Moreover, as a matter of policy, it is arguable whether we should encourage or, indeed, welcome as routine a policy of litigation that could have some negative effect on companies in the long run.[69] In any case, even in the absence of these legal and policy impediments, other obstacles, namely the costs of collective action, imperfect information and the natural inclination of most shareholders to focus on immediate monetary benefits (as opposed to long-term benefits), would likely preclude any binding agreements among shareholders.

3.2.3.5 Costs

There is a whole set of issues with respect to the funding of the derivative action. These issues relate to the question of how a shareholder is able to maintain a derivative action without some sort of financial aid. One may wonder what incentive a shareholder will have to sue on behalf of the company as, even if the litigation is successful, any damages recovered accrue to the company and the shareholder will therefore receive only a pro rata share of the gains of a successful action. As will be seen in Chapter 5, the company may be ordered to pay the costs of litigation, but that does not in itself produce a positive incentive to sue.[70]

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[68] R Kraakman H Park and S Shavell 'When Are Shareholders Suits in Shareholder Interests?' (1994) 82 Georgetown Law Journal 1733, 1749.

[69] As R Drury advocated some time ago in 'The Relative Nature of a Shareholders' Right to Enforce the Company Contract' [1986] CLJ 219. For a critic of Drury's approach see, AJ Boyle, above n 1, 20–22.

[70] Chs 5 and 6 respectively explore different aspects of this problematic issue.

3.3 POLICY RESPONSE NUMBER ONE: RE-ALLOCATING THE RESPONSIBILTY TO DETERMINE THE MERITS OF THE ACTION

The preceding discussion sets the stage for us now to examine ways to respond to the issues raised in Section 3.2. We have seen that the company lacks an authentic decision-making body. The individual shareholder may not be the most appropriate person to be determining whether a derivative action is in the best interests of the company; the company's board may be too tainted with self-interest to take the decision to litigate, and the company in general meeting is in the same position. The need then arises to cast around for an alternative voice. In this section, we evaluate the competence of three bodies that may, theoretically, be given such a role: a committee of independent directors, an 'independent organ' and the court.[71] As will be seen, there is no ready answer for the question which of these imperfect classes of decision-makers is more likely to make decisions that increase the value of the company.[72]

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[71] Theoretically, there may be other bodies such as creditors or employees who may fill this role, but the focus here is on those bodies which fit the shareholder-focused model of company law in English law. For other analyses of the alternatives available, see RC Clark *Corporate Law* (Little Brown and Co Boston 1986) 647–649; FA Gevurtz 'Who Represents the Corporation? In Search of a Better Method for Determining the Corporate Interest in Derivative Suits' (1985) 46 University of Pittsburgh Law Review 265. In favour of allowing creditors to obtain standing to carry out derivative action on the grounds that creditors have important interests to protect prior to a liquidator being appointed, see V Finch 'Creditor Interests and Directors' Obligation' in S Shiekh and W Rees (eds) *Corporate Governance and Corporate Control* (Cavendish London 1995) 111, 130–131; In Australian law see I Ramsay, above n 35, 165–166; In Canadian law see BR Cheffins, above n 11, 230 239–241; in Israeli law, see A Reisberg 'Promoting the Use of Derivative Actions' (2003) 24 Company Lawyer 250, 250–251.

[72] See also F Easterbrook and D Fischel *The Economic Structure of Corporate Law* (Harvard University Press Reprint edn 1996) 106.

3.3.1 Committee of Independent Directors

A possible decision-making body for determining whether a derivative action is in the interests of the company is a committee of independent directors.[73] The use of Special Litigation Committees ('SLCs') comprising independent directors is common in the US.[74] What is the rationale for the use of these committees? One reason is that directors possess more information about the company's affairs than a shareholder who does not have ready access to this information. In addition, as already noted, decisions to litigate are in a sense commercial decisions, involving not only cost-benefit analyses but also considerations of potential damage to the company's reputation.[75] Undue and unnecessary litigation will certainly do more harm than good for the company. As one commentator puts it, 'there will often be sound reasons for avoiding the washing of corporate linen in the courtroom'.[76] There is therefore merit in saying that these are decisions best made by a commercially minded board.

One important statistic, however, casts immediate doubt on the use of these committees. These committees in the US have rarely, if ever, recommended that a derivative action in its entirety be continued.[77] This record demonstrates what some

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[73] On the history and evolution of these committees in US law see D DeMott 'Shareholder Litigation in Australia and the United States: Common Problems, Uncommon Solutions' (1987) 11 Sydney Law Review 259, 275–279.

[74] It derives, in part, from r 23.1 of the Federal Civil Procedure which provides that the 'complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority'.

[75] See above n 11 and accompanying text.

[76] C Hale, above n 19, 225.

[77] See eg JC Coffee 'New Myths and Old Realities: The American Law Institute Faces the Derivative Action' (1993) 48 Business Lawyer 1407, 1422–1424; D DeMott, above n 73, 277; RC Clark *Corporate Law* (Little Boston 1986) 648–649.

commentators refer to as a structural bias on the part of independent directors.[78] The credibility of reliance upon independent directors is called into question by the uniformity with which committees determine derivative actions not to be in the corporation's best interests.[79] What, then, might explain this?

There are several reasons to believe that the SLCs' independence may be more apparent than real. Here it will suffice to repeat the thrust of the argument. Some would respond with lengthy organizational, psychological, or sociological critiques of the board's capability or objectivity.[80] The concern is founded on the observation that the defendants and the members of the SLC share a common cultural bond: directorship of a public company. The natural empathy and collegiality that this bond engenders makes an adverse judgment of a colleague's behaviour distasteful at best. Further, when the committee is formed after the instigation of the derivative action, the situation is rife with opportunities for the defendants to select for committee membership those directors most sympathetic to their position.[81] Likewise, SLCs operate under the constant threat of dissolution should they displease the board by pursuing the plaintiff's cause with excessive zeal.[82] Consequently, this structural bias, when applied to SLCs, equates to an inescapable and conclusive assumption against nearly any derivative action on the

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[78] I Ramsay, above n 35, 172.

[79] D DeMott, above n 73, 277.

[80] For an elaborate summary of these arguments, see J Cox and H Munsinger 'Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion' (1985) 48 Law & Contemporary Problems 83.

[81] J Coffee and D Schwartz 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform' (1981) 81 Colombia Law Review Rev 261, 283.

[82] JD Cox 'Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project' (1982) Duke Law Journal 959, 962–963.

part of members of the committee.[83] Overall then, there are sufficient reasons to believe that in deciding that an action should not be brought against one of their number, the independence and neutrality of the committee must always be suspect.[84]

The reliance upon independent directors is also called into question by the fact that it is still needs to be the subject of judicial review. This raises several questions. First, should the court accept the 'business judgment' of the committee or review the decision itself? Or should it only do so if its independence is suspect? To what extent, then, should a court defer to a recommendation of SLCs?[85] In practice, this fundamental question has been fiercely debated in US courts[86] and proposed Model Acts[87] with no clear resolution emerging. Secondly, if judicial review of the merits of a decision of a committee of independent directors is utilized, this may be seen as an undesirable duplication of tasks.[88] Still, a third and somewhat deeper reason also explains why this system is deeply flawed. Arguably, there is a case for the committees' views to be justified to the court, even when the

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[83] PN Edwards 'Compelled Termination and Corporate Governance: The Big Picture' (1985) Journal of Corporation Law 373, 398.

[84] See also DD Prentice 'Notes: Shareholder Actions: The Rule in Foss v Harbottle' (1988) 104 LQR 341, 346.

[85] LS Sealy, above n 48, 182–183; J Solovy B Levenstam and DS Goldman 'The Role of Special Litigation Committees in Shareholder Derivative Litigation' (1990) Tort and Insurance Journal 864.

[86] While some courts have shown considerable deference to recommendations of SLCs (*Auerbach v Benett* 47 NY 2d 619, 393 NE 2s 994 (1979)), others rejected any notion of wholesale deference to the recommendation of the SLC (the Delaware Supreme Court in *Zapata Corp v Maldonado* 430 A2d 779 (Del 1981).

[87] cf the Model Business Corporation Act (drafted by the American Bar Association's committee on Corporate Governance) with that of the American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* (Proposed Final Draft 1992) 725–766.

[88] I Ramsay, above n 35, 173.

board is clearly independent. Although the conventional wisdom seems to assume that the granting of any residual oversight to the court subtracts from the power in the board, this is an unconvincing premise. The existence of judicial oversight may, in fact, enhance the board's leverage. The knowledge that one is being watched and that one must justify one's actions improves the behaviour of most individuals. Above all, the need to explain one's justifications to the court gives disinterested directors a basis for refusing to accept reasons that merely are pretextual or cosmetic. Absent judicial oversight, passivity may sometimes be the path of least resistance. But once it is understood that the director's position must ultimately be defended in court, passive acquiescence becomes less attractive. Internally, disinterested directors can justify their resistance not in terms of their personal objections or misgivings, but in terms of the legal risks or public appearances. In short, the existence of judicial review is needed to strengthen the hands of outside directors and enhance internal systems of accountability.[89]

3.3.2 Independent Organ

A variation on the US style committee of independent directors was formulated under English law but, as will be seen, this is an even more debatable criterion.[90] In *Smith v Croft (No 2)* Knox J held that ultimately there is one question which has to be answered in order to determine the rule in *Foss v Harbottle*: 'is the plaintiff being improperly prevented from bringing these proceedings on behalf of the

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[89] JC Coffee, above n 77, 1425–1426.

[90] Although no explicit reference to those American developments is made in *Smith v Croft*, it is reasonable to believe that Knox J was influenced by these innovative features.

company?'[91] Knox J submitted that if an 'independent organ' of the company considered that such an action would not be in the interests of the company, the action was properly prevented.[92] Knox J suggested that term 'independent organ' describes a group of persons within the company whose views would be taken into account for these purposes. Essentially these are persons whose votes would not be disregarded on the grounds that they had been (or would be) 'cast with a view to supporting the defendants rather than securing benefit to the company, or that the situation of the person whose vote is considered is such that there is a substantial risk of that happening'.[93] As to the question of what constitutes an independent organ, Knox J held that '[t]he appropriate independent organ will vary according to the constitution of the company concerned and the identity of the defendants who will in most cases be disqualified from participating by voting in expressing the corporate will'.[94]

The judgment is superficially attractive in that it leaves the decision whether or not to bring an action with the independent majority.[95] However, there are a number of difficulties inherent in the decision, not least that it makes minority

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[91] [1988] Ch 114, 185.

[92] ibid (relying on the decision in *Taylor v National Union of Mineworkers (Derbyshire Area)* [1985] BCLC 237).

[93] ibid. This seems similar to the view expressed in some US cases, where it was proposed that the court might, in its discretion, appoint a special committee of independent and knowledgeable persons to determine whether the continuance of the action would be in the company's best interest. See eg *Miller v Register and Tribune Syndicate* 336 NW 2d 709 (Iowa 1983). The difference would be that the committee might be less likely to have a pro-defendant bias, as the case with the common litigation committees in the US. See further RC Clark *Corporate Law* (Little Boston 1986) 649.

[94] ibid.

[95] This is the first time that the concept of the 'independent' shareholder has been articulated by the courts as having a role to play in company law. Normally, the fact that a shareholder is interested in a transaction does not preclude him from exercising his rights. Above n 56.

claims even less likely to succeed. It has rightly been the subject of critical comment.[96] Let us focus now on several problems with the role that Knox J gave to the 'majority within the minority'. To simplify the discussion, these problems will be classified under two headings, namely conceptual problems and policy issues.

3.3.2.1 Conceptual problems

First, as a concept, 'independent organ' is not clearly defined in the Consultation Paper[97] or the Report[98] and was only vaguely delineated in *Smith v Croft*. The Report recommended that the court should take account of the views of an independent organ that for commercial reasons the action should or should not be pursued. It conceded, however, that since the law in this area is still 'in a state of development by the courts', the views of an independent organ should not be conclusive on the issue whether or not leave should be granted.[99]

It is difficult to agree with this. First, it has been suggested that in the 'wrong' judicial hands the ability to invoke majority shareholders' power (or other independent organ's power) may well enable the worst aspects of the Court of Appeal's decision in *Prudential* to be smuggled back in the exercise of the new statutory discretion to grant leave. In the case of listed companies it might kill off

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[96] See eg AJ Boyle 'Director's Fiduciary Duties: The Continuing Problem of Effective Enforcement' (1987) 10 Forum International 8; AJ Boyle 'The Judicial Review of the Special Litigation Committee: The Implications for the English Derivative Action after Smith v Croft' 11 (1990) Company Lawyer 3; M Stamp 'Minority Shareholders: Another Nail in the Coffin' 9 (1988) Company Lawyer 134.

[97] Consultation Paper paras 16.38–16.41.

[98] Report para 6.89, where it concedes that the meaning of 'independent organ' is far from being clear.

[99] Report para 6.90.

the use of this remedy at an early stage.[100] Secondly, if the views of the independent organ need only 'to be taken into account', the same concerns with respect to the US style litigation committees arise here: this may be seen simply as an undesirable duplication of tasks. Thirdly, there is a problem with the burden of proof on minority shareholders to establish a lack of independence on the part of any particular shareholder. This can be a real obstacle to a successful derivative action.[101] It will be necessary for the minority shareholder to adduce evidence to show that, on the balance of probabilities, there is a substantial risk that the votes were cast in order to support the majority rather than derive any advantage to the company. Knox J did not discuss whether this was a subjective or objective test; indeed, the test to be applied in relation to cases concerning alteration of articles is itself not free from doubt.[102] Finally, in many situations, it will be difficult to ascertain shareholders' independence adequately without a full hearing as this may be the only way. But such an inquiry would contravene the admonition in *Prudential* that the *Foss* point should be dealt with early in the proceedings, which should not be allowed to devolve into a full trial on the merits.[103] Moreover, in many cases, there may not, as a matter of fact, be such an organ capable of making this decision, especially in the case of listed companies.[104] It is also possible that if the independent organ is a group of shareholders, they are not required to hold any particular percentage of shares, and so the percentage may be a small one. In large

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[100] AJ Boyle, above n 1, 79–80.

[101] See also M Stamp, above n 96, 135–136.

[102] See eg *Greenhalgh v Ardene Cinemas Ltd* [1951] 1 Ch 286.

[103] [1982] Ch 204, 221.

[104] Take, for example, the first instance decision in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 and *Taylor v National Union of Mineworkers (Derbyshire Area)* [1985] BCLC 237.

companies the practicality of identifying the independent group among thousands of shareholders would probably prove insurmountable.[105] Where the shareholders are divided into, say, two 'camps', the 'independent organ' will not be discoverable.[106] Moreover, it appears that the appropriate independent organ need not be a group of shareholders and may even be the directors or a committee of the directors, in which case the observations made with respect to the US litigation committee will equally apply.[107] In fact, it would be an effective tactic for a board faced with what it saw as inappropriate derivative litigation to form a sub-committee to look into the matter (eg by commissioning a firm of accountants) which could, in turn, resolve to terminate the derivative action. It may well be that the subcommittee would then be held to be an appropriate independent organ within the *Smith* doctrine.[108]

3.3.2.2 Policy issues

From a policy viewpoint, it is highly questionable whether there is any serious need to model new devices to control English derivative actions on what are in fact specifically American developments. First, judicial review of the work of the special litigation committees in the US has a very different procedural context from the *Smith* litigation. The problems of abuse in the context of the American derivative action are on a wholly different scale from anything that is likely to

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[105] Only the costs associated with such a procedure would be horrendous. See also B Pettet *Company Law* (Longman Harlow 2001) 240.

[106] As well illustrated in *Barrett v Duckett* [1995] 1 BCLC 73. See also AJ Boyle, above n 1, 29.

[106] Consultation Paper para 16.44.

[107] Above, under 3.3.1.

[108] B Pettet, above n 105, 240.

occur in English courts.[109] Secondly, given all the difficulties and the credibility of reliance upon the SLC device in the US discussed above, it ought not to commend itself to other jurisdictions.[110]

3.3.3 Judicial Oversight

The foregoing analysis clearly indicates that a need persists for a measure of judicial oversight. If such a need exists, it is because the existence of the bodies discussed above as a complete and wholly pre-emptive substitute for judicial oversight is in doubt. There is no doubt that some may question whether courts are the best body to be determining the merits of the action.[111] The thrust of the argument is that judges have been habitually cautious when faced with litigation which invited them to intervene in corporate law issues.[112] It has been further suggested that courts are inappropriate for certain tasks such as reviewing managerial business incompetence, under-performance or inefficiency. Also, there are problems with an over-reliance on courts.[113] In short, the critical charge is that courts do not understand business decision-making and fail to recognize that

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[109] As will be seen in ch 5 (under 5.2 and, in particular, 5.2.3) the English system of costs works in a wholly different way from 'counsel fee awards' in derivative actions in the US.

[110] D DeMott, above n 73, 279; AJ Boyle, above n 97.

[111] D Fischel and M Bradley, above n 53, 273 ('judges lack business expertise and strong incentives to maximize the value of the firm'); FA Gevurtz, above n 71.

[112] As explicitly stated in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] 1 Ch 204, 224; See also K Uff 'Class, Representative and Shareholders' Derivative Actions in English Law' (1986) 5 Civil Justice Quarterly 50, 61. In the past, it was argued that judicial intervention under English law in the affairs of public companies remains firmly within the realm of private law, and is limited to affording a practical remedy to a wronged plaintiff. See further GR Sullivan, above n 59, 237.

[113] I Ramsay 'Courts and Corporate Law' Unpublished manuscript in I Ramsay, above n 35, 173.

legitimate reasons sometimes exist why even a meritorious litigation should not be pursued.

Such criticisms have an apparent 'obviousness' about them. And although there is an essential core of truth in these allegations, they simply miss the point. The question on which the suitability of the court should be assessed is rather simple: how well can courts perform the specific task of *evaluating* the potential success of litigation? Arguably the court is the most qualified body for such a task. First, courts do have expertise in evaluating the *potential success of litigation*. The talents that a court is generally thought to lack, namely business intuition, a feel for the marketplace and the ability to trade off risk for return, are *not* called for here in the same degree.[114] Indeed, to the extent that the determination hinges on an appraisal of the *merits* of the litigation, it has been suggested that the court's perspective and expertise are superior to the board's.[115] Further, there is no reason why an independent expert may not, in appropriate cases, be allowed to investigate and advise the court on the action, which, in turn, may provide the court with better and more neutral information than either a resolution in a shareholders' meeting or the views of an allegedly 'independent' organ.[116] Finally, courts have a lengthy history of determining cases involving breaches of duty and have developed considerable expertise and knowledge in this area.[117] It should come as no surprise

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[114] I Ramsay, above n 35, 173; T Frankel and WM Barsky 'The Power Struggle Between Shareholders and Directors: The Demand Requirement in Derivative Suit' (1983) 12 Hofstra Law Review 39, 52.

[115] J Coffee and D Schwartz, above n 81, 282–283. Recall that special litigation committees tend to recommend dismissal almost invariably.

[116] As the case in South African and Australian legislation. See ch 4 under 4.4.4.4 (G).

[117] See ch 2 under 2.4.2.1.

then that both the Law Commission and the CLR proposed that the court will be expected to discharge the task of determining whether a derivative action proposed by the individual shareholder is in fact in the best interests of the shareholders as a whole.[118] It is now, indeed, widely acknowledged in most jurisdictions in which the derivative action has been put on a statutory footing that the court should be entrusted with this task.[119]

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[118] Consultation Paper, paras 16.32–16.34; Report, paras 6.77–6.79.

[119] See ch 4 under 4.2.3.

3.4 POLICY REPONSE NUMBER TWO: FORMULATING A PROPER SCREENING MECHANISM

Thus far we have seen that because the company lacks an authentic decision-making body to determine whether or not a derivative action is in the best interests of the company as a whole, the court is expected to discharge the task of determining this question. In this section, we examine a second, and complementary, response to the problem that the litigating shareholders may not have the purest of intentions in mind. Most commonly, the solution is to set out various preconditions to the court granting leave that would constitute a screening mechanism to sift out cases that are without merit. If these are properly devised, then, theoretically, the derivative action should not be cast in an unfavourable light.

3.4.1 Current Screening Mechanisms

So, how should the criteria be structured? A fine balance is needed here. On the one hand, it is important to establish an expeditious means for screening and dismissing non-meritorious cases. On the other hand, it is critical that the sets of hurdles should not form a formidable barrier that will prove insuperable to minority shareholders. In many ways, the precise threshold requirement chosen reflects the attitudes towards the derivative action device in that particular jurisdiction.

In this respect, the present position in the UK reflects both the failure to produce an agreed answer to this issue and unfavourable views on the derivative

action.[120] But even if the criteria hold out the possibility of greater levels of enforcement of directors' duties, nonetheless whether this potential will be realized will depend largely on how the courts discharge the discretion entrusted to them. The danger must be that the judiciary will adopt an overly restrictive approach to the Law Commission's criteria in order to give effect to the perceived exceptional nature of shareholder derivative actions.[121] Therefore the true test of the effectiveness of the action will be whether the complexity surrounding the ability to pursue a derivative action will continue to act as a deterrent to potential actions when compared with viable alternatives.[122]

3.4.2 Issues Relevant to the Grant of Leave

The purpose of this section is to explore and contrast the general approaches of the English Law Commission Report, which well illustrates the current overriding views in English law, with Canadian statutes on a policy level.[123] This comparative perspective will illustrate the relative strengths and deficiencies of the present position.

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[120] See also DD Prentice, above n 85, 346.

[121] J Poole and P Roberts 'Shareholder Remedies – Corporate Wrongs and the Derivative Action' (1999) Journal of Business Law 99, 11.

[122] See ch 7 under 7.5.

[123] The Canadian statutes on derivative actions have been around since the 1970s and are found in ss 238–240 and s 242 of the Canada Business Corporations Act 1985 ('CBCA') and ss 244–246 of the Ontario Business Corporations Act 1982 ('OBCA'). A number of statutory derivative actions were modelled on them (eg the Australian statutory derivative action introduced into the Corporations Act on March 2000); further, the CBCA marked the first decisive break with the English model by a major Commonwealth jurisdiction and, in particular, it has been said that the aim was to depart from the common law restrictions contained in *Foss v Harbottle* and the related exceptions. See RW Dickerson et al *Proposals for a New Business Corporations Law in Canada* Vol 1 (Information Canada Ottawa 1971).

Under Canadian law, four statutory criteria *must* be satisfied before leave is granted by the court:[124] (1) that reasonable notice has been given to the directors of an intention to apply for leave to commence derivative action; (2) that the directors will not bring, diligently prosecute or defend, or discontinue the action; (3) that the complainant is acting in good faith: and (4) that it appears to be in the interests of the company that the actions be brought, prosecuted, defended or discontinued. As will be seen, Canadian courts have adopted a fairly flexible approach to each of the above criteria, although the steps taken by the shareholder to meet the s 239 criteria can also be extremely time-consuming and may not be cost-effective.[125]

Under the Law Commission Report, the principal screening devices are 'modern, flexible and accessible criteria for determining whether a shareholder can pursue the action'.[126] The Report opposed any definitive criteria for granting leave on the basis that there is a danger that they would be incomplete and would not fit the circumstances of each case.[127] Instead, it concluded that the court should take into account *all* the relevant circumstances *without limit*, but it also listed specific matters which it considered the court should take into account.[128] Put simply, these criteria are merely factors to be considered alongside several others, not a

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[124] CBCA s 239(2). The wording of the derivative action provision in both CBCA and OBCA is largely very similar. We shall focus on CBCA.

[125] L Thai 'How Popular are Statutory Derivative Actions in Australia? Comparisons with United States, Canada and New Zealand' (2002) 30 Australian Business Law Review 118, 126.

[126] As part of the proposed new derivative procedure. Report para 6.15.

[127] Report paras 6.74, 6.76, 6.79.

[128] Report para 6.70.

mandatory requirement as in Canada. The paragraph setting out the specific matters deserves to be reproduced in full:[129]

> **50.10** Application under rule 50.9
>
> (1) In considering an application under rule 50.9 the court must take all relevant matters into account.
>
> (2) In particular the court must take the following matters into account
>
> > (a) whether the member is acting in good faith in seeking to continue the claim as a derivative claim;
> >
> > (b) whether the claim is in the interests of the company, taking account of the views of the company's directors on commercial matters;
> >
> > (c) whether the directors' activity as a result of which the cause of action is alleged to arise may be approved by the company in general meeting and (if it may be) whether it has been;
> >
> > (d) whether the company in general meeting has resolved not to pursue the cause of action;
> >
> > (e) the opinion (if any) of an independent organ that for commercial reasons the claim should or (as the case may be) should not be pursued;
> >
> > (f) whether a remedy is available as an alternative to the claim.

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129 Report, Draft CPR 50.9 and 50.10 in Appendix B.

So, what may be the cumulative effect of these fairly elaborate provisions? If the reader has not been exhausted by simply reading this lengthy list, perhaps the first striking point to note is that this list well illustrates how procedurally and substantively English law has developed to provide disincentives to prospective plaintiffs. Imagine a bona fide shareholder who genuinely contemplates taking an action and reads through this (non-exhaustive, it should be stressed) list. It is no surprise, as the Law Commission itself admits, that it could easily be seen as maintaining a policy of not favouring derivative actions and as a signal of an over-restrictive approach to shareholders which would over-deter them (see below). Faced with these complexities, the average shareholder will often give up in despair already at this early stage.

3.4.2.1 Rationales

The point has already been made above that with respect to (c), (d) and (e) -it is highly questionable whether any of these matters may be relied on when deciding whether the action should be continued. We shall leave (f) for later.[130] This leaves us with (a) and (b), both of which are considered in detail shortly. Before, it is useful to examine briefly the arguments on which the Consultation Paper relies in formulating its wide discretion. First, it considers that such discretion will give courts the flexibility to allow cases to proceed in appropriate circumstances, while giving advisers and shareholders the necessary guidance on the matters which the court will take into account in deciding whether to grant leave.[131] Secondly, it

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[130] It relates to the relationship between the derivative action and s 459 CA 1985 petition, and in particular, whether s 459 can be used to 'outflank' the derivative action (*Re Saul Harrison & Sons Plc* [1995] 1 BCLC 14) discussed in ch 7.

[131] Report para 6.14.

explains that the wording makes plain that the discretion is wide and that the matters set out are only some examples of the matters to which the courts should have regard. The paper concludes that the most important advantage of listing these factors is that these proposed provisions should assist in building up a body of reported cases which will guide shareholders and advisers.[132]

There are, nonetheless, various difficulties with this approach. As the Consultation Paper elsewhere admits, it could be argued that because the factors are not weighted, the discretion is so open that the case law will provide little guidance because invariably each case will turn on its own facts.[133] Secondly, and more importantly, it may also produce, as did the case law on the common law derivative action, *over-cautious* judicial decisions.[134] It is also open to debate whether the list of non-binding criteria may have the benign effect that the Law Commission intends.[135] In fact, the Law Commission itself listed a number of arguments against the approach it has adopted.[136] If anything, given that the tendency of courts is to erect as many obstacles as possible in the way of a minority applicant who comes before the court as a litigant in a derivative action, these arguments are much more compelling. First, a list may appear to be a set of hurdles which applicants have to

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[132] Consultation Paper para 16.44.

[133] See also AJ Boyle, above n 1, 73.

[134] This may be most evident when respect to public listed companies. It is likely that all the old *Foss* attitudes may be reintroduced in the exercise of the new judicial discretion. Coupled with the fact that the Report is somehow more restrictive in setting forth the specific matters which the court must take into account, and the new specific guideline of 'whether the company in general meeting has resolved not to pursue the cause of action', all this may prove to have a deadly effect in 'choking off' derivative actions. See further A Boyle above n 1, 73–74.

[135] A Boyle, above n 1, 73.

[136] Consultation Paper para 16.43.

overcome and which would deter them. Secondly, it could be seen as maintaining a policy of not favouring derivative actions and as a signal to adopt an over-restrictive approach to them. Thirdly, it could be seen as constraining the flexible exercise of discretion which the Law Commission was anxious to encourage, in that the inclusion of these and the omission of others may suggest that these are the only relevant criteria or the most important. Finally, it is not truly helpful by way of guidance to advisers or shareholders in relation to 'good faith' and 'interests of the company' because these are open-textured phrases which have been given numerous meaning by different courts.

As will be highlighted next, there is much substance in these arguments. The use of these last two tests is replete with uncertainty in conception and highly unworkable in practice. These are two of the most common tests in use in case law, statutory derivative actions across jurisdictions and various law reforms. They may thus illustrate best the difficulties with the content of current screening mechanisms. The argument that follows is not that the policy premise these two tests reflect is not a sound one. There is no doubt that they both represent vital checks before commencing litigation on behalf of the company for the various concerns set out above. But the question is whether there is a need to resort to these two somewhat tortuous and indirect terms that function as rhetorical devices rather than substantive standards in assisting the court to determine the merits of the case in question. It will be left to the next chapter to explain how these issues can be addressed. For now, it will suffice to concentrate on the problems.

3.4.2.2 Applicant's good faith

The requirement that the shareholder is acting in good faith can be found in almost all jurisdictions where the derivative action has been put on a statutory footing.[137] A number of reasons have been typically put forward for the inclusion of good faith.[138] These include the need to determine whether the applicant has been complicit in the matters complained of, the prevention of strike suits[139] brought, for example, to further the interests of a business competitor or someone making a proposed takeover offer, or the need to preclude personal vendettas and vexatious actions.[140] The test is used also in other contexts in company law, such as under section 35A(1) CA 1985, or the requirement that a director must exercise any power vested in him 'honestly, in good faith and in the interests of the company'.[141]

The definition of 'good faith' is somewhat tortuous and indirect.[142] Serious questions have been raised as to whether this requirement has a valid and independent role to play, for if the case is itself meritorious, good faith of the applicant is likely to be present in any event.[143] Conversely, a court would

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[137] Such as s 239 (2)(b) of the CBCA 1985 or s 198 of the Israeli Companies Act 1999.

[138] See generally *Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action* Report No 12 (1990) 20–21 (Australia).

[139] A phrase used in North America to describe applications made in order to further the interests of someone other than the company. Consultation Paper 162 n 89.

[140] This may help, for example, protect against complicity and against the purchase of shares for the purpose of litigation by vexatious litigants. See in this respect Lord Bingham's recent discussion of what constitutes a vexatious proceeding in *Attorney General v Barker* [2003] 1 FLR 759.

[141] *Dorchester Finance v Stebbing* [1989] BCLC 498, 501–502.

[142] And as the Law Commission acknowledged, its express presence could encourage litigation as to its meaning in this context. Consultation Paper 163. The Report takes the view, nonetheless, that it should not be defined. It believed that while extremely difficult to define it was generally readily recognizable. Report para 6.76.

[143] B Welling *Corporate Law in Canada* (2nd edn 1992) 528.

generally refuse leave to an applicant whom it considered to be acting in bad faith so that it may not be necessary to state this factor specifically.[144] The Law Commission, indeed, noted that it was unlikely that a court would grant leave to an applicant whom it considered was acting in bad faith, but considered that since it is a relevant criterion it was of sufficient importance to be mentioned expressly.

The experience in Canada serves to illustrate the difficulty in construing the term, as it is also not defined in the Canadian statutes. Canadian courts have not given a blanket definition. Instead some courts have adopted the merits approach, considering the facts of each case on its own merits.[145] But there have been other cases in which the good faith requirement was considered a serious issue to be considered so that a lack of good faith was ground enough for denying an application for leave.[146] In the latter cases, the onus of demonstrating good faith is one that must be discharged by the applicant. For example, the court has identified the applicant to be acting in bad faith in a case where the applicant was motivated by potential tactical advantages in commencing the action.[147] It can be seen then, that in most cases good faith functions as a rhetorical device rather than a substantive standard. That is, it is an open-textured term, which operates as a speech-act, as opposed to a structured mode of analysis.[148]

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[144] A Reisberg, above n 71, 253.

[145] BR Cheffins, above n 11, 249.

[146] ibid.

[147] *Vedova v Garden House Inn Ltd* (1985) 29 BLR 239 (Ont HC).

[148] SJ Griffith 'Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence' (2005) 55 Duke Law Journal 1 http://ssrn.com/abstract=728431; BR Cheffins, above n 11, 248 and the evidence therein.

3.4.2.3 Interests of the company

Draft Rule 50.10 also requires the court to take into account the views of the company's directors on commercial matters when considering whether the claim is in the interests of the company. The Report clarifies that this does not mean that the court would be bound to accept the views of the directors. In fact, the existence of a conflict of interest may affect the weight to be given to them, and the court would give no weight to views which no reasonable director in that position could hold.[149] This flexible approach adopted by the Report is effectively an application of the US business judgment rule.[150] Such an approach deals with the legitimate concerns thrown up by shifting the decision to litigate away from the commercial arena to one that is in the purview of the courts, a task that may not be relished by the judiciary.[151] The fear, however, is that too much deference to the business judgment rule will remove much of the bite from the derivative action and deprive it of the ability to perform the very function it was created to perform, that of policing boards of directors. Some middle path must therefore be found, something undoubtedly easier said than done.[152] Development of a business judgment rule is a

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[149] The Report thus holds firmly the view that it is not appropriate to require an applicant for leave to prove that the action is in the interests of the company. On the other hand, where the court is satisfied that the proceedings are not in the interests of the company, there is no good reason why the proceedings should continue, and the court should refuse leave. Report para 6.79.

[150] This judge-made rule is a judicial gloss on duty of care standards which sharply reduces exposure to liability for claims for breach of duty/negligence where certain factors are established. Its purpose is to encourage capable persons to serve as directors by reducing their risk exposure to hindsight reviews of their unsuccessful decisions, to limit litigation over corporate decision-making and, importantly, to avoid intrusiveness by public officials (judges) into private sector business affairs. See *Joy v North* 692 F 2d 880, 893 (2d Cir 1982). See RC Clark *Corporate Law* (Little Boston 1986) 124–141; ME Eisenberg 'The Duty of Care and the Business Judgment Rule in American Corporate Law' [1997] 2 CFILR 185.

[151] PKM Choo, above n 13, 78.

[152] One possibility is to follow s 237(3) of the Australian Corporations Act, which provides for a link between the business judgment rule and the statutory derivative action in the form of a rebuttable presumption that, in certain spelt-out situations, proceeding with litigation will not be in the company's interests.

possibility latent within English law, and there are those who believe that such a development seems desirable.[153] But it is beyond the scope of this chapter to examine this subject in any detail.

Let us re-focus now on the test itself. It is found in most jurisdictions where the derivative action has been put on a statutory footing.[154] It seems to reflect the view at common law that the action must be brought genuinely in the interests of the company[155] and not for the benefit of a rival company which has fostered the litigation and indemnified the litigant against costs.[156] Although understandable and commendable as a concept, since an action which is clearly not in the interest of the company should not, indeed, be allowed to proceed, arguably it is a concept which is notoriously difficult to ascertain and is open to wide judicial interpretation.[157]

The fundamental question is how one can ascertain, ahead of the litigation itself, whether that particular action is or is not in the best interests of the company. On the one hand, it has been suggested that in some cases it would be relatively

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[153] See eg S Deakin E Ferran and R Nolan, above n 18, 167. On the ways in which English law might properly develop this doctrine see ME Eisenberg 'The Duty of Care and the Business Judgment Rule in American Corporate Law' [1997] 2 CFILR 185.

[154] See eg s 239(2)(c) of the CBCA.

[155] *Barratt v Duckett* [1995] 1 BCLC 243, 250 *per* Peter Gibson LJ. It has been suggested that this question can be answered only on the facts of a particular case. PL Davies *Gower and Davies' Principles of Modern Company Law* (7th edn Sweet & Maxwell London 2003) 443.

[156] *Forrest v Manchester, Sheffield and Lincolnshire Rly* (1861) 4 De GF & J 126.

[157] The difficulty with this concept can be seen in other areas of company law, such as alterations of the articles. See *Peters' American Delicacy Co Ltd v Heath* (1939) 61 CLR 457, 512; *Redwood Master Fund Ltd v TD Bank Europe Ltd* [2002] EWHC 2703. See further DD Prentice 'Alteration of Articles of Association – Expropriation of Shares' (1996) 112 LQR 194, 195–196.

straightforward to satisfy this test.[158] The clearest case would be where directors had no legitimate reason for refusing to take action for loss caused by breach of duty. Conversely, the fact that a derivative action is used as a vehicle to carry on a bitter dispute between shareholders may indicate that the case has not been brought in the best interests of the company.[159] There could also be good commercial reasons for not taking action. These could include, for example, the board's reluctance to disturb a long-standing profitable relationship with a customer, or its conviction that the recovery by the company would be much less than the costs of the proceedings. Usefully, Gevurtz has identified some issues that may assist the court when addressing the question of whether it is 'in the interests of the company' to pursue a derivative action. These include the probability of success, the intangible costs to the company, such as distraction of personnel and the time lost by litigation, or the size of the potential recovery.[160]

This calculus, however, is somewhat indefinite and rather complicated. Equally, it may not be easily quantified or detected. First, the concept of 'the interests of the company' is a notoriously fragmented one because it is almost impossible to say who 'the company' is for this purpose.[161] Must the interests of creditors, shareholders who do not support the proceedings or employees be considered here? Consider, for example, the following scenario. Two minority shareholders in a private company decide to bring a derivative action against two

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[158] *Enforcement of the Duties of Directors and Officers of a Company by means of a Statutory Derivative Action* (Report No 12 1990) 22 (Australia).

[159] See eg *Barratt v Duckett* [1995] 1 BCLC 243, 250.

[160] FA Gevurtz, above n 71.

[161] An illustration of this difficulty may be found in Lord Wilberforce's comments in *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360, 381, where he said that this phrase should not become little more than an alibi for a refusal to consider the merits of a case. On the facts of the case, it meant little more than '... in the interests of the majority'.

directors who between them hold, say, 75% of the shares. Further assume that there are no other shareholders in the company, and that the company is extremely profitable with ample reserves and there is no question of any creditor having an interest in the outcome of the litigation. Who then is 'the company' in this situation? It is surely absurd to divorce the company from the underlying protagonists in such a situation.[162] Another problem is that it is more difficult for a shareholder to fulfill the 'best interests' criterion than one would think. In particular, in a large company, the shareholder may need to gather support from other shareholders in order to obtain a desired number to show that it is 'in the interests of the company' to institute proceedings.[163]

Arguably, this veritable Pandora's box of unanswered questions raises more problems than it solves.[164] In deciding that an action is or is not 'in the interest of the company', how is a court to determine the inherently speculative costs of future attorney's fees and expenses related to litigation, or time spent by corporate personnel preparing for trial? How is a court to quantify the effect of the case on corporate goodwill, corporate morale and the distraction of key personnel?[165] Should the court also take into account the potential adverse impact of continuing litigation upon the company's ability to finance its operation? What about cases which the court considers at the outset to be arguable but not likely to succeed, but which ultimately bring rewards? Should future costs be discounted to present value

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[162] A Borrowdale 'The Statutory Derivative Action' (2000) New Zealand Law Journal 409, 410.

[163] FH Buckley M Gillen and R Yalden *Corporations: Principles and Policies* (3rd edn Emond Montgomery Publishing Ltd 1995) 702.

[164] See also *Joy v North* 692 F 2d 880, 898 (2d Cir 1982).

[165] See ch 2 under 2.2.

and, if so, at what value? Should financial considerations, such as possible gains for the company, be taken into account here? What if the court finds a likely net return to the company which is not substantial in relation to the shareholder equity? Should a court grant leave for actions which are clearly not going to bring any direct proceeds to the company but which nonetheless involve wrongdoing by a company's own directors?[166]

Moreover, the ambiguous concept of 'in the interests of the company' may lead courts to adopt different interpretations of the same concept, resulting in considerable uncertainty for the business community. This last point is usefully illustrated by contrasting the various interpretations the term has received from the Canadian and Israeli courts. Curiously, under this criterion, Canadian courts tend to distinguish a derivative action from a personal claim. Leave to bring a derivative action is denied where the dispute is more correctly characterized as a personal dispute between the complainant and some other shareholder within the company.[167] Israeli courts, on the other hand, tend to link this concept to the 'good faith' of the plaintiff. The case law suggests that the good faith requirement will likely be met if the derivative action appears to be in the interest of the company![168] Perhaps this illustrates best how these two criteria are linked and the fact that it is, indeed, very hard to make a distinction between the two.[169]

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[166] See further A Reisberg, above n 71, 254.

[167] *Stankovic v Leighton* (1988) 28 CPC (2d) 155; *Johnson v Meyer* (1987) 62 Sask R 34.

[168] Conversely, it is arguable that the lack of good faith indicates that conducting the proceedings is not in the interests of the company. See the recent case in *Ben-Ari v Avner* (2004) TA 8794/03 (Israel) and the decision of the Supreme Court of South Australia in *Hurley v BGH* (1982) 6 ACLR 791, 797–798 *per* Chief Justice King.

[169] See further A Reisberg, above n 71, 253–255.

3.5 CONCLUSION

This chapter argued that good intentions often make bad law. There is no doubt that some of the hurdles facing shareholders which make the derivative action cumbersome are there to perform a vital function, namely to protect the company against the single shareholder who through malice or misjudgment will waste the company's time and money. Although each of these policies has its own logic, they reflect in the aggregate a deep-rooted tension between the courts' recognition that some legal form is necessary by which to hold corporate directors accountable and the fear that an overly liberal remedy would be exploited by shareholders in an abusive manner. What is extraordinary in this context is how procedurally and substantively English law has developed to provide disincentives to prospective plaintiffs. Although any empirical data has generally been lacking by which to corroborate either the critics or the defenders of the derivative action, the common law and the Law Commission have been more impressed by the risk of derivative actions being motivated by personal objections than they have by the risk that confining derivative actions will lead to less litigation than the company's interest requires. But if the current policies are maintained, then no shareholder is likely to step forward even in situations where litigation would increase total share value.

In striking a proper balance for the aforementioned tension, this chapter has laid the foundations for the discussion in subsequent chapters. In particular, the chapter has highlighted the importance of two methods that are imposed in order to protect against abuse of these proceedings: (1) reallocating the responsibility to

determine the merits of actions from the shareholder to courts; and (2) providing a screening mechanism to identify cases that are without merit. The following chapter addresses the procedural complexity of derivative actions and seeks to replace overbroad restrictions to the plaintiff's standing to sue with more specifically *focused* checks to discourage non-meritorious litigation. The argument is that the baby should not be thrown out with the bath water by denying shareholders *any* realistic access to a litigation remedy. If the mechanisms that are employed to protect against abuse of these proceedings are properly devised, then the court should not view the utility of the derivative action with such hostility and disdain.

The Functional and Focused Model

Table 4-1: A bird's Eye View of the Functional and Focused Model

1. Foundations and Synthesis	
Issue	**pages**
The role of derivative actions in a changing menu of governance	155
The derivative action as a constraint on management misconduct	168
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2. General issues		
Issue	**Proposed Rule**	**pages**
Type of cases	All breaches of directors' duties without limitation	199
Type of companies	Not restricted to any particular type of company; Multiple derivative actions should also be allowed	208
Who may be qualified to bring an action?	A member and present (but not past) directors	209
Notice to the company	To provide the company the opportunity to vindicate its own rights	232

3. Operation and Delivery of the Model		
Formulating an expeditious screening mechanism	A substantive standard at the heart of the inquiry: identifying those actions that appear likely to increase corporate value as set out below	212
Shareholder standing	The conduct of the shareholder should take a backseat role in the courts' assessment	225
Access to information	The court should be allowed to use its general jurisdiction and allow access to information in appropriate cases	228
The problem of funding	Adopting 2 strategies:(i) rewarding plaintiffs by providing them with part of the proceeds of a successful action; and (ii) allowing contingency fees agreements subject to proper safeguards	Chapters 5 and 6

4. Facilitating and Preserving the Model		
The lack of adequate incentives to sue for shareholders	Providing various 'carrots' to shareholders subject to the discretion of the court	Chapters 5 and 6
The unclear interaction between the s 459 and the derivative action	Introducing specific measures to clarify interaction and maintain doctrinal consistency	Chapter 7

The Functional and Focused Model—

Part I: The Foundations

4.1 INTRODUCTION

The existing analysis of how the derivative action functions and how the use of this mechanism in the general scheme of law enforcement may promote deterrence of wrongdoing and compensation of harm, ie the two primary objectives identified in Chapter 2, falls short of providing an adequately coherent theoretical account on either descriptive or normative grounds. Analytically, a sound theoretical understanding of the derivative action is necessary for three primary reasons. First, as will be seen in Chapter 5, the use of the derivative action will rarely, if ever, be economically rational. In financial terms, a shareholder lacks any direct remedy that would make the action worthwhile for him or her. If all shareholders share the same view, then no one is likely to step forward even in situations where litigation would increase total share value. Secondly, in order to be socially desirable, policy prescriptions must identify the relevant welfare-enhancing determinants.[1] Finally, in order to be effective, legal reforms and regulatory measures must target and possess a *functional* capacity to affect the respective incentives that bear an impact on the attainment of the social objectives of law enforcement.[2]

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1 L Kaplow and S Shavell 'Any Non-Welfarist Method of Policy Assessment Violates the Pareto Principle (2001) Journal of Political Economy 109.

2 G Halfteck 'The Class Action as a Financial Call Option' Harvard John M Olin Discussion Paper No 466 (March 2004) http://www.law.harvard.edu/programs/olin_center/ (15 March 2004).

Trying to fill this gap, this chapter develops a model to analyse and explain the use of the derivative action referred to as the ***Functional and Focused Model*** ('FFM').[3] The premise driving this model is an understanding that a coherent model for the use of the derivative action is required. Consistent with the preceding discussion, its starting premise is that litigation is a failsafe remedy, a safety net for instances when other mechanisms of accountability fail. Once the role of the action is redefined to meet contemporary challenges as set out below, the challenge is: (1) to simplify procedures and establish a fair and balanced procedure for derivative action litigation; (2) to address its core dilemmas, most notably that of properly funding the action and lack of positive inducement to litigate; and (3) closely harnessing the derivative action to the corporate interest it represents by inviting the court to consider the public character of the norms raised by the derivative action. The FFM puts into operation the constructive attributes described above by validating principles to govern derivative actions and tackle those difficulties that arise only in the context of these unique proceedings.

The chapter is organized in two parts. **Part I** provides the setting. Section 4.2 discusses the role of derivative actions in the corporate governance matrix. It shows how the traditional picture no longer accurately describes the action in the corporate governance setting. Section 4.3 then discusses the specific role that the derivative action may play in such a constantly changing system. The various points

[3] An abbreviated version of this chapter entitled 'The Derivative Action as a Corporate Governance Tool: A Functional and Focused Model to Litigation' has been submitted for publication in OJLS.

teased out throughout the preceding discussion are finally crystallized in **part II** of the chapter. Section 4.4 concentrates on the characteristics of the FFM and the potential content to be covered by it. First, section 4.4.1 sets out the aims of the model, followed by an outline and the policy premises underlying the FFM. Section 4.4.2 then attempts to unearth and illuminate the value of deterrence against corporate misconduct. Section 4.4.3 considers strategies that can be pursued to reverse the negative effects of those forces (as identified in chapter 2) that weaken the social meaning of derivative actions. Subsequently, these key characteristics are reduced to practical recommendations to be included in the FFM in section 4.4.4. It should be noted that although, structurally, the foundations of the FFM are laid down in this chapter, the complementary building blocks of the FFM are addressed in the three chapters that follow.

4.2 THE ROLE OF DERIVATIVE ACTIONS IN A CHANGING MENU OF GOVERNANCE

4.2.1 Introduction

The time is now ripe to pick up from where we left in Chapter 1. We have seen that the director-centric legal system is only a portion of the corporate governance matrix. Law is part of a rich array of constraints that also includes markets and norms as regulators of corporate behaviour. The market for director services influences governance and the takeovers market has become a key component of governance in addition to the product market and the capital market. Private ordering has also provided a variety of monitoring mechanisms including auditors, analysts and attorneys. Disclosure, a key legal requirement in English law, facilitates monitoring and incentives generated by private ordering.

At the same time that these mechanisms have been growing, derivative actions in English law have been increasingly limited by a variety of procedural and substantive restrictions imposed to prevent perceived abuses generated by such actions. Unlike the situation in the US, the action is now so restrictive under English law that it is not a real alternative. Against this setting, it is not surprising that shareholders are rarely willing to bear the expenses of such actions, with the result that it would be a rare shareholder, indeed, who would fly in the face of this lethal mix of disincentives to commence litigation. The academic analysis of derivative actions, for the most part, reflects the view that derivative actions are an ineffective instrument of corporate governance. The argument, of course, can be viewed from two perspectives. Against the plaintiff shareholder it can be argued that the

availability of the derivative action, at least a theoretical availability (for even in the more vigorous atmosphere of the US, the chances of success are indeed slim),[4] encourages frivolous and vexatious litigation and that therefore this action needs to be rigorously controlled.[5] Alternatively, the derivative action could be used as a legitimate corporate governance tool to redress the concerns which all scholars have with issues centred on management accountability and lack of shareholder voice.[6] For those who contend that derivative action is just another form of litigation, the writer would argue that it is not. Admittedly, it is an imperfect and flawed mechanism, but so are most other mechanisms of corporate governance (including shareholder voting and the market for takeovers), and such a sceptical assessment only suggests the need for reform, not abolition. How this might be done is explained below, but the following comments serve as a useful bridge between the arguments in this section and those still to come.

4.2.2 Enhanced Protection of Minority Shareholders

In discussing how to enhance the potential effectiveness of the action, it is useful first to explain why, potentially, law can play an important role in the corporate governance context. In recent years various economists and academic lawyers have hypothesized on the effect various legal frameworks have had on the evolution of

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[4] MP Dooley *Foundations of Corporation Law* (Foundation Press New York 1995) 302–305; R Thompson R Blakey and R Thomas 'The Public and Private Faces of Derivative Lawsuits' Vanderbilt Law and Economics Research Paper No 04-14, 38-39 http://ssrn.com/abstract=555813 (12 October 2004).

[5] For a recent explication of this view see eg J Payne 'Shareholders' Remedies Reassessed' (2004) 67 MLR 500, 504.

[6] See eg I Lynch Fannon 'A Transatlantic Case: The Derivative Action as a Corporate Governance Tool' Dublin University Law Journal (forthcoming) with permission from the author.

corporate governance. A large and growing body of empirical studies has given the so-called 'law matters' theory[7] a powerful boost.[8] The thinking is that the law 'matters', in the sense that a legal regime which allows investors to feel confident about owing a tiny percentage of shares in a firm constitutes the 'bedrock' that underpins an economy where widely held public companies dominate (ie the US and the UK).[9] This 'law matters' theory is primarily utilized for explaining or theorizing developments in various jurisdictions. For the purpose of our discussion, nonetheless, it may shed some light on the normative implications that may induce a better corporate governance regime.

Although in both the US and the UK companies moved to the forefront without the legal system playing a pivotal role,[10] the experience in these two countries indicates that a significant growth in the number of people investing in shares can provide a suitable platform for the introduction of reforms designed to assist minority shareholders.[11] Recent research suggests that the degree of protection a country's legal system provides for outside investors has a significant effect on its corporate governance regime. More precisely, laws favouring minority

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[7] This is drawn from BR Cheffins 'Law as Bedrock: The Foundations of an Economy Dominated by Widely Held Public Companies' (2003) 23 OJLS 1.

[8] Prominent in this stream of evidence is a series of papers by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W Vishny. For an overview of the literature see R La Porta et al 'Investor Protection and Corporate Governance' (2000) 58 Journal of Financial Economics 3. This paper provides the fullest statement of the 'law matters' thesis. Others suggest that the movement is in the opposite direction with economic change driving regulatory reform. See JC Coffee 'Convergence and its Critics: What are the Preconditions to the Separation of Ownership and Control?' ssrn.com (abstract id=241782). Cheffins suggests that both views may be tenable.

[9] BR Cheffins, above n 7, 2.

[10] In the UK mechanisms other than formal legal regulation primarily served to protect shareholders as the country's system of ownership and control was taking shape; over time, nonetheless, the country adopted an increasingly legalistic regime. BR Cheffins, above n 7, 2.

[11] BR Cheffins, above n 7, 2.

shareholders are associated with a large number of listed companies, more valuable stock markets, reduced private benefits of control and a lower concentration of ownership and control.[12]

Why should law make so much difference? The method implied by the 'law matters' thesis is to give minority shareholders protections against misconduct by fostering investors' confidence. The essential insight underlying the 'law matters' thesis is that, in an unregulated environment there is a real danger that, say, a public company's insiders, such as senior managers, will cheat 'outside' investors who own equity.[13] Such confidence means that investors are willing to pay full value for shares made available for sale, which in turn lowers the cost of capital for firms that choose to sell equity. Public offering of shares can easily follow. The conditions therefore are well suited for a widely dispersed pattern of share ownership.[14] The fact that law may influence the manner in which corporate governance evolves has therefore potentially significant *policy* implications.

Crucial to the foregoing discussion is one further issue. Recent developments have shed light on the need to rethink the benefits of derivative actions in the international context. As trade barriers fall, markets expand, information flows improve and restrictions on investment disappear, it has become progressively easier for investors from one country to invest in companies in

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[12] BR Cheffins, above n 7, 2 and the references cited therein.

[13] An illustration of the thesis is provided by the US legal system which regulates quite closely opportunistic conduct by insiders. According to the 'law matters' theory, minority shareholders feel 'comfortable' in this sort of protective environment. BR Cheffins, above n 7, 6.

[14] BR Cheffins, above n 7, 6 and the references cited therein.

another country.[15] In a competition for global savings, sophisticated investors will be attracted to jurisdictions which have structures that serve shareholders' interests.[16] A crucial element in the attractiveness of a particular locality will be its system of corporate governance.[17] An important aspect in the structure of corporate governance is the *level of protection* it offers for minority shareholders.[18] There is, indeed, plenty of anecdotal evidence which illustrates that protection of minority shareholders is emerging as an important international corporate governance topic.[19]

In the UK, fears that top executives lead a privileged existence and have ample scope to act in a misguided or dishonest fashion have helped to make corporate governance a prominent topic in recent years. Indeed, concerns about low standards of managerial accountability provided the catalyst for the establishment of the Cadbury, Greenbury and Hampel Committees.[20] Since investors in a country

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15 See generally R Gilson 'Globalizing Corporate Governance: Convergence of Form or Function' in J Gordon and M Roe (eds) *Convergence and Persistence in Corporate Governance* (Cambridge University Press 2004) 128.

16 H Hansmann and R Kraakman 'The End of History of Corporate Law' in J Gordon and M Roe (eds) *Convergence and Persistence in Corporate Governance* (Cambridge University Press 2004) 33, 48–50; RAG Monks and N Minow *Corporate Governance* (Blackwell Cambridge MA 1995) 270–271. On the European dimension see, J Lowry 'Eliminating Obstacles to Freedom of Establishment: The Competitive Edge of UK Company Law' [2004] CLJ 331.

17 E Berglöf 'Reforming Corporate Governance: Redirecting the European Agenda' (1997) 24 Economic Policy 93.

18 There is also a wider concern with respect to a plaintiff who is a shareholder in a large multinational group structure, where, in view of the lack of legal clarity, it is impossible to assess what, if any, internal remedies are realistically open to such a plaintiff. See I Lynch Fannon, above, n 6; J Dine *The Governance of Corporate Groups* (Cambridge University Press 2000) 53–55.

19 See eg BR Cheffins 'Minority Shareholders and Corporate Governance' (2000) 21 Company Lawyer 41; DK Denis and JJ McConnell 'International Corporate Governance' (January 2003) ECGI – Finance Working Paper No 05/2003; http://ssrn.com/abstract=320121; R La Porta et al 'Investor Protection and Corporate Governance' (June 1999) http://ssrn.com/abstract=183908.

20 See discussion in ch 1 under 1.3.2.2. These three committees, nonetheless, had very little to say on the status of the minority shareholder. Moreover, the Law Commission explicitly distinguished the work it was doing from that which had been attracting attention in corporate governance circles in the UK. Consultation Paper para 1.5.

with an 'outsider/arm's length' system of ownership and control have good reason to be fearful of 'agency costs' arising from self-serving managerial conduct, a key corporate governance objective should be to improve the accountability of corporate executives.[21] Consistent with such reasoning, the Cadbury, Greenbury and Hampel Committees sought to influence managerial behaviour by issuing guidelines designed to enhance the role of non-executive directors and to improve links between executive pay and corporate performance. While these committees have clearly improved the situation, as we saw in Chapter 1, recent research has suggested that these mechanisms for controlling managerial power are less effective than they might be.[22] The point here is not that these mechanisms are not important but rather that they are imperfect. This, in turn, suggests that the derivative action could have a role in minimizing agency costs.

4.2.3 Historical Perspective

It would be useful at this point to add another dimension to our discussion, namely the historical context of derivative actions. We begin by outlining the traditional view of the action. We then show how the traditional picture no longer accurately describes the action in the corporate governance setting. We then go on to discuss the specific role that the derivative action may play in such a system.

The first important point to note is that the decision not to allow the plaintiffs to bring the action in *Foss v Harbottle* seems to have been based primarily upon a desire to uphold contemporary norms of company management and

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[21] BR Cheffins, above n 19, 41.

[22] Ch 1 under 1.3.2.2 and 1.5.

ownership.[23] This desire is understandable if we consider that *Foss* was decided at the height of the industrial revolution, with incorporation not yet being freely available and limited liability still twelve years away.[24] It was noted by Wigram V-C that 'corporations like this [incorporated by individual private statute] ... are in truth little more than private partnerships',[25] suggesting that he was relying on partnership principles, with their connotations of mutual trust and good faith between individual business people, and presupposing mechanisms of consultation, and genuinely universal and equal suffrage among members, as a justification to suppress individual members' wishes in favour of the will of the majority.

It was thus considered necessary that corporate managers be shielded from undue shareholder interference, to encourage risk-taking and entrepreneurship. The Act which provided for the company's incorporation clearly placed its management in the hands of the directors, subject only to challenge by all shareholders in general meeting,[26] and thus it would be the very antithesis of the statutory control structure to allow shareholders to make, in essence, a management decision. Injustice, we are to assume, is not a problem because individual shareholders contract into this arrangement upon entering the company and therefore should be aware of the

[23] B Prunty 'The Shareholders' Derivative Suit: Notes on its Derivation' (1957) 32 New York University Law Review 980, 983–984 notes that the right of a shareholder to sue management on the company's behalf had been recognized prior to *Foss*, in cases like *Hichens v Congreve* (1828) 1 Russ & M 150 but that, by 1843, 'the prospect of an avalanche of disgruntled or querulous shareholders' seems to have led the courts to the conclusion that judicial restraint on such action was required.

[24] These two characteristics, now central to the utility of the corporate form in modern business, were introduced by the Joint Stock Companies Registration and Regulation Act 1844 and the Limited Liability Act 1855 respectively. The Chartered Companies Act 1837, in force when the case was decided, permitted incorporation only by the granting of letters patent upon regal or ministerial approval.

[25] (1843) 2 Hare 461, 491.

[26] ibid 492.

consequences.[27] The predominant attitude of the courts, at that time, towards shareholders' rights was that the 'best interests of the company' (as determined by the wishes of the majority) should necessarily prevail over the interests of any individual shareholder.[28] This principle was described as fitting within the 'formalist model' of corporate law,[29] in that it provided a mechanism by which decisions could be justified in an entirely objective way. The resulting action (or, in the context of *Foss*, inaction) of the corporation is justified simply on the grounds that it is what most of the constituents wanted. After all, even if the minority is profoundly convinced that a decision not to sue is wrong, the minority is still a minority and not the majority.[30]

This attitude towards corporate management, although understandable and even perhaps justifiable in the circumstances in which *Foss v Harbottle* was decided, was never appropriate as an absolute standard. In *Foss* itself, Wigram V-C referred to the possibility of the rule being relaxed in situations where 'no adequate remedy remained except that of a suit by individual corporators' or where 'the claims of justice' required such relaxation.[31]

Since then, however, developments in the business environment and in the characteristics of the corporate form itself have prompted a shift away from treating

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[27] M Maloney 'Whither the Statutory Derivative Action?' (1986) 64 Canadian Bar Review 309, 313.

[28] S Bottomley 'Shareholders' Derivative Actions and Public Interest Suits: Two Versions of the Same Story?' (1992) 15 University of New South Wales Law Journal 127, 138.

[29] A term coined by G Frug 'The Ideology of Bureaucracy in American Law' (1984) 97 Harvard Law Review 1277, 1282.

[30] *MacDougall v Gardiner* (1875) 1 Ch D 13.

[31] (1843) 2 Hare 461, 492.

majority rule as the principle which will prima facie be followed by the courts in shareholder disputes, and towards a more balanced view of the rights of minorities in relation to those of the majority.[32] The corporate group, rather than what Wigram V-C described as the 'private partnership', has become 'the quintessential model of corporate business activity in the late twentieth century'.[33] In this context, corporate activity (and in particular the exercising of directors' discretion in business decision-making) has become more of a 'public' concern,[34] which should therefore be subject to greater judicial scrutiny in order to protect individual members' rights.[35] It follows that, in the case of larger companies at least, the liberalization of shareholder remedies is a recognition that the individual members of such companies do not normally have the means to control errant directors without judicial interference. However, the same liberalization is also evident in cases involving smaller, closely held companies which, although relatively less significant in economic terms, still make up the vast majority of companies[36] (and thus also the majority of companies involved in litigation arising from intra-corporate disputes). This appears to be based on a realization by the courts that, although these companies may in practical terms be little more than incorporated partnerships, there are certain characteristics of the corporate form[37] which can

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[32] M Berkahn 'The Derivative Action In Australia and New Zealand: Will The Statutory Provisions Improve Shareholders Enforcement Rights?' (1998) 10 Bond Law Review 74, 79.

[33] S Bottomley, above n 28, 141–142.

[34] See in this respect the discussion in ch 2 under 2.4.2.1.

[35] JE Parkinson *Corporate Power and Responsibility – Issues in the Theory of Company Law* (Clarendon Press Oxford 1993) 21–40; S Bottomley, above n 28, 141–142.

[36] At the end of 2001, there were 12,400 public companies (0.8% of the register) and 1,491,500 private companies (99.2% of the register) in the UK. DTI *Companies in 2001–02*, Table A2.

[37] Such as the majority rule principle, the presumption that management power will reside solely with the directors rather than shareholders, and the existence of a written constitution which may purport to exhaustively define members' rights and duties.

result in a member's legitimate expectations regarding his or her role within the company being frustrated.[38] The trend towards greater recognition of minority enforcement rights is also evident from the introduction of several exceptions to the rule in *Foss* in the years following the judgment, and from the broadening of the scope of these exceptions.[39]

4.2.4 Policy Shift

Thus far we have seen that some change to the existing rules was necessary in order to give shareholders a more significant role in corporate governance. As a result, numerous jurisdictions put the derivative action under the microscope, and a 'second generation' in the guise of a statutory procedure has emerged.[40] In fact, shareholder-initiated actions are now being accommodated in countries that had previously rendered them ineffective.[41] The introduction of the statutory derivative action in many of these jurisdictions was prompted by the recognition that an enhanced shareholder role (as owner and investor) is necessary if management's obligations and duties to its shareholders are to constitute more than a precatory body of law. It is perhaps helpful, at this point, to briefly survey the reasons put

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[38] As the rich case law on s 459 CA 1985 well illustrates: discussion in ch 7.

[39] As set out by the Court of Appeal in *Edwards v Halliwell* [1950] 2 All ER 1064 and restated in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204.

[40] New Zealand and Singapore introduced the statutory derivative action in 1993. Australia and Israel followed suit in 2000 after nearly a decade of study and deliberation. The statutory derivative action has been around for some time in Canada and South Africa.

[41] Germany has recently reduced the ownership threshold qualifying shareholders to demand legal action against directors from a 10% equity stake to a lesser 5% stake. T Baums 'Company law Reform in Germany' (2003) 3 JCLS 181. Japan has altered its rules on attorney's fees to create meaningful incentives for shareholder litigation. See below ch 5 under 5.2.1 and H Hansmann and R Kraakman, above n 16, 53–54.

forward in favour of allowing the derivative action to function as an effective tool of corporate governance.

In the US, the derivative action is seen as a regulator of corporate management[42] and one of the most effective means of enforcing the management's duties and obligations under the law.[43] It is seen as a means of complementing and enhancing the existing regulatory capability of social and market forces as well as public administration.[44] In other jurisdictions, the introduction of a statutory procedure to govern the conduct of derivative actions was considered necessary to counter the restrictive nature of the rule in *Foss* and to allow the derivative action to function as an effective tool of corporate governance. In Canada, the Dickerson Committee felt that the best means of enforcing a corporation law is to confer reasonable power on the allegedly aggrieved party to initiate legal action to resolve the problem.[45] In New Zealand, the statutory derivative action is seen as a means for the more effective enforcement of the obligations under the constitution of the company and under their Act.[46] In Australia, the desire was for a more potent and accessible weapon to deter and punish managerial misconduct,[47] the state of the existing law being inadequate for this purpose because of the restrictive nature of

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[42] *Cohen v Beneficial Industrial Loan Corp* 337 US 541, 548 (1949).

[43] This statement must be seen in the context of the unique environment for derivative actions in the US, which provides a financial incentive to attorneys to police management. See ch 5 under 5.2.2.

[44] See generally MP Doole *Foundations of Corporation Law* (Foundation Press New York 1995); RC Clark *Corporate Law* (Little Boston 1986).

[45] Proposals for a New Business Corporations Law for Canada (Dickerson Report 1971) 476.

[46] Law Commission *Company Reform and Restatement* (Report No 9 1989) para 86.

[47] PKM Choo 'The Statutory Derivative Action in Singapore – A Critical Examination' (2001) 13 Bond Law Review 64, 68.

the rule in *Foss v Harbottle*.[48] Some Australian commentators questioned the need to introduce a statutory form of the derivative action. This was due to the observation that the Australian judiciary appears more than willing to avoid the insidious web woven by the rule in *Foss v Harbottle*.[49] In particular, this robust attitude towards minority shareholder rights was manifested in the increasing judicial support for a fifth exception 'in the interests of justice' to the rule in *Foss v Harbottle*, and in the expansive view taken of shareholders' personal rights, which effectively bypassed the procedural difficulties of *Foss v Harbottle*.[50] Nevertheless, it was considered that this attitude of the courts in itself engendered a certain amount of uncertainty,[51] and the availability of a 'direct accountability mechanism that can be used by shareholders in an efficient and effective manner' would do much to remove this uncertainty in the interests of enhancing corporate governance and maintaining investor confidence.[52] According to the Corporations Law Simplification Task Force, the overall objective of introducing a statutory derivative action to confer rights on shareholders should be to provide an incentive for management to exercise its powers appropriately and discharge its functions for the ultimate advantage of the shareholders.[53] In Israel, the introduction of the statutory

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[48] See the Explanatory Memorandum to the Corporate Law Economic Reform Program Bill 1999 paras 6.14–6.15. On the main limitations on the ability of shareholders to bring derivative actions under Australian law see E Boros *Minority Shareholders' Remedies* (OUP 1995) 189–192.

[49] LS Sealy 'The Rule in *Foss v Harbottle*: the Australian Experience' (1989) 10 Company Lawyer 52; I Ramsay 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 University of New South Wales Law Journal 149, 159.

[50] *Biala Pty Ltd v Mallina Holdings Ltd (No 2)* (1993) 11 ACSR 785, 848, *per* Ipp J. For further discussion on this exception see E Boros *Minority Shareholders' Remedies* (OUP 1995) 185–189.

[51] Corporate Law Economic Reform Program (CLERP) Proposals for Reform *Directors' Duties and Corporate Governance* (Paper No 3 1997) para 5.3.2.

[52] ibid.

[53] Corporations Law Simplification Task Force *Commentary on Draft Provisions Dealing with Proceedings on Behalf of a Company by Members and Others* (1995).

derivative action in 2000 was unequivocally premised on the objective of encouraging the use of derivative actions. The new procedure includes several features which illustrate the legislator's will to turn the derivative action into a beneficial tool in enforcing corporate accountability. The derivative action is made more widely accessible for prospective plaintiffs through a variety of ways of mitigating the effect of distorted litigation incentives.[54] Finally, in Singapore, the Select Committee clarified that the primary purpose for the inclusion of the derivative action was to provide minority shareholders with greater remedies, thereby strengthening the rights of the minority shareholder.[55]

[54] See discussion in A Reisberg 'Promoting the Use of Derivative Actions' (2003) 24 Company Lawyer 250.

[55] In the first reported decision on the statutory derivative action in *Teo Gek Luang v Ng Ai Tiong and Ors* [1999] 1 SLR 434, 438, Lai Kew Chai J stated that 'such derivative ... actions are intended to improve the standards of private corporate governance since directors who breach their duties to the company could be made accountable'.

4.3 THE DERIVATIVE ACTION AS A CONSTRAINT ON MANAGEMENT MISCONDUCT

So, what role should the derivative action have in corporate governance? A useful starting point is to examine the role that might be taken in relation to public companies.

4.3.1 Public Companies—Constraints and Limitations of other Mechanisms

Let us assume, for the purpose of our discussion, that shareholders in the UK are *not* allowed to bring derivative actions against public companies. Interestingly, such a case exists. The Singapore statutory derivative action applies only in connection with companies that are *not* listed on the Singapore Stock Exchange.[56] So, would it be sensible to follow this?[57] The Singapore Select Committee gave its reasons for the exclusion of the listed company in the following terms:

> The Committee was of the view that the proceedings and performance of public listed companies are already monitored by various regulatory authorities and disgruntled shareholders of such companies have an avenue in that they can sell their shares in the open market.[58]

The arguments in the following pages concern themselves with explaining why the above two objections, properly understood, are in relation to the UK

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[56] The Singapore derivative action is modelled after the statutory derivative action in the Canadian Business Corporations Act and is found in ss 216A and 216B of the Companies Act cap 50. For a critical and comparative examination of the derivative action in Singapore see PKM Choo, above n 47.

[57] This view is merely meant to provide us with a starting point to the theoretical discussion which follows. It is by no means a comparative inquiry.

[58] Report of the Select Committee on the Companies (Amendment) Bill para 45.

incoherent and erroneous respectively. There are at least five strong indications supporting the extension of the applicability of the derivative action to listed companies.

First, to deny the listed shareholder the availability of a statutory derivative action on the basis that he has the option of selling his shares on the market is to ignore the deterrent effect of the action.[59] Perversely, this may actually provide wrongdoers with a perceived sense of immunity.[60] After all, the derivative action's usual raison d'être is 'a form of pleading originally introduced on the ground of necessity alone in order to prevent a wrong going without redress'.[61] Moreover, it is important to remember that the derivative action is a remedy for shareholders who want to *remain* in the company and challenge the wrongdoing by directors.[62] It is not for those shareholders who are disinterested and would prefer to sell their share and exit the company. In any event, sale may not always be the best option, eg if an alleged wrongdoing has depressed share values.

Secondly, the argument that the proceedings and performance of public listed companies are already monitored by various regulatory authorities misses the point. It is easy to see why those whose function it is to represent the interests of large

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[59] See discussion above in ch 2 under 2.3.3.

[60] Recall the powerful words of Lord Denning in *Wallersteiner v Moir (No 2)* [1975] QB 373, 395: 'Some wrongdoers know this and take advantage of it. They loot the company's funds knowing there is little risk of an action being brought against them.'

[61] *Smith v Croft (No 2)* [1988] Ch 114, 185 *per* Knox J.

[62] See eg S Deakin E Ferran and R Nolan 'Shareholders' Rights and Remedies: An Overview' [1997] 2 CFILR 162, 163 (quoting B Hannigan in a panel discussion at a conference on *Shareholders' Rights and Remedies* in Cambridge in April 1997); L Kosmin 'Minority Shareholders' Remedies: A Practitioner Perspective' [1997] 2 CFILR 201, 213; PKM Choo, above n 47, 82.

public companies are likely to resist any changes in the law which might encourage an 'active' market in civil litigation by minority shareholders.[63] The ability of regulatory authorities and agencies to monitor management, however, is necessarily bound by practical, budgetary and perhaps political constraints, as we saw in Chapter 1. While the exclusion can perhaps be justified to some extent by reference to the checks imposed by market forces, as we saw, the effectiveness of market forces, particularly in relation to one-time breaches of duty, is limited. Put simply, the derivative action and, say, the hostile takeover are not substitutes for one another in a public policy sense. It should come as no surprise then that that the move to exclude listed companies from the Singapore statutory derivative action was not without controversy.[64]

Thirdly, although listed companies have widely dispersed shareholdings, inherently the very composition of the board would probably depend on the majority shareholders and it is not inconceivable that the personal preferences, objectives or vision of these shareholders be prioritized at the expense of the minority.[65] It is important, particularly in the case of public listed companies with widely scattered shareholdings where the board is in de facto control, that serious fraud or misappropriation of assets by officers and managers (also below board level) should not be immune from derivative actions.[66] It is possible that the board members may have their own motives for suppressing litigation. In short, dismissal

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[63] Such as the CBI and leading firms of City solicitors. See above ch 3 under 3.1.

[64] See further KY Low 'Minority Shareholder Protection: Major Changes under Singapore Law' (1994) 3 Asia Business Law Review 90.

[65] PKM Choo, above n 47, 82.

[66] A Boyle *Minority Shareholders' Remedies* (Cambridge University Press 2002) 66.

of dishonest officers or senior managers should not be allowed to become the *only* possible remedy.[67]

Fourthly, as more powers in relation to the running of the company were conferred on the management, the shareholder's position in the company was increasingly being relegated to a backseat, simply waiting to receive dividends, if these were declared. With shareholders' hands tied with legal strings, courtesy of *Foss*, an important check on mismanagement was not allowed its full potential. But potential investors must have the confidence that the officers of corporate entities operate them honestly and in the best interests of the shareholders, both majority and minority. If not, they must believe that they can do something about it. It would certainly be too late to make legislative amends if perceived managerial ineptitude and corporate wrongdoing were manifested in the form of a lack of investor confidence. A certain level of shareholder activism ought thus to be encouraged.[68] Inevitably, allowing for increased shareholder activism will foster a new reality that management will have to take greater account of shareholder interests and rights. As Professor Coffee opined more than a decade ago, 'the knowledge that one is being watched and that one must justify one's actions improves the behaviour of most individuals'.[69]

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[67] This state of affairs is even more unsatisfactory in the case of groups of companies. See below under 4.4.4.1 (under B).

[68] PKM Choo, above n 47, 93–94.

[69] JC Coffee 'New Myths and Old Realities: The American Law Institute Faces the Derivative Action' (1993) 48 The Business Lawyer 1407, 1425. See also Cialdini's study referred to in ch 2 under 2.4.1.

Indeed, shareholders have in recent times been taking directors of listed companies to task over issues such as director remuneration and dividend payments.[70] The recent ousting of Michael Green from his planned role at the merged Carlton-Granada group was described in the papers 'as the most naked display of shareholder power for a decade'.[71] These kinds of sentiments lie behind the renewed movement of shareholder activism[72] which has been coming to the fore over the last several years and which reached its zenith with the ousting of Green.[73] In this respect, if the derivative action were seen as a viable option for shareholders, they would potentially have a bigger role in the governance of management and a greater chance of protecting their interests.[74] In the long run, the availability of the derivative action could reduce the need for public enforcement and bureaucratic oversight of corporate conduct.[75] Likewise, private enforcement multiplies society's

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[70] JK Galbraith has recently explained that excessive pay represents the peddling of an 'innocent fraud', as he calls it; The Guardian (August 14, 2004) and his new book, *The Economics of Innocent Fraud* (Houghton Mifflin 2004). Additionally, Galbraith writes about the 'bezzle', describing missing corporate funds—like the ring around the bathtub—that varies in size with the business cycle. The funds tend not to be noticed during times of prosperity, but they come to light when earnings turn downward. When that time comes, we can expect a lot of investor unhappiness and, inevitably, more active actions by shareholders. JK Galbraith *The Great Crash 1929* (1955) (Mariner Books Reprint edn 1997) 137–138.

[71] The Guardian (November 3, 2003). The 2003 AGM season was described as 'stormy and directors' pay was commonly at the epicentre of the storm. Outright rejection of reports was rare but levels of abstentions and 'no' votes were sufficiently large to cause embarrassment in some cases.' E Ferran 'Company Law Reform in the UK: A Progress Report' (March 2005) ECGI - Law Working Paper No. 27/2005 http://ssrn.com/abstract=644203, 27.

[72] See, for example, the growing number of shareholders' associations in the UK in recent times (such as the UK Shareholders' Association (www.uksa.org.uk), Manifest (www.menifest.co.uk) and ProShare (www.proshare.org.uk) who call for such a role by providing shareholders with information on company issues as they come up.

[73] For a discussion of the potential benefits of intervention power for shareholders in the context of corporate decisions see LA Bebchuk 'The Case for Empowering Shareholders' (April 2003) www.law.harvard.edu/faculty/bebchuk/pdfs/2003.bebchuk.empowering-shareholders.pdf (17 January 2004).

[74] PKM Choo, above n 47, 83.

[75] See also American Law Institute *Principles of Corporate Governance and Structure: Restatement and Recommendations* (Tentative Draft No 1 1982) ch 1.

enforcement resources, and probably minimizes enforcement costs, because the private enforcer will be restrained by the fact that it is typically compensated only when successful. There is thus no surprise that the DTI sees the topic of shareholder activism as a natural progression from the reforms of boardroom practice and executive pay that have occupied it for much of the past few years.[76]

A fifth aspect shaping shareholder influence relates to the potential for a much bigger role in corporate governance for the institutional investor, particularly in public companies where the ability of institutional investors to threaten proceedings would seem to be powerful sanction where recalcitrant directors refuse to respond to other forms of pressure.[77] Much has been written and said in relation to the role of institutional shareholders in English law both in terms of their contribution to short-termist English industry rather than long-term planning, and in terms of their contribution to corporate governance.[78] Given the constraints of space, this important subject cannot be discussed in any length. Instead, several brief comments can be made.

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[76] This view seems to underline many of the proposed measures in the recent White Paper: 'Shareholders are the lifeblood of a company, whatever its size. We want to promote wide participation of shareholders, ensuring that they are informed and involved, as they should be'. White Paper *Company Law Reform* Cm 6456 (London: DTI, March 2005) 5.

[77] S Deakin E Ferran and R Nolan, above n 62, 163; AJ Boyle, above n 66, 12–13.

[78] Literature on the subject is voluminous. One of the key aspects of the corporate governance debate is the extent to which institutional shareholders should take, or be required to take, a more active role in monitoring management. See eg Garrido and Rojo 'Institutional Investors and Corporate Governance: Solution or Problem?' in Hopt and Wymeersch *Capital Markets and Company Law* (OUP 2003); J Charkham and A Simpson *Fair Shares – The Future of Shareholder Power and Responsibility* (OUP 1999) ch 13; AR Goobey 'The Responsible Owner in Action' [1999] 2 CGI 115; JE Parkinson, above n 35, 166; PL Davies 'Institutional Investors In The UK' in Prentice and Holland (eds) *Contemporary Issues in Corporate Governance* (OUP 1993); GP Stapledon 'Institutional Investors: What are their Responsibilities as Shareholders?' in JE Parkinson et al (eds) *The Political Economy of the Company* (Hart Publishing Oxford 2000) 195; GP Stapledon Institutional Shareholders and Corporate Governance (OUP 1996).

The argument is that apart from the greater likelihood of a direct return from their efforts, investors with sizeable stakes in a large number of companies may see some advantage by seeking occasionally to hold wrongdoing or inept directors to account.[79] Also, for the institutional investor, the typical 'dumping' response to mismanagement in listed companies would not be a viable option.[80] The sale of large blocks of shares by an institutional investor is very likely to send the wrong kind of signal to the market, resulting in an adverse effect on the share price. To protect their portfolios, therefore, it may be that increased activism on the part of institutional investors would be the only responsible way forward.[81] Institutional dominance of the stock market has been on the rise over the years in the UK.[82] Indeed, it has been acknowledged that there is considerably more institutional activism today than, say, a quarter of a century ago[83] and that this activism is continuing to grow.[84] Like shareholders in American and Canadian companies, a large number of institutional shareholders in UK companies recognize their inability to exit an ailing company and now vote their shares.[85]

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[79] It is unfortunate in this respect that the Court of Appeal in *Prudential* should have sought to discourage such initiatives. See also JE Parkinson, above n 35, 242.

[80] PKM Choo, above n 47, 83.

[81] ibid 84.

[82] J Charkham and A Simpson *Fair Shares – The Future of Shareholder Power and Responsibility* (OUP 1999) ch 13. The CLR found that more than 80% of quoted shares in British companies are controlled by institutional investors. CLR *Final Report* para 6.22.

[83] Though a great deal of this takes place behind closed doors and so is not visible to the outsider observer and it is likewise difficult to measure the frequency of these private, 'behind the scenes' communications. PL Davies *Introduction to Company Law* (OUP 2002) 142; BR Cheffins *Company Law, Theory Structure, and Operation* (OUP 1997) 639.

[84] BS Black and JC Coffee 'Hail Britannia?: Institutional Investor Behavior Under Limited Regulation (1994) 92 Michigan Law Review 1997, 2038–2041.

[85] ibid. In this respect, the National Association of Pension Funds and the Association of British Insurers have made much of the running in extending shareholder activism in the UK. S Deakin and J Cook 'Empirical Evidence on Corporate Control in Literature - Survey on Factual, Empirical & Legal Issues' 10.12.1, http://www.dti.gov.uk/cld.esrc10.pdf (15 March 2002). See also BR Cheffins

In short, institutional shareholders need to be encouraged to litigate in what they deem is an appropriate case to protect their own investors.[86] Fostering institutional activism must be coupled with tackling the impediments to increased shareholder activism as outlined in the recent White Paper.[87] Solutions that can provide for this will ultimately enhance better corporate governance, but more on this later.

4.3.2 Policing Management in Closely Held Corporations

Derivative actions retain also an important role in policing management in closely held corporations.[88] Unlike public corporations, there is no market for a private company's stock or similar constraints on manager's misuse of the centralized power that is given to directors. Ultimately, the fragility of the minority shareholder's position and the insecurity of his interests leave him open to majority abuse. Derivative actions can play an important role in protecting minority shareholder rights in this setting. And although English law caters well for most of the needs of the minority shareholders in private companies, through, for example, the case law on section 459 CA 1985 coupled with developments in the law of just

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'Corporate Governance in the United Kingdom: Lessons for Canada' (1997) 28 Canadian Business law Journal 69, 86; J Holland 'Self Regulation and the Financial Aspects of Corporate Governance' (1996) JBL 127, 132.

[86] See, for example, the US Private Securities Litigation Reform Act (Pub L No 104-67, 109 Stat 737 (1995)). One of its provisions is designed to encourage shareholders with the largest financial interest, usually institutional investors, to play a larger role as lead plaintiffs in derivative actions than they have in the past. Securities Act of 1933 § 27(a)(3), 15 USC § 77z1(a)(3) (Supp 1999).

[87] Above n 76.

[88] This point is discussed fully in ch 7 under 7.3.1 and 7.3.3.

and equitable winding up,[89] it will be seen in Chapter 7, nonetheless, that several important factors combine to ensure that the derivative action has still an important role to play.

4.4 SYNTHESIS—THE FUNCTIONAL AND FOCUSED MODEL

4.4.1 Introduction

It is fruitful to pull together now the various strands of discussion so far. Having established the need for a redefined role for the derivative action in English law, we turn to the methodology to be used in developing the content of this new role in corporate governance. The writer proposes the adoption of what he calls a ***Functional and Focused Model*** **('FFM')** for derivative action litigation. In this introductory section the aims of the model will be set out, followed by an outline and the policy premises.

4.4.1.1 Aims of the model

The FFM builds on the view of the derivative action laid out in Chapters 1, 2 and 3 above and finalized in the preceding sections of this chapter. Its aim is to: (1) simplify procedures and establish a fair and balanced procedure for derivative action litigation; (2) address its core dilemmas, most notably that of properly funding the action and lack of positive inducement to litigate; and (3) closely harness the derivative action to the corporate interest it represents by inviting the court to consider the *public character* of the norms raised by the derivative action.

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[89] See generally A Boyle, above n 66, chs 4 and 5.

The model throws light on the challenges facing minority shareholders. It explains how these problems can be dealt with. It balances the gains and misgivings of litigation as a means to redress wrongs. The FFM developed here focuses, then, on what makes derivative actions *special*. It addresses the procedural complexity of derivative actions and seeks to replace overbroad restrictions on the shareholder's standing to sue with more specifically focused tests to discourage non-meritorious litigation. As will be seen in Chapters 5 and 6, a primary interest of the theoretical inquiry of the FFM is in gaining insight into how the derivative action mechanism shapes the incentives of private agents, namely shareholders and their attorneys, and how these incentives affect the magnitude of the deterrence and compensation effects of the derivative action (the two primary objectives of the action). By doing so, the FFM provides a standpoint from which to judge any future reform. As demonstrated below, the FFM offers novel descriptive insights that significantly enhance the existing understanding of derivative action. These insights, in turn, carry far-reaching implications for designing and implementing welfare-enhancing social policy at legislative, rule-making and judicial levels.

4.4.1.2 Outline of the model

Two words describe the proposed model best: 'functional' and 'focused'. It is functional, for the derivative action should be used only if it serves one of its prime functions, namely deterrence and compensation. By this is meant that the model highlights the functional logic behind the derivative action. It is in this sense that functionalism is a question and not an answer.[90] The 'functional' aspect of the

[90] See the corresponding test proposed below under 4.4.4.4.

inquiry involves closely harnessing the derivative action to the corporate interest it represents by inviting the court to consider the *public character* of the norms raised by the derivative action as set out below. Secondly, the framework that the model develops is also 'focused' in the sense that the litigation should be focused on (1) those areas or instances in which other mechanisms of accountability fail, and (2) the nature of inquiry conducted by the court.

Intertwining these conceptual observations into a cohesive model of derivative actions, the model conceptualizes derivative action law enforcement as a theoretical as well as practical device. More concretely, the model explicates that there is room to develop and put forward a policy of promoting the use of the derivative action, when, and only when, it can further one of its prime functions. This policy of the FFM is based on the value to shareholders of having this 'weapon of last resort' which could benefit them both in the rare instances in which it would be actually used and, more importantly, in the instances in which its mere existence would induce management to act in shareholders' interests.[91] This is not to encourage shareholder litigation for its own sake, but instead to ensure that the exercise of bona fide shareholder power to commence litigation is not discouraged, and also to ensure that the derivative action has a fair chance of reaching its potential as a tool in corporate governance. At the same time, increasing the scope for shareholder intervention in the hope of enhancing corporate accountability is laudable, provided the necessary safeguards are in place. The risk, of course, is that encouraging shareholder involvement may result in increased counter-productive litigation.

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[91] See ch 2 under 2.3.3.1.

In attempting to steer a middle course between excessive reliance on a litigation remedy and judicial recourse for the shareholders on the one hand, and unreasonable interference in the affairs of the company on the other hand, the FFM is particularly sensitive to the danger of over-deterrence and the impact of the potential risk of litigation on the willingness of well-meaning directors to serve, as well as on their conduct as directors.[92] In striking the proper balance, the FFM also recognizes that the derivative action is neither the initial nor the primary protection for shareholders against managerial misconduct.[93] Ultimately, litigation is a failsafe remedy, a safety net for instances when other mechanisms fail.[94] This, in turn, requires a revised, more modest and yet more realistic approach to derivative action litigation in English law. When properly structured, then, the derivative action should enhance the capabilities of other mechanisms of accountability by: (1) ensuring a measure of judicial oversight; (2) providing for a remedy that does not depend upon the ability of widely dispersed shareholders to co-ordinate action; (3) protecting transactions by corporate controllers from unreasonable interference; and (4) increasing deterrence of misconduct or generation of net recoveries (the two primary objectives).

The two major tensions analysed in the preceding discussion, that between the need to make the action effective and the danger of its exploitation and that between the rationales of deterrence and compensation, explain the basic

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[92] See discussion in ch 2 under 2.2.

[93] As explicated in ch 1.

[94] See generally JC Coffee, above n 69.

architecture of this model. The following premises exemplify the model's desire to seek a balance that recognizes the merits on both sides of these issues.

4.4.1.3 Policy premises

The policy premises can be brief and reasonably straightforward:

(1) Deterrence should be recognized as a major benefit of the derivative action. Shareholders have generic interests in the observance by corporate fiduciaries of their duties and such interests may sometimes outbalance their financial interest in a recovery in a specific action.[95] Correspondingly, compensation can also be achieved through a derivative action, even if it will be sometimes insufficient or misdirected.[96] The model seeks to balance and accommodate the two rationales rather than assign a uniform priority to one over the other.[97] This is reflected in the test provided below.

(2) It should be made clear that the deterrent value of shareholder litigation is tied to the public's perception of the value of such litigation. Accordingly, efforts should be made to (a) reverse the negative effects of those forces that weaken the social meaning of derivative actions so that the action is more likely to be viewed as an

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[95] See ch 2 under 2.3.3.1.

[96] See ch 2 under 2.3.2.

[97] See also American Law Institute *Principles of Corporate Governance and Structure: Restatement and Recommendations* (Tentative Draft No 1, 1982) 236.

instrument that affirms desirable norms in the corporate setting,[98] and (b) enhance the public aspect of the derivative action.[99]

(3) The model acknowledges the legitimacy of the company's need to seek the termination of a derivative action that is adverse to its best interests, but also acknowledges the fact that shareholders should not be denied any realistic access to a litigation remedy solely on the basis of their standing. It follows that the scope of the remedy should be confined to and focused on those areas where it is mostly needed. The model recommends procedural safeguards subject to judicial scrutiny.

(4) The screening procedure needs to ensure that it will develop and frame the central issues in the litigation for judicial examination in a manner that is both reliable and efficient. It should lay down clear, balanced and coherent criteria to be met for the grant of leave.

(5) Finally, the model recognizes the critical role of: (a) conditions that may facilitate litigation (eg access to information), and (b) costs and fees as incentives to commence litigation. In response, the FMM puts into operation strategies to resolve the problems of funding and lack of incentives respectively.[100]

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[98] As explained below under 4.4.3.

[99] See discussion in ch 2 under 2.4 and below under 4.4.3.

[100] As set out below in chs 5 and 6.

Before it is possible to reduce the characteristics of the FFM to the contents to be covered by it (as set out in section 4.4.4 below) there are two broad themes underlying the analysis in the following two sections. First, section 4.4.2 attempts to unearth and illuminate the value of deterrence against corporate misconduct. Secondly, section 4.4.3 considers strategies that can be pursued to reverse the negative effects of those forces (as identified in chapter 2) that weaken the social meaning of derivative actions, so that the action is more likely to be viewed as an instrument that affirms desirable norms in the corporate setting. It will be seen that elements discussed in the first three chapters surface again in different guises in subsequent sections below, reinforcing and illuminating what has gone before.

4.4.2 The Value of Deterrence against Corporate Misconduct

4.4.2.1 Introduction

Recall first that a significant value of derivative action arguably lies in its deterrent capacity. Recall also that this is often overlooked in empirical studies because researchers cannot quantify its effects precisely.[101] It will be seen below that while we do not know what percentage of frauds or self-dealing transactions are deterred because of the possibility of being exposed or challenged in shareholder litigation, the probability of detection of corporate wrongdoing is greater when private plaintiffs are able to pursue such actions. This value should therefore be added to the balance sheet on the benefit side of the ledger. Using that lens to focus on potential deterrent or influential conduct, let us look at a few specifics.

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[101] See ch 2 under 2.3.3.1.

4.4.2.2 The deterrence rationale in company law

At least two points must be briefly explained here. The first is that there is nothing unique in assigning a deterrent role to derivative actions as this rationale plays a major part in English company law.[102] One could perhaps be forgiven the assumption that to assert that the derivative action should be seen as dealing with issues at the heart of company law is to assert something trivial and banal. And yet this section wishes to emphasize this proposition, in order to show that it *fits neatly* with current policies shaping English company law.

Take for example the Company Directors Disqualification Act 1986. A major objective of disqualification is to raise standards of conduct among directors generally.[103] The idea is that other directors will be influenced to behave in accordance with the standards which the disqualified director has failed to attain.[104] Put simply, disqualification is concerned with general deterrence.[105] And although

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[102] Deterrence also plays an important part in other areas, most notably, insolvency legislation. White Paper *A Revised Framework for Insolvency Law* (Cmnd 9175 1984) para 2. A salient example is s 214 of the Insolvency Act 1986. The threat of personal liability for the company's obligations, which s 214 creates, does something to provide a counter-incentive for directors. See A Keay, *McPherson's Law of Company Liquidation* (Sweet & Maxwell London 2001), 621–634. Moreover, s 214 can operate at the point of the incorporation (*Re Purpoint Ltd* [1991] BCLC 491, 498) and this theoretically acts as a deterrent against the incorporation of economically non-viable companies. See further DD Prentice 'The Incorporation Theory – The United Kingdom' [2003] EBLR 1, 2.

[103] See eg A Walters 'Directors' Duties: The Impact of the Company Director's Disqualification Act of 1986' (2000) 21 Company Lawyer 110, 115.

[104] ibid.

[105] On whether the deterrent effect of the director disqualification rules has been a success in terms of yielding a net social benefit see eg V Finch *Corporate Insolvency Law* (Cambridge University Press 2002) 536; E Ferran, 'The Role of the Shareholder in Internal Corporate Governance: Enabling Shareholders to Make Better-Informed Decisions' (2003) 4 EBOLR 491, 501-503 and the evidence therein.

different judicial philosophies or rationales can be discerned from the case law,[106] there is no doubt, as Hoffmann LJ held, that Parliament intended mandatory disqualification to serve a wider purpose than simply protecting the public from the disqualified director:[107]

> The purpose of making disqualification [under section 6] mandatory was to ensure that everyone whose conduct had fallen below the appropriate standard was disqualified for at least two years, *whether in the individual case the court thought that this was necessary in the public interest or not.* Parliament has decided that it is occasionally necessary to disqualify a company director to encourage the others (emphasis added).

This quotation is reproduced in full to highlight a simple point: a similar reasoning is used by the American judiciary to justify the deterrence objective in derivative actions.[108]

The second point is that because it is accepted that derivative actions are obsolete, the law turns to other means, at times less adequate. For example, broadly speaking, a company commits an offence if it gives unlawful financial assistance and, inter alia, is liable to a fine.[109] Arguments for imposing criminal as well as civil sanctions on directors for unlawful assistance include their deterrent effect, but

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[106] See discussion in V Finch ibid 522–523 and by the same author 'Disqualifying Directors: Issues of Rights, Privileges and Employment' (1993) Industrial Law Journal 35.

[107] In *Re Grayan Building Services Ltd (In Liquidation)* [1995] Ch 241, 253. Deterrence is emphasized in other cases such as *Re Swift Ltd Secretary of State for Trade and Industry v Ettinger* [1993] BCLC 896; see further A Walters and M Davis-White *Directors' Disqualification: Law and Practice* (Sweet & Maxwell London 1999) especially chs 2 and 4.

[108] For example, in *City of Riverside v Rivera* 106 S Ct 2686 (1986) a derivative action was allowed to continue, even in the absence of profits for the company in question, on the grounds that the public benefits in such actions outweigh its private benefits.

[109] s 151 (3) CA 1985. Every officer of the company who is also in default is also guilty of a criminal offence: ss 151–158 CA 1985.

also the existence of 'structural and commercial factors that may inhibit companies from commencing litigation against their officers',[110] because 'it is notoriously difficult for shareholders to establish standing with this type of claim'.[111] In other words, the law turns to these alternative means, partly because the derivative action *is not a viable option*! So, following this logic, if proposals aimed at diffusing problems and flaws identified in the initiation of these actions can be put forward, then, theoretically, making derivative actions a viable option may also mean that (1) there might be less need to employ these, arguably, less than adequate penalties (at least not to the same extent);[112] and (2) the derivative action may, in turn, be used as a legitimate corporate governance tool to redress the concerns with issues raised above.

4.4.2.3 'Private' remedies or 'non legally enforceable norms'

A somewhat overlooked benefit of the deterrence aspect of the derivative action relates to the impact it may have internally on the company subject to the litigation.[113] US case law has recognized that when the the derivative action is dismissed (for whatever reason), the plaintiff may have nonetheless conferred a

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[110] E Ferran *Company Law and Corporate Finance* (OUP 1999) 403.

[111] ibid.

[112] This, in turn, raises another question, namely why derivative actions are preferable over, say, criminal penalty (usually in the form of fines). On the concerns over the ineffectiveness of criminal law in combating company fraud see eg GR Sullivan 'Restating the Scope of the Derivative Action' [1985] CLJ 236, 238 and the references therein; JE Parkinson, above n 35, 354–361; LE Ribstein 'Market vs Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002' (28) Journal of Corporation Law http://ssrn.com/abstract=340521; R Romano 'The Sarbanes-Oxley Act and the Making of Quack Corporate Governance' Yale ICF Working Paper No 04-37 http://ssrn.com/abstract=596101 (12 February 2005).

[113] A growing area of corporate law scholarship in the US considers the dissonance between the relationship of company law and modern commercial and corporate practices which leaves a vacuum. Arguably, this is currently filled by the adoption of private remedies. See generally Symposium 'Norms and Corporate Law' (2001) 149 University of Pennsylvania Law Review 161; Symposium 'Social Norms, Social Meaning and the Economic Analysis of Law' (1998) 27 JLS 537.

benefit on the company.[114] Such a benefit can arise when internal remedies or reforms are instituted following the litigation. This may include the departure of key personnel who may have been involved in alleged wrongdoing, or structural reforms such as non-cosmetic organizational reform, provision for a review of compensation practices, or modifications of compensation plans. We illustrate next why, arguably, there would be such a benefit.

Assume shareholder A brings a meritorious derivative action against director B who sits on the board of company C alleging material self-dealing by director B. Further assume that after an initial court hearing, the action is not allowed to proceed by the court, say because the court believes the shareholder will not be able to represent the company properly. By that time, however, alerted by the allegations, the board investigates the matter further and reaches a settlement with director B. Alternatively, the board takes internal corrective or disciplinary action (ie suspension from taking part in board meetings and reduction in remuneration). Either way, it can be presumed that shareholder A has 'caused' the settlement or corrective action by alerting the board of company C. Arguably then, even if an action is unsuccessful at the end of the day, it may nevertheless induce or push for some positive measures from the point of view of better governance. This may also have a forward-looking benefit in the form of future protection and avoidance of continuing abuse.[115] Viewed in this way, shareholder A has rendered a substantial service to the governance of company C, its shareholders and the class of

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[114] See eg *Lewis v Anderson* 81 FRD 436, 439 (SDNY 1978); *United Operating Co v Karnes* 482 F Supp 1029 (SDNY 1980).

[115] Both internally in the particular company and for the benefit of all shareholders in the market, in part because shareholders hold diversified portfolios and will benefit from the decision's impact on other companies. See ch 2 under 2.3.3.1.

shareholders generally. Arguably, shareholder A in our example, could have alerted the board without the need to resort to costly litigation. However, the point here is that the threat of the action itself and, say, the adverse publicity it might entail, have prompted the board to introduce corrective measures. It is doubtful whether, without the threat of the action, such drastic measures or corrective actions would have been introduced in the first place.

Although it would not always be easy to pinpoint that any resulting benefit to the company was causally related to the derivative action, a recent example involving Allied Irish Banks Plc ('AIB') in the City of Baltimore Circuit Court, Maryland, illustrates what may be the consequences when it does.[116] For present purposes, it is not necessary to repeat the complex sets of events; it is only relevant to note that in February 2002 it was discovered that substantial losses were incurred during the period 1997 through 2002 by the unauthorized currency trading activities of an employee of AllFirst Bank (a subsidiary of AIB). Media attention prompted an investigation which was authorized by AIB management, designed to establish the sequence of events and to consider questions regarding management infrastructure, governance and oversight mechanisms in the group. The investigation eventually led to a report on this matter which was made available to the public.[117] However, some US holders of ADRs (American Depository Receipts) were not satisfied either with the actions of the management of AllFirst, nor were they satisfied with the actions of the Board of AIB in relation to the fraudulent activities of individual traders at AllFirst. Accordingly, a company known as

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[116] See further I Lynch Fannon, above, n 6.

[117] See further www.aib.ie.

Tomran Inc (a holder of ADRs in AIB) filed a derivative action on behalf of AIB against the current and former directors of Allfirst Bank and against Allfirst Bank to recover losses caused to the company arising from this trading. The first hurdle (that of *locus standi*) turned out to be the last, as the standing of the beneficial owner was fatal to its claim. The derivative action was dismissed.[118] However, the response of the Board of AIB following the litigation included rigorous structural changes and prompted the departure of key personnel. It also induced behavioural changes. The point ought by now to be clear. The derivative action added to the deterrence. The critical point here is that it accomplished intrinsic benefits which corrected an abuse which would have been prejudicial to the rights and interests of the company or would have affected the enjoyment of protection of an essential right to the shareholder's interest.[119]

4.4.2.4 Infrequency of proceedings

There is an important point to be made now. Recall that the UK does not have nor, despite proposed reforms to the derivative action,[120] is it likely in future to have a large number of derivative actions.[121] In Canada, where the statutory derivative action has been operative for many years, there has not been an abundance of cases in the area, although there have been some important cases. Canadian writers have

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[118] The substantial difficulties encountered in the case are discussed in I Lynch Fannon, above, n 6.

[119] See also *Bosch v Meeker Cooperative Light & Power Association* 257 Minn 362, 101 NW 2d 423 (1960).

[120] As the recent White Paper acknowledged it is possible but unlikely that putting derivative actions on a statutory footing will affect the low number of cases brought. White Paper *Company Law Reform* Cm 6456 (London: DTI, March 2005) Annex A, 277.

[121] See eg JC Coffee 'Privatization and Corporate Governance: the Lessons from Securities Market Failure' (1999) 25 Journal of Corporation Law 1 (noting the sharp contrast between the UK and US in shareholder enforcement); E Ferran 'Company Law Reform in the UK' (2001) 5 Singapore Journal of International and Comparative Law 516.

therefore opined that the statutory derivative action has failed to make a dramatic practical impact.[122] Focusing on the infrequency of proceedings may, nonetheless, portray an overall misleading picture. It is not necessarily a flaw that there may in practice be few cases brought under the derivative action jurisdiction.[123] In fact, this is in line with the very nature of the derivative action, as is explained next.

First and foremost, recall that a derivative action is an action that should only be brought in exceptional circumstances. The principle underlying the limitations on the derivative action, that generally the company is the proper plaintiff and that only in exceptional circumstances cases should shareholders be able to sue on its behalf, is a sound one.[124] No one would welcome a change in the law which opened the floodgates to corporate litigation. The real problem with the law as it stands at present is that, although in theory it contains a derivative action, the rules relating to it have become so uncertain and obscure that no one can predict with much confidence when such an action will be allowed to proceed, if at all.[125] This means that the success of any replacement would best be judged *not* by the quantity of the case law generated under the new procedure, but by whether the rules governing the circumstances in which such an action may be brought were made more *comprehensible* and *accessible* so that, in exceptional circumstances, the commencement of a derivative action was regarded as a remedy worth pursuing instead of being ruled out at an early stage of a dispute as being far too difficult

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[122] BR Cheffins and J Dine 'Shareholder Remedies: Lessons from Canada' (1992) 13 Company Lawyer 89, 94.

[123] S Deakin E Ferran and R Nolan, above n 62, 164; PKM Choo, above n 47, 81.

[124] See ch 3, nn 9–16 and accompanying text.

[125] S Deakin E Ferran and R Nolan, above n 62, 164.

even to contemplate.[126] This last point is indeed confirmed by the view of one practitioner.[127]

Secondly, given the deterrence objective of the action, a positive interpretation could be that the evidence in Canada indicates that the action is *indeed working*! A low number of actions litigated is not necessarily an indication that the derivative action is failing to make an impact. In fact, if the courts had been swamped with derivative applications, the fear expressed by the UK Law Commission and others that the availability of the action would enhance the scope for involving companies in futile and disruptive litigation[128] would certainly have been vindicated.[129] There will always be frauds and corporate malpractice. The law has not eliminated these, nor will derivative actions or any other mechanism of corporate governance. It is nevertheless likely that the derivative action, if perceived as a potent threat and if freed of its procedural handcuffs, may have an effect on those involved in corporate governance and, over the long run, may change their values and the ways in which they go about their tasks. There will be cases where such proceedings prove justified as a technique of redressing serious corporate abuse 'on the ground of necessity alone in order to prevent a wrong going without redress'.[130]

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[126] ibid 165.

[127] Kosmin suggests that the average practitioner often gives up in despair and turns to alternative routes, not always successful ones, and that the Law Commission's description of the law in this area as being virtually inaccessible save to lawyers specializing in the field is being too generous. L Kosmin, above n 62, 212–213.

[128] For a firm advocate of this view see eg C Hale 'What's Right with the Rule in Foss v Harbottle?' [1997] 2 CFILR 219, 226.

[129] See also PKM Choo, above n 47, 81.

[130] *Smith v Croft (No 2)* [1988] Ch 114, 185, *per* Knox J.

Finally, that the infrequency of proceedings is probably not an accurate pointer to the effectiveness of the derivative action can also be seen from the experience with wrongful trading actions.[131] The available evidence indicates a relatively low number of wrongful trading petitions, especially compared with disqualification proceedings.[132] There are different views about the extent to which section 214 has been a success.[133] At the same time, although there has not been an abundance of cases in the area, there have been some important ones.[134] More importantly, it has been suggested that the infrequency of proceedings is probably not an accurate pointer to the effectiveness of the provisions.[135] In many situations the wrongful trading provisions are operating on the minds of directors who will have been warned about the dangers they face once the company becomes insolvent.[136] It can be seen then that the legislation presents an important theoretical limitation on the otherwise prevalent doctrine of limited liability. And there is no reason to assume that the same incentives could not present themselves with respect to derivative action litigation. In fact, almost twenty years ago, Sullivan argued that

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[131] Under s 214 IA 1986. See also the stimulating discussion on what is generally the socially optimal level of litigation given its expense and how it compares to the privately determined level of litigation in S Shavell 'The Level of Litigation: Private Versus Social Optimality' John M Olin Center for Law, Economics, and Business Harvard Law School (Discussion Paper No 184 June 1996).

[132] See evidence in R Mokal 'An Agency Cost Analysis of the Wrongful Trading Provisions' [2000] CLJ 59. It is estimated that disqualification cases are now reaching a figure of 1,500 per year. See A Hicks 'Wrongful Trading – Has it been a Failure?' (1993) 9 Insolvency Law and Practice 134; R Perry and D Milman 'Transaction Avoidance Provisions in Corporate Insolvency: An Empirical Study' (1998) 14 Insolvency Law and Practice 280.

[133] See eg B Pettet *Company Law* (Harlow Longman 2001) 39; F Oditah 'Wrongful Trading' [1990] LMCLQ 205; R Mokal ibid.

134 eg *Re Produce Marketing Consortium Ltd (No 2)* [1989] BCLC 520; *Re Hydrodam (Corby) Ltd* [1994] 2 BCLC 180; *Re Sherborne Associates Ltd* [1995] BCC 40; *Re Brian D Pierson (Contractors) Ltd* [2000] 1 BCLC 275.

[135] B Pettet *Company Law* (Longman Harlow 2001) 39.

[136] ibid.

Vinelott J's judgment in the first instance in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*,[137] if rightly understood at the time, could have increased the potential efficacy of the derivative action in relation to particular instances of misconduct and as a general deterrent.[138]

4.4.2.5 A note on insurance and indemnity

At least two final points must be explained here. Note first that although the FFM recognizes that the real benefit of the derivative action is more likely to lie in the deterrence rationale rather than the financial recovery it yields, it by no means seeks to maximize deterrence. Only a system that restricted insurance or invoked punitive damages[139] for knowing breaches of duty could conceivably deter in terms of the traditional logic of deterrence.[140] We stop short of such an attempt here. Still, some deterrence is better than no deterrence at all, particularly in a world where other market, social and cultural forces also play a restraining role.[141] Secondly, the deterrent threat of the derivative action may arguably be undercut to some extent in cases where the company has, at an earlier stage, bought the director insurance against liability for breach of duty. In 1989 section 310 CA 1985 was amended so as to permit such insurance to be purchased at the company's expense and for the

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[137] [1981] Ch 229.

[138] In particular, Sullivan argued that it is open for future courts to build on this analysis as a valuable means towards increasing the accountability of corporate controllers. GR Sullivan 'Restating the Scope of the Derivative Action' [1985] CLJ 236, 239.

[139] Such as the US where they are common. Until recently, punitive damages were rarely if ever used in the UK, although there is now some evidence of a potential drift towards 'punitive' approaches to regulation in the UK where greater emphasis is placed on criminal sanctions. R Baldwin 'The New Punitive Regulation' (2004) 67 MLR 351.

[140] See above ch 2 under 2.3.3.3.

[141] As highlighted in the discussion in ch 1. See also JC Coffee, above n 70, 1440.

benefit of the director.[142] However, although such insurance has the unattractive feature of shareholders paying to protect their representatives against the consequences of wrongs done by those representatives to the company,[143] it is important to remember that such insurance is *not* available in respect of wrongdoing *intentionally* aimed at the company and such insurance is, in fact, unlawful as contrary to public policy.[144] Similarly, as well as or instead of buying insurance against liability for breach of duty, section 310(3)(b) CA 1985 permits the company, on a particular occasion, to indemnify the director against the costs of defending an action for breach of duty, but only if the director is found *not* liable.[145] A consultative document from the DTI, published in December 2003, raised the possibility of relaxing the law so as to put directors and auditors into a more favourable position.[146] However, eventually the Government relaxed the law on

[142] CA 1985 s 310 (3) (a). In the absence of such insurance it is obviously extremely difficult to attract good directors to a public company and, indeed, such purchases are now commonplace. See B Hannigan *Company Law* (Butterworths London 2003) 198 and the references cited therein. On the recommendations of the CLR on this issues (broadly the retention of these provisions) see CLR *Final Report* para 6.3; *Developing the Framework* para 3.74.

[143] The sale of liability insurance raises a basic problem. The risk against which liability coverage protects its holders is having to pay legally mandated sanctions. And because the purpose of legal sanctions is, in significant part, to discourage and to punish unwanted behaviour, the fundamental issue arises whether liability insurance might undermine the effect of the law and thus be socially undesirable. See further S Shavell 'On the Social Function and the Regulation of Liability Insurance' (March 2000) Geneva Papers on Risk and Insurance Theory http://ssrn.com/abstract=224945 (21 March 2003).

[144] PL Davies, above n 83, 195–196. From a director's point of view, it is also worth bearing in mind that insurance cover does not reduce the negative reputational implications of a liability claim. Although in the past liability claims brought by or on behalf of companies against their directors were rare, Hirt reports that there were about 25 reported cases concerning such liability claims in the main law reports between January 2002 and August 2003. These included at least two derivative actions, namely *Bracken Partners Ltd v Gutteridge* [2003] EWHC 1064 and *Konamaneni v Rolls Royce Industrial Power (India) Ltd* [2002] 1 WLR 1269. HC Hirt 'The Company's Decision to Litigate against its Directors' (2005) JBL 159.

[145] s 309A of the Companies (Audit, Investigations and Community Enterprise) Act 2004 (pt I c 3) (provisions protecting directors from liability).

[146] *Director and Auditor Liability*: A Consultative Document (December 2003) discussed in E Ferran 'Company Law Reform in the UK: A Progress Report' (5 November 2004) http://ssrn.com/abstract=644203 (15 January 2005) and M Hammill and C Jones 'Review of Issues Raised in the Government's Consultation on Directors' Liability' (2004) 15 ICCLR 309, 312.

indemnification of directors only to the extent of permitting companies to indemnify directors in respect of most liabilities to third parties and to pay directors' legal costs upfront, provided that the director repays if he is convicted in any criminal proceedings or judgment is given against him in any civil proceedings brought by the company or an associated company.[147]

4.4.3 Enhancing the Social Meaning of the Derivative Action

In Chapter 2 we observed that the derivative action as currently structured and conducted does not achieve its full utility in controlling management behaviour. More specifically, we saw that ambiguity and tying the action to a failed objective currently weaken the social influence of the action in English law,[148] whereas the procedural requirements that fostered court screening of the action's merits as well as the control of settlements are two important features which enhance the social meaning of the action.[149] This section briefly considers strategies that can be pursued to reverse the negative effects of those forces that weaken the social meaning of derivative actions, so that the action is more likely to be viewed as an instrument that affirms desirable norms in the corporate setting.

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[147] s 310 has now been reformed by c 3 of the Companies (Audit, Investigations and Community Enterprise) Act 2004, which came into force on 6 April 2005. The 2004 Act inserts new ss 309A, 309B, 309C and 337A into the CA 1985, and retains s 310 to cover auditors only. See also the White Paper *Company Law Reform* Cm 6456 (DTI London March 2005) s 3.3.

[148] ch 2 under 2.4.2.1 and 2.4.2.2.

[149] ch 2 under 2.4.3 and 2.4.4.

4.4.3.1 Reorienting the judiciary's focus—confirming the public nature of derivative actions

Thus far we have seen that because the interests of the shareholders and the company may diverge, actions often seem to be concluded in a way which does not command public respect for the case brought or the process.[150] The expressive value of the derivative action is thus diminished. The most apparent error English courts make in this respect is elevating the *private effects* of the case over *deterrence* in defining the mission of the derivative action.[151] A useful step for more closely harnessing the derivative action to the corporate interest it represents is to invite early consideration by the court of the *public character* of derivative actions. Put simply, courts should reverse their orientation so that their examination of the derivative action emphasizes the *public character* of the norms raised by the derivative action. Useful guidance in implementing the purpose of this new emphasis will be provided below. Before that it is perhaps useful to illustrate why the judiciary is capable of such a change. The most obvious thing to point out is that although judicial pronouncements and case law doctrines illustrate that judges are cautious about intervening in company affairs, this does not mean that a court will always stand aside.[152] There are situations in which it is necessary to require judicial intervention in enforcing shareholder rights.[153] One circumstance where the judiciary takes a different approach is where the conduct involved is fraudulent,

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[150] Above n 148.

[151] See eg the Court of Appeal's refusal to endorse the public spirit of the plaintiffs in bringing the action in *Prudential Assurance* [1982] 1 Ch 204.

[152] BR Cheffins, above n 83, 316.

[153] See eg C Baxter 'The Role of the Judge in Enforcing Shareholder Rights' [1983] CLJ 96, 110.

dishonest or otherwise tainted by self-interest.[154] With cases involving such behaviour, the courts are less hesitant to intervene. This approach is consistent with the nature of the expertise that judges bring to company law cases. While judges may not have a background which leaves them well positioned to scrutinize conventional corporate policy-making, they are better situated when the conduct in question is deceitful, underhanded or self-serving.[155] Secondly, the judiciary is more likely to drop its cautious approach to company law matters when Parliament has legislated in relation to an area and has indicated that the court should be willing to step into the breach.[156] Section 214 IA 1986 has prompted the judiciary to evaluate directors' conduct more closely than has traditionally been required.[157] Another legislative innovation which has caused the judiciary to take a more interventionist approach in evaluating the level of care, skill and diligence used by directors is Parliament's expansion of the power of the courts to disqualify individuals from serving as a director.[158] Focusing on derivative actions alone, then, gives an inaccurate picture of judicial activism in the corporate field in the UK. The large number of unfair prejudice and disqualification cases provides plenty of examples of judges fashioning and developing the law to fit contemporary conditions.[159]

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154 Essentially, the primary alleged claims in derivative actions. See above ch 2 under 2.4.2.1.

155 BR Cheffins, above n 83, 316–317.

156 ibid 318.

157 ibid 319.

158 See the Company Directors Disqualification Act 1986. *Re Barings Plc (No 5)* [1999] 1 BCLC 433, a disqualification case, is widely acknowledged as the leading modern authority on the duty of care of directors. Recent commentary is voluminous. See eg A Walters 'Directors' Duties: The Impact of the Company Director's Disqualification Act of 1986' (2000) 21 Company Lawyer 110, 115; 'Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties' (Law Commission Consultation Paper No 153); C Riley 'The Company Director's Duty of Care and Skill: The Case for an Onerous but Subjective Standard'(1999) 62 MLR 697; J Bird 'The Duty of Care and the CLERP Reforms' (1999) 17 CSLJ 141.

159 E Ferran, above n 122. See ch 7 below.

Indeed, perhaps the boldest change has been with petitions under section 459 CA 1985, where the courts have on the whole shown greater willingness to step in to resolve internal company disputes. This approach has been generous and purposive, and in keeping with a current move to greater scrutiny of internal management.[160] These are particularly important developments because, as will be seen in Chapter 7, there is no doubt that breaches of duty susceptible to the derivative action are now capable of constituting unfairly prejudicial conduct.[161] So, the success of section 459 has been as much due to a transformation in judicial attitudes as to its revised wording. There was perhaps something of an awareness on the part of the judges that they were on trial, and that it was important not to be seen to kill off the remedy with the same zeal and thoroughness as had characterized their predecessors' approach.[162] In this respect, it is perhaps unfortunate that although the Law Commission's proposals hold out the possibility of greater levels of enforcement of directors' duties,[163] the Law Commission itself evidently approves of the policies which underline the present restrictive standing rules for individual shareholders.[164] And if the court simply transfers those policies from the common law to their interpretation of the discretion conferred upon them, then the changes brought about by the reform will be limited.[165]

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[160] See also B Hannigan 'A Code of Conduct for the Quasi-Partnership' (1988) LMCLQ 60.

[161] ch 7 under 7.3.2.

[162] See eg LS Sealy 'Shareholders' Remedies in the Common Law World' [1997] 2 CFILR 172, 176, 177.

[163] Especially breaches of the director's duty of care which are excluded currently from the scope of the derivative action. See below under 4.4.4.1.

[164] Report para 6.13.

[165] PL Davies, above n 83, 250–251.

4.4.3.2 Providing adequate incentives to shareholders

There is great value in providing 'positive and 'negative' incentives—'sticks and carrots'—for shareholders to take action on behalf of the company. The 'stick' currently exists in the form of the discretion provided to the court and the need to satisfy procedural requirements prior to granting leave to bring an action. As will be seen in Chapter 5, the company may be ordered to pay the costs of the litigation, but that does not in itself produce a positive incentive to sue. So a way must be found to provide 'carrots' that would ensure that shareholders would have some hope of receiving a personal benefit if the action is successful, but more on this later.

The Functional and Focused Model—

Part II: Procedural and Substantive Aspects

4.4.4 Introduction

We are finally in a position to address the central issue of this chapter. The key characteristics discussed so far can finally be reduced to a number of practical recommendations to be included in the FFM. Although the FFM does not seek to make a comprehensive identification of all the matters governing derivative action litigation, it identifies *key areas* for review which are germane for preserving the derivative action as a mechanism of accountability and address its major flaws. Combined together, the areas discussed below- namely, (1) the nature of cases arising under the derivative action (section 4.4.4.1); (2) who may be qualified to bring a derivative action (4.4.4.2); and (3) formulating an expeditious screening mechanism (4.4.4.3) - set guidelines for designing effective regulatory measures where derivative actions are used to enforce the law.

4.4.4.1 Nature of cases arising under the derivative action

A useful starting point is to ensure that the measures governing the derivative action should *not* restrict the use of the remedy to any particular type of company and should *not* place any explicit limits on the type of conduct which can be the subject matter of litigation.[1]

[1] cf the Canadian statutory action, which was cited as a model for the Law Commission's proposed framework. Consultation Paper 165. See generally BR Cheffins 'Reforming the Derivative Action: The Canadian Experience and British Prospects' [1997] 2 CFILR 227, 241–243.

A. Type of conduct

In theory, the types of causes of action which should be the subject of the derivative action should be as wide as possible so as to persuade shareholders, in appropriate circumstances, to utilize this remedy. As noted earlier, the Law Commission proposed that the power of the individual shareholder to bring a derivative action would be extended to all breaches of directors' duties, whether ratifiable or not, provided the shareholders in general meeting had not actually ratified a ratifiable breach or had decided not sue in respect of it.[2] But given our discussion above in relation to the problems associated with objectivity and the practicality of the general meeting to take such decisions,[3] coupled with the fact that the law is in considerable disarray as to what breaches may be ratified by shareholders,[4] there is no reason why ratification should be allowed to remain a deciding factor.[5] Instead, it is proposed that shareholders should be able to apply for leave of the court *irrespective* of whether a breach is ratifiable or whether ratification *has* taken place.[6] If the experience in Canada is anything to go by, there will only be a handful of cases where a judge needs to take into account shareholder approval of impugned conduct in determining whether to grant leave.[7] It must be of some significance then

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[2] Report, paras 6.38–6.41 accepted substantially by the CLR, which proposed also that whether or not ratification is effective will depend on whether it had been effected without the support of the wrongdoers or those under their influence. CLR *Final Report* para 7.46. It is unclear whether this approach will help clarify the law on ratifaction. See B Hannigan *Company Law* (Butterworths London 2003) 464–465.

[3] ch 3 under 3.2.2.

[4] See discussion in ch 3 under 3.2.2.1.

[5] See further A Boyle *Minority Shareholders' Remedies* (Cambridge University Press 2002) 76–78.

[6] See s.237 of the Corporations Act in Australia; s.198 of the Israeli Companies Act 1999; s.165 of the New Zealand Companies Act 1993; s.242(1) of the Canadian Business Corporations Act 1985.

[7] In which case the weight to be attached to ratification seemingly can range from none to a lot depending on the level of involvement of the defendants and whether they control the company. BR Cheffins, above n 1, 254–255 and the cases cited therein.

that the rigid approach taken to actual ratification has not been adopted in most commonwealth and other legislation.[8]

Turning to the type of causes of action which should be the subject of the derivative action, it is interesting to note that the Law Commission's proposal clearly holds out the possibility of greater levels of enforcement of directors' duties, especially breaches of the director's duty of care, which are excluded currently from the scope of the common law derivative action.[9] So, why this sudden change of heart? The Law Commission explained that there is no reason why directors should shelter behind the procedural rule of *Foss*. It also observed that well-organized and competent companies run by directors who know and follow their respective duties have nothing to fear from this advance. And as for the common argument of increased litigation, this is dismissed as 'overstated'.[10]

But there is a much more fundamental question here: why has the law treated claims raising the duty of care so dissimilarly from claims raising the 'duty of loyalty'?[11] The standard academic answer has been that judicial competence is lesser in the former case, and thus the prospect of judicial error is greater in cases

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[8] S Watkins 'The Common Law Derivative Action: An Outmoded Relic?' (1999) 30 Cambrian Law Review 40; A Boyle, above n 5, 78.

[9] cf *Daniels v Daniels* [1978] Ch 406, 414 with *Pavlides v Jensen* [1956] Ch 565.

[10] Report paras 6.38–6.41.

[11] By 'duty of loyalty' the writer means to describe all the fiduciary duties to control management conflicts and limit the risk of managerial diversion of assets or information as used in R Kraakman PL Davies et al. *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2004) 114.

where a conflict of interest is absent.[12] Clearly, when a business decision proves erroneous, multiple explanations for that failure are possible. It could be that the decision-maker was negligent but, conversely, the truth may be that a risk that was accepted knowingly and prudently simply came to an unfortunate fruition.[13] Or, it could be that a new and unforeseeable risk arose and matured after the time the business decision was irrevocably made. Because business decision-making involves unavoidable trade-offs between risk and return, some prudent decisions will prove disastrous. Examining these decisions with the 20/20 vision of judicial hindsight, courts may be unable to distinguish accurately lack of care from statistical bad luck. If this risk of judicial error is considerable, then to the extent the derivative action is relied upon to enforce the duty of care it may deter legitimate risk-taking by management and service on the board, rather than negligence.[14]

In contrast, conflict situations involving self-serving behaviour are more likely to be culpable and at the expense of corporate interest. The possibility of non-culpable error is therefore much smaller. When a fiduciary fails to disclose a conflict of interest to disinterested directors, the chances are much greater that the fiduciary did so opportunistically, not innocently.[15] Self-dealing is seldom unavoidable in the same manner as business risk. With the exception of remuneration decisions there usually is another party with whom the company

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[12] H Damsetz 'A Commentary on Liability Rules and the Derivative Suit in Corporate Law' (1986) 71 Cornell Law Review 352; K Scott 'Corporation Law and the American Law Institute Corporate Governance Project' (1983) 35 Stanford Law Review 927.

[13] JC Coffee 'New Myths and Old Realities: The American Law Institute Faces the Derivative Action' (1993) 48 Business Lawyer 1407, 1426–1427.

[14] See ch 2 nn 18–22 and accompanying text.

[15] For a stimulating account of the fiduciary obligation see P Birks 'The Content of Fiduciary Obligation' (2000) 34 Israel Law Review 3.

could have transacted on similar terms. Conflicts of interest are something that courts have a long history of policing,[16] and unlike the duty of care, they do not require courts to evaluate risk and return trade-offs with which they are uncomfortable[17] and inexperienced.[18] In fact, legal scholars substantially agree on the idea that judicial review of loyalty cases does not seem to entail costs outweighed by its benefits, because the task before the court is one for which it is well suited, so the costs of inquiry and error are sufficiently low.[19] Further, in the case of duty of loyalty violations, the likelihood of detection is lower, and the magnitude of the expected gain is higher. Not only can self-dealing be concealed, but it tends to become self-perpetuating. Once a manager has engaged in one unfair self-dealing transaction, there is less social or moral inhibition to dissuade that manager from engaging in similar transactions. In addition, other managers may detect the self-dealing behaviour and emulate it. In short, unlike simple incompetence, self-dealing can be contagious and can corrupt the organizational culture. Given this greater likelihood that undetected self-dealing will lead to recidivism, the deterrent gains from a derivative action contesting breach of the duty of loyalty seem greater.[20]

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[16] See eg *Aberden Rly Co v Blaikie Bros* (1854) 1 Macq 461; *Motivex Ltd v Bulfield* [1988] BCLC 104.

[17] *Pavlides v Jensen* [1956] Ch 565, 576 *per* Danckwerts J.

[18] JC Coffee, above n 13, 1427.

[19] See eg L Enriques 'The Law on Corporate Directors' Self-Dealing: A Comparative Analysis' (1998) http://ssrn.com/abstract=135674; F Easterbrook and D Fischel *The Economic Structure of Corporate Law* (Harvard University Press Reprint edn 1996) 103; RB Thompson 'The Law's Limits on Contracts in a Corporation' (1990) Journal of Corporation Law 377, 408.

[20] JC Coffee, above n 13, 1427–1428.

Whatever the case may be, if the experience in Canada and the US is anything to go by, the actions which plaintiffs have sought to bring have typically been based on allegations of self-serving conduct carried out by the company's directors.[21] A recent empirical study of shareholder litigation in Delaware confirmed these results. As **Table 4-2** illustrates, more than 58% of the derivative action cases (128 out of 218) allege management self-dealing, that is, improper benefits to managers.

Table 4-2 – Claims Raised in Derivative Action Cases in Delaware[22]

Allegations in Complaint	**Public Entity Defendant**	**Private Entity Defendant**	**Total Number of Cases**
Self-Dealing and Benefits to Managers	97	31	128
Duty of Care[23]	31	1	32
Oppression to Minority	2	19	21
Charter Amendment	7	0	7
Misleading Statement	5	0	5
Other Allegations	15	10	25
Total Non-Acquisition Cases	157	61	218

[21] For Canada see BR Cheffins, above n 1, 241–243 and the evidence therein; For the US, see JA MacKerron 'Shareholder Derivative Litigation and the Nexus of Contracts Corporation (1992) 40 Kansas Law Review 679, 685.

[22] Source: R Thompson and R Thomas, 'Shareholder Litigation: Reexamining the Balance between Litigation Agency Costs and Management Agency Costs' Vanderbilt University Working Paper Number 02-10, 4 http://ssrn.com/abstract_id=336162 (13 January 2004) 65.

This was the largest empirical study of shareholder litigation in the US and consisted of more than 1000 corporate duty cases filed in the Delaware Chancery Court in 1999 and 2000. Arguably, Delaware is the best forum to study shareholder litigation because it has the most active of any state courts in the US with arguably the strongest corporate law judges.

[23] In these derivative actions, the plaintiffs are claiming that managers have not kept adequate financial records, or have failed to supervise properly the operation of the company.

The researchers concluded that there is little indication that derivative actions are playing much role in policing duty of care issues relating to the ongoing management of companies, but instead show a dominant focus in Delaware in policing conflicts of interests.[24] In this regard, derivative actions play a role in reducing management agency costs. This evidence, of course, is hardly applicable to the UK. However, at least it is not inconsistent with the theory presented above. But more important, the same pattern is evident in Canada, which has more in common with the UK from a structural viewpoint.[25]

B. Multiple derivative actions

The modern tendency is for companies to have subsidiaries and associated undertakings. This tendency gives rise to the issue of whether a shareholder in a parent company may bring a derivative action on behalf of a subsidiary or associated company within the group. Logically an action by a shareholder of a parent company on behalf of a subsidiary is called a 'double' derivative action and, if on behalf of a 'second tier' subsidiary, it would be called a 'triple' derivative action.[26] It is therefore easier to refer to all these actions as 'multiple' derivative actions. Such an action may be appropriate where a shareholder in one company (A) can show that the directors of company A and of a subsidiary (B) or related company (C) (which may not be a direct subsidiary or a direct investment of

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[24] Interestingly, Table 4-1 also reveals that the third largest category (about 10% of the cases) include claims of self-dealing, almost all involving closely held companies (19 out of 21 cases). This seems to confirm the premise that derivative actions retain an important role in policing management in closely held corporations. See below under 'C'.

[25] The evidence in Canada also indicates that, even if the Law Commission's proposed derivative action procedure were extended to include breaches of directors' duties of care and skill, there would *not* be an abundance of cases in the area. BR Cheffins, above n 1, 243.

[26] For the reverse situation, where a shareholder complains about the conduct of a parent company, see the cases set out in Consultation Paper paras 9.9–9.13.

company A), have wrongly prevented the enforcement of a cause of action vested in subsidiary B or related company C.[27]

The idea of a multiple derivative action has been first recognised and developed in the US since at least the latter part of the nineteenth century, particularly where the plaintiff is a shareholder in a group structure based on wholly owned subsidiaries.[28] The Law Commission notes that double derivative actions are available in Canada under the CBCA 1985[29] and multiple derivative actions are available in New Zealand.[30] However, it rejects the idea on the grounds that it was not persuaded that it would be helpful or practical to include such a provision and that situations calling for its use are likely to be extremely rare.[31]

Like others,[32] the writer takes a different view here and believes that the need to expose fraud and serious abuse in groups of companies would seem to require a more realistic approach. This means that the particular needs of groups of companies should be considered and catered for.[33] In the US, it has been rationalized in the following terms:[34]

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[27] Consultation Paper para 16.51.

[28] See eg *Goldstein v Groesbeck*, 142 F 2d 422 (2d Cir 1944); *Kaufman v Wolfson* 1 AD 2d 555, 151 NYS 2d 530 (1st Dep't 1956).

[29] Consultation Paper Appendix F para 2.6.

[30] Consultation Paper Appendix F para 4.3.

[31] Report para 6.110.

[32] Including the CLR *Developing the Framework*, para 4.133; AJ Boyle, above n 5, 85–86.

[33] As was illustrated recently in relation to s 459 CA 1985 petitions in *Gross v Rackind* [2004] EWCA Civ 815.

[34] *Brown v Tenney* 532 N.E. 2d 230, 233 (Ill. 1988). cf Civil Case 1931/00 (22 August 2002) (Israel), where a shareholder in a parent company was allowed to bring a derivative action on behalf of a

> Without triple or double derivative suits a shareholder of record in the holding company would . . . be without remedy, even where, as here, the holding company is the wrongdoer. The additional layer in the corporate structure would prevent the righting of many wrongs and would insulate the wrongdoer from judicial intervention. *The law, however, cannot be deceived by specious and illusory devices, disguises, or circuitry of action.* (author's emphasis)

This, indeed, seems to sit well with the derivative action's usual raison d'être.[35] Further, allowing multiple derivative actions is justified in the case of a corporate group where a blind eye has been shown by the board towards abuse by directors and managers at a lower level in the group hierarchy.[36] Similarly, not allowing multiple actions will severely limit the use of the remedy even where serious fraud and abuse have occurred, which in many cases will not involve the board of the parent company.[37] It would seem then that the observations made by the trial judge in *Gross v Rackind*[38] with respect to the use of section 459 CA 1985 in similar circumstances appear to be equally applicable to derivative actions.[39]

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subsidiary, although he held *no shares* in the subsidiary, on the grounds that denying the right to bring such an action would diminish the effectiveness of the derivative action as a supervisory tool of the organs of the company. This is an interesting development as the Israeli Companies Act 1999 is *silent* with respect to multiple derivative actions.

[35] *Smith v Croft (No 2)* [1988] Ch 114, 185.

[36] AJ Boyle, above n 5, 86.

[37] As Boyle notes, breach of duty of care and skill may be very difficult to establish against members of the parent company's board who fail to detect more serious breaches of duty at lower levels of this group hierarchy; ibid. This problem is magnified in a large multinational group structure, on which see I Lynch Fannon,'A Transatlantic Case: The Derivative Action as a Corporate Governance Tool' Dublin University Law Journal (forthcoming) with permission from the author.

[38] [2003] EWHC 3298 (Ch) and [2004] EWCA Civ 815.

[39] Judge Weeks observed that '[it] would seem to me strange if a commercial re-organisation had deprived the shareholders of the protection of section 459'. ibid para [9]. A difficult question is whether the application of the derivative action in those circumstances needs to be limited to quasi-partnerships. Beyond a quasi-partnership group of companies, it would be difficult to ignore the *Salomon* principle to find the affairs of one company in a group being the affairs of another. See *Adams v Cape Industries Plc* [1990] Ch 433 and discussion in R Goddard and H Hirt 'Section 459 and Corporate Groups' (2005) JBL 247.

C. Types of companies

It has already been indicated several times in the text that the derivative action should be available to all types of companies. The Law Commission did not recommend that any special adjustments should be made to take into account the distinctions between closely held companies and publicly quoted companies. For the reasons set out above, it is submitted that this is, indeed, the right approach. The same position exists in Canada. The pattern emerging there is that most of the decisions have involved closely held companies.[40] The same pattern is evident in New Zealand and Israel.[41] By contrast, in the US, public companies are involved more frequently in derivative action litigation than are smaller ones,[42] the most likely explanation for the different pattern is the existence of institutional distinctions which affect the incentives of those who will potentially bring derivative actions.[43] In the UK, the pattern emerging is similar to that in Canada, New Zealand and Israel. Derivative actions against public companies in the UK are, indeed, rare.[44] This is hardly surprising. Closely held companies in the UK which, although relatively less significant in economic terms, make up the vast majority of

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[40] BR Cheffins, above n 1, 241–243 and the evidence therein.

[41] For New Zealand see PKM Choo 'The Statutory Derivative Action in Singapore – A Critical Examination' (2001) 13 Bond Law Review 64, 78; For Israel see A Reisberg 'Promoting the Use of Derivative Actions' (2003) 24 Company Lawyer 250.

[42] R Thompson and R Thomas, above n 22; BR Cheffins, above n 1, 242 and 258–259.

[43] For an 'entrepreneur' US lawyer seeking to maximize his expected return, publicly quoted companies, for distinctive reasons which exist in the US, are more promising candidates than are closely held companies. MP Dooley and EN Veasey (1989) 'The Role of the Board in Derivative Litigation' 44 Business Lawyer 503, 541–542.

44 Since *Prudential Assurance* in the early 1980s there have been very few cases involving public companies. To be sure, raw numbers of derivative actions filed are not very instructive because settlements are unreported; nonetheless, out of 80 or so cases in LexisNexis involving some derivative action type claims in the past 10 years, the writer could find very few examples, none of which include companies the size of *Prudential*.

companies,[45] and thus also the majority of companies involved in litigation arising from intra-corporate disputes.

4.4.4.2 Who may be qualified to bring a derivative action?

At common law, only an individual who is a member of a company can obtain standing to commence a derivative action. Usually, a former shareholder, a creditor and an employee cannot litigate such proceedings.[46] No changes will be made if the Law Commission's proposals are implemented.[47]

This is not the case elsewhere. Under the Israeli Companies Act 1999 any shareholder or director is entitled to bring a derivative action.[48] In addition, a creditor[49] of the company is also allowed to bring a derivative action on behalf of the company, if a forbidden distribution by the company has been made.[50] In Singapore, a 'complainant' includes 'any other person who, in the discretion of the Court, is a proper person to make an application'.[51] This is similar to the position in Canada although the Canadian definition is slightly broader. According to section 238 of the Canadian Business Corporations Act 1985 'complainants' include past and present shareholders as well as past and present directors or officers. In New

[45] See ch 1, n 174.

[46] A former member can, nevertheless, bring a derivative action in relation to wrongs done to the company before he became a member. See eg *Seaton v Grant* (1867) LR 2 Ch App 459. The plaintiff must be a shareholder when the action is brought (*Birch v Sullivan* [1957] 1 WLR 1247).

[47] Consultation Paper paras 20.32–20.33.

[48] s 194 (A) of the Companies Act 1999.

[49] With respect to the problematic standing of creditors to initiate derivative action see ch 3 above, n 84 and accompanying text.

[50] s 204 of the Companies Act 1999.

[51] s 216A(1) of the Companies Act cap 50.

Zealand, only current shareholders and directors are included in the pool of potential applicants. The Australian provisions confer standing on a member, a former member and a person entitled to be registered as member of the company or of a related company, as well as an officer or former officer of the company.[52] There is no catch-all class in the derivative actions of these jurisdictions and the respective lists of persons who can apply to bring a derivative action appear exhaustive.

At first blush, a wide grant of standing accords with the deterrence objective of the derivative action as set out by the FFM. Certainly, if the directors and management know or believe that their actions can be challenged by a larger class of interested stakeholders, they will, in theory, be deterred from acting without care and/or without regard for their duties.[53] The Law Commission, however, is unconvinced of the merits of a wide grant of power,[54] and, indeed, there are practical problems associated with too wide a grant. First, former shareholders and directors are more likely to be acting in their own interests rather than in the company's interests, given that they are no longer directly associated with the company. Secondly, it may not be appropriate to allow a person to become a plaintiff where he is no longer entitled to receive a share in a possible future compensation.[55]

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[52] Under s 236 (1) of the Australian Corporations Act.

[53] PKM Choo, above n 41, 71.

[54] '... since there is bound to be a current member who (if the wrong has not been ratified) could maintain proceedings.' Consultation Paper para 20.33.

[55] See ch 2 under 2.3.2.2.

On the other hand, allowing former members to take action acknowledges the fact that these former members may have been compelled to leave the company in view of the potential dispute leading to a court battle on behalf of the company. Certainly, there is justification for not granting standing to debenture holders as arguably they did not bargain for it and this could also be providing them with the means to interfere with management. Although the other pre-requisites to the bringing of the action should and are meant to take care of the obviously unmeritorious cases, there may be cases that may slip through the net, notwithstanding and in spite of an improper motive. In such 'borderline' cases, there will probably be a need for more vigilant supervision of the conduct of the proceedings.[56]

Whatever the case may be, the impact of widening the classes of people may not be significant. First, even in jurisdictions which allow for wider classes of people, evidence suggests that the vast majority of derivative actions are invoked by current shareholders.[57] Secondly, in Canada, where the applications were made by former shareholders[58] or former directors,[59] these were denied primarily because the court felt that such applicants lacked 'sufficient interest' in the outcome of the derivative action. This was notwithstanding the fact that these classes of applicants

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[56] L Taylor 'The Derivative Action in the Companies Act 1993' (1999) 7 Canterbury Law Review 314, 316.

[57] This is clearly evident in Canada and in Israel. A Reisberg, above n 41, 251; BR Cheffins, above n 1, 239 and the cases cited therein.

[58] *Jacobs Farms Ltd v Jacobs* (1992) OJ No 813 (Ont Gen Div).

[59] *Schafer v International Capital Corporation* [1997] 5 WWR 99 (Sask QB).

have a prima facie right conferred by legislation to bring the application.[60] Given these findings, it is proposed that under the FFM, a member and present (but not past) directors should be entitled to bring a derivative action.[61]

4.4.4.3 Formulating an expeditious screening mechanism

We arrive now at the central facet of the FFM, namely formulating judicial screening of the action. In Chapter 3 two common checks which are relevant to the grant of leave were examined.[62] The argument was not that the policy premise they reflect is not a sound one, but: (1) it is questionable whether as they are currently structured they provide the court with the necessary tools to determine the merits of the case in question, as they function as rhetorical devices rather than substantive standards; and (2) it is desirable to distinguish sharply between the issue whether the allegations in the statement of claim, if true, disclose the legal liability to *the company* and the logically separate issue of whether *the plaintiff* has standing to enforce any liability.[63]

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[60] In *Jacobs Farm Ltd v Jacobs* (1992) OJ No 813 (Ont Gen Div) Blair J opined that 'it could not have been the intention of the Legislature ... to clothe every former shareholder and every former director with the status of a complainant for the purposes of bringing a derivative action'. Baynton J (above n 59, 104) explained the necessity for this 'sufficient interest rule' on the grounds that such a rule is required to distinguish between applicants who have a bona fide potential financial stake through the corporation in the outcome of the derivative action and applicants who seek leave for an improper purpose.

[61] There seems no reason not to permit the board to decide in favour of litigation, if that would normally fall within its grant of management powers. See ch 3 under 3.2.2.

[62] Namely, the 'good faith' and 'in the interest of the company'. See ch 3 under 3.4.2.1.

[63] See ch 3 under 3.4.2.3. Because of the complicated nature of these proceedings some scholars have suggested that it might not be necessary for the claimant to even make out a prima facie case at the preliminary stage. See R Keane *Company Law in Ireland* (3rd edn Butterworths Dublin 2000) 319–320, though, the present writer believes, some proper checks are nonetheless essential.

A. The proposed rule: identifying those actions that appear likely to increase corporate value

The proposed rule addresses the procedural complexity of derivative actions and seeks to replace overbroad restrictions to a plaintiff's standing to sue with more specifically *focused* checks to discourage non-meritorious litigation. Accordingly, instead of asking 'is the plaintiff being improperly prevented from bringing these proceedings on behalf of the company?',[64] the central inquiry should focus on *identifying and precluding those actions that appear likely to decrease corporate value*. At first glance, the above rule might appear to be doomed by the difficulty of the task that the courts must perform in valuing the benefits of the derivative action. Derivative action litigation is already hard to value in terms of the benefits.[65] Assessing its costs and benefits from an *ex ante* perspective would seem to be harder still. On closer inspection, however, assessing the value of derivative actions divides readily into component tasks that fall well within the scope of judicial competence.[66]

As an initial matter, there are two independent grounds for allowing the action to proceed: generation of net recoveries or deterrence of misconduct.[67] The court should thus conduct an inquiry based on these two alternative decision rules: judges should ask ***whether the litigation is likely to yield any recovery*** net of litigation costs, and ***whether the action is a plausible deterrent.***

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[64] *Smith v Croft (No 2)* [1988] Ch 114, 185.

[65] Consultation Paper para 14.1.

[66] See ch 3 under 3.3.3. Moreover, this involves precisely the same *type* of evaluation which is performed when determining whether the action is 'in the interests of the company', albeit with a more convenient, focused and efficient standard.

[67] Recall that a derivative action increases corporate value in these two circumstances. See ch 2 under 2.3.

B. How will the inquiry operate?

(1) Consider first the rule that courts would allow the action to proceed on the basis that litigation is likely to yield recovery net of litigation costs. This exercise would entail a detailed ex ante cost-benefit analysis which requires balancing the expected value of recovery against the legal costs of continuing the action in each case.[68] This inquiry would not be burdensome for the court to administer.[69] An action without deterrent value only benefits the company through net recovery,[70] while its costs include, for instance, both litigation expenses and increases in insurance or salary costs that are associated with directors' liability.[71]

New tools could be developed in due course to assist the court in estimating the value of actions, such as adopting a '*cost-effectiveness*' test. Where the undertaking of a procedure or its costs are challenged, the courts should ask how the expected costs (in time and monetary worth) of undertaking a derivative action compare with the value of its expected benefits (ie the expected recovery for the company or the general deterrence).[72] The notion of efficiency employed here may

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[68] cf s 165 (1) (b) of the New Zealand Companies Act 1993, which requires the court to take into account when considering leave 'the costs of the proceedings in relation to the relief likely to be obtained'.

[69] In *Joy v North* 692 F 2d 880, 892 (2d Cir 1982) Judge Winter framed a similar test in the following terms: 'Where the court determines that the likely recoverable damages discounted by the probability of a finding of liability are less than the costs to the corporation in continuing the action, it should dismiss the case'; ibid. Much of the attraction of the *Joy* test lies in Judge Winter's painstaking inventory of the ex post costs and benefits associated with the derivative action, very much in the form provided in ch 2 above under 2.2 which could be used by the court in this exercise.

[70] That is, any form of recovery, including, for example, the return of the company's property.

[71] R Kraakman H Park and S Shavell 'When Are Shareholders Suits in Shareholder Interests?' (1994) 82 Georgetown Law Journal 1733, 1765.

[72] F Easterbrook and D Fischel *The Economic Structure of Corporate Law* (Harvard University Press Reprint edn 1996) 93.

be labelled *transaction cost efficiency.*[73] A method is efficient then, given a particular amount of resources dedicated towards implementation, when it can put into operation the set of substantive goals to a greater degree than would be possible for any other feasible method.[74] This would certainly be in line with current case law,[75] the Law Commission proposals that require that court to consider whether a remedy is available as an alternative to the claim[76] and, of course, consistent with our underlying premise that litigation is a failsafe remedy, a safety net for instances when other mechanisms of accountability fail.

(2) Turning to the deterrence benefit, to allow an action to proceed on this rationale, courts need only make an up-or-down judgment about the *likelihood* of deterrence.[77] This rationale should be employed when the court believes that the prospects of the litigation will *substantially* enhance the prospects of deterrence[78] in

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[73] Essentially, what it means is that a method of implementing a set of substantive goals is efficient in this way when the resources it consumes in the process of implementation are lower than would be consumed by adopting any other feasible method of implementation. This draws on, but is not coterminous with, the insights provided by the branch of economics which goes by the same name. See the contributions to O Williamson and S Masten *Transaction Cost Economics* (Edward Elgar Aldershot 1995). Specifically concerning the definition of efficiency, P Milgrom and J Roberts *Economics, Organization & Management* (Prentice-Hall New Jersey 1992), 22–30, is particularly helpful.

[74] It is obvious that to attain transaction cost efficiency should be a (procedural) goal of every part of a defensible legal system. This is how efficiency is employed here, ie to determine whether the law attains its substantive goals in the cheapest feasible way. See further R Mokal 'Consistency of Principle in Corporate Insolvency' (December 2001) 39 http://ssrn.com/abstract=303722.

[75] *Barrett v Duckett* [1995] 1 BCLC 243, 250 *per* Gibson LJ.

[76] Report para 6.70 and Draft CPR 50.9 and 50.10 in Appendix B.

[77] cf s 165 (1) (b) of the New Zealand Companies Act 1993 ('the likelihood of proceeding succeeding').

[78] For example, when a judgment is forward-looking in the sense that future protection and avoidance of continuing abuse deserves judicial consideration. Thus a judgment establishing an important precedent or principle that will be of continuing value to all shareholders merits continuance. See also *Bosch v Meeker Cooperative Light & Power* 101 NW 2d 423, 427 (1960).

the light of matters of *public policy*.[79] The writer envisages that the public policy calculus will include a fuller consideration of the action's prospective impact both on the company and the climate within which it operates as well as on 'corporate UK'.[80] The court may, for instance, weigh the probable benefits to all similar companies through proscribing the challenged conduct and consider as well whether its proscription and any concomitant deterrence will likely occur in some other proceedings.[81] While carrying out this exercise, the court could be expected to include within their finding the policy reasons for holding that the action be allowed to proceed on a deterrence rationale and why the particular case is likely to *substantially* enhance the prospects of deterrence.[82] The rationale is threefold: (1) it

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[79] This point was usefully framed in *Zapata Corp v Maldonado* 430 A 2d 778, 789 (Del 1981) ('The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interests'). Perhaps the best example is where a derivative action holds an entire board of experienced directors liable for breach of duty. See *Smith v Van Gorkom*, 488 A 2d 858 (Del 1988). Arguably we all benefited from the 'public good' provided by Mr Moir's plight in *Wallersteiner v Moir (No 2)* [1975] QB 373. There is also ample evidence from the US to support this point. *Rosenfeld v Black* 445 F 2d 1337 (2d Cir 1971) set a standard of conduct which reverberated throughout the mutual fund industry. The case held that an adviser to a mutual fund occupied a fiduciary relationship to it and could not sell that position for a profit. The profit in that situation amounted to pennies per share. But the point here is that the case set a standard of conduct for an entire industry. The same could be said of many other notable cases: *Perlman v Feldmann* 219 F 2d 173 (2d Cir 1955); *Moses v Burgin* 445 F 2d 369 (1st Cir 1971); *Fogel v Chestnutt*, 533 F 2d 731 (2d Cir. 1975), to name a few. None of those derivative actions involved large recoveries for the companies for whom they were brought. And certainly if you calculated the recoveries on a share by share basis, they would have been tiny. But they were of immeasurable importance to the integrity of corporate governance by setting standards for corporate actors. See further SM Grossman 'Commentary: The Social Meaning of Shareholder Suits' (1999) 65 Brooklyn Law Review 47.

[80] Professor Cox, for example, through an elegant description of the role of the derivative action in reducing systematic risk, advances an economic analysis as a justification for a deterrent rationale. The thrust of the argument is that managerial misconduct contributes to systematic risk and therefore to the cost of each company's capital. Reduction in managerial misconduct through the deterrence force of derivative actions can therefore have a positive effect on an overall allocation of resources. J Cox 'Compensation, Deterrence and the Market as Boundaries for Derivative Suit Procedures' (1983) 52 George Washington Law Review 745, 746–755.

[81] Such an approach was employed in *Diamond v Oreamuno* 301 NYS 2d 78, 84–85 (1969), where the court believed there would be little prosecution of corporate fiduciaries for insider trading by either investors or the SEC.

[82] cf *Item Software (UK) Ltd v Fassihi* [2004] EWCA Civ 1244 at [62]–[68], *per* Arden LJ who put forward in clear terms the policy reasons for holding that a director's duty of loyalty requires him to disclose his misconduct. Arguably, there are also improvements that could be made in the settlement process. If the derivative actions are to serve a social purpose, it is important that these settlements

will facilitate the emergence of a consistent policy on when to allow the action to proceed based on this rationale; (2) the court will gradually feel more comfortable with the deterrence rationale as cases accumulate; and (3) it will encourage compliance with the law and with proper standards of behaviour. Misbehaviour will be discouraged before it occurs as lawyers will be able to advise boards of directors about their responsibilities and the potential liabilities which they can incur.[83] The desire to avoid suits provides a lever for influencing the conduct of senior management and the board.[84]

(3) Let us explain now how the deterrence inquiry will operate in practice. Although the decision about the *likelihood* of deterrence could not be made with mathematical precision, it is expected that courts would learn over time that some types of action, even if uneconomic in the sense that they fail to recover their immediate costs, ultimately result in beneficial deterrence of harmful misconduct.[85] Presumably, a court in evaluating an action's deterrence prospects would look chiefly to the

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(involving serious corporate wrongdoing) be made publicly available. The court should require that the briefs in support of the settlement discuss the legal and factual issues in the case. The disclosure of that information would not only go far in meeting the concerns about the private nature of these cases and their settlements, but would add greatly to the deterrent effect.

[83] Although most decisions are fact-specific, process-oriented, and invariably judgmental narratives of the directors' behaviour, scholars in the US found that the social force of the opinions lie not only in their results but also in the guidance lawyers pass on to their clients from the courts' narratives of acceptable and unacceptable conduct. DD DeMott 'Puzzles and Parables: Defining Good Faith in the MBO Context' (1990) 25 Wake Forest Law Review 15, 29–31; EB Rock 'Saints and Sinners: How Does Delaware Corporate Law Work?' (1997) 44 University of California Law Review 1009, 1094–98. This point is well illustrated in relation to the UK wrongful trading provisions, which arguably operate on the minds of directors who will have been warned about the dangers of liability they face once the company becomes insolvent. Above under 4.4.2.4, nn 134-136 and accompanying text.

[84] The lawyer, when confronted by broad standards, will emphasize in his advice the positive affirmations of the director's conduct that the lawyer finds in these narratives, preferring the certain over the speculative course. R Calnan 'Directors' Duties: Companies in Financial Difficulties' lecture delivered at the Faculty of Laws, UCL (28 January 2005).

[85] And even if judges estimate the deterrence benefit of an action solely in terms of the harmfulness of managerial misconduct, as one might suspect will often be the case, introducing deterrence into the judicial calculus is a step in the right direction.

penalties that it imposes on wrongdoers and the probability that shareholders could detect similar misconduct.[86] For example, misconduct involving breaches of fiduciary duties by managers, or self-dealing that is widely known or can be discovered by close analysis of the public record,[87] are presumptively subject to detection and therefore to deterrence, provided that the action imposes genuine penalties on the directors at fault.[88] By contrast, it might be possible to determine early on that some actions (such as actions targeting misconduct that shareholders are inherently unlikely to detect or that impose no obvious costs on defending directors) would probably justify dismissal. For example, much serious misconduct by directors (such as bribery and insider dealing) is often inherently unlikely to be detected by shareholders acting alone. Derivative actions involving these forms of wrongdoing usually 'piggyback' on governmental or internal corporate investigation.[89] In these cases, the deterrence inquiry must ask whether the *additional* sanction imposed by a derivative action, beyond the penalties that wrongdoers face from the original investigation, *substantially* enhances the prospects of deterrence. When this seems unlikely, as when derivative actions piggyback on criminal or DTI investigations, the action can only be justified by positive net corporate recoveries (the alternative rule in the inquiry). Conversely, actions against serious misconduct may well deter future misconduct (and hence merit continuation on a deterrence ground) when high damages are expected or

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86 One may be sceptical of complaints that lacked specific allegations of misconduct, since the wrongdoing in these complaints would be presumably difficult to detect or deter a second time.

87 Such as through provisions which require detailed disclosure of direct and indirect self-dealing transactions. See eg s 317 CA 1985.

88 R Kraakman H Park et al, above n 77, 1763–1764.

89 As well illustrated in the case involving Allied Irish Banks Plc, above under 4.4.2.3.

when public enforcement proceedings is likely to follow in the wake of the litigation.[90]

C. What should be the relationship between the compensation and deterrence rationales?

Pursued dogmatically, either rationale can lead to absurd results, as illustrated below. Rather than follow either principle to the limits of its logic, the sounder course is to compromise by treating the compensation rationale as primarily *a limit* on the deterrence justification.[91] Alone, a deterrence rationale can justify a company expending almost any sum to bring a wrongdoer to account, whereas a compensation rationale gives the defendant a strategic incentive to threaten to conduct a prolonged and expensive defence. For example, assume a director has misappropriated £500,000 in a complicated fraud. Ex ante, a compensation rationale could justify expenditures of up to £499,999 to recover that sum; any greater expenditures, however, would not produce a net recovery. In the latter situation, shareholders would be better off if the wrong is not rectified than if more money is wasted. This logic implies then that as long as it is expensive for the company to win a litigated recovery against the director, these expenses may justify a corporate termination of the action, even though the fiduciary breach was serious. However, if we posit that the corporate expenditures in the litigation will discourage other potential wrongdoers, then it follows that such expenditures reduce the average agency cost that shareholders must incur in order to hold their management accountable, even if they do not produce a compensatory benefit. In

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[90] R Kraakman H Park et al, above n 77, 1762–1763.

[91] JC Coffee 'Litigation and Corporate Governance: An Essay on Steering between Scylla and Charybdis' (1983) 52 George Washington Law Review 789.

theory then, the fully diversified shareholder may benefit even if £300,000 is expended to recover £200,000.[92]

At some point, one which cannot, however, easily be identified, the deterrence rationale must be rejected. The problem with the deterrence rationale is that it is open-ended and speculative. One does not know whether expenditures of, say, £800,000 or even more would also produce a deterrence benefit in excess of the costs incurred. Nor can one begin to estimate the marginal deterrence benefit, if any, of each additional successful derivative action. To see why, suppose that directors have a 15% probability of discovering a self-dealing opportunity in each year, but that such self-dealing could be deterred by the threat of a derivative action. An optimal litigation policy would always dictate a derivative action against self-dealing directors in order to deter misconduct without cost and absolutely. However, the company which is sensitive to effects on its reputation would only allow the action to proceed if the present value of future deterrence gains exceeds the net cost of an action (including damage to reputation lasting well into the future). Because these future gains might not be realized for many years and would have to be discounted accordingly, the company would prefer not to sue today unless the corporate losses from self-dealing were very large.[93] Finally, the greatest problem with a single-minded focus on deterrence is that not all (and probably not most) shareholders are fully diversified.[94] These shareholders lose, rather than gain,

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[92] ibid.

[93] R Kraakman H Park et al, above n 77, 1756.

[94] Although shareholders have the ability to diversify their portfolios so as to minimize the risk of any single investment, most investors are not *fully* diversified because they hold assets other than marketable securities, such as real estate, insurance, pensions, or small business holdings. As a result, they may wish to hold an undiversified securities portfolio to wrap around their other investment assets in order to achieve full diversification on an overall level. This theme was

when the corporate recovery falls below the company's expenditures in a derivative action, even if a deterrence surplus is created that benefits the other, fully diversified shareholders.[95]

For all these reasons, *a deterrence rationale should be constrained by a compensatory ceiling.*[96] Clearly at some point a disproportion between the expected costs and the expected recovery should justify dismissal, even if the action is a legally meritorious one (also in the sense of the public good it may entail).[97] One cannot define with precision where this point lies and, because of this indeterminacy, one must rely upon judicial discretion. As a result, the FFM does not attempt any precise balancing formula between the two rationales but instead contemplates case-by-case judicial balancing.[98]

D. An illustration of the proposed inquiry

As **Table 4-3** illustrates, it is possible to predict that most cases will congregate along more or less four 'prototype' scenarios.

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developed in JC Coffee 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) 70 Virginia Law Review 717, 748–749.

[95] J Coffee, above n 97.

[96] ibid.

[97] A ceiling is an important limitation, since there is no economic reason to compel a company to act as a 'guinea-pig' for other companies when the net costs the action imposes on the company whose managers are sued clearly outweighs its financial returns from the action. In fact, it could be argued that since the initiation of litigation is in many ways an 'investment decision' for the company (see ch 2 under 2.2) any director advising shareholders to take action when the litigation costs are likely to be high and yield little or no recovery may be acting negligently.

[98] The notions of compensation and deterrence must each be interpreted in the context of each case, as the costs and benefits of a litigation remedy vary with the context. The public company characteristics may, for example, introduce several considerations not necessarily present in the similar factual setting of a small company harmed by its dominant shareholder (say of the type involved in *Nurcombe v Nurcombe* [1985] 1 WLR 370). cf pt VII of ALI, *Principles of Corporate Governance: Analysis and Recommendations* (Tentative Draft No 3 1984).

Table 4-3

Identifying those actions that appear likely to increase corporate value				
	'Prototype' Scenarios	**Compensation**	**Deterrence**	**Outcome**
1	**'The optimal scenario'** Litigation is likely to yield recovery and is likely to deter misconduct (eg judgment establishing an important precedent)	√	√	The action should clearly proceed
2	**'Borderline scenario A'** Very little expected deterrence, but the prospect of the action is likely to yield X recovery	√	—	The action should proceed upon finding that the action is likely to yield a positive recovery net of litigation costs
3	**'Borderline scenario B '** Very little expected recovery, but the prospect of the action is likely to deter Y misconduct	—	√	The action should proceed upon finding that it is likely to substantially enhance the prospects of deterrence. However, at some point a disproportion between the expected costs and the expected recovery should justify dismissal (the compensatory ceiling)[99]
4	**'The non-benefit scenario'** Litigation is unlikely to yield any recovery, and is unlikely to deter misconduct	—	—	The action should clearly be dismissed

[99] Note that even the US cases cited in n 85 above, which were primarily justified in the sense of the public good deterrence entailed, still involved some recoveries for the companies for whom they were brought.

E. An assessment of the benefits of the proposed inquiry

As a practical matter, the merits of the proposal seem to turn on how accurately courts or potential litigants can estimate the value of actions. There is no doubt that attempting to screen value-decreasing cases at the outset of litigation is likely to be less conclusive than screening at later points in the litigation. Indeed, there will be cases which the court considers at the outset to be arguable, but not likely to succeed, which ultimately bring a reward. That is the very nature, however, of a legal screen.[100] The choice is not between a more or less accurate measure of value, but between what is currently an inaccessible criterion to evaluate the merits of derivative actions at an early stage[101] and a standard which provides a *convenient, focused and efficient method* by which to judge whether to allow the action to proceed. It follows that where the strength of plaintiff's cases indicates a real possibility of ultimately increasing corporate value, there is little justification for not allowing the action to proceed.

Another advantage of the proposed inquiry is that it does not involve the courts in any untoward involvement in the business affairs of the company, nor will it be costly. In fact, in most cases, the deterrent benefit will be obtained without any cost at all. If the case can be justified by positive net corporate recoveries (that is, the alternative rule in the inquiry) permission to continue should be granted anyway, so

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[100] Perhaps the real difficulty in proposing to screen derivative actions based on their contributions to corporate value lies less in the logic of screening than in the issue of who screens: boards or courts? Here, the arguments on both sides track the familiar debate discussed in ch 3 under 3.3. On the one hand, screening by independent directors is likely to be cheaper and better informed as to the facts than screening by judges; on the other hand, screening by courts is likely to be better informed about the law and less prone to structural bias than screening by boards. See also R Kraakman H Park et al, above n 77, 1768.

[101] See ch 3 under 3.4.2.

that any potential deterrence benefits that might be obtained would follow without extra cost. But the real novelty in the proposed two-rationale inquiry concerns the *substantive standard* at the core of the test: the derivative action ought to be judged on the basis of the *value* it creates for companies, and not solely on the basis of an ad hoc 'necessity in order to prevent a wrong going without redress'.[102] It is in this sense that the 'functional' and 'focused' elements of the FFM come under the spotlight. The derivative action should be allowed to proceed only if it serves one of these prime objectives. The FFM highlights the *functional* logic behind the derivative action: a derivative action would be allowed to proceed only if it serves a substantive goal. This goal, in turn, *justifies* the existence of this law enforcement by demonstrating why it is *worthwhile* having it. This perspective enables us to clarify the statement made above: although a derivative action is undoubtedly a procedural device, it cannot solely be justified on a procedural basis.[103] A set of substantive goals should be exogenously specified (ie deterrence of misconduct or generation of net recoveries) if the derivative action is to turn into an effective controlling mechanism in corporate governance.[104] In principle, then, the maintenance of public standards should be seen rather as being something of value

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[102] *Smith v Croft (No 2)* [1988] Ch 114, 185.

[103] See also C Hale 'What's Right With the Rule in *Foss v Harbbottle*?' [1997] 2 CFILR 219, 222.

[104] In order to fully appreciate this point, it is useful to consider the difference between the English and Australian approaches here. Broadly speaking, the picture that consistently comes through from Australian derivative action cases shows a willingness to get to the substantial issue, undistracted by consideration of *locus standi* or procedure. Sealy describes the difference between the English and Australian approaches as the difference between 'Why should we?' and 'Why not?'. LS Sealy 'The Rule in Foss v Harbottle: The Australian Experience' (1989) 10 Company Lawyer 52. The novelty in the proposed test above is that it answers both questions, namely why should we (ie in order to promote deterrence or compensate the company for the harm caused), but also why and when we shouldn't use this remedy (ie when these objectives are absent).

in its own right,[105] as this inquiry may not exclude cases with obvious deterrent value simply because their expected recovery is small as explained above.

Turning to the 'focused' element, there are two dimensions here: first, litigation should be *focused* on those areas or instances in which other mechanisms of accountability fail. For example, recall that the most significant weakness in the market for corporate control solution as a deterrence to managerial misbehaviour lies in its ineffectiveness against so-called 'one shot' breaches of fiduciary duties by managers as well as in relation to private companies. Yet this is one of the major objects of derivative actions.[106] The derivative action should therefore have a role to play in redressing and deterring this type of managerial misbehaviour. The second dimension of the 'focused' element lies in the notion that litigation should be *focused* in the nature of inquiry conducted in court as set out by the proposed inquiry above and as illustrated next.

F. Shareholder standing

Having by this stage established whether the company has a valid claim to proceed with, the court can turn to deal with the standing of the *particular* shareholder who wishes to pursue the action. To reiterate, the Law Commission Report acknowledges the unique position of the shareholder in that 'the applicant may benefit commercially if he succeeds in the derivative action, and thus has an ulterior

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[105] See also JE Parkinson *Corporate Power and Responsibility – Issues in the Theory of Company Law* (Clarendon Press Oxford 1993) 202.

[106] See ch 1 under 1.4.1.

motive[107] in bringing it. But nonetheless, the court may consider that he is an appropriate person to bring the action and that the action ought to be brought'.[108] Although slightly inaccurate, this recognizes the prevalent *inherent duality* which seems to exist within the majority of minority claims.[109] It is inevitable that while the individual shareholder sues to uphold the right of the company, he also therewith attempts to simultaneously protect indirectly his personal interests. But as explained earlier, as a general rule, a derivative claim is equivalent to a claim by the company itself and as a result, the conduct of the shareholder should take a *backseat role* in the courts' assessment of whether the derivative action should go forward.[110] In this way, the assessment on the merits of the case could *concentrate* on whether the claim should be allowed to proceed on the grounds set out above (which highlights again the *focused* nature of the FFM).[111]

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[107] The use of the term 'ulterior motive' is arguably inappropriate. 'Ulterior' is inaccurate because apart from situations when a shareholder is abusing the derivative action jurisdiction which exists to do justice to the company (*Barrett v Duckett* [1995] 1 BCLC 243), as is explained in ch 6 under 6.2.2.2, it is both expected and hoped that a shareholder will assume the role of initiator (unless, of course, there is someone else who is expected to assume the risk of litigation, ie lawyers). Likewise, 'motive' is a concept which is notoriously difficult to apply, often being mixed and difficult to prove. Moreover, the idea of denying someone an otherwise valid claim solely on the basis of an improper motive is contrary to other, arguably analogous, areas of company law. J Payne 'Clean Hands in Derivative Actions' [2002] CLJ 76, 82.

[108] Report para 6.76.

[109] In some situations it may be difficult to determine whether an action should be personal or derivative in from. A classic example is *Marx v Estates and General Investments Ltd* [1976] 1 WLR 380. Note also the rule against 'reflective loss'. Painting with a broad brush, this rule proscribes a shareholder from recovering for damage which is merely a reflection of the company's damage. See discussion in ch 6 under 6.2.2.3.

[110] The rationale is that if the wrongdoer's duty is owed to the company and the right to enforce that claim belongs to the company and not to the shareholder, why should any conduct by a shareholder destroy the company's right of action? See further J Payne, above n 107, 77 and 81.

[111] For a Similar approach see s 165 of the New Zealand Companies Act 1993. There seems to be no bar for a shareholder to bring a derivative action, provided the requirements under s 165 are satisfied. These focus on issues such as costs of the proceedings, the likelihood of the proceedings succeeding, and the company's interest and *not* the shareholder's standing.

However, it is inescapable that in some cases the plaintiff will be in an acute conflict of interest in pursuing the derivative action.[112] Although that might not (and should not normally) be a fatal obstacle to the grant of permission to continue the action, it is certainly a matter that requires the most careful scrutiny.[113] This question can only be decided on the circumstances of each case (in light of factors such as the shareholder's behaviour or relationship with the wrongdoers). The writer thus takes the view that it would be unwise to employ any strict formula to decide this question.[114] Instead, the court should use its *general discretion* and powers to prevent a *particular* shareholder to pursue the action on behalf of the company.[115] For example, if the court believes that the shareholder is acting *only* in his own self-interest it may well be legitimate to prevent him from taking an action.[116] In such cases, the conduct of the shareholder should have personal consequences for him, but should *not* have consequences for the company.[117] It follows that it is possible for the court to accept that the company may have a valid

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[112] For example, having received money unlawfully from the company.

[113] *Portfolios of Distinction Ltd v Laird* [2004] EWHC 2071 discussed in A Reisberg 'Judicial Control of Derivative Actions' (2005) 8 ICCLR 335.

[114] Ch 3 under 3.4.2.1 and 3.4.2.2. Cf, Report para 6.76.

[115] *Bhamjee v Forsdick* [2003] EWCA Civ 113 discussed in C Gibson 'Dealing with Vexatious Litigants: The "New" Range of Civil Restraint Orders' (2004) 25 Company Lawyer 53.

[116] For example, when a shareholder buys shares in a company and decides to bring a derivative action against its directors (assuming there are adequate grounds for this action on the basis of the directors' behaviour) when its purpose is *not* to protect the company but to tie up management time and to provide a substantial distraction to the company's business in the hope of providing an advantage to a third company in which he is involved. J Payne, above n 107, 81–82.

[117] The neatness of this proposition hides the fact, nonetheless, that in some cases when the company is very small (as in *Nurcombe*), imposing consequences on the plaintiff shareholder will inevitably have an impact on the company itself. J Payne, above n 107, 85–86.

claim, but to deny the right to *this* shareholder to pursue that claim on behalf of the company because of some aspect of that shareholder's position.[118]

G. Access to information

A critical issue that *must* be remedied is access to information. Given the difficulty of obtaining, in advance of litigation, adequate evidence to support alleged wrongdoing (even where this is strongly suspected), the effort to streamline litigation must address the thorny issue of disclosure and the asymmetry of information between management and shareholders or between large and small shareholders.[119] The rationale is threefold: (1) there must be instances when litigation could be prevented by allowing the shareholder a right to inspect records;[120] (2) the very existence of such a right might act as a deterrent and thereby encourage good management;[121] and (3) shareholders must be allowed to judge accurately the strength of the potential claim.[122] Without the necessary access to information, then, many shareholder actions, in both public and private companies, will in practice be prohibited from the outset.

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[118] As in *Barrett v Duckett* [1995] 1 BCLC 243. In *Portfolios of Distinction* (above n 113) the court held that the best way forward was to appoint an independent receiver over the company, as there were serious questions about the plaintiff's good faith in purporting to act for the benefit of the company.

[119] Recall that the case law confers on shareholders only scant corporate rights to 'internal' company documents. *Arrow Trading and Investments v Edwardian Group Ltd* [2004] EWHC 1319 and discussion in ch 3 under 3.2.3.2 and 3.5.1.

[120] L Kosmin 'Minority Shareholders' Remedies: A Practitioner Perspective' [1997] 2 CFILR 201, 218. Recent evidence indeed suggests that disclosure potentially deters litigation rather than triggers it. L Bernadatte et al 'Does Disclosure Deter or Trigger Litigation?' Journal of Accounting & Economics (Forthcoming 2005) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=604683 (13 February 2005).

[121] See also J Poole and P Roberts,'Shareholder Remedies – Corporate Wrongs and the Derivative Action' [1999] JBL 99, 125; D Sugarman 'Reconceptualising Company Law: Reflections on the Law Commission's Consultation Paper on Shareholder Remedies: Part 1' (1997) 18 Company Lawyer 226, 243.

[122] See also, E Ferran *Company Law and Corporate Finance* (OUP 1999) 123.

The question of whether a shareholder in a derivative action should be entitled to early disclosure of the company's documents was considered by the CLR.[123] The CLR acknowledged that the logic of a derivative process is that the shareholder suing in the right of the company and for its direct benefit should be entitled to the information that would be available to the company. It also acknowledged that the CPR provide inadequately for early disclosure. Nonetheless, while as a matter of logic the CLR agreed that it might be argued that a potential plaintiff in a derivative action should have pre-trial access to the company's papers, in practice, the CLR believed, like the Law Commission,[124] that disclosure should be a matter to be governed by the court once the proceedings *have commenced*, and granted only when the court is satisfied that there is a *serious issue* to be tried.[125]

It is hard to agree with this. First, the logic behind this is erroneous: how can the court be satisfied that there is a serious issue to be tried if the shareholder is initially prevented from gathering information to establish exactly that? Secondly, as a matter of policy this serves only as another disincentive for a shareholder to bring a derivative action, if he is denied access to relevant information when he is suspicious about wrongdoing. Finally, given the suspicion English courts have generally shown towards shareholders who come before the court, it is highly unlikely that the court will consider granting disclosure orders favourably.

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[123] CLR *Developing the Framework* 131–132.

[124] The Law Commission considered and rejected the case for pre-action discovery of documents in such cases, but suggested that this issue might be considered in the context of a pre-action protocol. Report paras 7.13–7.16.

[125] Above n 123, 132.

It is possible that the lack of effective means of information-gathering by shareholders could be overcome by less direct means, as is well illustrated in Japan. The surge of derivative action litigation in Japan in recent years has been partly explained by the fact that, in many cases, derivative actions 'piggyback' on government enforcement, often in the form of criminal prosecution.[126] Before the 1990s, shareholders who wished to sue faced an uphill battle in gathering information about defendants' conduct.[127] But beginning in the early 1990s prosecutors began to pursue aggressively individual wrongdoers in the corporate context.[128] With increased criminal enforcement and public announcements of state-gathered evidence, potential shareholder-plaintiffs were able to gather more information about corporate activities, and specifically management misdeeds, than they had in the past. In effect then, prosecutorial and investigative powers became a substitute for the lack of effective means of information-gathering by shareholders.[129]

The writer believes, nonetheless, that the effort to streamline litigation must address informational problems more directly, as the following anecdotal examples

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[126] Additional factors, mainly in the form of financial incentives, are discussed below in ch 5 under 5.2.1.

[127] Information disclosure is not terribly abundant; shareholder rights to view corporate records are predicated on the holder having at least 3% of the shares; cause must be shown to appoint an outside inspector; and pretrial discovery is nonexistent. MD West 'Why Shareholders Sue: The Evidence from Japan' Michigan Law and Economics Research Paper No 00-010 (November 2000) http://ssrn.com/abstract=251012 (9 March 2003).

[128] After the bursting of the Japanese real estate and stock market bubble that characterized the late 1980s, and with an influx of foreign business.

[129] See evidence in MD West, above n 127.

illustrate.[130] First, South African legislation, in the limited context of the statutory derivative action, provides as a first step for the appointment by the court of a curator ad litem, whose role is to investigate the shareholder's complaint and advise the court whether the litigation should be allowed to proceed.[131] The curator is given unrestricted access to the company's books and records. Secondly, section 319 of the Australian Corporations Law provides a mechanism, subject to a number of limits, to enable access to documents. It empowers the court, on application by a shareholder acting in good faith and for a proper purpose, to order that the applicant be allowed to inspect the company's records, not personally, but through a lawyer or registered company auditor acting on his behalf, on such terms as the court thinks fit. Finally, according to German law, the right to obtain information can be exercised through a formal procedure known as the special audit (*Sonderprüfung*).[132] This means that a shareholder or a minority of shareholders can require a special audit on a particular matter to be conducted by a person, usually an auditor, who is appointed by the court for this special purpose.

In short, it is proposed that the court should be allowed to use its general jurisdiction and allow such access in appropriate cases.[133] Clearly there must be safeguards to avoid abuse and care must be taken to ensure that persons such as

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[130] In most jurisdictions rights of discovery prior to initiation of litigation are either very limited or non-existent. D Faber 'Reform of Shareholders' Remedies' in *Developments in European Company Law* (Kluwer Law 1998) 119, 127.

[131] Under Companies Act 1973 s 266.

[132] KL Hopt 'Shareholder Rights and Remedies: A View from Germany and the Continent' [1997] 2 CFILR 261, 264.

[133] One way that could be followed is along the lines of a new Delaware legislation liberalizing the ability of shareholders to obtain books and records of the company 'if they have a targeted, proper purpose' to see what is going on. See SB 127, 142nd Gen Assembly (Del. 2003) (amending Del Code Ann Tit 8, s 220).

business competitors do not acquire shares in order to exploit such a right of access. However, subject to these restraints, such a right would provide protection for shareholders, avoid many misunderstandings and encourage boards to manage their companies in a regular and proper manner. Paradoxically, this may even lead to fewer shareholder disputes being litigated.[134]

H. Notice to the company

Finally, a procedure should be enacted which requires a limited period of notice to be given to the company if a shareholder is to maintain the action, albeit that notice may be waived in urgent cases. This is to provide the company with the opportunity to vindicate its own rights.[135] The cause of action rightly belongs to the company, and it should therefore have the first option of pursuing its own rights. It is possible that the directors may decide themselves that the company should shoulder the responsibility for the action, thus making the derivative action unnecessary. Alternatively, the directors may be able to take such steps to correct or remedy the situation that formed the basis for the derivative action, which may satisfy the prospective plaintiff's concerns.[136] Indeed, notice to the company is now a common pre-condition to the grant of leave for a shareholder to pursue statutory derivative actions in numerous jurisdictions, although the precise period differs.[137]

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[134] See evidence in L Bernadatte et al, above n 120.

[135] BR Cheffins, above n 1, 245–247.

[136] Including internal sanctions such as dismissal or demotion of a defendant employee. Consultation Paper 156–157.

[137] This varies between no minimum notice period specified (in Canada, under CCBCA 239 (2) (a)) to 45 days under Israeli law). The Law Commission put that figure at 28 days (Consultation Paper 147). For arguments in favour of a longer period see J Poole and P Roberts 'Shareholder Remedies – Corporate Wrongs and the Derivative Action' [1999] JBL 99, 104.

The requirement should allow the court to make such interim order as it thinks fit where the complainant establishes that it would not be expedient to give notice as required. This envisages situations where the directors are hostile, under the domination of the wrongdoers, or where timeous litigation is of the essence.[138] The position is broadly similar in the US, where a shareholder must first provide the board with a 'demand' to sue. A judge, however, can waive the demand requirement when it is futile to expect the directors to make a reasoned and unbiased decision on the matter, for example, because the alleged wrongdoers comprise or control a majority of the board. A complex and unclear jurisprudence has in turn developed on the issue of excusing demand.[139] If carefully construed, however, this should not be allowed to be the case in English law. The Canadian approach could be followed, where unlike the 'demand' requirement in the US, the notice need not specify each and every cause of action; it is enough that the notice contains some information to determine the nature of the shareholder's claim.[140] After all, the notice is not intended to be a form of pleading.

4.4.4.4 Funding derivative actions: a re-examination of costs and fees as incentives to commence litigation

There is an additional crucial tailpiece to our discussion so far. As will be seen below, the treatment of fees has a direct impact on the frequency of litigation. The

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[138] cf s 237 (2) (e) of the Australian Corporations Act 2001 and the proposed UK procedure in Report, paras 6.58–6.59, and Draft Rule 50.4 (3) Appendix B.

[139] For an overview see, American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* (1994) 55–57 and 63–68.

[140] A written request that the board takes action together with details of the claim comprised in a letter to the board appears sufficient. See *Re Doan Development Corp* (1984) 10 DLR (4th) 216, 221–222 (BC) and generally B Welling *Corporate Law in Canada: The Governing Principles* (2nd edn Butterworths Toronto 1992) 527–528.

more advantageous the fee rule is to the prospective plaintiff the greater the employment of litigation. An understanding of the economic effect of fees on the decision to commence litigation allows the development of rules to encourage those actions which advance the policy objectives behind the FFM. The following two chapters address this aspect of the FFM.

4.4.4.5 Maintaining doctrinal consistency

The final building block of the FFM concerns practical aspects of the law governing derivative actions. Chapter 7 will argue that it is vital to clarify the interaction and uneasy relationship between the unfair prejudice remedy under section 459 CA 1985 and the derivative action in order to maintain doctrinal consistency, but more on this later.

4.5 CONCLUSION

This seems an appropriate point at which to consolidate the discussion in the first four chapters. The Functional and Focused Model ('FFM') for derivative action litigation presented here builds on the view of derivative action law laid out in Chapters 1, 2 and 3 and finalized in the preceding sections of this chapter. The FFM is a descriptive and analytic device. By focusing on what makes derivative action procedure special, it helps illuminate the structure of the derivative action. Its ultimate aim is to reformulate the application, structure and incentives to bring the action, in order for it to be both effective and reliable as well as address modern dilemmas. The premise driving this FFM is an understanding that to allow the common law derivative action to lurk 'dormant' in the hinterland of company law would be to ignore the possibility that the derivative action could be used as a legitimate corporate governance tool to redress the concerns which all scholars have with issues centred on management accountability and lack of shareholder voice. If the latter is the case and the derivative action, as the writer believes it to be originally conceived, presents a real opportunity for active corporate governance, then any recommendations which provide procedural and substantive clarity ought to be welcomed.

On the whole, the FFM seems to have accomplished a threefold objective: first, the FFM responds to and, indeed, fills the critical shortcoming of the academic literature on derivative actions by providing a *theoretical structure* of derivative action as a law enforcement mechanism in the corporate governance context.

Secondly, the FFM advances a conceptually inclusive analytic framework and offers insights that, taken together, provide the requisite underpinnings for *policy* analyses of derivative action. Thirdly, the FFM sets guidelines for designing *effective regulatory measures* where derivative actions may be used to enforce the law.

The foundations of the FFM which were put together in this chapter are meant to provide a procedure for analysing and justifying this body of law. It is time now to turn to the strategic part of the FFM, namely resolving the issues relating to the costs and fees of derivative actions and providing positive inducements to litigate.

The Functional and Focused Model –

Strategic Aspects

Funding Derivative Actions: Costs and Fees as Incentives to Commence Litigation

5.1 INTRODUCTION

The argument so far has concerned itself with reformulating the application and structure of the derivative action. It is time now to put forward the second and strategic part of the FFM, namely resolving the issues relating to the costs and fees of derivative actions.

Litigation is expensive, and its cost is a major obstacle in the path of a minority shareholder bringing a derivative action on behalf of the company. A rational shareholder will normally prefer to sell his shares rather than litigate. In financial terms, a shareholder lacks any direct remedy that would make the action worthwhile for him or her. Even if the litigation is successful, any damages recovered accrue to the company and the shareholder will therefore receive only a pro rata share of the gains of a successful action.[1] There is also the prospect that the shareholder may have to pay not only the expenses of his or her litigation but also the legal expenses of the defendant if the action is unsuccessful.[2] A prospective plaintiff, being aware that the company and other shareholders will 'free-ride' on his or her efforts, has a strong incentive to leave it to someone else to sue. Overall

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[1] And then only indirectly and only to the extent that the proceedings cause the value of his own share to rise sufficiently, so that he might be willing to sue in order to sell his shares later at increased prices. This result, nonetheless, is far from certain as a successful action may reduce share values. Also, shareholders who own small stakes in the company have little incentive to bring a derivative action because the benefit of the suit accrues to shareholders according to the *size* of their holding, *not* their efforts in bringing the action.

2 Owing to the English 'loser-pays' rule that costs follow the event.

then, even if shareholder litigation results in intangible deterrence benefits, there should be little reason for individual shareholders to sue. If all shareholders share the same view, then no one is likely to step forward even in situations where litigation would increase total share value.[3] The use of derivative actions will rarely then, if ever, be rational. It would be a rare shareholder indeed who would fly in the face of this lethal mix of disincentives to commence litigation. Even in appropriate circumstances, then, shareholders will be left with little alternative but to turn their backs on litigation. The question then is what can be done to alter the situation whereby the shareholder 'has nothing to gain but much to lose'?[4]

The treatment of fees has a direct impact on the frequency of suit. The more advantageous the fee rule is to the prospective plaintiff the greater the employment of litigation.[5] This result is significant for policy analysis as it assists in the creation of rules that permit judicial determination of questions deemed important to societal interests. An understanding of the economic effect of fees on the decision to commence litigation allows the development of rules to encourage those actions which advance policy objectives.[6]

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[3] BR Cheffins 'Reforming the Derivative Action: The Canadian Experience and British Prospects' [1997] 2 CFILR 227, 257–258.

4 To use the words of Lord Denning in *Wallersteiner v Moir (No 2)* [1975] QB 373, 395.

[5] A major theme in the literature on the theory of litigation relates to the basic problem that the private incentives to litigate may diverge from what is socially desirable and the strategies that may be employed in order to create proper incentives to litigate. S Shavell *Foundations of Economic Analysis of Law* (Harvard University Press 2003) ch 18.

[6] As set out by the FFM above. See further JD Wilson 'Attorney Fees and the Decision to Commence Litigation: Analysis, Comparison and an Application to the Shareholder's Derivative Action' (1985) 5 Windsor Yearbook of Access to Justice 142, 169.

Chapter 5

This chapter is concerned with costs and fees in derivative actions in the context of incentives for such litigation.[7] It explores the critical role of costs and fees in initiating and maintaining derivative actions. The chapter proceeds as follows. Section 5.2 briefly explicates the economics of derivative action litigation. As part of this, the US rules on derivative action fees are examined. After rehearsing the common law recognition of the problems of the impecunious shareholder in the form of indemnity costs orders, Section 5.3 exposes major flaws in the operation of these orders. In response, possible solutions to rectify the funding problem will be examined and assessed in the next chapter.

[7] An earlier version of this chapter and the first three sections of chapter 6 entitled 'Funding Derivative Actions: A Re-examination of Costs and Fees as Incentives to Commence Litigation' appeared in (2004) 4 JCLS 345.

5.2 THE ECONOMICS OF DERIVATIVE ACTION LITIGATION

5.2.1 Introduction

In this section, the writer attempts to unravel the economic nature of derivative litigation. The shareholders' derivative action permits the assertion of company claims by shareholders. The form of cause employed in derivative action litigation is deceptive, as the prosecuting shareholder is normally named as the plaintiff and the company named as nominal defendant.[8] In English law, it has been described as an exception to the 'elementary principle that A cannot, as a general rule, bring an action against B to recover damages or secure other relief on behalf of C for an injury done by B to C. C is the proper plaintiff because C is the party injured, and, therefore, the person in whom the cause of action is vested'.[9]

Such a form of the action, nonetheless, conceals the true nature of the parties. In reality the company is the true plaintiff in interest, and in all but exceptional cases any damages or other relief obtained flow directly to the company and not to the nominal plaintiff. This fact has a significant impact on the nominal plaintiff's decision to commence litigation, as his interest in the outcome will generally be quite diffuse and remote. It is usually thought that a litigant will commence an action only when the expected value of the litigation is equal to or

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[8] See eg, *Taylor v NUM* [1985] BCLC 237, 246.

[9] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] 1 Ch 204, 210.

greater than zero. In the classic derivative action, however, with no direct payment to the plaintiff, the value of the expected award will be quite low.[10] In listed companies, in theory there may be an increase in the value of shares as the asset base of the company is increased; nonetheless, this result is far from certain. The value of shares is determined by a large number of factors beyond the underlying asset value. In fact, a successful derivative action may reduce share values because of bad publicity about the case or because a loss of confidence in directors may result.[11] An imbalance therefore arises in derivative litigation, as the fees faced by the nominal plaintiff will, in most cases, outweigh the potential benefit accruing to him. This consequent deterrence to derivative actions is common to both English and American fee rules. Rational plaintiffs therefore will rarely initiate derivative actions. Empirically, however, this is not the case in the US. The fact that the action is employed in the US is due to adjustments in the usual cost rules, the most significant of which are the 'common fund' and 'substantial benefit' doctrines and the recognition of contingency fee arrangements.[12] The fact that no similar doctrines exist in English law may partly explain the limited use of derivative actions.[13]

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[10] JD Wilson, above n 6, 171.

[11] ibid.

[12] The pattern of derivative litigation can be explained in large measure by the incentive structure which exists for lawyers in the US. See eg R Romano 'The Shareholder Suit: Litigation without Foundation?' (1991) 7 Journal of Law Economy & Organization 55, 84; R Romano 'Corporate Governance in the Aftermath of the Insurance Crisis' (1990) 39 Emory Law Journal 1155, 1157; D DeMott 'Shareholder Litigation in Australia and the United States: Common Problems, Uncommon Solutions' (1987) 11 Sydney Law Review 259, 273.

[13] Of course this is not the whole picture. Recall the standing and policy issues discussed in chs 1, 2, 3 and accompanying text. Arguably, the differences also stem largely from the political influence of the organized bar. Because the organized bar in the US is usually quite influential in the design of corporate rules, it has been able to ensure a relatively wide-ranging derivative remedy despite the remedy's unpopularity among corporate managers. See ch 1, under 1.4.1.

That the issue of costs has a great impact on the utility of the derivative action can also be seen from the Japanese experience.[14] Japan's present statutory derivative action[15] evolved from an original version that was borrowed from Germany.[16] In Japan, there is a strong traditional cultural aversion to litigation as a means of settling disputes.[17] Indeed, litigation, it seems, is seen as a 'dangerous characteristic of the foreigner who does not know better'.[18] Notwithstanding this cultural position, Japanese shareholders have, in recent years, been stepping up lawsuits against corporate leaders using the derivative action.[19] Seen against a corporate scene of management control and ignored shareholder interests, this state of affairs could indicate a general trend for increasing litigation, particularly in commercial matters, perhaps fuelled in part by the increasing exposure the Japanese have to Western influence and expressions of individualism and liberty.[20] The real

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[14] See generally MD West 'Why Shareholders Sue: The Evidence from Japan' Michigan Law and Economics Research Paper No 00-010 (November 2000) http://ssrn.com/abstract=251012; A Williams 'Japan's Recipe for Dispute Resolution' [1996] International Commercial Litigation 2.

[15] Arts 267–268 Commercial Code.

16 PKM Choo 'The Statutory Derivative Action in Singapore – A Critical Examination' (2001) 13 Bond Law Review 64, 92.

[17] A Williams 'Japan's Recipe for Dispute Resolution' [1996] International Commercial Litigation 2; T L'Estrange 'Major Issues in Litigation in the Asia Pacific Rim' [1996] International Commercial Litigation 24.

18 A Williams ibid.

19 While shareholders in Japan filed fewer than 20 derivative actions against directors from 1950 to 1990, West reports that by the end of 1993, 84 suits were pending in Japanese courts. By 1996, that number rose to 174, and by the end of 1999, there were 286 such suits, including 95 filed in 1999 alone. This is an increase of over 10,000%. MD West, above n 14; C Milhaupt 'Property Rights in Firms' in J Gordon & M Roe (eds) *Convergence and Persistence in Corporate Governance* (Cambridge University Press 2004) 246.

[20] A Williams, above n 17.

reason, however, is not merely the general shift in attitude but the dramatic changes in Japanese law in late 1993 making it easier and, more importantly, cheaper for shareholders to bring derivative actions.[21] In this respect, one should consider the unique position in the US where the derivative action is driven not by incentives being made available to shareholders but by incentives available to the legal profession. Therefore it is worth looking a little more closely at the costs rule in the US in order to understand why this makes a difference.

5.2.2 The US Rules on Derivative Action Fees

The treatment of fee shifting rules differs sharply between the US and the UK.[22] In the US the general rule is that each party is responsible for his own attorney's fees. By contrast, the English rule is that costs follow the event; that is, the unsuccessful party is generally ordered to pay part of the legal expenses incurred by the victor. This divergence provides a convenient basis for comparing the effect of the differing treatment of fees on the decision to bring a derivative action. As we shall see, in the context of derivative actions, the American treatment of fees in such actions provides significantly lower disincentives to prospective plaintiffs than does the English rule.

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[21] In Japan, where the loser pays court costs (under the Minsoh art 89), if a plaintiff wins, because the damages accrue to the company, the Commercial Code (art 268(2)) provides that the company shall pay a 'reasonable amount' of attorneys' fees. Absent extraordinary circumstances, defendants pay their own attorneys' fees. See further MD West 'The Pricing of Shareholder Derivative Actions in Japan and the United States' (1994) 88 NW University Law Review 1436, 1459.

[22] As Wilson points out, the divergence between the jurisdictions is not altogether clear. JD Wilson, above n 6, 142–143 and the references therein. For a stimulating account on the relationship and differences between the two legal systems see PS Atiyah and RS Summers *Form and Substance in Anglo-American Law: A Comparative Study of Legal Reasoning, Legal Theory and Legal Institutions* (Clarendon Press Oxford 1987).

The position in the US is unique, as a rather flexible costs formula is employed in derivative action procedures. Under the US Rules of Civil Procedure the general rule is that regardless of the outcome of the litigation both parties bear their own legal costs.[23] At the same time, it is common practice to apply the contingency fees arrangement, whereby an agreement is entered into by the attorney and his client to have attorneys' fees fixed at a percentage, based on the amount recovered should there be a successful outcome or where the matter is settled.[24] In other words, the attorney fees are contingent on the case being successfully litigated or on settlement of the case.[25] The question then is why would there be an economic value for an attorney to take on a derivative action case?

When an individual shareholder is successful in a derivative action, it is the company that is entitled to receive the amount awarded by the court and it is this amount that will be shared by the litigant and other shareholders. The attorney will usually be paid if the derivative action generates an income. But not all actions lead to tangible relief. Without an exception to the general contingency fees rule, this would certainly be enough to create a disincentive for any attorney to take on derivative litigation.[26]

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[23] See eg JC Coffee 'The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation' (1985) 48 Law & Contemporary Problems 5, 15–16; MP Dooley, *Foundations of Corporation Law* (Foundation Press New York 1995) for a brief introduction to the trials and tribulations of US lawyers.

[24] For a recent contribution which considers a wide variety of specific questions related to contingency fee practice in the US see HM Kritzer *Risks, Reputations, and Rewards: Contingency Fee Legal Practice in the United States* (Stanford University Press 2004).

[25] It is reported that the attorney's fees are usually in the range of 15–30% of the total recovered; s 7.17 of the American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (Proposed Final Draft 1992) 206.

[26] ibid.

In order to encourage attorneys to take on derivative actions, the courts in the US have adopted two approaches—'the common fund'[27] and 'the substantial benefit test', the latter being an exception to the contingency fee rules. Based on these approaches, there are two methods for calculating attorneys' fees in derivative actions. The first method is the percentage scale, which is applicable when the case generates a common fund for the company—the attorney will then be paid in the range of 20 to 30% of the common fund, depending on the prior agreement between the attorney and his client. Stated differently, a percentage scale will be used to calculate attorneys' fees if derivative action results in a tangible monetary relief.[28] In a case where derivative litigation results in an intangible or therapeutic relief only, the courts will apply the alternative method, known as the 'lodestar method', to allow attorneys to be paid for their work. The lodestar method is applicable if the derivative action results in a substantial benefit to the company, whether by judgment or settlement.[29] As a result of the well-built fee structure in

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[27] According to the doctrine, when a fund is recovered which benefits a class of persons beyond the nominal plaintiff, the legal fees expended in recovery are treated as a first charge against the fund. The theory of the doctrine is based on unjust enrichment and demands that all beneficiaries contribute pro rata to the expense of recovery. In the early application of the doctrine a monetary fund had to be recovered or saved. The shortcomings of the restrictive application became obvious when injunctive or declaratory relief was sought as there was no fund to charge. This deficiency was cured by judicial innovation, which extended the doctrine to situations where a substantial, although not monetary, benefit was obtained, justifying an award of attorneys' fees against the benefiting entity (*Sprague v Ticonic National Bank* (1939) 307 US 161). The literature on the common fund doctrine is vast. See eg s 7.17 of the American Law Institute 'Principles of Corporate Governance: Analysis and Recommendations' (Proposed Final Draft 1992); CG Hammett 'Attorney's Fees in Shareholder Derivative Suits: The Substantial Benefit Rule Re-examined' (1972) 60 California Law Review 164.

[28] L Thai 'How Popular are Statutory Derivative Actions in Australia? Comparisons with United States, Canada and New Zealand' (2002) 30 Australian Business Law Review 118, 123.

[29] The lodestar method was formally recognized by the US Supreme Court in *Mills v Electric Auto-Life Co* 396 US 375, 392 (1970). The court explained that the lodestar method is simply a method for calculating attorneys' fees based on the number of hours reasonably spent on the work, multiplied by the applicable market hours rate. The lodestar method may be used irrespective of whether a common fund is generated, and the final figure calculated by the attorney is subject to the court's scrutiny. The court has a discretion to adjust the final figure, depending on a number of factors, such as novelty or complexity of issues, quality of representation, risk and the like. See further L Thai, above n 28, 124 and the examples therein.

the US, it is common to see attorneys functioning more like 'entrepreneurs' who conduct litigation almost entirely on their own, with virtually no monitoring by the shareholders whose names are used only as the key to the courtroom door.[30] Attorneys tend to have a liking for derivative actions more than shareholders. The contingency fees arrangement and the lodestar method are perhaps the two most important mechanisms that affect not only who pays the attorneys' fees and how these fees are calculated, but also how the plaintiffs' attorneys conduct the derivative action litigation.[31] Not surprisingly, win or lose, derivative actions appear to be fairly common in the US, compared with the UK or other commonwealth jurisdictions, where contingency fees type arrangements are not employed in derivative action litigation.[32]

5.2.3 The Risk of Litigation is Shifted from the Plaintiff to the Attorney

Given the foregoing discussion, it becomes easier to appreciate the fundamental difference between the American and the English derivative action. The effect of the common fund doctrine and supplementing mechanisms as employed in the US is to reduce the *personal risk* faced by the nominal plaintiff. The policy underlying these exceptions to the usual American rule is that derivative actions are an

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30 JC Coffee 'The Regulation of Entrepreneurial Litigation' (1987) 54 University of Chicago Law Review 877; J Macey and G Miller 'The Plaintiff's Attorney Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform' (1991) 58 University of Chicago Law Review 1.

31 L Thai, above n 28, 124.

32 L Thai, above n 28, 124.

efficient method of enforcing corporate duties and obligations, but without adequate fee incentives such actions would not be pursued by rational plaintiffs.[33]

At the same time, it should be noted that the fee incentives provided by the common fund and substantial benefit doctrines only *reduce* rather than eliminate the deterrent effect of fees in shareholder litigation.[34] With respect to the common fund doctrine, the plaintiff *must* prevail in order that a fund be created.[35] On the other hand, if the plaintiff is unsuccessful he will remain liable for lawyers' fees. Similarly, under the substantial benefit rule, not only must the plaintiff prevail but, as is clear from the very phrasing of the rule, the effect of the judgment must substantially benefit the company. Even if successful on the merits, the plaintiff thus may still retain liability for fees.[36] This in turn means that, owing to the remaining liability for fees under the above exceptions to the general American rule, some disincentive or deterrence to litigation remains.[37]

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[33] *Schechtman v Wolfson* (1957) 244 F 2d (2d Cir) 537, 539.

[34] JD Wilson, above n 6, 172.

[35] See above n 27 and accompanying text.

[36] *Schechtman v Wolfson* (1957) 244 F 2d (2d Cir) 537, 540.

[37] In practice, however, the risk of litigation is shifted from the plaintiff to the attorney. Most American shareholder litigation appears to be handled on a contingency fee basis. See eg Hornstein 'Legal Therapeutics: The 'Salvage' Factor in Counsel Fee Awards' (1956) 69 Harvard Law Review 658, 659 (arguing that the shareholder action would not be employed without contingency fees); R Romano 'The Shareholder Suit: Litigation without Foundation?' above n 12, 84 ('[t]he principal beneficiaries of the litigation appear to be attorneys, who win fee awards in 90% of settled suits'). It is arguable that this assignment of risk is justified as (1) the attorney will normally have much greater monetary interest in the litigation than will the shareholder plaintiff (*Central RR & Banking Co of Georgia v Pettus* (1885) 113 US 116); and (2) lawyers may be better able to internalize the risk of litigation than the individual plaintiff, as they are able to calculate expected value over a range of actions (analogous to portfolio diversification) which allows the prosecution of some risky cases. E Mackaay *Economics of Information and Law* (Boston 1982) 173.

5.3 A RE-EXAMINATION OF INDEMNITY COSTS ORDERS

5.3.1 Introduction

By contrast to the American mechanisms employed in derivative action litigation, the traditional way in which most commonwealth jurisdictions address the obstacle of funding in a derivative action is by recognizing that the plaintiff should be indemnified for costs incurred in the proceeding, usually by allowing the court discretion on this matter. This is because the rights being vindicated are those of the company and recovery flows to it.[38] As such the entity should be liable for payments of costs.[39] In essence, then, a prima facie right of indemnification by the company by means of an indemnity order arose 'on the plainest principles of equity'.[40] The question is how well does the indemnity order address the issue of costs?

It is generally thought that by providing such compensation for a shareholder with respect to costs a formidable deterrent to the commencing of a derivative action is removed.[41] Similarly, it is believed that the possibility of awarding a cost indemnity order is a 'significant incentive' to use the derivative

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[38] That an action under one of the exceptions to *Foss v Harbottle* is truly a derivative action, rather than one brought by the minority shareholder in his own right, was a late recognition in English law (*Wallersteiner v Moir (No 2)* [1975] QB 373).

[39] JD Wilson, above n 6, 177.

[40] *Wallersteiner v Moir (No 2)* [1975] QB 373, 391 & 403–404 *per* Lord Denning and Buckley LJ.

[41] See eg DD Prentice 'Wallersteiner v Moir: The Demise of the Rule in Foss v Harbottle?' (1976) 40 The Conveyancer 51, 59.

action.[42] But, as will be seen below, these views are not entirely supported by the way in which these orders operate and are perhaps somewhat optimistic.[43] More importantly, they ignore the realities of derivative action litigation. A closer examination reveals some fundamental flaws in the operation of these orders.

5.3.2 The Common Law Recognition of the Problems of the Impecunious Shareholder

The common law has recognized the problems of the impecunious shareholder, with the major modern development being the judgments in *Wallersteiner*[44] where the court reasoned that in derivative actions it would be appropriate for the company to pay the shareholder's costs in that it is the company which benefits directly from any recovery. The paragraph setting out the reasons deserves to be reproduced.[45]

> Suppose there is good ground for thinking that those in control of a company have been plundering its assets for their own benefit. They should be brought to book. But how is it to be done? ... at present there is nothing effective except an action by a minority shareholder. But can a minority shareholder be really expected to take it? He has nothing to gain, but much to lose. He feels strongly that a wrong has been done—and that it should be righted. But he does not feel able to undertake it himself. Faced with an estimate of the costs, he will say: 'I'm not going to throw away good money after bad'. Some wrongdoers know this and take advantage of it. They loot the company's funds knowing there is little risk of an action being brought against them.

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[42] Consultation Paper para 18.1.

[43] See also, J Lowry 'Reconstructing Shareholder Actions: A Response to the Law Commission Consultation Paper' (1997) 18 Company Lawyer 247, 253; D Sugarman 'Reconceptualising Company Law: Reflections on the Law Commission's Consultation Paper on Shareholder Remedies: Part 2' (1997) 18 Company Lawyer 274, 277.

[44] [1975] QB 373, 389.

[45] [1975] QB 373, 395.

This quotation from Lord Denning's judgment shows that the rule in *Foss v Harbottle* is, in many ways, essentially an issue of costs[46]—a plaintiff minority shareholder runs the risk of having to pay substantial costs, while the directors (against whom the action in reality is being brought) may be indemnified by the company against the costs of defending an action for breach of duty.[47] Therefore '...it is not the question of standing that remains the greatest problem for the minority shareholder but the question of costs. This remains a burning issue'.[48] If a procedure could be devised to compensate a shareholder, irrespective of outcome, for his costs, then a formidable deterrent to the commencing of a derivative action would be removed, or at least reduced.

The difficulties that dogged Mr Moir in his battle are well known. By the time Lord Denning MR and the other learned judges of the Court of Appeal considered his financial plight, Dr Wallersteiner had successfully delayed resolution of the case for over ten years. Mr Moir exhausted his financial resources as well as considerable time and labour. He had obtained judgment against Dr Wallersteiner, but at the same time had been unable to enforce it and, in any event, any recovery would (directly) benefit the company alone.

Mr Moir's plight found sympathy with the Court of Appeal, particularly with Lord Denning, who was even prepared to allow a contingency fee arrangement.

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[46] DD Prentice, above n 41, 58.

[47] Subject to certain qualifications. See discussion in ch 4 under 4.4.2.5.

[48] R Baxt 'What is the Real Fuss about Foss v. Harbottle' (1994) 12 CSLJ 178, 180.

Therefore the court formulated a procedure to be followed on an application by a shareholder for an indemnity order as to costs,[49] which was designed to balance the interests of the minority shareholder and the company.[50] The test approved by the majority of the court for granting such orders was that the company be ordered to pay the costs of a bona fide plaintiff, when it would have been reasonable for an independent board of directors to bring such an action in the company's name.[51]

The court also believed that the plaintiff should himself be indemnified by the company in respect of his own costs even if the action fails. The court explained that it is a well-known maxim of the law that he who would take the benefit of a venture if it succeeds ought also to bear the burden if it fails. This indemnity should extend to his own costs taxed on a common fund basis[52] (albeit this could be less generous than an award of costs on an indemnity basis).[53] Eventually, *Wallersteiner* orders came to be seen as having the potential for being oppressive.[54] They were usually made without notice to the other side, shortly after the beginning of the proceeding and on affidavit evidence. The result would be that the company would thereafter find itself paying for an action which it almost invariably did not want brought, and which would usually put the whole management under intense

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[49] For an extensive analysis of this order and its effect see DD Prentice, above n 41, 59.

[50] The court modelled the procedure for the application to claim the order on that already established in the case of a trustee, who is entitled to indemnification in respect of proceedings on behalf of the trust property or in execution of the trust. *Wallersteiner v Moir (No 2)* [1975] QB 373, 404 *per* Buckley LJ. See also *Re A Company* [1987] BCLC 82. As to trustees see *Hardoon v Belilios* [1901] AC 188 (HL).

[51] *Wallersteiner v Moir (No 2)* [1975] QB 373, 404 *per* Buckley LJ.

[52] ibid, 392 *per* Lord Denning MR, 405 *per* Buckley LJ.

[53] Buckley LJ (ibid 407) contemplated that this more generous measurement could be used when necessary. ibid.

[54] *Smith v Croft* [1986] 2 All ER 551 *per* Walton J, discussed below.

pressure.[55] Later, the revised procedure was re-enacted in simplified form as part of the CPR Rule 19.9[56] which, while expressly authorizing the court to give the plaintiff an indemnity against costs out of the assets of the company on such terms as it thinks appropriate, also expressly requires the court's approval for the continuance of a derivative action.[57] So the application for an indemnity has been integrated into the application for leave to proceed. This means that the price of the possibility of the company's financial support for the claim is a greater degree of supervision by the court over the individual shareholder's conduct.[58]

In any event, any indemnity granted is likely to have to be renewed and reviewed as the litigation proceeds.[59] The order for an indemnity also requires the plaintiff to refer back to the court for approval of any offer of settlement of the suit.[60] This may reduce the possibilities for 'gold-digging' claims against the company which are settled on terms advantageous to the plaintiff shareholder and the defendants but which do not reflect the value of the company's right or are not in the interests of the company.[61] Interestingly, the provision that the court may make an order that any offer of settlement be referred back to the court for consideration is analogous to that in the US system for class and derivative actions,

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[55] BG Pettet *Company Law* (Longman Harlow 2001) 235–236.

[56] In the past, RSC Ord 15 r 12A.

[57] r 19.9 (3). *Portfolios of Distinction Ltd v Laird* [2004] [2004] EWHC 2071 discussed in ch 2 n 147.

[58] PL Davies *Gower and Davies' Principles of Modern Company Law* (7th edn Sweet & Maxwell London 2003) 455.

[59] ibid.

[60] Above n 57.

[61] PL Davies *Gower and Davies*, above n 58, 455; DD Prentice 'Wallersteiner v Moir: A Decade Later' [1987] The Conveyancer 167, 176.

which does not otherwise exist in the procedure under English law.[62]

5.3.3 Fundamental Flaws in the Operation of Indemnity Costs Orders

The *Wallersteiner* procedure was, at the time, an imaginative attempt to deal with the problems of funding. Subsequent decisions and developments, however, have added formidable difficulties to the *Wallersteiner* procedure and its operation. It is the purpose of this section to critically examine the major flaws in the operation of indemnity costs orders. As will be seen, the assumption that the system of indemnity costs orders strikes the right balance in enabling minority shareholders to bring derivative actions without enormous expense is open to question.[63]

5.3.3.1 Lack of incentives

The first fundamental point to note is that an indemnity order presupposes that a shareholder plaintiff will want to bring the action on behalf of the company in the first place. In other words, it does not provide the shareholder with any incentive to commence litigation, but rather, *once he has made the decision to sue*, allows him to be indemnified for costs involved in such a decision.[64] It follows that there seems to be some kind of confusion with regard to what exactly can be achieved through the use of indemnity orders. The confusion seems to occur because of two separate issues: namely, providing an incentive and lifting a deterrent are thought to be the same. But although it is true that a deterrent to the commencing of a

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[62] A Marks and W Rees 'Shareholders' Actions' (1991) 2 ICCLR 39, 41.

[63] See also AJ Boyle *Minority Shareholders' Remedies* (Cambridge University Press 2002) 83.

[64] *Wallersteiner v Moir (No 2)* [1975] QB 373, 403–404.

derivative action is removed by means of indemnity costs orders (it is possible that the shareholder will be indemnified for costs incurred in the proceeding), it does not necessarily follow that these orders offer a 'significant incentive' to use the derivative action.[65] Removing a deterrent is simply not the same as providing an incentive.[66] All that these orders do is to restore the shareholder's position to exactly the same starting position had the shareholder not decided to pursue the action on behalf of the company, that is, with no liability for costs. Indeed, it has been explained in the case law that indemnity orders are *not a direct incentive* given to a shareholder to promote the use of derivative actions, but rather a *reflection* of the rights being protected in the action[67] or a *form* of legal aid.[68]

In fact, despite indemnity costs orders there are still remarkable disincentives to commence litigation.[69] A person with a small shareholding has little financial incentive to sue on behalf of the company because the return to that person will be, at most, a percentage of the recovery which reflects the percentage of the shares of the company that person holds. Even then, the shareholder may not

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[65] See also JE Parkinson *Corporate Power and Responsibility – Issues in the Theory of Company Law* (Clarendon Press Oxford 1993) 241.

[66] An incentive can take the form of a reward given directly to shareholders in order to promote or encourage the use of derivative actions. See s 201 of the Israeli Companies Act 1999, under which the court has discretion to award successful plaintiffs part of the proceeds of a successful derivative action beyond their indirect recovery, so that the plaintiff can benefit directly in monetary terms. This may increase the accessibility of the remedy in the eyes of prospective plaintiffs, because, essentially, the shareholder can gain from the action directly. Moreover, this is an incentive because it sends a clear message to prospective shareholders that the legislator has been enthusiastic in encouraging the use of the derivative action, even at the price of detracting from the right of the company to receive all the proceeds of a successful action. See further A Reisberg 'Promoting the Use of Derivative Actions' (2003) 24 Company Lawyer 250, 251–253.

[67] *Jaybird Group Ltd v Greenwood* [1986] BCLC 318, 328.

[68] *Smith v Croft* [1986] 2 All ER 551, 565.

[69] For a stimulating debate about incentives to litigate generally see S Shavell 'The Social versus the Private Incentive to Bring Suit in a Costly Legal System' (1982) JLS 333; L Kaplow 'Private versus Social Costs in Bringing Suit' (1986) 15 JLS 371; S Shavell 'The Fundamental Divergence between the Private and the Social Motive to Use the Legal System' (1997) 26 JLS 575.

receive an immediate cash return.[70] And in addition, not all actions lead to a tangible relief.[71] These factors have a significant impact on the plaintiff's decision to commence litigation, as his interest in the outcome will generally be quite diffuse and remote. As it stands, there is nothing in the way indemnity costs orders work to dislodge this.[72]

A further difficulty lies in the fact that the court has discretion to order the plaintiff an indemnity against costs out of the assets of the company in such terms as 'it thinks fit'.[73] First, given that the court has such a wide discretion, how should it go about deciding this?[74] Secondly, it causes great concern to shareholders, even bona fide, to know that the court will only make costs orders when it considers appropriate.[75] Finally, leaving much to the attitude of a particular judge, although

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[70] For example, the directors may choose not to pay out recovery by way of dividend and instead invest it in some other venture. PL Davies *Gower and Davies*, above n 58, 447.

[71] Recall that it is not uncommon that the relief takes the form of a tracing order against and a charge over the misappropriated assets where the directors misappropriated the company's assets. A recent example is *Clark v Cutland and others* [2003] EWCA Civ 810 (un unfair prejudice case, treated as if it were a derivative action, as there was a derivative action in the background with which the petition had been consolidated).

[72] The proposals put forward by the Law Commission have nothing to add. It proposes that the court's powers to make costs indemnity orders should remain unchanged, as the court will continue to have its power to make costs indemnity orders 'as it thinks fit'. Report para 6.104 and draft r 50.13.

[73] Report para 6.104. See also CPR r 19.9(7).

[74] One possible way is adopting a 'cost-effectiveness' test as discussed above, ch 4 nn 78–80 and accompanying text.

[75] It is arguable that this requirement adds nothing to the wide discretion the courts already have. When will the court consider it 'inappropriate' to grant a costs order? Presumably when the shareholder is motivated by malice or personal factors and the claim is not being pursued bona fide on behalf of the company (*Barrett v Duckett* [1995] 1 BCLC 243, 256 *per* Gibson LJ). But in such cases, the shareholder could also be judged to have lost the right to a costs order anyway since, prior to granting leave, the court must be satisfied that the plaintiff is acting in good faith, reasonably and with a view to the best interests of the company (eg *Smith v Croft* [1986] 1 WLR 580).

The problem with such wording can also be seen in s 242 of the Australian Corporations Act under which the court has power to make various costs orders 'as it thinks appropriate'. Thai (above n 28, 136) notes that s 242 has not resolved the shareholder's costs problems, as it is unclear as to how far the court will go in deciding certain actions to be doubtful (and so denying indemnity)

commendable on grounds of flexibility, may nevertheless be counter-productive in some cases.[76]

5.3.3.2 The problematic interrelationship between the application for an indemnity and the application for leave to proceed

A. Procedure may result in a costly mini-trial to establish entitlement

The problem with any procedure for obtaining a pre-emptive costs order is to ensure that it is not in itself so costly as to defeat the object of the exercise. In *Wallersteiner* the court was at pains to emphasize that an application for costs should be kept 'simple and inexpensive' and that it should on no account be allowed to 'escalate into a minor trial'.[77] Under the procedure for derivative actions the application for an indemnity has been integrated into the application for leave to proceed.[78] In considering the plaintiff's applications for permission to continue and indemnification, the court has therefore to consider whether the action has any real prospect of success.[79] This means, as the Law Commission acknowledged, that the standing of the member to bring a derivative action has to be established as a preliminary issue by evidence which shows a prima facie case on the merits. Without effective case management, however, this can result in a mini-trial which

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and how these orders will affect the shareholders. It is naïve to assume that it would be much different in the UK, given the fact that under the Law Commission's proposal the same terminology is used (see above n 72).

[76] As well illustrated in *McDonald v Horn* [1995] 1 All ER 961, CA, when the court proposed further restrictions. It was suggested that the court should not normally authorize the funding of proceedings until there has been an investigation of the plaintiff's complaints made by an independent party (but note now CPR r 19.9(7)). For a recent example of an unsuccessful attempt to obtain a costs order see *Halle* v *Trax BW Ltd* [2000] BCC 1020.

[77] *Wallersteiner v Moir (No 2)* [1975] QB 373, 394 *per* Lord Denning.

[78] Set out in CPR r 19.9 (7).

[79] R Reed, 'Derivative Claims: The Application for Permission to Continue' (2000) 21 Company Lawyer 156, 158.

increases the length and cost of the litigation.[80] There is a danger that this requirement may result in the proceedings devolving into a trial on the merits as the court will have before it the evidence that is to be proven in the case, and inevitably the merits of the action will cast a shadow over the proceedings for an indemnity order. Essentially, there is the prospect that the cost of litigation may exceed the benefit realized by the company.[81]

In particular, CPR, Rule 19.9(4) now provides that the plaintiff needs to support his application for permission by 'written evidence'. In practice, written evidence supporting permission applications has done little more than verify the facts on which the claim and the entitlement to sue on behalf of the company are based, often in a brief perfunctory paragraph confirming the allegations made in the particulars of claim.[82] In many shareholder disputes, however, there are bitter disputes of fact, and the defendant can only respond to the plaintiff's allegations by showing cause against the application by a witness statement in reply.[83] Although the permission procedure was instituted precisely to obviate the need for a defence at this stage, the defendant's witness statement in reply, if properly particularized in responding to the plaintiff's contentions of control and fraud on the company, starts looking very like a defence and can cost as much to produce.[84]

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[80] Consultation Paper, para 14.1. See also the judicial case management under the Civil Procedure (Amendment) Rules 1999, r 1.4 (1).

[81] D DeMott, above n 12, 269.

[82] R Reed, n 79 above.

[83] ibid.

[84] ibid.

Furthermore, even where the plaintiff's factual allegations are unfounded, to prove the contrary in a complicated shareholder dispute extending over the long period during which such disputes usually develop would normally require a long witness statement in reply.[85] The time estimate for the hearing of the permission application could correspondingly extend as the defendant's advocate will have not only to present his client's evidence but also to undertake an often complicated critical analysis of the plaintiff's evidence.[86] This seems a long away from the notion in *Wallersteiner* that the proceedings for an indemnity order are to be expeditious, simple and designed merely to determine whether or not a reasonable independent board of directors would authorize such an action.[87]

B. The relationship between the indemnity procedure and the exceptions to the rule in *Foss v Harbottle* and its effect on the economics of litigation

There is also a related and much more complicated issue here as to the relationship between the indemnity procedure and the exceptions to the rule in *Foss v Harbottle*.[88] The uneasy question of whether, and in what circumstances, *Foss* may be avoided is linked inextricably with the (formally) separate issue as to whether the minority shareholder is entitled to an indemnity order against the company,[89] in accordance with *Wallersteiner*. In each instance, the concern has been with the extent to which argument upon the substance of the alleged abuses may be heard.

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[85] ibid.

[86] ibid.

[87] *Wallersteiner v Moir (No 2)* [1975] QB 373, 397 D–E *per* Lord Denning.

[88] DD Prentice, above n 41, 65; Beck 'The Shareholders' Derivative Action' (1974) 52 Canadian Bar Review 159, 196–202.

[89] M Stallworthy 'Minority Rights and the Continuing Thrall of Foss v Harbottle' (1988) Conveyancer and Property Lawyer 217, 218.

The judgment in *Smith v Croft* illustrates how difficult it is to separate the costs point from the standing point.[90]

This obviously has also an adverse effect on the economics of litigation, as was illustrated in the case of *Prudential Assurance Co Ltd v Newman Industries Ltd*,[91] where the costs of maintaining and successfully prosecuting a derivative action, when the action was eventually concluded, far exceeded the financial benefit realized by the company.[92] Besides the obvious implications this has on any given case, this clearly has also a substantial effect on both the practice and use of derivative actions (ie potential litigants might be deterred by such examples) and the legal system as a whole. The evidence in the UK, indeed, indicates that under the current indemnity order system, derivative action cases are taking longer to litigate[93] and involve more pretrial practice.[94]

C. The court may more readily be persuaded against making an indemnity order

In some cases, the fact that the application for an indemnity has been integrated into the application for leave to proceed may be unfair to both the company and the

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[90] [1986] 1 WLR 580. See also C Graham 'Case Comment: Reconciling Conflicting Interest: *Wallersteiner* Revisited' (1986) 7 Company Lawyer 153, 155; DD Prentice, above n 61, 171–172.

[91] [1982] 1 Ch 204.

[92] The Court of Appeal finally determined that the defendants caused £45,000 in damage to the company, but that paled in comparison to the 'small fortune' running into six figures apparently spent by the plaintiffs on legal fees. It is not surprising therefore that the derivative action procedure was referred to as 'lamentable litigation' with its 'horrendous costs' [1982] 1 Ch 204, 220. See in this respect the judicial case management under the Civil Procedure (Amendment) Rules 1999, r 1.4 (1).

[93] In *Prudential Assurance Co Ltd v Newman Industries* Ltd *(No 2)* [1981] Ch 257 the minority shareholder's action lasted, at first instance, over 70 days.

[94] LS Sealy 'Problems of Standing, Pleading and Proof in Corporate Litigation' in BG Pettet (ed), *Company Law in Change* (London 1987) 1, 6–7 and 13.

shareholder. From the company's viewpoint, an early application may fail to screen out frivolous and ill-founded action. There is a danger that an order may be made before the completion of discovery and inspection, and at this stage the plaintiff could inevitably swear with a clear conscience that his case is well founded.[95] Conversely, it makes the case for a shareholder very much harder when he is required to prove his entitlement, before the case has been heard on its merits, with very little evidence and facing a suspicious court.[96]

In addition, the defendants can strongly resist any application made by the plaintiff for an indemnity order against the company. In the past, when the issue of the plaintiff's entitlement to sue was determined as a preliminary issue, the plaintiff was most likely to succeed in his accompanying application for an indemnity.[97] Now, there is a serious problem of achieving the right balance in indemnity order procedures. It is inevitable that the more evidence adduced on an application for an indemnity order the more prolonged will be the proceedings,[98] which seems to defeat the notion of 'simple and inexpensive' procedures. Moreover, in the case of quasi-partnerships, it is the very possibility of an order for an indemnity that has often persuaded the plaintiff to bring a derivative action rather than seeking relief

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[95] *Smith v Croft* [1986] 1 WLR 580, 583.

[96] In *Smith v Croft* a good portion of the judgment was taken up with analysis of the allegations against the directors and, although Walton J stressed that he was not trying the case on its merits, the refusal of an indemnity order where all the facts are before the court will often result in abandonment of the litigation at this stage. See also *Barrett v Duckett* [1995] 1 BCLC 243; C Baxter 'The Role of the Judge in Enforcing Shareholder Rights' [1983] CLJ 96, 110; GR Sullivan 'Restating the Scope of the Derivative Action' [1985] CLJ 236, 237.

[97] R Reed, above n 79, 158.

[98] DD Prentice, above n 61, 172.

by a personal action, for example by presenting a section 459 petition.[99]

D. Danger of under-settling the action

In any event, the realization that the plaintiffs will have to fund the action themselves, even though any recovery will be that of the company, may result in a serious difficulty. This may well cause the applicant to give greater consideration to settlement options. In fact, this can give rise to serious possibilities of collusion because the directors can buy off the applicant in disregard of the rights of the company and its members.[100] One of the curiosities of the derivative action is that there is no control over the right of the plaintiff shareholder to reach a compromise in the action despite the fact that he appears in a representative capacity and the compromise may be on terms that are beneficial to the plaintiff shareholder and the defendants but not in the interests of the company.[101] Because of the dangers that this obviously presents, the abandonment or compromise of a derivative action is made subject to judicial control[102] as well as in most jurisdictions.[103]

5.3.3.3 The problematic 'financial need test'

Walton J in *Smith v Croft (No 1)*[104] approached the issue of costs rather cautiously and added a further obstacle when he applied a 'financial need test' against the

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[99] R Reed, above n 79, 158. Note the recent decision in *Clark v Cutland and others* [2003] EWCA Civ 810; ch 7 below under 7.1, 7.2.2 and 7.4.2.

[100] Consultation Paper 268.

[101] DD Prentice, above n 63, 175.

[102] Under CPR r 19.9 (3).

[103] A similar requirement is found in r 23.1 of the Federal Rules of Civil Procedure in the US, in New Zealand (Companies Act 1993, s 168), under the Canada Business Corporations Act 1985, s 242 (2) and under the Israeli Companies Act 1999, s 202.

[104] [1986] 1 WLR 580.

applicants. In that case, Walton J found that it would be 'palpably unjust' for the court to order an indemnity without full discovery: 'Unless [everything] has been so disclosed, how is the company to be in a position to lay facts which will have the effect of demolishing the plaintiffs' case before the court?'[105] Walton J then stated the rationale of *Wallersteiner* to be that a plaintiff should not be precluded from pursuing an 'obviously just case' because of lack of funds. Walton J's standard of 'obviously just case' was extremely high;[106] nonetheless, he went further and, on the basis that the company should not have to bear extra costs except in the clearest cases, brought the financial status of the applicant into play. Walton J found that justice requires that the plaintiff establish his genuine need for indemnification, ie 'that he does not have sufficient resources to fund the action in the meantime'.[107] Regrettably, this narrow approach for indemnification has been followed by courts across the Commonwealth.[108]

The approach of Walton J exemplified in *Smith v Croft* was rightly criticized at the time as being an irrelevant consideration, on grounds of both principle and practicality, in deciding whether or not an indemnity order should be granted.[109] Also, this more restrictive approach to *Wallersteiner* orders was not

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[105] [1986] 1 WLR 580, 589.

[106] [1986] 1 WLR 580, 597.

[107] [1986] 1 WLR 580, 597.

[108] See eg the Canadian case in *Intercontinental Precious Metals Inc v Cooke* [1994] WWR 66; in the Australian case *Farrow v Register of Buildings Societies* [1991] 2 VR 589, the court held that it would grant costs if it appeared that the shareholder were destitute or so financially handicapped that the case otherwise could not proceed.

[109] DD Prentice, above n 61, 173–174.

followed in a later case.[110] On grounds of principle, the reason for granting the order in *Wallersteiner* was because the plaintiff was bringing the action as the 'representative' of the company and his wealth was an irrelevant consideration in determining his status to do so.[111] There could be no question, for example, of denying a trustee or an agent an indemnity order if they were otherwise entitled to one merely on the grounds of their wealth.[112] Indeed, in the Canadian case of *Turner v Mailhot*,[113] the court pointed out that a test based on the financial ability of the applicant to carry on the action offended against the principle that the shareholder is acting as the agent of the company.[114] The court also believed that an applicant who has obtained leave must have satisfied the conditions laid down in *Wallersteiner* and is therefore prima facie entitled to an order for costs. However, it is only a prima facie entitlement and thus may be displaced by other factors such as, ironically, an inability to meet the financial costs.[115]

There are other compelling reasons why an indemnity order should be granted even if a shareholder has sufficient wealth to finance the action. A shareholder may simply not be willing to risk depleting his wealth by bringing a derivative action given that the benefits of recovery will be shared with others and the gain to the shareholder may be minimal if his holding in the company is not

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[110] *Jaybird Group Ltd v Greenwood* [1986] BCLC 318, 327.

[111] DD Prentice, above n 61, 173.

[112] ibid.

[113] (1985) 50 OR (2d) 561.

[114] (1985) 50 OR (2d) 561, 567 (explaining that the section of the Business Corporations Act that governs applications for leave to bring derivative actions simply states in statutory language the gist of what the judges of the court articulated in *Wallersteiner*).

[115] ibid 567.

significant.[116] Likewise, Walton J was concerned by the fact that the early payment as to costs under an indemnity order would impose a burden on the company. It is true that legal proceedings should only be commenced after careful thought, not least because of the significant costs that might be incurred.[117] At the same time, the reason for granting an early payment as to costs under an indemnity order, nonetheless, is the failure of the company to bring the action in the first place and it is difficult to see therefore why this should be a factor in denying a wealthy plaintiff an indemnity order. The court after all enjoys considerable discretion as to the basis on which costs will be granted and this can be used to avoid any possible unfairness to the company.[118]

Turning to grounds of practicality, a wealth bar could be easily evaded by using as a nominal plaintiff a shareholder who lacked resources and who was willing to act in a 'representative' capacity for shareholders whose wealth would preclude them from obtaining an indemnity order.[119] Moreover, where there is more than one plaintiff it would be unclear how their resources were to be pooled, if at all, in applying a rule that wealth debarred a plaintiff from obtaining an indemnity order. No doubt a solution could be fashioned to deal with these problems, but to do so would greatly complicate the already complicated procedure

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[116] DD Prentice, above n 61, 173.

[117] An interesting comparison can be made with insolvency procedures. When proceedings commenced in the name of a company in liquidation fail, the liquidator will not be thanked by the creditors for the fact that the company's funds will be used to pay a likely costs award against the company. See A Keay 'Pursuing the Resolution of the Funding Problem in Insolvency Litigation' (2002) 3 Insolvency Lawyer Journal 90. In *Re Exchange Travel (Holdings) Ltd (in liq) (No 3)* [1997] 2 BCLC 579, Phillips LJ observed that the costs incurred by the liquidators in a preference action exceeded what was at stake.

[118] DD Prentice, above n 61, 173.

[119] *Jaybird Group Ltd v Greenwood* [1986] BCLC 318, 328.

for obtaining an indemnity order and it would, in all probability, be far from simple and expeditious to apply.[120]

It is difficult to disagree with this. If an indemnity order were to be precluded because of the wealth of the plaintiff, this would greatly curtail the remedy's reach. Likewise, it would be to overlook one of the principal justifications for the existence of the derivative action in the first place, that it is a form of pleading originally introduced on the ground of necessity alone in order to prevent a wrong to the company going without redress.[121] If this is the reason why derivative actions are allowed, then why should the wealth of a shareholder be a relevant consideration in determining his status or indeed his entitlement to be indemnified for costs, when he is bringing the action *on behalf of* the company and *for the benefit of* the company?[122]

5.3.3.4 On what basis are indemnity costs orders awarded?

Given the foregoing discussion regarding the 'financial test' requirement, it becomes clear why it has been submitted that the circumstances in which indemnity orders are granted are open to restrictive interpretation.[123] Essentially, it is unclear when and under what circumstances an application for costs and indemnity will be made in favour of shareholders. This is because the more restrictive approach to

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[120] ibid.

[121] *Smith v Croft (No 2)* [1988] Ch 114, 185 *per* Knox J.

[122] Essentially, the same rationale arguably requires that equitable defences which exist between a minority shareholder personally and a wrongdoer be irrelevant for the purpose of deciding whether to allow a derivative action to proceed. See J Payne 'Clean Hands in Derivative Actions' [2002] 61 CLJ 76, 86. Ch 4 under 4.4.4.4 (F).

[123] See eg E Ferran 'Company Law Reform in the UK' (2001) 5 Singapore Journal of International and Comparative Law 516.

Wallersteiner orders exemplified in *Smith v Croft* was not followed in *Jaybird Group Ltd v Greenwood.*[124] Instead there is a fundamental question which remains open, namely whether costs orders are granted as a *reflection* of the rights being protected in the action,[125] as a *form* of legal aid[126] (and thus subject to a means test) or perhaps on other grounds.

This is one of the least intellectually satisfying rationales of indemnity costs orders. The question on which basis these orders are granted is an important one as a matter of both principle and policy. It affects the way in which the indemnity order is to be computed (ie whether on a common fund basis,[127] on an indemnity basis[128] or whether subject to a means test[129]). This affects not only the degree of availability of these orders but also their size (ie how generous they should be). This, in turn, affects the shareholder's decision whether or not to initiate proceedings in the first place (the logic being that the more generous these costs order are, the more willing a shareholder may be to commence litigation). Likewise, this fundamental question is interlinked with the seemingly separate question to what extent these orders are (or should be) given as a form of incentive

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[124] [1986] BCLC 318, 328.

[125] *Jaybird Group Ltd v Greenwood* [1986] BCLC 318, 328. This view is supported by Davies *Gower and Davies*, above n 58, 455.

[126] *Smith v Croft* [1986] 2 All ER 551, 565.

[127] *Wallersteiner v Moir (No 2)* [1975] QB 373, 392 *per* Lord Denning MR, 405 *per* Buckley LJ.

[128] Buckley LJ did contemplate that this more generous measurement could be used when necessary (ibid, 404).

[129] In case it is seen as a form of legal aid as in *Smith v Croft* [1986] 2 All ER 551, 565.

to shareholders, as was explained above.[130] A determination of this question is vital for a principled and reasoned development of the law.[131]

5.3.3.5 The shareholder may not be compensated if the company becomes insolvent

Another issue which is usually overlooked is that under an indemnity order the shareholder will not be recompensed if the company proves to be insolvent and the action is unsuccessful.[132] An indemnity order does not confer any security in the nature of a lien on any part of the company's assets.[133] On the one hand, it should be noted that the risk of insolvency is one often faced by litigants in all sorts of cases.[134] So in this respect there is nothing unique here. On the other hand, shareholders should not, in effect, be putting their own money at risk, or feel they are 'going to throw away good money after bad'[135] when they are suing on behalf of the company and for the benefit of the company. Furthermore, in the case of an insolvent company, the plaintiff would gain little benefit from an indemnity order, a point that persuaded Lord Denning in *Wallersteiner* to fashion a contingent fee

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[130] For example, it is possible that this option should be ruled out if it is accepted that these orders are granted as a reflection of the rights being protected in the action. This, in turn, would mean that we should seek other means of funding to supplement or substitute these orders.

[131] Not least because of the deterrent effect this may have on a shareholder's decision to commence proceedings. Regrettably, the Law Commission consultation paper shied away from addressing this question. It seems to be too often true that when an issue is treated as a matter of procedure (the question which the rule in *Foss* addresses is that of *locus standi*) rather than one of substance, there does not appear to be the same need to justify or articulate properly the principle which is being applied. LS Sealy, above n 94, 3.

[132] DD Prentice, above n 41, 59.

[133] *Qayoumi v Oakhouse Property Holdings Plc* [2003] 1 BCLC 352.

[134] *Wallersteiner v Moir (No 2)* [1975] QB 373, 408 *per* Scarman LJ.

[135] ibid, 395 *per* Lord Denning.

procedure to deal with the problem of providing funds for shareholder litigation where the company has no assets.[136]

Interestingly, in *Watts v Midland Bank Plc*,[137] Gibson J did not allow a plaintiff to be indemnified out of the assets of the company.[138] The reason for this was that the company appeared to be hopelessly insolvent and therefore Gibson J believed that there was no way in which the plaintiffs could have benefited as *shareholders* from any derivative action. It is hard to agree with this. First, where the action for which the indemnity order is being sought could result in the company recovering sufficient assets so as to return to solvency, then the insolvency of the company should not be a bar to the granting of an indemnity order.[139] In this context, it is often overlooked that recovery by a company in a derivative action will indirectly benefit the creditors, as they will have first claim on its assets. This aspect of the derivative action is often lost sight of. Creditors, for example, could have benefited from a derivative action in *Watts*.[140] In any case, as a matter of principle the fact that there was no way in which the applicants could have benefited as *shareholders* from any derivative action should be an irrelevant consideration post-*Wallersteiner*. This is because, as explained above, post-*Wallersteiner* it is clear that a shareholder is not enforcing a right that belongs to him but rather one that is vested in and therefore derived from the company. The

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[136] DD Prentice, above n 61, 174.

[137] [1986] BCLC 15.

[138] ibid 22f.

[139] DD Prentice, n 61, 174–175.

[140] It is clear, nonetheless, that there are other ample means available to creditors to seek redress when a company's assets have been wrongfully dissipated.

right question should therefore be: is there any way in which the *company* could have *benefited* from a derivative action (shareholders being but one of the constituencies of the company)?

5.4 CONCLUSION

This chapter has explored the critical role of costs and fees in initiating and maintaining derivative actions. We saw that the fact that the action is employed in the US is due to adjustments in the usual cost rules, the most significant of which are the 'common fund' and 'substantial benefit' doctrines and the recognition of contingency fee arrangements. In addition to the immense hurdles discussed in previous chapters, the fact that no similar doctrines exist in English law may partly explain the limited use of derivative actions.

By contrast to the American mechanisms, the traditional way in which English law has addressed the obstacle of funding in a derivative action is by recognizing that the plaintiff should be indemnified for costs incurred in the proceeding by allowing the court discretion on this matter. A close analysis of the operation of indemnity costs orders has revealed serious flaws in the operation of these orders. Under the current system, it is clear that: (1) obtaining an indemnity order does not act as an overall suppressor of the funding problem; (2) it does not provide a positive inducement to litigate—it will still be true that the plaintiff in derivative proceedings concerning a company of any size will have little or nothing to gain from their successful outcome; and (3) there is also little likelihood that this will sway shareholders to opt for the derivative action in lieu of section 459 proceedings.[141]

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[141] Particularly in light of *Clark v Cutland and others* [2003] EWCA Civ 810. See ch 7 under 7.1, 7.2.2 and 7.4.2.

Overall, then, it is a less than adequate response to the formidable funding problem inherent in derivative actions. Regrettably, the Law Commission's conclusion that the possibility of cost indemnity orders is a 'significant incentive' to use the derivative action does not appear to reflect the realities of the current position and is much too optimistic. The question is then what fee formulas or financial mechanisms can be employed in order to bolster the distorted incentives of potential derivative actions litigants. It is the purpose of the following chapter to look into a menu of possibilities.

Pursuing the Resolution of the Funding Problem

6.1 INTRODUCTION

In the previous chapter we saw that the operation of indemnity costs orders offers a less than adequate response to the formidable funding problem inherent in derivative actions. The existence of two-way fee shifting with liability on the nominal plaintiff makes pursuit of the action uneconomic, and thus the viability of the action demands some adjustment of those rules. Such adjustment should obviously heed the arguments advanced in favour of the derivative action and those against over-empowering shareholders to bring these actions, as discussed above.[1]

The purpose of the chapter is to examine four possible avenues to rectify the economic impediments to derivative actions.[2] The first two focus on short-term solutions and involve the company and the plaintiff shareholder. Section 6.2.1 considers making a mandatory requirement for the company to pay the costs of the action. Section 6.2.2 looks at the merits and demerits of rewarding the shareholder with part of the proceeds of a successful action. The last two sections concentrate on solutions in which the risk of loss is shifted on to the plaintiff's attorney. Section 6.3 explores new possibilities in the guise of conditional fee agreements; Section 6.4 assesses the possibility of adopting a US-style contingency fees in the limited context of derivative actions. Section 6.5 concludes.

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[1] ch 2 under 2.2 and ch 3 under 3.2.2.

[2] Some of the themes below draw on A Reisberg 'Financing Derivative Actions: The Way Forward' (2006) JBL (forthcoming).

6.2 MENU OF OPTIONS: SOLUTIONS INVOLVING THE COMPANY AND THE SHAREHOLDER

6.2.1 Option One: A Mandatory Requirement for the Company to Pay the Costs of the Action

It is arguable that once the court grants leave to the plaintiff to commence the derivative action, it should be *mandatory* and not discretionary for the company to pay the costs of the proceedings. After all, prior to granting leave, the court must be satisfied that the plaintiff is acting in good faith, reasonably and with a view to the best interests of the company.[3] If these requirements are met, it is difficult to see why the company should not be required to pay the costs of the legal action.[4]

Indeed, under section 166 of the New Zealand Companies Act 1993, when an application is made the court *must* order that the costs of the proceedings will be paid by the company rather than the applicant personally, unless this would be 'unjust or inequitable'.[5] This provision seems to be designed to overcome the disincentive to litigate stemming from the normal rule that the losing party will also pay the other side's costs.[6] Leaving the issue of costs and indemnification to the

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[3] *Smith v Croft* [1986] 1 WLR 580; *Jaybird Group Ltd v Greenwood* [1986] BCLC 318; Report para 6.104 and draft r 50.13.

[4] I Ramsay 'Corporate Governance, Shareholder Litigation and the Prospects for Statutory Derivative Action' (1992) 15 University of New South Wales Law Journal 149, 164.

[5] cf the case of Japan, where if a plaintiff wins, because the damages accrue to the company, art 268 (2) of the Commercial Code provides that the company shall pay a 'reasonable amount' of attorneys' fees upon the plaintiff's motion.

[6] s 166 clearly uses the term indemnity for costs in 'bringing' the action, not an indemnity for having already 'brought' the action. This appears to provide for the applicant to be indemnified from the time of a specific application under s 166, which in most instances will be made at the time of the hearing of the s 165 application. P Fitzsimons 'The Companies Act 1993: A New Approach to Shareholder Litigation in New Zealand' (1997) 18 Company Lawyer 306, 310.

outcome of the substantive action results in the applicant being placed in an uncertain position. The wording of this provision should, on the face of it, provide shareholders with more confidence and security. The effectiveness of this provision in relieving the 'deterrent effect' has, nonetheless, been somewhat disappointing in practice.[7] An apparently more generous provision is section 18 (5) of the New Zealand Securities Amendment Act 1988, which provides that in a derivative action for insider trading brought under that Act, the company will *always* be liable for the shareholder's costs, *irrespective* of the result.[8] This presumption is arguably more shareholder-oriented and also less vague than the wording of section 166, where it is unclear whether liability for costs under that section proceeds on the same basis.[9]

In short, a *mandatory* requirement for the company to pay the costs of the action seems to improve on the English indemnity costs order, by virtue of providing a shareholder with more certainty and confidence. But although this 'advanced' form of indemnity order is a step in the right direction, it does not change the basic problems. First, the intention of the requirement can be easily defeated by a restricted and confined interpretation (as well illustrated by the chilling welcome it received by the judiciary in New Zealand). Secondly, even if

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[7] In *Vrij v Boyle* [1995] 3 NZLR 763, 768, the first case since the introduction of the statutory derivative action, Fisher J held that questions of costs and indemnity from the company should be reserved until after the substantive proceedings had been concluded, and decided on the basis of the outcome of the action on its merits. Since then there have been very few applications for leave to bring derivative actions. M Berkahn 'The Derivative Action in Australia and New Zealand: Will the Statutory Provisions Improve Shareholders' Enforcement Rights?' (1998) 10 Bond Law Review 74, 96.

[8] M Berkahn ibid 97.

[9] ie whether the section includes the defendant's costs, for which the applicant may be responsible if the action is unsuccessful.

the action is successful, a shareholder may still not be better off than fellow shareholders who made no effort to support the proceedings.[10]

6.2.2 Option Two: Rewarding the Plaintiff with Part of the Proceeds of Litigation

6.2.2.1 Outline of proposal

A more beneficial step towards rectification of the funding problem would be to allow the court to use its discretion to reward successful plaintiffs with part of the proceeds of a successful action beyond their indirect recovery.[11] The writer deliberately uses the term 'reward' to make a distinction between the notions of 'award' and 'reward'.[12] This also clarifies that the proposal does not intend to offend against the basic principle that recovery and relief belong to the company under a derivative action. This can be made through recognition of a US-style common fund doctrine[13] either by statute or through judicial action. From a structural point of view this seems just and fair. Once the corporate veil is pierced, we find that a shareholder has, essentially, worked for the benefit of the company and all the other shareholders.[14] Since these shareholders all hold fungible interests, we can treat the fractional interest in the company as marking their precise stake in

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[10] Given that the benefit of the suit accrues to shareholders according to the size of their holding, not their efforts in bringing the action.

[11] See eg the Israeli Companies Act 1999 s 201, discussed in A Reisberg 'Promoting the Use of Derivative Actions' (2003) 24 Company Lawyer 250, 253.

[12] The rationale is explained below under 6.2.2.2.

[13] See ch 5 above n 27 and accompanying text.

[14] In addition, recovery by a company in derivative action will indirectly benefit the creditors, as they will have first claim on its assets. Ch 5 nn 137-140 and accompanying text.

the outcome of the litigation.[15] Once the action is successfully brought, the 'champion' shareholder is rewarded.[16] Each shareholder therefore bears the same fractional interest in the payment as he obtains from the successful recovery, so that the gains from the transaction are divided up in accordance with their respective investments.[17] In effect, this reward represents an efficient solution to the well-recognized 'free-rider' problem that arises whenever an individual must incur costs to benefit a group of which the individual is a member. Unless some mechanism exists by which to allocate these costs among the group in proportion to the respective benefits to be received, the individual (here, the plaintiff shareholder) has an inadequate incentive to proceed.

We should not stop here, however. Under the English fee shifting rules, there is no reason why the company could not, in turn, be allowed some recovery of those reward fees from the wrongdoer under a winner-takes-all method.[18] The reward could also be linked to a clear benefit to the company as a result of the action,[19] and can be limited to a reasonable percentage of the proceeds. The court should be provided with discretion to adjust the figure, depending on a number of factors, such as novelty or complexity of issues, quality of representation, risk and

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15 R Epstein 'Class Actions: Aggregation, Amplification and Distortion' Chicago Working Paper Series Index (April 2003) 13 www.law.uchicago.edu/Lawecon/index.html (16 June 2003).

16 eg if the claim was successful, say 5% of the recovery would be paid to the agent-shareholder. *Papera Traders Co Ltd v Hyundai Merchant Marine Co Ltd (No 2)* [2002] EWHC 2130 (Comn).

17 R Epstein, above n 15.

18 *Clark v Cutland* [2003] EWCA Civ 810. See also BR Cheffins 'Reforming the Derivative Action: The Canadian Experience and British Prospects' [1997] 2 CFILR 227, 257.

19 In a case where derivative litigation results in an intangible or therapeutic relief only, the courts will be able to reward the shareholder if the derivative action results in a substantial benefit to the company, whether by judgment or settlement. See also the Israeli Companies Act 1999, s 201 (discussed in ch 5 above n 66).

the like. In this way, the size of the reward will be derived (lineally) from the benefit it brought the company.[20] Looked at in this way, it does not largely offend the basic rule that the proceeds of the action belong to the company, as it is likely that the benefit to the company can be such that the detraction from the company's proceeds to allow for such a reward may be *de minimis*. The idea is, after all, to make it worthwhile enough for those litigants who genuinely desire to benefit the company to embark on this risky journey. It is further submitted that a US-style common fund doctrine can be adopted, if the result of the case is beneficial to the members generally.[21] This does not impose additional liability on the losing defendant. Rather, where one party has created or preserved a fund for the benefit of others (ie the company and its shareholders), the others should contribute to the active party's costs.[22] The payment comes from the fund itself, as a prior charge before the beneficiaries receive it.[23]

6.2.2.2 Rationale explained

Let us focus now on the rationales. The basic logic is this: the knight who steps forward to maintain the suit is paid by the company out of the winning of the

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[20] Very much as the substantial benefit rule works in the US, where the effect of the judgment must substantially benefit the company. See ch 5 above nn 27–37 and accompanying text.

[21] In *Marx v Estates & General Investments Ltd* [1976] 1 WLR 380, a shareholder was given his costs out of the company's assets on a common fund basis since the result of the case was beneficial to the members generally. See also *Wallersteiner v Moir (No 2)* [1975] QB 373, 395 *per* Lord Denning.

[22] As explained in *City of Klawock v Gustafsan* (1978) 585 F 2d 428, 431 (9th Cir.).

[23] In the US, derivative actions have been described as 'model cases' for using the common fund doctrine on the basis that litigation may enhance or preserve the assets of a company. In such cases, shareholders directly benefit from the augmentation of corporate assets. *Mills v Electric Auto-Lite Co* 396 US 375 (1970).

action. This simple expedient seems to have the right incentive features.[24] This development is clearly warranted by a full understanding of the derivative action. The company and its creditors receive the benefit of the litigation and thus should be required to pay the costs of recovery lest they be unjustly enriched.[25]

The primary rationale thus rests on unjust enrichment.[26] A shareholder's successful claim against wrongdoing directors on behalf of the company creates a public or collective good[27] which benefits all the other shareholders at no cost. In the first place, those who make the efforts are entitled to reasonable compensation for their services from those 'who accepted the fruits of [their] labors'.[28] Essentially, this is a similar rationale to the one behind indemnity costs orders.[29] The crucial difference is that here the shareholder may be better off than fellow shareholders who made no effort to support the proceedings, because he may get an additional monetary reward.[30] In fact, this is also in line with the very nature of the derivative action, because it is both expected and hoped that a shareholder will assume the role of initiator (unless, of course, there is someone else who is

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24 R Epstein, above n 15.

25 JD Wilson 'Attorney Fees and the Decision to Commence Litigation: Analysis, Comparison and an Application to the Shareholder's Derivative Action' (1985) 5 Windsor Yearbook of Access to Justice 142, 177.

26 On the theory of unjust enrichment as support for the common fund doctrine see *Mills v Electric Auto-Lite Co* 396 US 375, 372 (1970).

27 Regarding this concept, see generally M Olson *The Logic of Collective Action: Public Goods and the Theory of Groups* (Harvard University Press Cambridge Mass 1971).

28 *Central RR & Banking Co v Pettus* 113 US 116, 127 (1885) ('It is repugnant to fundamental principles of equity ... that they should not reap where they have not sown.').

29 In *Wallersteiner v Moir (No 2)* [1975] 1 QB 373, 392 Lord Denning explained that 'it is a well-known maxim of the law that he who would take the benefit of a venture if it succeeds ought also to bear the burden if it fails'.

30 cf the situation with indemnity costs orders in ch 5 under 5.3.3.1.

expected to assume the risk of litigation).[31] After all, without the shareholder's willingness to initiate these actions the alternative for the company and its shareholders is to get nothing at all. But what if the action fails? Assuming that the minority shareholder had reasonable grounds for bringing the action, and that it was a reasonable and prudent course to take in the interests of the company (or that he fulfilled the FFM's thresholds), he should not himself be liable to pay the costs of the other side, but the company itself should be liable, because he was acting for it and not for himself.[32]

Secondly, rewarding the shareholder directly is supported by the fact that in many cases the company will be liable for the fees of its executives in such litigation.[33] Indemnification of officials is justified by the theory that they act as the company and thus liability is truly that of the corporate entity. Exactly the same reasoning applies here. The plaintiff represents the company and recovery flows to it. As such the entity should be liable for full payment of fees.[34] Indeed, the procedure invented by the Court of Appeal in *Wallersteiner* is predicated on the assumption that the plaintiff stands to the company in a relationship analogous to agent and principal or trustee and beneficiary.[35] It is suggested therefore that the court will be guided here by the principle that the shareholder, for practical

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[31] As in the US, where the driving force is thought to be lawyers who stand to gain substantial fees. See ch 5 above n 12 and accompanying text.

[32] *Wallersteiner v Moir (No 2)* [1975] QB 373, 395. See discussion in ch 5 under 5.3.2.

[33] Subject to the qualifications as discussed in ch 4 under 4.4.2.5.

[34] JD Wilson, above n 25, 177.

[35] ch 5 above n 52. Walton J doubted whether these procedures were strictly analogous and he put forward a number of reasons for this (*Smith v Croft* [1986] 1 WLR 580, 588). While his objections have some substance they are hardly compelling. DD Prentice 'Wallersteiner v Moir: A Decade Later' [1987] The Conveyancer 167, 170.

purposes, acts as the company, stepping into the shoes of those agents who are either unable or unwilling to take an action.

Thirdly, it is also possible that, although the shareholder is willing to step forward and pursue the action on behalf of the company, he may, nonetheless, simply not be willing to risk depleting his financial resources by bringing a derivative action, given that the benefits of recovery will be shared with others.[36] In addition, rewarding the plaintiff with part of the spoils of litigation means that the shareholder will be in a much more secure position than under costs orders. With the latter there might be a shortfall between the amount of costs ordered to be paid and the amount of costs recovered from the defendant. For example, the defendant's assets might be insufficient to meet the order.[37] It is also possible that, when the costs are assessed, they will not cover the full amount of the costs incurred by the plaintiff, leaving a shortfall.[38]

Finally, it is worth noting that rewarding successful plaintiffs with part of the spoils of litigation is a method used successfully in a number of jurisdictions. For example, the Canadian,[39] Israeli[40] and New Zealand[41] statutes all allow

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[36] ibid 173.

[37] *Halle* v *Trax BW Ltd* [2000] BCC 1020.

[38] ibid. The court also suggested that if the costs have been incurred for the purpose of obtaining damages payable to the company, the plaintiff might be able to claim a lien on the damages to reimburse his costs.

[39] Under s 240 of the Business Corporations Act 1985 (CBCA). But this option, although clearly permissible, has been ruled out by Canadian courts. BR Cheffins, above n 18, 257.

[40] Under the Companies Act 1999 s 201.

[41] The Companies Act 1993 s 167 (d) provides that the court may, at any time, make an order directing that any amount ordered to be paid by a defendant in the proceedings must be paid, in

compensation to be paid to members directly rather than to the company. Admittedly, these are rules designed to bolster the incentives of potential derivative litigants.[42] This gives recognition to the fact that, although in a technical sense the company is the plaintiff in a derivative action, it is actually the minority shareholders whose interests are affected by the wrong done to the company; and it is these shareholders who are in a better position to institute proceedings on behalf of the company against the wrongdoers.[43] Their efforts are thus more appropriately compensated by allowing the court discretion to reward them with a direct personal benefit if the claim succeeds.

It should be noted that the Law Commission rejected a somewhat similar (but not identical) suggestion that it should be open to the court to make an order granting a personal benefit to the shareholder bringing the derivative action, such as an order that the defendant wrongdoers buy the plaintiff's shares.[44] It was argued that the very nature of the derivative action is that it seeks a benefit for the company and that it is contrary to principle to permit an applicant a personal benefit. But the objection on the grounds that this may blur the distinction between personal and derivative actions is hard to reconcile with the recent decision in

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whole or part, to former and present shareholders of the company or related company instead of to the company.

[42] Gower considered this to be necessary to avoid someone who has bought shares obtaining effectively an unjustified reduction in the price paid, and he cited *Regal (Hastings) Ltd v Gulliver* as an example of such a case. *Final Report of the Commission of Enquiry into the Working and Administration of the Present Company Law of Ghana* (1961) 153.

[43] L Thai 'How Popular are Statutory Derivative Actions in Australia? Comparisons with United States, Canada and New Zealand (2002) 30 Australian Business Law Review 118, 126.

[44] Consultation Paper paras 16.48–16.50 and Report para 6.108.

Clark v Cutland.[45] Also, it is difficult to see why there should be an objection to relief of this kind in situations where justice would seem to require judgment in this form.[46] In the US, a few exceptions have been developed wherein recovery may be paid to the shareholder, when payment to the company would permit the majority to profit from their own wrongdoing (such as when the offending directors control a majority of shares).[47] After all, why should the court hand back the proceeds of a successful action to controlling shareholders who were actively involved in the wrongdoing to their company and are likely to repeat their actions?[48]

6.2.2.3 Rewarding the plaintiff and the 'reflective loss' rule

It could inevitably be argued that it is not open to the shareholder to bargain away any part of the proceeds of a successful action as this could infringe the rule against 'reflective loss'. Painting with a broad brush, this rule proscribes a shareholder from recovering for damage which is merely a reflection of the company's damage.[49] The rationale behind this rule is that the shareholder's personal claim

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[45] [2003] EWCA Civ 810. Post-*Cutland* a mixture of personal and corporate issues is inevitable. See discussion in ch 7 under 7.3.1.

[46] Arguably, the court should have been given the power to grant pro rata recovery in appropriate circumstances in small private companies. Further, a s 459 petition may not always be appropriate. AJ Boyle *Minority Shareholders' Remedies* (Cambridge University Press 2002) 84–85; AJ Boyle, 'Personal and Derivative Actions' (1999) 20 Company Lawyer 58, 59.

[47] *Trustees v Greenough* 105 US 527 (1881); *May v Midwest Refining Co* 121 F 2d 431 (1st Cir 1941). See further J Dawson, 'Lawyers and Involuntary Clients: Attorney Fees from Funds' (1974) 87 Harvard Law Review 1597, 1602.

[48] See also AJ Boyle, above n 46, 84–85.

[49] This principle was clearly established in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] 1 Ch 204, 222–223 and followed or distinguished in various cases until it was reconsidered and endorsed by the House of Lords in *Johnson v Gore Wood* [2002] 2 AC 1. For comment see E Ferran 'Litigation by Shareholders and Reflective Loss' [2001] 60 CLJ 45; P Watts (2001) 117 LQR 388. The CLR (para 7.51) adopted the approach in *Johnson*. *Johnson* was later significantly qualified in *Giles v Rhind* [2002] 4 All ER 977, where their Lordships allowed a claim for reflective loss in circumstances where a shareholder had prevented the company from pursuing its cause of action. On the effect of this decision on *Johnson* see B Hannigan *Company Law* (Lexis-Nexis Butterworths 2003) 468–470. See also the recent decision in *Gardner v Parker* [2004] EWCA

must fail because it is a claim to recover a diminution in the value of his shares and this is 'merely a reflection of the loss suffered by the company'.[50] It follows that the company is the primary agent to recover in such circumstances.

As is clear from the wording of the rule itself, the purpose of the rule is to determine the right course of action when personal and corporate rights may be asserted in the same action.[51] Put differently, whatever the policy reasons behind this rule may be,[52] it is concerned with situations where the shareholder and the company *both* have a *cause of action* against the defendant. By contrast, under the proposal put forward here, the cause of action, as well as relief, unquestionably belongs to the company. The proposal simply provides the court with discretion to reward a plaintiff, not because the shareholder has a cause of action but rather on the basis of the effort and work done by the shareholder in pursuing the action (a form of wages) and as a form of incentive. Secondly, when we move to ask why a shareholder should be debarred from recovering reflective loss, it is apparent that the answer lies in a series of policy premises, as advanced by the House of Lords in *Johnson*.[53] Similarly, it is because of policy considerations that granting such a reward is justified here.[54] Further, if one accepts the rationale under indemnity cost

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Civ 781.

[50] *Prudential* ibid 223.

[51] PL Davies *Gower and Davies' Principles of Modern Company Law* (7th edn Sweet & Maxwell London 2003) 455.

[52] It is unclear whether a shareholder is debarred because it is a loss which the shareholder should be forbidden to recover for policy reasons or because it is no loss at all. C Mitchell 'Shareholders' Claims for Reflective Loss' (2004) 120 LQR 457.

[53] *Johnson v Gore Wood* [2002] 2 AC 1.

[54] ie to ensure that the exercise of bona fide shareholder power to commence litigation is not discouraged, and also to ensure that the derivative action has a fair chance to reach its potential as a tool of corporate governance.

orders, there should conceptually be no difficulty in rewarding the plaintiff, as this is simply a logical extension in response to practical concerns (ie pursuing the action is uneconomic).[55] In this respect, it is evolutionary, not revolutionary. Finally, as already explained, the detraction from the company's proceeds to allow for such a reward is likely to be *de minimis,* and in any case subject to judicial discretion. At worst then, this would involve *de minimis* departure from principle.

[55] After all, it was considerations of policy that persuaded Lord Denning in *Wallersteiner* to allow a US-style contingency fee in derivative actions. See also *Chitty on Contracts* (29th edn Sweet & Maxwell London 2004) para 16-055.

6.3 SOLUTIONS INVOLVING THE PLAINTIFF'S ATTORNEY

It is the purpose of this section to examine possible solutions to the funding problem in which the risk of loss is shifted on to the plaintiff's attorney.

6.3.1 Option Three: Conditional Fee Agreements

A recent development across the whole area of civil litigation may have opened up entirely new possibilities. In most types of civil proceedings legal aid has now been replaced by the new system of conditional fee agreement regulated under the Courts and Legal Services Act 1990 by provisions brought into force by subsequent statutory instruments.[56]

6.3.1.1 How do conditional fee agreements work?

A conditional fee agreement ('CFA'), also known as 'no-win-no-fee' agreement, allows a lawyer to agree to take a case on the understanding that if the case is lost he will not charge his client for the work he has done. If, however, the case is won, the lawyer is entitled to charge a success fee calculated as a percentage of his normal costs[57] to recompense him for the risk he has run of not being paid.[58] It is generally thought that lawyers working under a CFA are likely to be more

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[56] See the Conditional Fee Agreements Order 1998 (SI 1998/1860). See generally 'Access to Justice with Conditional Fees', a Lord Chancellor's Department Consultation Paper (March 1998); K Underwood *No Win, No Fee, No Worries: Conditional and Contingency Fees Explained* (2nd edn 1998); *Chitty on Contracts* (29th edn Sweet & Maxwell London 2004) para 16-056.

[57] Of up to 100% of the lawyer's normal bill.

[58] The success fee is set according to the risk the lawyer is taking. The higher the chance of winning, the lower the success fee should be set, and vice versa. This helps to ensure that the risks are managed by those who are in the best position to know what the risks are—the lawyers.

concerned to ensure that they do not take on cases where the chances of success are not sufficiently good.[59] The idea is that a lawyer on a CFA may expend considerable time urging highly meritorious issues and yet end up with no fee if he does not confer a financial benefit.[60] Conversely, in the cases that are taken on, the lawyer is encouraged to achieve a favourable outcome for his client to earn his success fee. CFAs are usually linked with an insurance policy taken out after the event ('ATE') which, if the case is lost, pays the other side's costs and the plaintiff's own out-of-pocket expenses (but, importantly, *not* his own lawyer's fees).[61]

6.3.1.2 Conditional fee agreements and derivative actions

In *Wallersteiner* Lord Denning was willing to authorize the continuation of the action on a US-style contingency fee basis. Scarman and Buckley LJJ rejected this on the grounds that such an innovation could only be introduced after a comprehensive assessment by a body set up to consider the issue.[62] As it stands, US-style contingency fees are still abhorrent, while CFAs were given cautious

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59 The economic literature on conditional fees is discussed in W Emons and N Garoupa 'The Economics of US-style Contingent Fees and UK-style Conditional Fees' (Discussion Paper No 04.08 May 2004) http://ssrn.com/abstract=550301; W Emons 'Conditional versus Contingent Fees' CEPR (Discussion Paper No 4532 August 2004) http://ssrn.com/abstract=594823; E Winand 'Playing It Safe with Low Conditional Fees versus Being Insured by High Contingent Fees' (December 2004) http://ssrn.com/abstract=633021; H Gravelle and M Waterson 'No Win, No Fee: Some Economics of Contingent Legal Fees' (1993) Economic Journal 1205.

60 GD Hornstein 'Legal Therapeutics: The "Salvage" Factor In Counsel Fee Awards' (1956) 69 Harvard Law Review 658, 660.

61 D Marshall 'Conditional Fee Agreements' (2001) 151 NLJ 1186.

62 [1975] QB 373, 406.

approval.[63] CFAs, however, may not prove to be as effective as contingency fees, for both theoretical and practical reasons.

From a theoretical viewpoint, there are two major concerns. First, it has been suggested that a CFA may not be employed in a derivative action on the basis that it detracts from the right of the company to receive all the proceeds of a successful action.[64] It has been said to 'require creative judicial "law making" to interpret the diversion of funds to the plaintiff's lawyer as not amounting to a breach of the traditional rule'.[65] These concerns are perhaps justified under the US model of the contingent fee. The CFA, however, differs from the US model, in that the latter allows the lawyer to *share in the proceeds* of a successful action (which belongs to the company). The CFA, on the other hand, allows only *an uplift in the fees* recoverable by the successful plaintiff (the company) from the losing defendants (the wrongdoers). In any event, the same argument that has already been made can be repeated: it is simply a realistic method in the modern context of financing derivative litigation which ultimately, if successful, benefits the company.[66]

Turning to the second point, it is arguable that the deterrent effect of the English rule may now be mitigated by the fact that under CFAs attorneys are permitted to assume the risk of litigation, thus eliminating, to some extent, the risk

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63 MJ Cook *Cook on Costs* (Sweet & Maxwell, London 2001/02) ch 42, 465.

64 AJ Boyle R Sykes and LS Sealy *Gore-Browne on Companies* (44th edn Jordon Bristol) para 28.9.2; AJ Boyle, above n 46, 37 and 83. In both the common law derivative action and its proposed statutory successor the proceeds of a successful action must accrue to the company alone.

65 *Gore-Browne on Companies* ibid.

66 AJ Boyle, above n 46, 37. As Epstein puts it: 'ask potential plaintiffs whether they would give up a third of the winnings for the funding of their claims, and very few will not agree enthusiastically'; H Epstein 'The Liberalisation of Claim Financing' (2003) 153 NLJ 153.

from the shareholder plaintiff, who will normally have only a small stake in the outcome. It does not, however, reverse it as under the American contingency agreements and supplementing mechanisms. As will be seen below, when a contingency arrangement is applied to the American rule, the expected value of litigation can always be kept at the plaintiff's point of indifference, as even when the value to the plaintiff is zero there is no liability to fees. By contrast, with two-way fee shifting system, the allowance of the CFA offers only a partial solution to the problem of over-deterrence, as a losing party will remain liable for the opposite party's costs.[67] This is likely to have a much greater freezing effect on shareholder litigation than, say, contingent fees, because there is no way around the 'loser pays' rule, which, in turn, makes any litigation strategy much costlier *ax ante*.[68]

Deterrence consequently remains under the current system and unless some sort of mechanism is to supplement this, CFAs are not likely to make much of an impact on derivative action litigation.[69] In practice, one way to supplement the deterrent effect that remains under the CFA is through the development of a flourishing market in innovative insurance products specifically tailored to cover the client's potential liability for his opponent's costs.[70] Historically, however, there has been a limited market in legal expenses insurance in England.[71] Also, it is

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[67] Access to Justice Act 1999 ss 27, 29, and the Conditional Fee Regulations 2000.

[68] L Enriques 'The Comparative Anatomy of Related Party Transactions Law', paper presented at the conference 'The Anatomy of Corporate Law' (London School of Economics, 30 June 2003).

[69] See also J O'Hare K Browne and R Hill *O'Hare & Hill Civil Litigation* (9th edn Sweet & Maxwell London 2000) ch 2.

[70] So-called 'after the event' insurance. A Walters and J Peysner 'Event-Triggered Financing of Civil Claims: Lawyers, Insurers and the Common Law' (1999) 8 Nottingham Law Journal 1, 2.

[71] ibid. The explanatory notes to the Access to Justice Bill envisaged insurance policies which can be taken out when someone is contemplating litigation to cover the costs if the case is lost. Indeed,

still unclear whether insurance cover against the risk of losing will be available at sensible rates for a wider range of cases, as this may be very expensive.[72]

There is also the question of disbursements. First, it is unreasonable and unrealistic to expect that lawyers should always be willing to shoulder the 'up-front costs' out of their pockets, whether insurance premiums or disbursements involved in cases under a CFA.[73] Therefore, unless insurance cover can be obtained for such costs at an affordable level, or some other solution is found,[74] this will end any prospect of access in cases involving pre-trial costs that the lawyer is unwilling to bear. In practice, this means that cases with substantial initial costs are unlikely to be viable. This is likely to be a major obstacle with regard to derivative actions. Experience indicates that derivative action cases are taking longer to litigate[75] and involve more pretrial practice.[76] Further, there are all the court fees and other disbursements during the litigation—who is to pay these? With an indemnity order this is clear: any indemnity granted is likely to have to be renewed and reviewed as the litigation proceeds, so the court has discretion to order the company to pay

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in *Callery v Gray (No 2)* [2001] EWCA Civ 1246 the court held that CFAs can be signed and 'after the event' policies taken out at the outset.

[72] Cover through general legal costs insurance before the event is, by comparison, relatively inexpensive, but such policies have not proved popular in England and the experience in the last 20 years suggests that this is unlikely to change significantly. M Zander 'The Government's Plans on Legal Aid and Conditional Fees' (1998) 61 MLR 538, 549.

[73] MJ Cook, above n 63, 511.

[74] Interestingly, Zander notes that the Consultation Paper explained that the Government intended to establish 'a transitional limited fund' for high investigative cost cases, whatever that may mean. Zander, above n 72.

[75] In *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] 1 Ch 204, the minority shareholder's action lasted, at first instance, over 70 days.

[76] In *Prudential* (ibid) the court considered that it would often be necessary to hold a full-scale trial of the merits of the case before it could determine whether a derivative action was permissible.

this.[77] Under CFAs, however, this question is unclear.[78] Finally, there is as yet very little information on a range of vital issues, including how CFA cases work out in the result, what cases are being turned down by lawyers,[79] what clients think of them and, most importantly, what impact the market for insurance will have on all these questions.[80]

As compared with the right to share in the plaintiff's recoveries (under contingency fee agreements), the hope of augmented costs, which can be challenged before a costs judge in more ways than one, comes a very poor second.[81] In fact, CFAs have been described as 'a scheme of Byzantine intricacy replete with opportunities for satellite litigation. It is simply too complex'.[82] Although perhaps a little exaggerated, this description does contain an essential core of truth. It is thought that 'CFAs are a transitional phase, and it is time to open up the debate on what might replace or supplement them'.[83] In support, recent studies on CFAs amount to a persuasive argument for fully fledged US-style contingency fees.[84] Opting then for contingency fees' more acceptable cousin,

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[77] Supreme Court Practice, 1995, Vol l, 233.

[78] For example, would the lawyer agree to pay these court fees and other disbursements as well? If so, would the lawyer inevitably demand to increase his fees to compensate for this?

[79] G Wignall 'CFAs and the Bar' (2001) 151 NLJ 355.

[80] The trouble is that there are so many rules and problems that the theory that taking on a no win/no fee case earns a 100% uplift in the hourly rate is not something that can necessarily be enjoyed in practice. H Epstein, above n 66.

[81] H Epstein, above n 66.

[82] H Epstein, above n 66.

[83] J Peysner 'What's Wrong with Contingency Fees?' (2001) 10 Nottingham Law Journal 22, 44.

[84] F Bawdon 'Nothing to lose?' (1999) 149 NLJ 1890; M Zander 'If Conditional Fees, why not Contingency Fees?' (2002) 152 NLJ 797.

conditional fees, is an ingenious response to the need to protect plaintiffs from costs.[85] More specifically, in derivative action litigation it may not lift the formidable barriers of funding, as the plaintiff will still have to assume some risk (under the English two-way fee shifting rule) and when personal risk in the litigation is high the result is over-deterrence of the action. It remains to be seen whether, and for how long, CFAs, in their current form, will remain part of the current system of funding litigation in light of recent consultation.[86]

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[85] J Peysner, above n 83, 46. A recent study analysing the incentives that these two forms of funding provide the attorney with to work hard concluded that contingent fees are clearly better because the attorney's effort is tied to the amount at stake, whereas under conditional fees the choice of effort is independent of the judgment. W Emons and N Garoupa, above n 59, 243.

[86] In June 2003 the Department for Constitutional Affairs published a Consultation Paper 'Simplifying Conditional Fee Agreements' aimed at encouraging a debate about how to make the CFA regime simpler. The paper looked at whether the detailed requirements in the CFAs are still appropriate. Then, in 2004 a Consultation Paper 'Making Simple Conditional Fee Agreements a Reality' sought views on the departments' response to the 2003 Consultation Paper. It summarised responses to the June 2003 paper and made some specific proposals. All respondents agreed that the current CFA secondary legislation is unnecessarily complex and should be simplified and the regime made more transparent. Many commented that most of the client care and contractual requirements effectively duplicated the Law Society's Professional Rules. In August 2005, a further report was released summarising the responses received to the 2004 Consultation Paper, and highlighting how the consultation process has influenced the final shape of the policy and the conclusions that the department reached on some of the proposals, including revoking the existing conditional fee agreements, and collective conditional fee agreement regulations. All reports are accessible on http://www.dca.gov.uk/consult/confees/congate.htm

6.4 INTRODUCING CONTINGENCY FEES FOR DERIVATIVE ACTIONS?

In the previous section we saw the difficulties associated with conditional fee agreements. In this section we put the case in favour of allowing contingency fee agreements for derivative actions. We explain why the time is now ripe for such a move and ponder how in derivative action litigation this may be beneficial. There is no doubt that to permit a lawyer to conduct a derivative action on the basis of a contingency fee should be subject to proper safeguards. The final part of this section considers thus how these safeguards could be structured.

6.4.1 Introduction

A contingency fee arrangement ('CGFA') is helpfully defined in the 1989 Green Paper on the subject as:[87]

> One whereby a lawyer agrees that he will accept his client's case on the basis that he receives no payment if the case is lost, but that if it is won, he will be paid some percentage or share of the award made by the court.

Traditionally, the English system has rejected CGFAs. There are two common objections to CGFAs:

(1) They tend to produce a conflict of interest between lawyer and client. The lawyer's direct financial interest in the outcome is said to affect his ability to give genuinely impartial advice, eg he may be

[87] Green Paper, *Contingency Fees* (Cm 571 January 1989) para 1.1.

tempted to encourage early settlement against the client's interests.[88]

(2) They may encourage litigants to pursue unmeritorious claims, leading to an explosion of litigation.[89]

The above views reflected the common law preoccupation with the prospect of rapacious lawyers instigating actions rather than merely being an objective and reactive service profession.[90] In addition, there were political reasons which blocked the way to move towards CGFAs.[91] The outcome of the debate was described as 'a triumph for semantics'.[92] CGFAs were still an abhorrence, but CFAs were given cautious approval, though as Cook puts it, this was 'a distinction without a difference'.[93]

6.4.2 Argument One: A Change in the Climate

While the above objections have some substance, they are hardly compelling. The first striking point is that the traditional English approach which rejected CGFAs

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[88] Walters and Peysner, above n 70, 7. For other problems of contingent fee agreements in the American context see KM Clermont and JD Currivan 'Improving on the Contingent Fee' (1978) 63 Cornell Law Review 529, 569–577.

[89] Above n 86, para 1.2.

[90] On the question why did common law opposition to contingency fees survive so long, see M Spencer 'The Common Law Legacy and Access to Justice: Contingency Fees and the Birth of Civil Legal Aid' (2000) 9 Nottingham Law Journal 32.

[91] Lord Irvine, the Lord Chancellor at the time, was particularly opposed to them. J Peysner, above n 83, 40.

[92] MJ Cook, above n 63, 465.

[93] ibid.

has clearly now been abandoned by the courts.[94] Public policy does not today condemn a lawyer who conducts a case on the basis that he will be paid if he wins but not if he loses.[95] Indeed, the introduction of CFAs suggested that there is now a new policy in making justice accessible to people of modest means.[96] Objections to CGFAs founded on this consideration are therefore now outmoded.[97] Secondly, and more importantly, both CFAs and CGFAs make the fee dependent on the *outcome*, so the classic objections to contingency fees apply to both.[98] Under CFAs the lawyer clearly has also a direct financial stake in the outcome of the litigation and so the ethical ground for objection to CGFAs must therefore be regarded as having collapsed.[99] As Middleton stated:[100]

> There is no essential difference in principle between conditional and contingency fees. Indeed, in some ways the latter may be preferable. Contingency fees create an incentive to achieve the best possible result for the client, not just a simple win. And they reward a cost-effective approach in a way that conditional fees, where the lawyers' remuneration is still based on an hourly bill, do not.

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[94] *Thai Trading Co (A Firm) v Taylor* [1998] 3 All ER 65.

[95] *Awwad v Geraghty & Co* [2001] QB 570. The resistance to contingent fees is also diminishing in the EU and Japan, as litigation becomes a more acceptable part of the business environment. G Hertig 'Convergence of Substantive Law and Convergence of Enforcement: A Comparison' in J Gordon and M Roe (eds) *Convergence and Persistence in Corporate Governance* (Cambridge University Press 2004) 340.

[96] That is the very essence of CFAs under the Courts and Legal Services Act 1990, s 58 and the Conditional Fee Agreements Regulations 2000 (SI 2000/692).

[97] See also M Zander, above n 84.

[98] ibid.

[99] Zander, above n 72, 547.

[100] Sir Peter Middleton *Review of Civil Justice and Legal Aid* (September 1997) para 5.50.

6.4.3 Argument Two: Contingency Fees versus Conditional Fees

6.4.3.1 The case for simplicity

CFAs owe something to American style CGFAs in that they are event-triggered:[101] the plaintiff's lawyer is only paid if the case is won (ie settles or is won at a trial). However, under US-style CGFAs the solicitor takes a direct proportion of the winnings. In Section 6.3 we pointed out that the study on CFAs amounts to a persuasive argument for fully-fledged US-style CGFAs. Clearly, this is a concept which is acceptable to the clients because many of them believed that was what they were signing up to, anyway.[102] Research has also shown that, in practice, it is impossible reliably to discharge the requirement in the Regulations that the agreement be explained to the client.[103] Overall then, clients have little hope in understanding the intricacies of CFAs, let alone that the insurance products themselves are supremely complicated and present real difficulties in comprehension to clients and lawyers.[104] Using CGFAs, on the other hand, would also eliminate the need for the immensely complicated agreements now required for CFAs.[105] CGFAs are straightforward and have the beauty of simplicity: they remove the need to explain about prospects for success, success fees and the percentage cap on damages.[106]

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[101] Walters and Peysner, above n 70, 8.

[102] Many clients believed that the success fee was based on a percentage of damages, rather than on the solicitor's costs; ibid.

[103] F Bawdon 'Nothing to Lose' (1999) 149 NLJ 1890.

[104] Similarly, 'after the event' insurance, intriguingly called the market for 'morning after pills' by an American commentator, is new and relatively unproven. J Peysner, above n 83, 41–42.

[105] M Zander, above n 72, 547.

[106] ibid. For a comprehensive discussion on the problem of economic conflict of interest generally and problems of several models of contingent fee agreements in the US in particular see K Clermont and J Currivan, above n 87, 534–546 and 566–577.

6.4.3.2 Settling the case too low?

Both the lawyer on a CGFA and the lawyer on a CFA may have a self-interest in an early settlement at a lower level than the full potential damages. It guarantees a fee and speeds up cash flow.[107] Whereas fees charged under a CFA (like hourly rates) are unrelated to the level of settlement, under a CGFA, other things being equal, the greater the damages, the higher the fee. To the extent that the lawyer's and the client's financial interests are directly aligned, the CGFA may therefore energize the lawyer to work on the client's behalf even more than a CFA, for instance, by devoting additional resources to investigating the claim, or in advising rejection of an early low offer of settlement where under a CFA he would advise acceptance.[108] The CFA lawyer earns higher fees by putting in more hours regardless of whether it produces higher damages. The CGFA lawyer earns more by increasing the damages, but he will be concerned to see that the cost of doing so is not excessive.[109] With regard to the fear of abuse in settlements, a common observation about the contingent fee method of compensating a lawyer is that it creates an excessive motive, relative to his client's interest, for the lawyer to settle the case. The usual explanation is that, by settling, the lawyer obtains his share of the settlement without having to invest the additional time that would be required if the case were to go to trial.[110] Contrary to the conventional wisdom, however, Polinsky

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[107] The client too has an interest in early settlement which guarantees that he gets damages, and sooner rather than later.

[108] M Zander, above n 84.

[109] M Zander, above n 84.

[110] For a sample of authors who have come to these conclusions see GP Miller 'Some Agency Problems in Settlement' (1987) 16 JLS 189; Terry Thomason, 'Are Attorneys Paid what they're Worth? Contingent Fees and the Settlement Process' (1991) 20 JLS 187.

and Rubinfeld showed recently that, relative to a benchmark in which the client's welfare is maximized, the contingent fee system can create incentives for the attorney to settle cases *less* often, and for a *higher* amount.[111] In any case, as explained above, in order to reduce the possibilities for 'gold-digging' claims against the company, settlements are controlled in derivative actions by the court.[112]

6.4.3.3 Charging excessive fees?

Arguably, lawyers' fees earned under CGFAs may be disproportionate to the work involved and the risks taken. But the same is true of CFAs. Research indicates that the agreed success fee in CFAs is commonly fixed at a *higher* percentage rate than is justified by the risks.[113] As for the argument that CGFAs produce excessive fees, a leading US scholar has explained that, apart from spectacular exceptions available only to a few, in most cases there is not much in it.[114]

6.4.3.4 Increasing the costs?

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[111] The usual analysis of settlements under the contingent fee system does not take into account that, if the case were to go to trial, the lawyer would work fewer hours on the case than is in the client's interest. It thus mistakenly concludes that lawyers necessarily settle too often and for too little under the contingent fee system. A Polinsky and L Rubinfeld 'A Note on Settlements under the Contingent Fee Method of Compensating Lawyers' Stanford Law School Working Paper No 224 (September 2000) http://papers.ssrn.com/abstract=286055 (14 June 2002). Several other studies have come to similar conclusions. See eg J Miceli 'Do Contingent Fees Promote Excessive Litigation?' (1994) 23 JLS 211–224; L Bebchuk and A Guzman 'How would you Like to Pay for that? The Strategic Effects of Fee Arrangements on Settlement Terms' (1996) 1 Harvard Negotiation Law Review 53.

[112] See ch 2 under 2.4.4.

[113] S Yarrow 'Just Rewards? The Outcome of Conditional Fee Cases' (University of Westminster December 2000) Table 7.

[114] H Kritzer 'Lawyer Fees and Lawyer Behaviour in Litigation: What does the Empirical Literature Really Say?' (2002) Texas Law Review www.polisci.wis.edu/ kritzer/lawmisc/FeeArrangements.pdf ('[A]nalyses of the returns from contingency fee practice show that in a large proportion of cases lawyers actually make substantially less, on a per hour basis, than they would from work for which they could charge prevailing hourly rates').

The CFA has an obvious and serious perverse incentive for lawyers to increase their costs (whether by conscious or unconscious padding or doing more work) in order to increase the success fee. In this respect, CFAs are simply not as economically efficient as CGFAs, in which this factor does not operate.[115]

In a CFA the arrangement involves a multiplier of basic fees with a maximum of 100%.[116] In theory, this appears to be a good solution to the problem of potentially excessive fees. However, a major concern in setting a fee cap is whether it will provide the compensation needed to induce a lawyer to take meritorious cases and handle them properly.[117] Likewise, there are those who argue that fee caps invite lawyers to under-work,[118] and that they 'are largely cosmetic, keeping the final fee at what seems a reasonable level to the outside observer, while still permitting the lawyer covertly to pick and then milk (through under-work) the lucrative cases'.[119] Another difficulty is likely to arise when the lawyer is offered a simple and effective way of cutting to the chase (such as mediation), rather than going through a great deal of litigation. If it is possible to resolve the case at an early stage this would be in the interests of the clients, the court and system as a whole but may not be perceived to be in the interests of the lawyer whose base fee is reduced and, therefore, his success fee. CGFAs, by comparison, encourage claimants' lawyers to be efficient: they are not awarded for effort but

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115 J Peysner, above n 83, 39.

116 This compares with the contingency fee arrangement that incorporates a fee based on a percentage of damages recovered.

117 T Schneyer 'Legal-Process Constraints on the Regulation of Lawyers' Contingent Fee Contracts' (1998) 47 DePaul Law Review 371, 410.

118 ibid.

119 K Clermont and J Currivan, above n 87, 536 and 581.

skill.[120] Also, they give assurance to clients of their lawyer's motivation and extra work for lawyers with higher rewards for success.[121]

6.4.4 Argument Three: The Myth about Contingency Fees and Ethics

The question is whether CGFAs represent a greater challenge to ethics than CFAs? The answer is probably no. As was indicated above, the classic objections to contingency fees apply to both. This applies in particular to the objections voiced repeatedly over the years to the general effect that contingency fees would be liable to promote unethical conduct by lawyers.[122] While it is true that CGFAs offer particular challenges to solicitors to ensure that they put their client's interest first, nonetheless the conflicts of interest are endemic to the funding of litigation and inherent in a relationship between professional and lay client.[123] Accordingly, all financing arrangements or litigation contain ethical issues and perils. In England, CFAs or CGFAs do not stand out as offering unique dangers.[124] Such arguments therefore cannot sensibly be deployed to oppose CGFAs, other than on the basis that 'we don't want another variation on the contingency theme'.[125]

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[120] J Peysner, above n 83, 45.

[121] MJ Cook, above n 63, 465.

[122] See eg Benson Royal Commission on Legal Services (Cmnd 764 1979) para 16.4, 177.

[123] Yarrow and Abrams 'Conditional Fees: The Challenge to Ethics' (1999) 2 (2) Legal Ethics. There has been no large-scale research into the outcomes using solicitors' files and, indeed, access would be very difficult to organize. J Peysner, above n 83, 43.

[124] See further M Zander 'Will the Revolution in the Funding Litigation in England Eventually Lead to Contingency Fees' (2003) http://www.lse.ac.uk/collections/law/pdf/depaul.cont.pdf (12 March 2004)

[125] M Zander, above n 84.

6.4.5 Argument Four: The Experience with Contingent Fees in US Derivative Action Litigation

Opponents of CGFAs usually cite the experience of them in the US. However, as Middleton rightly noted:[126]

> Considering the differences between the two jurisdictions—notably the cost-shifting rule and the fact that juries here do not generally set damages—we should re-assess whether those concerns may be misplaced.

Further, a fear of the US predilection to litigate everything that comes along prejudices the opportunity to right wrongs that in the interests of justice ought to be righted. To exclude a proper remedy may amount to protection of the wrongdoer, and in extreme cases amounts to a fraudster's charter.[127] There are also structural differences between the two legal systems which suggest that CGFAs will work very differently in England. First, as explained earlier, with the cost-shifting rule, the allowance of any kind of CGFA offers only a partial solution to the problem of over-deterrence as a losing party will remain liable for the opposite party's costs.[128] Put simply, any form of a contingent fee does not eliminate the client's financial and psychological disincentives to bringing the action, but merely reduces them.[129]

As we saw, in the US the recognition of CGFAs and the 'common fund' doctrine permitting attorney compensation out of the amounts generated for the

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[126] Above n 99, para 5.50.

[127] H Epstein, above n 66. This is reinforced by the derivative action's raison d'être as explicated in *Smith v Croft (No 2)* [1988] Ch 114, 185 *per* Knox J.

[128] See ch 5 under 5.2.3.

[129] K Clermont and J Currivan, above n 87, 571.

benefit of the corporation have created a strong interest group within the organized bar that favours a relatively liberal scope for the remedy.[130] More relevant in terms of actual practice in the US is the economics of attorney compensation. The vast majority of derivative actions are brought by 'entrepreneurial' plaintiffs' attorneys who conduct the litigation almost entirely on their own and with virtually no monitoring by the shareholders whose name is used as the key to the courthouse door. In this respect, the shareholders' derivative suit in the US is very similar to the class action. What is also lacking in England, but present in the US, is a strong interest group in favour of such litigation. The bar, a natural constituency in favour of derivative litigation, has never been comfortable with conditional fee agreements, and is said to be 'less than enthusiastic about entering into conditional fee agreements'.[131] In the US, by way of contrast, each state's bar is an organized political group with a strong interest in maintaining the derivative action. Because of the US rules on fees, plaintiffs' lawyers have become specialized in class action and derivative litigation, and have become highly organized and effective lobbies to protect this source of income. The political influence of the various state bars has apparently been strong enough to protect the derivative lawsuit against attack despite the preference of incumbent managers that it be limited in scope. Fears that the worst excesses of US-style litigation, in which there would be a proliferation of claims that we would regard as wholly unmeritorious, would propel England into a wholly unacceptable legal culture are thus completely unfounded.[132]

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[130] ch 1 under 1.4.1.

[131] MJ Cook, above n 63, 465.

[132] See further H Epstein, above n 66.

There are additional indicators that suggest a very different practice here. First, the experience in Canada suggests that such fears have not materialized.[133] Secondly, as noted above, the floodgates argument should not be exaggerated.[134] Litigation is a daunting prospect at the best of times and in the context of companies it presents formidable difficulties. Thirdly, it is said that in the US juries allow for the impact of CGFAs by increasing the level of damages and that if CGFAs were permitted here there would have to be some equivalent raising of the level of damages.[135] However, this argument only has any relevance if either (1) the fee-shifting rule is changed, so that each side pays its own costs; or (2) the CGFA is not recoverable from the losing litigant.[136] With respect to (1), whatever the pros and cons of that issue, Zander believes that (at least at present) there would be little support for such a change. Turning to (2), since the success fee and insurance premium under CFAs are recoverable under the provisions of the Access to Justice Act 1999, it would be strange not to allow CGFAs equally to be recoverable. This is not to say that making success fees and insurance premiums recoverable was on balance a good idea. There is quite a case for the view that it will prove to have been a serious mistake in significantly inflating the cost of litigation, not least in generating far more arguments over costs.[137] Should the question become relevant, the position in the US is obviously different in that damages there are so often set by juries. One cannot imagine English judges increasing damages awards in respect

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[133] On which see below under 6.4.7.

[134] See ch 4 under 4.4.2.4.

[135] M Zander, above n 84.

[136] ibid.

[137] ibid.

of lawyers' fees.[138] Finally, it is not necessarily true that a contingent fee encourages the filing of speculative suits, ie suits where the probability of recovery is small but the recovery, if any, would be large, or the filing of nuisance suits, where there is a good chance that the defendant will buy off the plaintiff in order to save the costs of litigation.[139]

Another argument opposing CGFAs is that because the claimant on a contingent fee agreement has nothing to lose 'there is no reason not to pursue the case, and every incentive to do so, however lacking in merit'.[140] This line of argument, nonetheless, ignores the fact that no sane lawyer acting on a contingent fee would take on a likely loser.[141] In any event, the legal system relies on ethical and economic restraints on client and lawyer to discourage such suits.

The question then is whether changing from hourly bill to a contingent fee is likely to encourage suits of this kind. Since a contingent fee allows a plaintiff to sue without significant financial risk, contingency would seemingly encourage him to file. However, the risk of loss does not disappear; it simply shifts to the plaintiff's lawyer. Since contingency makes his fee depend on the outcome, the lawyer would shy away from any case with a probability of success so low that it makes the case a poor investment. Thus it is not at all clear that a contingent fee

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[138] ibid.

[139] K Clermont and J Currivan, above n 87, 571–573; T Miceli 'Do Contingent Fees Promote Excessive Litigation?' (1994) 23 JLS 211.

[140] D Tomkinson 'Duty above and beyond the Call of the Retainer' (2002) 152 NLJ 1324.

[141] In fact, US lawyers turn away a high proportion of would-be claimants. The most frequently given reason for refusing to act is pessimism about establishing liability. See further H Kritzer 'The Seven Dubious Myths Concerning Contingency Fees' (2002) 80 Washington University Law Quarterly 739.

encourages groundless speculative suits. Indeed, a contingent fee may even be more effective than a certain fee in deterring such suits.[142] Likewise, contingency itself gives little or no encouragement to nuisance suits.[143] CGFAs could encourage nuisance suits if the percentage is fixed high enough to overcome the lawyer's ethical and economic reluctance. However, that problem stems from the percentage nature of the fee, not from its contingency.[144]

6.4.6 Argument Five: Contingent Fees are More Compatible with Derivative Action

In his 1997 Report, Middelton suggested that the possibility of introducing CGFAs is definitely worth exploring at this stage. He explained that it might be particularly appropriate for very expensive cases where it was not practicable for even a large firm to bear the amount of risk involved.[145] As will be seen below, derivative actions are a particularly appropriate case to implement this. They can be also used as a 'test case' before introducing CGFAs into other areas of litigation, if one is not convinced yet of their potential contribution.[146] The strongest case for introducing CGFAs in the context of derivative action was made some time ago in *Wallersteiner v Moir (No 2)*.[147] Lord Denning was prepared to make an exception and authorize the plaintiff to enter into a CGFA (although it was unlawful at the time as being contrary to public policy on the ground that it was the offence of

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[142] K Clermont and J Currivan, above n 87, 571–573.

[143] ibid, 573.

[144] ibid.

[145] Above n 99.

[146] Zander urges the legitimation of CGFAs into all areas. Zander, above n 72, 549.

[147] [1975] QB 373.

champerty).[148] Nonetheless, Buckley and Scarman LJJ rejected this on the grounds that such an innovation could only be introduced after a comprehensive assessment by a body set up to consider the issue.[149] The passage setting out Lord Denning's reasons deserves to be reproduced in full:[150]

> The remedy, as I see it, is to do as is done in the US—to permit a solicitor to conduct a derivative action on the basis of a contingency fee. It should be subject to proper safeguards. The action should not be started except on an opinion by leading counsel that it is a reasonable action to bring in the interests of the company. The fee should be a generous sum—by a percentage or otherwise—so as to recompense the solicitor for his work —and also for the risk that he takes of getting nothing if he loses. The other side should be notified of it from the very beginning; and it should be subject to the approval of the Law Society and of the courts. With these safeguards I think that public policy should favour a contingency fee in derivative actions—for otherwise, in many cases, justice will not be done—and wrongdoers will get away with their spoils.

It is hard to disagree with this. There are also additional strong arguments in favour of permitting lawyers to conduct a derivative action on the basis of a CGFA. First, in the context of derivative actions, under a CGFA the minority shareholder would be *in a more secure position* than that under the indemnity order system. Recall that in the latter situation he will be unrecompensed if the company proves to be insolvent.[151] Secondly, using a CGFA will eliminate a lengthy and potentially expensive procedure, as there will be no need for lengthy investigations.[152] Equally,

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[148] ibid 393.

[149] ibid 403.

[150] ibid 395.

[151] See ch 5 under 5.3.3.5.

[152] Recall that in *Prudential* the action lasted, at first instance, over 70 days. Another 'procedural shambles' occurred in *Smith v Croft* [1986] 1 WLR 580.

there will be no room for restrictive interpretation,[153] and there will be no need to bring the financial status of the applicant into play.[154]

It is further submitted that using a CGFA will dislodge the fundamental problem of lack of incentives to engage in the litigation in the first place under an indemnity order system.[155] Using CGFAs will shift the risk of litigation from the plaintiff to the attorney, who will need to assess the likelihood of success and whether substantial benefit may flow to the company justifying an order that his fees be paid by the company. This will also eliminate the over-deterrence of the derivative action in cases when the plaintiff's personal risk in the litigation is low.[156] The imposition of the risk on the attorney, however, does not alter the basic deterrence offered by the fee rules in shareholder litigation: it merely alters who faces the risk of loss or a finding that the benefit was eventually not substantial. In theory, then, CGFAs may allow more litigation of cases without a clearly predictable outcome than a system without such fees.[157]

6.4.7 Argument Six: Comparative Perspective

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153 See our discussion in ch 5 under 5.3.3.4.

154 As suggested by Walton J in *Smith v Croft* [1986] 1 WLR 580, 597. Ch 5 under 5.3.3.3.

155 See ch 5 under 5.3.3.1.

156 Attorneys are able to calculate expected value over a range of actions. This permits a process analogous to portfolio diversification and allows the prosecution of some risky cases, as there may be also relatively safer litigation in the 'portfolio'. The attorney will normally also have a much greater monetary interest in the litigation than will the shareholder plaintiff. This gives the attorney a real incentive to commence litigation in appropriate cases. *Central RR & Banking Co of Georgia v Pettus* 113 US 116 (1885); E Mackaay *Economics of Information and Law* (Boston 1982) 173.

157 JD Wilson, above n 25, 174.

Lawyers are permitted to use CGFAs in the full sense of a percentage of the damages in most Canadian provinces (except Ontario), but every province adheres to the English rule that costs normally follow the event.[158] This creates a dynamic in Canadian litigation that differs from that in US litigation: CGFAs are not used as much as they are in the US.[159] The fears of abuse with CGFAs have thus not materialized. One reason may lie in the fact that the general fee shifting rule and the lack of recognition of a common fund or substantial benefit doctrine still leave disincentives to commence derivative actions.[160] In response, some scholars have therefore called for the American approach to be recognized in Canada, coupled with a certification process to ensure that a substantial question is presented.[161] The argument is that, once certified, the plaintiff's attorney would be entitled to fees regardless of the outcome on the merits, on the grounds that approval of the court is, for all matters, an acknowledgement that the company should have initiated the action in the first place.[162] Similar calls have been voiced in Australia, where the action has not been popular.[163] It has been suggested that unless the CGFAs are introduced together with the common fund doctrine and the substantial benefit test, the Australian statutory derivative action may not be truly effective.[164]

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[158] *McIntyre Estate v Ontario* (Attorney General) (2001) 53 OR (3d) 137 (Ont S C J) and M Zander 'Contingency Fees in Canada' (June 2002) Litigation Funding.

[159] R Schoenfeld M Penny and J Terry 'Understanding Litigation in Canada' (16 April 2001) New York Law Journal.

[160] See ch 5 under 5.2.3.

[161] JD Wilson, above n 25, 179–180.

[162] ibid and ch 2 under 2.4.3.

[163] Since the introduction of the statutory derivative action in March 2000 very few applications have been made to the courts for leave to bring such an action and the courts have dismissed those applications. See L Thai, above n 43, 133 and 136–137.

[164] L Thai, above n 43, 137.

6.4.8 The Difficulties in Introducing Contingency Fees into a System in which Costs Follow the Event

Given the foregoing discussion, it becomes clear why a CGFA seems to be far more advantageous than its alternatives. Notwithstanding, Buckley LJ in *Wallersteiner* pointed out some of the difficulties in introducing this procedure into a system in which costs follow the event.[165] Let us examine carefully these objections.

6.4.8.1 The first objection

Buckley LJ explained that the use of CGFA is often explained as justified by the need for a system which opens the doors of justice to litigants too poor to risk defeat in expensive litigation. The counsel for Mr Moir submitted that, if legal aid is not available for derivative action, similar considerations to those operating in the US indicate that CGFAs in such actions here would be in the public interest. In light of our discussion above, this seems like a forcible argument.[166] Further, as explained above, with the change in public policy the traditional English approach which rejected contingency arrangements as being against the public interest has clearly now been abandoned by the courts.[167]

6.4.8.2 The second objection

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[165] *Wallersteiner v Moir (No 2)* [1975] QB 373, 401-403.

[166] On the public perspective of derivative actions see ch 2 and ch 4 under 4.4.3.

[167] Above, under 6.4.2.

Buckley LJ also thought it was not possible to confine consideration of the introduction of CGFAs in this country to derivative actions, as there would be found to be other litigants who could make out as good a case for this sort of treatment, although maybe on different grounds. Before such a system was introduced to the English legal regime it would require comprehensive consideration by a body such as the Law Commission, the Lord Chancellor's Law Reform Committee or a specially appointed committee; and any change would have to be effected by an alteration in the relevant professional rules of etiquette or by legislation. All three 'requirements' have surely been met by now with the introduction of CFAs Likewise, there is not much substance in the argument that it is not possible to confine consideration of the introduction of CGFAs in this country only to derivative actions,[168] and there is no evidence to suggest any corruption. Finally, as we explain below, the introduction of CGFAs should, indeed, be accompanied by protective measures such as an alteration to the relevant professional conduct rules. In this respect, this is more of a safeguard.

6.4.8.3 The third objection

A further concern was highlighted by Scarman LJ:[169]

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[168] Contingency fees are, for instance, common in employment tribunal work which is not regarded as litigation and are also permitted in pre-litigation—defined as being prior to the start of legal proceedings.

[169] [1975] QB 373, 408.

> It would be strange if the company could be compelled to pay a percentage of the moneys it recovers in the action to the plaintiff's solicitor without its consent; for the order proposed by Lord Denning MR does not and cannot depend on the consent of the company which is, ex concessis, in the control of the defendant.

There are a number of ways of responding to this. The most obvious is to point out that, as explained above, that this is simply a realistic method in the modern context of financing derivative litigation which ultimately, if successful, benefits the company.[170] Secondly, this objection can be clearly dismissed by an understanding of the structure of the derivative action. By definition, a derivative action is commenced without the consent of the company which is in the control of the defendants. Even CPR Rule 19.9 expressly authorizes the court to give the plaintiff an indemnity against costs out of the assets of the company in such terms as it thinks appropriate. Surely, then, the court's discretion *replaces* the consent of the company, which is not possible in these circumstances. Thirdly, recall that it is not strange at all that the company should be compelled to pay a percentage of the moneys it recovers in the action to the plaintiff's solicitor, when, in fact, the company itself receives the benefit of the litigation. If anything, it is only a logical consequence that the company should be required to pay the cost of recovery lest it be unjustly enriched.[171] Finally, the plaintiff's lawyer represents the company and recovery flows to the company. As such the entity should be liable for payment of fees.[172]

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[170] See above under 6.3.1.2.

[171] Above under 6.2.2.2.

[172] ibid.

6.4.9 Formulating Proper Safeguards

There is no doubt that to permit a solicitor to conduct a derivative action on the basis of a CGFA should be subject to proper safeguards. We consider next the content of these rules.

6.4.9.1 Regulation and methods to calculate fees

In *Wallersteiner*, Lord Denning suggested that the action should not be started except on an opinion by leading counsel that it is a reasonable action to bring in the interests of the company, and that the fee should be a generous sum so as to recompense the solicitor for his work and also for the risk that he takes of getting nothing if he loses.[173] Obviously, it is understandable that a contingency fee which entitles the solicitor to a reward over and above his ordinary profit costs if he wins should be condemned as tending to corrupt the administration of justice.[174] The general rule that fees must be reasonable and that they are always challengeable both by the client and by the losing litigant applies in any event, but some form of more detailed prescription may be sensible.

At least two possible strategies could be adopted here. First, the CGFA could be introduced with or without restrictions in regard to the percentage of

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[173] Above n 149 and accompanying text.

[174] *Awwad v Geraghty & Co* [2001] QB 570.

damages that could be taken by the lawyer.[175] Regulatory rules laying down sliding scales or percentage maxima are open to objection on the ground that they are not sufficiently adjusted to the circumstances of the particular case. A partial answer to that is to give the court discretion to vary the rule, but this is open to objection as such discretion will lead to the court having to deal with endless applications for it to be exercised (more on which later).[176] A second solution would be to have a rule that the winning litigant could only recover a contingency fee of, say, one fifth of the damages. Since there are far more small and medium size cases than large ones, this would have the effect of making the recoverable fees *proportionate* to the size of the claim in the great majority of cases.[177]

Interestingly, the Law Reform Commission of Western Australia[178] considered the question whether it is possible to determine *ex ante* whether a CGFA provides for an excessive compensation.[179] The problem arises, in part, because of the difficulty of constructing a reasonable fee baseline against which the actual CGFA can be judged. In theory, the optimal fee is the amount required to induce a lawyer to take and properly handle a particular case. The difficulty is that the information required to construct the baseline is rarely available. The problem

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[175] ibid. In Canada, of the eleven provinces that permit contingency fees, ten have no cap. British Columbia and New Brunswick have rules prohibiting the lawyer from recovering both costs from the loser and the contingency fee. In the US, on the other hand, some states have downward sliding scales depending on the level of damages on the basis that a lawyer's efforts and risk do not rise proportionately with the level of damages.

[176] See further M Zander, above n 84.

[177] ibid. This, obviously, may affect the 'attractiveness' of the case in the eyes of potential lawyers.

[178] Which recommended in 1999 that the CGFA be introduced into Western Australian law. Review of the Civil and Criminal Justice System (Perth Final Report 1999) http://www.wa.gov.au/lrc/finalreport/finalreporthtml/ch16civilcosts.html (27 April 2002)

[179] ibid 144.

arises because of the practical difficulty of determining how risky is the case, its time demands, and the potential recovery before the case really begins.[180] This intricacy was highlighted in *Re Swartz*,[181] where the Arizona Supreme Court explained that a CGFA that is reasonable when initially agreed upon may later turn out to be excessive. In such a case, the court held, a lawyer has a duty to reduce his fee to a reasonable fee and to collect no more than a reasonable amount in light of the time and effort he devoted to the case.[182] It seems that the court would insist on using hindsight as their methodology of review, because by using hindsight they can at least gather evidence on the amount recovered, the effort expended, and the difficulties the case finally presented.[183] On the other hand, determining a baseline for judging the reasonableness of a fee will often be impossible. It is possible that in *Re Schwartz* the Arizona Supreme Court used the hindsight test not because it is theoretically the best measure of a fee's reasonableness, but as a concession to the practical problems.[184] Perhaps a way around this would be to follow the recommendation put forward by the Western Australia Attorney-General's Department, requiring lawyers, before proposing a CGFA, to assess the risks of winning or losing the case, advise the client in writing of that assessment, and be able to defend the imposition of a CGFA on the basis of those risks.[185]

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[180] G Visscher 'Contingency Fees in Western Australia' (2000) 7 Murdoch University Electronic Journal of Law.

[181] 686 P 2d 1236 (Ariz 1984).

[182] ibid 1244.

[183] T Schneyer 'Legal-Process Constraints on the Regulation of Lawyers' Contingent Fee Contracts' (1998) 47 DePaul Law Review 371, 395.

[184] ibid.

[185] Attorney-General's Department, The Justice Statement (Office of Legal Information and Publishing Canberra 1995) 49.

6.4.9.2 Approval of the court

There seems to be no reason why the defendants should not be notified that the case is maintained by a CGFA from the very beginning, as proposed by Lord Denning in *Wallersteiner*.[186] This will enable the company to deal with the application in an informed way. At the same time, to ask the court or the Law Society to approve such an arrangement in each case, as Lord Denning also recommended, would merely escalate costs while contributing little, if anything, to protecting the company. One of the main rationales for the review of the civil litigation was the costs and delays currently experienced in these proceedings.[187] This will certainly defeat that purpose. Also, on a practical level it will be difficult to implement. There is yet another difficulty with Lord Denning's proposal. The Appellate Division in South Africa has pointed to the danger that disclosure of a CGFA might subconsciously induce the courts, once they are aware of the existence of a CGFA, to increase awards to offset the impact of the uplift fee which the successful litigant will have to pay.[188]

Perhaps a more practical solution would be then for the courts to engage in random audits of CGFAs rather than reviewing each and every agreement entered into. This will also be less expensive and, of course, will save precious judicial time. Further, the Law Society could produce guidance for solicitors about using

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[186] Above n 149 and accompanying text.

[187] *Access to Justice – Final Report – Multi-Party Actions: Chapter 17* (Lord Chancellor's Department 1997). These are, essentially, the same reasons which induced the reforms introduced with respect to conditional fees. See above under 6.3.1.1

[188] South African Law Reform Commission (1996) para 4.101.

CGFAs and a model agreement for use between clients and solicitors, in the same manner as they provided for in the case of CFAs. This would certainly help to protect the company. Finally, if the CGFA is managed properly, protection of the company's interests can be achieved through (1) transparency, as lawyers will have to be open about what is likely to occur from the outset; and (2) proportionality, that is lawyers will seek to recover reasonable compensation which is proportionate to the resources that it is reasonable to allocate to the case.[189]

6.4.9.3 Is there a need to reform attorneys' professional ethics?

Arguably, the introduction of CGFAs should be accompanied with amendments to existing professional ethics rules. First, the plaintiffs' attorneys should be subject to applicable rules of legal ethics that clearly purport to constrain attorneys' behaviour and guard clients' interests. Secondly, courts too have a role in this regard.[190] The strongest disincentives to meritless or frivolous litigation should be prompt dismissal by the courts. Court control from the very early days should ensure this, so will an early determination of the merits.[191] Finally, courts must also be prepared to visit sanctions on lawyers who do not live up to the standards of professional behaviour expected.

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[189] See also G Robinson 'The CFA is Here to Stay – A Litigator's Guide to Conditional Fee Agreements and Other Funding Arrangements' (2001) 39 Journal of Personal Injury Litigation 44.

[190] It was recommended that costs should be actively considered by the judge throughout the case so as to restrain lawyers' abuse. *Access to Justice*, above n 186, 19.

[191] ibid.

6.4.9.4 Final adjustments

Side by side with the introduction of CGFAs, an important step towards rectification of the uneconomic viability of the derivative action would be the recognition of the common fund and substantial benefit either by statute or through judicial action as outlined above.[192]

[192] Above under 6.2.2.1.

6.5 CONCLUSION

It is all well and good to provide shareholders with the right to initiate proceedings on behalf of the company, but if those actions cannot practically be invoked when needed because of lack of funding and the high cost of litigation, the law is a nonsense. Good claims on behalf of the company ought not to fail because of financing problems. There is much therefore to be said for a policy underlying the FFM that reduces this hurdle. Unless the courts can be persuaded of the need to encourage the bringing of properly funded derivative actions by modifying the conceptual analysis of the derivative action as proposed above and in the previous chapter, it remains likely that the only recourse open to a prospective plaintiff will be the existing system of costs indemnity orders. But, as we saw, this system is deeply flawed and it is highly questionable whether it provides any adequate incentives to prospective shareholders and their legal advisers. In response, this chapter examined four possible solutions to rectify the funding problem. Although it is still early days, it is clear that the current introduction of conditional fee agreements backed by insurance is an ingenious response to the need to protect plaintiffs from costs. Also, with the two-way fee shifting system, the allowance of the CFA offers only a partial solution to the problem of over-deterrence, as a losing party will remain liable for the opposite party's costs. Unless some sort of mechanism is to supplement this, CFAs are not likely to make much of an impact on derivative action litigation. Similarly, making a mandatory requirement for the company to pay the costs of litigation may provide more security to shareholders, but ultimately may not alter the perverse incentives of potential derivative action litigants.

By contrast, rewarding plaintiffs in monetary terms by providing them with part of the proceeds of a successful derivative action may bolster the incentives of potential derivative action litigants. In the short term and until US-style CGFAs are allowed in England, this may prove to be the most beneficial way towards rectification of the funding problem. It is also straightforward and easy to implement. It is difficult to resist the conclusion that, in the long run, unless a US type of CGFA together with supporting mechanisms is adopted by the English system accompanied by proper safeguards as proposed above, it is unlikely that any reform will make the remedy more accessible. This will make litigation far more likely because it means that no individual shareholder need invest the emotional resources or time usually needed to pursue litigation, let alone the financial resources. This is clearly also warranted by an understating that CGFAs are more compatible with derivative actions as well as more advantageous than indemnity orders or conditional fee agreements. Instead of re-inventing the wheel, why not adopt the US model for the derivative action and see whether over a ten-year period (litigation is a lengthy process) the benefits are clearly outweighed by any evils that may be perceived in that time?[193] If so, one of the major hurdles to the use of derivative action as highlighted by the FFM, that of the financing the litigation, can be lifted. This will also mean that it is likely that future discussions on derivative actions will not remain solely academic.

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[193] There are some signs that this is already happening. See further S Ward 'Tentative steps into contingent minefield' (2002) 99 Law Society Gazette 21.

The Functional and Focused Model –

Maintaining Doctrinal Consistency

The Interrelationship between the Derivative Action and the Unfair Prejudice Remedy

7.1 INTRODUCTION

The argument so far has concerned itself with reformulating the application and structure of the derivative action as well as resolving the funding and lack of incentives barriers. And the FFM which was put together in previous chapters is meant to provide a procedure for analysing and addressing these concerns. However, given the constraints of space, the ambitions of the remainder of this thesis are more limited. The investigation will be restricted to certain important practical aspects of the law governing derivative actions.

Recall that the availability of 'other adequate remedies' may prevent a minority shareholder from bringing a derivative action.[1] An attractive alternative is the 'unfair prejudice' remedy under section 459 CA 1985. Shareholders, even in situations whereby they are adversely affected by the breach of the directors' duties, are more inclined to pursue the section 459 remedy. In many ways, this is a more flexible and useful remedy for the minority shareholder than derivative actions. The presence of this remedy and the unclear interaction between the two remedies projects an uneasy shadow, which in turn affects the viability of derivative actions.

[1] *Barrett v Duckett* [1995] 1 BCLC 243, 250; Report, Draft Rules 50.9 and 50.10 in Appendix B.

First, with the exception of situations where only the company would have an action, a shareholder would be better off to rely upon 'unfair prejudice' since there is no need to go through the expense and uncertainty of a preliminary costs orders application. In addition, there is no requirement to make an application for leave to bring the 'unfair prejudice' remedy. Secondly, two recent decisions indicate that section 459 could substantially replace the derivative action.[2] Even in situations where the relief sought is claimed under section 461 CA 1985, but is sought for the benefit of the company, it is still open for a shareholder to seek a recovery order against the company for payment to him of any cost incurred by him.[3] This is likely, in turn, as we explain below, to make (perhaps unintentionally) derivative actions even less attractive than they already are. Thirdly, proving unfair prejudice under section 459 may be easier than proving a breach of corporate rights or proving that the derivative action is 'in the interest of the company'.[4] Finally, in most cases, the applicant personally receives the benefit of the relief provided under 'unfair prejudice' whereas the benefit of any recovery under the derivative action accrues to the company directly and only indirectly to the applicant. The fact that recovery is the right of the company in derivative action means that a successful litigant will not be better off than fellow shareholders who made no effort to support the proceedings.[5]

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[2] *Bhullar v Bhullar* [2003] EWCA Civ 424 taken together with *Clark v Cutland* [2003] EWCA Civ 810.

[3] *Clark v Cutland*, ibid, para [35], considered below under 7.4.2.

[4] *Smith v Croft (No 2)* [1988] Ch 114 and see discussion in ch 3 under 3.4.2.3.

[5] See ch 5 under 5.2.1.

Against this backdrop, the popularity of the section 459 action is not surprising. The experience in Canada indeed illustrates that the derivative action will be perceived as more procedurally complex and the less favourable form of action without some limit being placed upon the *scope* of the unfairly prejudicial conduct action.[6] Several questions arise with respect to the interrelationship between the two remedies: (1) Should the derivative action be dispensed with in favour of a single form of action, making identification of the type of wrong less significant? (2) Alternatively, if it is necessary to maintain a clear division between personal and corporate actions and if accordingly both forms of action should be retained,[7] should the derivative action be applicable to corporate wrongs and the unfairly prejudicial conduct action solely reserved for personal wrongs? Or should it be possible to obtain a corporate remedy by means of a section 459 petition? And if so, at what price? The purpose of this concluding chapter is to look into these important questions. By way of disclaimer, it should be clarified that given the constraints of space, the chapter does not consider the theory underlying the unfair prejudice remedy in any detail,[8] and is not concerned either with the proposals to

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[6] This is the position despite the fact that when bringing such action shareholders face potential liability for costs. BR Cheffins 'Reforming the Derivative Action: The Canadian Experience and British Prospects', [1997] 2 CFILR 227, 259; BR Cheffins and J Dine 'Shareholder Remedies: Lessons from Canada' (1992) 13 Company Lawyer 89; JG MacIntosh 'The Oppression Remedy: Personal or Derivative?' (1991) 70 Canada Bar Review 29.

[7] Report para 6.11.

[8] For analyses of the theory underlying the unfair prejudice remedy, see E Boros *Minority Shareholder Remedies* (Clarendon Press, 1995) 135–141; AJ Boyle *Minority shareholders' remedies* (Cambridge University Press 2002) 112–118; J Lowry 'Mapping the Boundaries of Unfair Prejudice' in J de Lacey (ed), *The Reform of Company Law* (London Cavendish 2002) ch 10; R Goddard 'Enforcing the hypothetical bargain: ss.459-461 of the Companies Act 1985' (1999) 20 Company Lawyer 66; CA Riley 'Contracting out of Company Law: s.459 of the Companies Act 1985 and the Role of the Courts' (1992) 55 MLR 782; DD Prentice 'Minority Shareholder Oppression: Sections 459-461 of the Companies Act 1985' (1988) 8 OJLS 55.

reform section 459 discussed in recent years.[9] Instead, the focus here is on the interaction between the two remedies and, in particular on those aspects which may affect the *viability* of the derivative action.

The chapter proceeds as follows.[10] Section 7.2 briefly examines the history of section 459. Subsequently, the arguments of assimilating the derivative and section 459 actions into a single provision are assessed. Section 7.3 evaluates the merits of the demarcation of the two remedies. As will be seen, the assimilation of these two remedies should be resisted. Accordingly, Section 7.4 explores the measures that can be introduced to clarify and simplify the interaction between the two remedies. Section 7.5 concludes.

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[9] For a detailed discussion of the Law Commission's proposals see eg AJ Boyle *Minority shareholders' remedies* (Cambridge University Press 2002) ch 5; P Roberts and J Poole 'Shareholder Remedies – Efficient Litigation and the Unfair Prejudice Remedy' [1999] JBL 38. The CLR's proposals are broadly based on the principles put forward by the Law Commission but differ in several key respects. CLR *Final Report* para 7.41.

[10] For an article derived from this chapter entitled 'Shareholders' Remedies: In Search of Consistency of Principle in English Law' see (2005) 5 EBLR 1063.

7.2 THE INTERRELATIONSHIP BETWEEN THE UNFAIR PREJUDICE ACTION AND THE DERIVATIVE ACTION

7.2.1 Introduction

Section 459 of the CA 1985 provides that a member of a company may petition for an order on the ground that the affairs of the company 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 the members (including at least himself), or that any actual or proposed act or omission of the company is or would be so prejudicial. Under section 461(2) CA 1985, if the court is satisfied that a petition under section 459 is well founded, it may make such order as it thinks fit for giving relief in respect of the matters complained of.[11]

To appreciate the breadth of the modern unfair prejudice remedy it is useful to consider briefly its antecedence and to outline the role which its architects had in mind when framing the remedy. Initially, the remedy was introduced to give the courts more flexibility and as an alternative to winding up a company on just and equitable grounds.[12] The forerunner of section 459 was section 210 of the Companies Act 1948, which gave the court power to grant discretionary relief to minority shareholders where they had been victims of 'oppression'. However, section 210 turned out to be a disappointment in practice, partly because its wording was restrictive and partly as a result of a series of cases in which it was

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11 Including regulating the conduct of the company's affairs; requiring the company to do, or refrain from doing certain acts; authorizing civil proceedings to be brought in the name and on behalf of the company; and ordering the purchase of shares.

12 Consultation Paper para 7.5.

very narrowly construed,[13] so that relief was granted in only a very few cases. A fresh start was made with the Companies Act 1980, when section 210 of the 1948 Act was repealed and replaced by section 75 of the 1980 Act, which was consolidated as section 459 CA 1985. 'Oppression' was replaced by 'unfairly prejudicial' conduct, and in a number of other ways the scope of the section was broadened. The result is that a remedy under the new provision has proved to be much more readily available. A further statutory modification was made by the Companies Act 1989, which added the words 'of its members generally' to section 459 CA 1985, so that it is no longer necessary to show that the conduct complained of has had a discriminatory effect as between one part of the shareholders and another.

In its amended form, the new statutory remedy has proved very popular, particularly in its application to small companies.[14] The range of conduct covered and the flexibility of the relief offered means that it has rapidly become the most attractive solution for a dissatisfied shareholder. Likewise, it avoids the problems of standing and other complexities associated with the rule in *Foss v Harbottle* on the one hand, and the drastic consequences of a winding-up order on the other.[15] But this popularity has brought its own difficulties. In particular, since the jurisdiction to grant a remedy depends upon the 'unfairness' of the respondent's conduct, and since the determination of a suitable remedy may call for an examination of the

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[13] ibid para 9.1.

[14] On the difficulties of the application of s 459 with regard to public companies see eg *Re Astec (BSR) Plc* [1999] BCC 59, 86–87; J Payne, 'Section 459 and Public Companies' (1999) 115 LQR 368; DD Prentice, above n 8.

[15] Consultation Paper 148.

behaviour of all the parties concerned, many cases have occupied a considerable amount of court time and run up costs on an alarming scale.[16] In response to the widespread concern over these trends, the Law Commission has made recommendations for procedural changes designed to cut the length and cost of trials, and sought to find alternative ways of resolving internal disputes within small companies. It also put forward the view that if the circumstances in which a derivative action can be brought are made more transparent, members may be encouraged to bring this claim rather than the wide-ranging proceedings under section 459, and accordingly this will shift some of the burden from section 459.[17] This in itself suggests that the derivative action and section 459 have some functional equivalence.[18] It may seem strange at first sight that a right of petition under section 459 vested in the individual member may be used to secure the redress of wrongs done to the company, especially those committed by its directors. However, the language of section 459 is wider in scope and is drafted so as to protect the interests of the members and not just their rights, and it has been so interpreted by the courts.[19] Similarly, it cannot be denied that a wrong done to the company may affect the interests of its members. In fact, the Jenkins Committee, whose report recommended the introduction of the unfair prejudice remedy, envisaged that it would have a role in relation to wrongs done to the company.[20]

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[16] For example, in *Re Elgindata Ltd* [1991] BCLC 959, the hearing lasted 43 days and costs totalled £320,000, when the shares in dispute were worth less than £25,000. That did not even include the costs of the appeal.

[17] Consultation Paper 148.

[18] C Hale 'What's Right with the Rule in *Foss v Harbbottle*?' [1997] 2 CFILR 219, 221.

[19] For example, Slade J in *Re Bovey Hotel Ventures Ltd* (unreported, 13 July 1981), adopted by Nourse J in Re *R A Noble & Sons (Clothing) Ltd* [1983] BCLC 273, 290.

[20] *Report of the Company Law Committee* (Cmnd 1749, 1962) para 206.

Similarly, in December 1995 a specialist Chancery Working Group considered some of the implications of Lord Woolf's work[21] on Chancery proceedings.[22] It expressed the view that proceedings under section 459 were now instituted where formerly a derivative action would have been brought, and that this had a number of undesirable consequences, including a longer, less certain and more costly trial.[23] Overall then, there is no denying that 'enabling the court in appropriate cases to outflank the rule in *Foss v Harbottle* was one of the purposes of the section'.[24]

7.2.2 Towards Amalgamation of the Two Remedies?

Two recent decisions have re-affirmed the view that section 459 could substantially replace the derivative action.[25]Arden LJ gives no reasons for her expansion of the role of section 459 in *Cutland*. However, some strong arguments do exist to support this decision. First, the pre-*Cutland* line drawn by the judges allowed section 459 actions to be brought where a wrong is done to the company but only in order to support a claim for personal relief for the petitioner.[26] However, this approach is not necessitated by the terms of section 459 and there is nothing within the

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[21] Published in *Access to Justice: an Interim Report to the Lord Chancellor on the Civil Justice System in England and Wales* (June 1995).

[22] R Clark 'Changes at Chancery' (1996) 93/23 LSG 30.

[23] Consultation Paper 172 n 2.

[24] *Re Saul D Harrison & Sons Plc* [1995] 1 BCLC 14, 18 *per* Hoffmann LJ (as he then was).

[25] *Bhullar v Bhullar* [2003] EWCA Civ 424; *Clark v Cutland* [2003] EWCA Civ 810.

[26] See eg *Re Charnley Davies Ltd (No 2)* [1990] BCLC 760, 784 *per* Millett J. These cases undoubtedly blur the classic distinction between personal wrongs and corporate wrongs, and raise some potentially difficult questions about the ability of shareholders to recover reflective loss, but they do not infringe the principle of collective enforcement of directors' wrongs because of the personal nature of the remedy involved. H Hirt 'In what circumstances should breaches of directors'duties give rise to a remedy under ss 459-461 of the Companies Act 1985?' (2003) 24 Company Lawyer 100, 109.

legislation to prevent Arden LJ's approach.[27] Indeed section 461(2)(c) provides that a corporate remedy may be awarded by the courts, albeit via the commencement of a new piece of litigation in the company's name. In circumstances where a wrong is done to the company and corporate relief is sought by a petitioner, it is difficult to see why the cost and inconvenience of two sets of proceedings should be preferable to the court awarding corporate relief directly under section 461.[28] The chances of a petitioning shareholder wishing to undertake a second piece of litigation are also extremely unlikely given the fact that in most circumstances they are seeking to exit the company by obtaining a buy-out order. Unsurprisingly, section 461(2)(c) has been little used in practice and few reported cases exist in which such an order has been made.[29]

Secondly, as between these two forms of shareholder remedy, section 459 has been in the ascendant for some time. As we saw, the law regarding the ability of a minority shareholder to bring a derivative action has long been criticized as being 'complex and obscure'[30] which, coupled with the significant procedural and financial barriers to bringing a claim, means that very few derivative actions are actually brought. All in all, section 459 is, and is likely to remain, a far more attractive and convenient remedy for shareholders. Arguably then, a derivative action is now unnecessary because the common law action has been somewhat overshadowed by section 459 petitions.

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[27] J Payne, 'Shareholders' Remedies Reassessed' (2004) 67 MLR 500, 501–502.

[28] See eg *Re a Company* (No 005287 of 1985) [1986] 1 WLR 281; Consultation Paper para 10.9

[29] One example is *Re Cyplon Developments Ltd* (Court of Appeal, 3 March 1982). L Kosmin 'Minority Shareholders' Remedies: A Practitioner Perspective' [1997] 2 CFILR 201, 213 ('If ever an example were sought of an impractical remedy which exists only in the minds of the parliamentary draftsman, this is it').

[30] Consultation Paper para 6.6.

The initial conclusion might follow that perhaps the most efficient way to proceed is to clarify and slightly broaden section 459 and amalgamate the derivative action with the other types of actions available under this section.[31] In other words, a practical solution would be to combine the derivative and section 459 actions into a single provision embracing all forms of action. A unified provision could funnel all derivative actions through a leave procedure, while eliminating insupportable differences in matters of standing, procedure, remedies and substance as between derivative and section 459 actions.[32] Arguably, this would be desirable for several reasons. First, this would remove the unclear and confusing interaction between the remedies.[33] A single, wide-ranging provision would negate argument regarding dual or concurrent claims, while circumventing the chaotic mêlée left in the wake of *Foss v Harbottle*. Secondly, converting section 459 to the overt status of a remedy of all-round applicability would have the advantage of breadth and also of certainty in which cause of action to cite.[34] Finally, it is arguable that it is difficult to see a justification for the provisions to be separated if in truth they are both designed to achieve the same end of overseeing the actions of directors and management by providing shareholders with an avenue to seek redress for a wrong done.[35]

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[31] Regrettably, the Law Commission's reform has not seriously addressed the fundamental question of the distinction between personal and corporate wrongs. See further J Poole and P Roberts 'Shareholder Remedies – Corporate Wrongs and the Derivative Action' (1999) JBL 99, 112.

[32] JG MacIntosh, above n 6, 68.

[33] Similar calls have been voiced in Canada. MacIntosh argues that these two remedies are 'two pieces of a puzzle that steadfastly refuse to fit together in a tractable fashion'. He explains that this is hindering the orderly development of corporate law doctrine in Canada. JG MacIntosh, above n 6, 29–30 and 66–67.

[34] S Watkins 'The Common Law Derivative Action: An Outmoded Relic?' (1999) 30 Cambrian Law Review 40, 54.

[35] C Hale, above n 18, 222.

7.3 THE CASE FOR RETAINING TWO SEPARATE REMEDIES

Why, then, has it taken the courts so long to make use of section 459 to provide a substantive remedy to the company in relation to corporate wrongs, and why was the assimilation of these two remedies actively resisted by the Law Commission when it investigated the issue of shareholders' remedies? As will be seen below, there are, indeed, very compelling reasons for this resistance.

7.3.1 Leaving a Gap in the Enforcement Mechanisms of Corporate Governance[36]

First and foremost, recall that the rule in *Foss* v *Harbottle*, which stresses that in relation to a wrong done to the company the company is the only proper plaintiff, emphasizes the *collective* nature of the process of enforcing directors' duties.[37] The collective nature of the process is further emphasized in *Wallersteiner* v *Moir (No 2)* that the company and not the individual shareholder should bear the costs of the action in appropriate circumstances.[38] Under a derivative action the claim against the wrongdoers belongs to the company and should be treated as being equivalent to a claim by the company itself. The issue for the court is doing justice to the company, ie the shareholders as a whole in a solvent company, and not to the

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[36] The section draws on J Payne 'Shareholders' Remedies Reassessed' (2004) 67 MLR 500.

[37] *Smith* v *Croft (No 2)* [1988] Ch 144; J Payne, above n 36, 503.

[38] [1975] QB 373, discussed in ch 5 under 5.3.2.

petitioning shareholder. This means that a shareholder should *not* have an indefeasible right to bring an action on the company's behalf.[39]

However, the effect of the judgment in *Cutland* is that section 459 can be used by a minority shareholder to obtain a corporate remedy in response to a corporate wrong without going through the leave and notice requirements which are in place in a derivative action, and which are in place to deal with the concerns raised in *Prudential*.[40] *Cutland* potentially means that the decision whether to litigate on behalf of the company can be delegated to individual minority shareholders, whether the company likes it or not and whether in the court's view it would be better for the company as a whole for the action be brought or not.[41] Nothing in Arden LJ's judgment in *Cutland* suggests any limits to this principle. This is a very different role for section 459 from that envisaged pre-*Cutland*, in which section 459 was developed by the courts as a *personal remedy* for shareholders, whether in response to personal wrongs[42] or in relation to corporate wrongs.[43]

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[39] J Payne 'Clean Hands in Derivative Actions' [2002] CLJ 76. It is inappropriate to allow a shareholder such as that in *Barrettt* v *Duckett* to circumvent the procedural hurdles designed to protect the company by bringing a s 459 claim to right the same wrong.

[40] One control which would remain in place in s 459 is the need to show that the wrongdoers are in de facto control of the company. *Re Legal Costs Negotiators Ltd* [1999] 2 BCLC 171.

[41] J Payne, above n 36, 503–504.

[42] As Payne notes (above n 36, 504) when the House of Lords reviewed s 459 in *O'Neill* v *Phillips* [1999] 1 WLR 1092 Lord Hoffmann emphasized this aspect, setting out two broad categories of cases in which s 459 will be relevant: where the company's controllers act in breach of the constitution or where the controllers' behaviour is lawful in the sense that it does not breach the constitution but it nevertheless breaches some informal agreement between the shareholders. This was not intended to be an exhaustive list, but nevertheless it is telling that both of these categories involve resolutely personal wrongs to the shareholder.

[43] See eg *Re Saul D Harrison & Sons Plc* [1995] 1 BCLC 14.

So, if the change of role is to take place then it should only come at a price, the price being a recognition that substantive relief for the company under section 459 must be denied in some circumstances in order to protect the company against malicious or misguided minority shareholders.[44] However, problems run deep here. Unsurprisingly, it has been suggested that the tools which are available to the judges at present to screen out inappropriate actions under section 459 are inadequate for this task.[45] These concepts, nonetheless, have been developed in a way which focuses very strongly on the petitioner's position and whether his or her rights attaching to shares have been infringed. Lord Hoffmann in *O'Neill* v *Phillips*, with its emphasis on contractualism, stresses the fundamentally promissory nature of the basis on which relief may be granted. This makes some sense given the courts' view, pre-*Cutland*, of section 459 as a personal claim to provide personal relief to the petitioner. However, clearly, this focus on inter-shareholder disputes provides no basis for determining whether or not a claim on the company's behalf under section 461 would be in the collective best interests of the shareholders.[46] The judges' discretion under section 461 could be used to refuse a substantive corporate remedy if the shareholder's claim was felt to compromise the collective position, but of course by that point the time and expense of litigation has already been expended. Instead, new tools will need to be developed to accomplish this task. But these tools are either not practical or far from ideal, in part because they

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[44] J Payne, above n 36, 504.

[45] These tools are, first, to require there to have been unfair prejudice to the petitioner and, secondly, to use their discretion under s 461 if they believe that the collective position has been too heavily compromised. J Payne, above n 36, 504–505.

[46] One effect of the requirement of unfair prejudice may be to prevent some forms of corporate wrongdoing being litigated in some circumstances, for example where there is a breach by a director of his duty of care and skill and no gross mismanagement is involved. However, this operates in a manner unrelated to the issue of potential misuse of the jurisdiction by the petitioning shareholder. ibid.

involve introducing collective concepts such as ratification into what is at heart a personal claim, and in part because those collective concepts are themselves in a state of some disarray.[47]

It can be seen then that importing a screening process into section 459 may be impractical. Fundamentally, section 459 is a remedy for shareholders who have suffered personal harm in a form amounting to 'unfair prejudice'. Essentially, section 459 is *the* minority shareholder's remedy.[48] The derivative action is, simply, a different creature: its function is to enable minority shareholders, in limited circumstances, to pursue an action for harm done to the company and to recover on the company's behalf.[49] If the law is to retain coherence, it is important that this distinction is observed.[50] In any event, a plaintiff cannot rely with any certainty on the unfair prejudice remedy as a means of exercising enforcement rights belonging purely to a company. There could still be circumstances where a shareholder might be unable to obtain relief under section 459 where harm has been done to the company, eg where the petitioner has contributed to the situation with the result that the prejudice is not regarded as 'unfair',[51] or where that relief is limited because of the petitioner's conduct.[52] There is no reason therefore why claims

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[47] J Payne, above n 36, 504–506. Ch 4 under 4.4.4.1 (A).

[48] C Hale, above n 18, 221.

[49] S Deakin E Ferran and R Nolan 'Shareholders' Rights and Remedies: An Overview' [1997] 2 CFILR 162, 164.

[50] C Hale, above n 18, 222.

[51] Although it is not necessary that a petitioner 'come with clean hands', his conduct may be relevant in deciding whether the relief should be granted and what the nature of such relief should be. *Re London School of Electronics* [1986] 1 Ch 211; *Jesner v Jarrad Properties Ltd* [1993] BCLC 1032.

[52] *Re London School of Electronics* [1986] 1 Ch 211.

based on breaches of fiduciary duties by directors, *where the plaintiff prefers to remain a shareholder*, should be forced into section 459 based on a different statutory test.[53] Also, as will be seen below, derivative actions are often more focused than a section 459 petition and in that sense an easier subject of case management by the court. In short, the change of role envisaged in *Cutland* should be resisted, for the reasons set out above. Section 459 is clearly an attractive and convenient remedy for shareholders and its impact, particularly in private companies, should not be underestimated. However, reliance on section 459 alone and the abolition of any form of derivative action could leave a gap in the enforcement mechanisms of corporate governance.[54] It is the purpose of the following sections to show that, doctrinally, there are valid reasons for these two remedies to co-exist, not least from a practical viewpoint.

7.3.2 Section 459 and Breaches of Fiduciary Duties

The main proposition advanced in this section is that founding a petition under section 459 upon breaches of fiduciary duty owed to the company is somewhat controversial. Following *O'Neill v Phillips*,[55] it is firmly established that conduct will be unfair where it breaches the terms on which it was agreed that the company would be run. Unfairness can also arise where a power is exercised in a manner regarded by equity as contrary to good faith. The courts have found that breaches of directors' duties can form the basis of a successful petition under sections 459–

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[53] L Kosmin, above n 29, 213.

[54] S Deakin E Ferran and R Nolan, above n 49, 164. On the reasons which exist to justify the difference in approach between shareholders' remedies in public and private companies, see BR Cheffins *Company Law: Theory, Structure and Operation* (OUP 1997) 463–471.

[55] [1999] 1 WLR 1092 (HL).

461,[56] as can a director's exclusion from management where an expectation of participation exists.[57]

However, founding a petition under section 459 upon breaches of fiduciary duty owed to the company is somewhat controversial, not least because of two related issues. First, the petitioning shareholder normally seeks a personal remedy (such as an order that his shares be bought by the company or majority shareholders), where the wrong has been suffered by the company.[58] Secondly, personal relief granted to a member as a result of a petition under section 459 based on a wrong done to the company seems to sit uneasily with the principle that a shareholder cannot 'recover' for damage, which is merely a reflection of the company's damage. This principle was clearly established in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*[59] and reconsidered and endorsed by the House of Lords in *Johnson v Gore Wood.*[60] It makes the company the primary agent to recover in such circumstances. This seems to be the right approach to protect, on the one hand, the defendant(s) from double recovery and, on the other hand, the interests of the

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[56] Above n 25. The application of s 459 in respect of breaches of directors' duties is restricted, however, by the requirement that the conduct of the company's affairs must be unfairly prejudicial. Thus conduct by a director in his personal capacity (ie stealing money from the company's safe) cannot be remedied by a petition under s 459. R Hollington *Minority Shareholders' Rights* (3rd edn Sweet & Maxwell 1999) 75 (re-named *Shareholders' Rights* in the recent 4th edn (Sweet and Maxwell London 2004).

[57] See eg *Re Phoenix Office Supplies Ltd.* [2002] EWCA Civ 1740.

[58] See further HC Hirt, above n 26. For a recent judicial consideration of this point, see *Atlasview Ltd v Brightview Ltd* [2004] All ER (D) 95, paras [58]–[64].

[59] [1982] 1 Ch. 204, 222–223. See also AJ Boyle 'Personal and derivative actions' (1999) 20 Company Lawyer 58.

[60] [2001] 1 All ER 481, HL. On the application of the principle including later developments see ch 6 under 6.2.2.3.

creditors.[61] On the other hand, it was held recently that the principle of reflective loss will not provide a bar to an action under section 459.[62]

In addition, it has been suggested that the function of section 459 with regard to directors' duties should be very limited, as this undermines the policy on which the rule in *Foss v Harbottle* is based. [63] To reconcile such use of section 459 with the principles of the rule in *Foss v Harbottle*, a petitioner should be required to demonstrate that his interests as a member are unfairly prejudiced as a result of the presence of two elements, namely, a director's breach of duty and the majority's 'wrongful' failure to initiate or prevention of litigation against the wrongdoer in circumstances where a derivative action is not available.[64] It was further suggested that it would generally only be possible to establish the second element if the wrongdoing director is also the majority or controlling shareholder. For this reason, it was concluded that the application of section 459 with regard to breaches of directors' duties would normally be confined to companies that are small in terms of the number of shareholders involved, particularly quasi-partnerships.[65] However, as Auld LJ pointed out in *Phoenix Office Supplies Ltd v Larvin*,[66] 'it is important to keep in mind that s 459 is designed for the protection of members of companies'. This is a significant point to take into account when analysing and interpreting

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[61] *Johnson v Gore Wood* [2001] 1 All ER 48, 528–529 and E Ferran 'Litigation by Shareholders and Reflective Loss' [2001] CLJ 245, 246–247.

[62] *Atlasview Ltd v Brightview Ltd* [2004] All ER (D) 95 (Apr) paras [58]–[64].

[63] HC Hirt, above n 26, 110.

[64] ibid.

[65] ibid.

[66] [2002] EWCA Civ 1740, para [27].

section 459. At any rate, it seems unlikely that it was the legislator's intention to allow a shareholder *without more* to avoid the restrictions of the rule in *Foss v Harbottle* by presenting an unfair prejudice petition.[67]

7.3.3 The Law Commission's Arguments

The Law Commission briefly considered unifying the remedies, exclusively in the context of channelling all proceedings into section 459 actions. It rejected this option on three counts. It is worth looking carefully at the expressed rationales behind this position.

First, under section 459 the applicant must show unfairly prejudicial conduct. In a derivative action, apart from the preliminary issue as to standing, the issue is whether the company has a cause of action against (say) a director. If the main complaint in section 459 proceedings is that a party to the proceedings has committed a wrong against the company, the applicant, in order to succeed in his proceedings, must show not only that the company has a good cause of action in respect of this wrong, but also that the company's failure to pursue this cause of action is unfairly prejudicial conduct. In order to bolster his case the applicant will probably include a number of other allegations of unfairly prejudicial conduct. In this way the issues in section 459 proceedings, from a case management point of view, are less focused and, moreover, tend to proliferate. It follows that from 'the point of view of limiting costs and making economical use of court time, it may be

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[67] Hirt, above n 26, 103. See also JE Parkinson *Corporate Power and Responsibility – Issues in the Theory of Company Law* (Clarendon Press Oxford 1993) 258–259.

better if the issues are confined to the wrong to the company if this is the substantial complaint, and the issues would be so confined at trial if the proceedings were a derivative action'.[68] In addition, the Law Commission points out that, if claims for wrongs to the company are combined with personal claims in an unfair prejudice petition, the proceedings will lack a clear focus from a case-management point of view. This has adverse implications for limiting costs and the economical use of court time. There is also the problem that, if a shareholder decides to apply for a personal remedy (for example a buyout) under section 459, then, even though the complaints which he has proved could have led to relief in favour of the company, the court cannot on that ground alone refuse him personal relief. This means that the cause of action vested in the company is not affected by the judgment. Moreover, so long as the directors remain unwilling to enforce it, it will not be enforced unless a liquidator is appointed. The advantage of a derivative action, on the other hand, is that 'it offers the possibility that, in appropriate circumstances, the company's cause of action may be enforced without a liquidation'.[69] Thirdly, 'creditors are likely to be better off and treated equally if wrongs to the company are remedied by relief for the company, rather than its shareholders personally under section 459'.[70] The Commission also points to the duty of care and skill which, while it involves a wrong to the company, does not amount to unfairly prejudicial conduct unless there is serious mismanagement.[71] It is perhaps helpful at this point to turn to **Table 7-1,** which aims to illustrate why the

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[68] Consultation Paper, para 16.4.

[69] ibid.

[70] ibid.

[71] ibid.

Law Commission's position is correct.[72] As the table clearly shows, there are some striking differences between the two remedies as they are currently drafted and used, which, in turn, suggests that the derivative action has sufficient relevance to merit independent existence.

Table 7-1: The derivative action vis-à-vis the unfair prejudice remedy

Major differences		
	Derivative action	**The 'unfair prejudice' remedy**
Who may apply?	A shareholder	(1) A member or members (2) A person to whom shares have been transferred by operation of law, (eg trustee in bankruptcy) (3) The secretary of state
On behalf of whom?	The company[73]	Normally, a shareholder seeking to protect his rights as a member and not as agent for the company[74]
Who are the respondents?	Company is made a nominal defendant	Normally, controlling shareholders and/or directors. If the company is made a party, this is usually made on a nominal basis.
Relief/ Main beneficiaries	The company[75]	Primarily concerned to protect members of quasi-partnership companies, who have taken their interest on the basis of legitimate confidences and expectations.[76]
Equity requirements	A shareholder may be prevented if there is evidence of 'behaviour by the minority	It is not necessary that a petitioner come with clean hands, but his conduct may be relevant in deciding

[72] It is worth emphasizing that **Table 7-1** intends to be representative rather than exhaustive as it serves to illustrate the different perspective as between the two remedies.

[73] *Wallersteiner v Moir (No 2)* [1975] QB 373, 391.

[74] *Jones v Jones and others* [2002] EWCA Civ 961. But note s 461(2)(c) under which the court has specific powers 'to authorize civil proceedings to be brought in the name and on behalf of the company'.

[75] Shareholders only gain indirectly and to the extent that the value of their shares increased.

[76] These factors do not render a s 459 action for shareholders in a public company *impossible*, just *unlikely* as the court have acknowledged. *Re Astec (BSR) Plc* [1999] BCC 59, 86–87 confirmed in *CAS (Nominees) Ltd v Nottingham Forest Plc* [2002] 1 BCLC 613, 627. On the concept of 'legitimate expectations' see *Re A Company* (No.00477 of 1986) [1986] BCLC 376; *Re Saul D Harrison & Sons Plc* [1995] 1 BCLC 14, 19–20; as modified in *O'Neill v Phillips* [1999] 1 WLR 1092, 1102.

Major differences		
	Derivative action	**The 'unfair prejudice' remedy**
	shareholder, which, in the eyes of equity, would render it unjust to allow a claim brought by the company at his insistence to succeed'[77]	whether the relief should be granted and what the nature of such relief should be[78]
Interim relief	The court can order interim relief	Usually, the court will not grant interim relief prior to a trial on the merits[79]
Can a former member sue?	A former member has no standing to sue,[80] but he can nonetheless bring derivative actions in relation to wrongs which were done to the company before he became a member[81]	A former member has no standing to sue, even if the conduct which he wishes to complain about occurred while he was a member[82]
Discretion of the court	Must apply for permission to continue the claim and may not take any other step in the proceedings except where the court gives permission[83]	The court has discretion as to what type of relief should be granted, and even as to whether relief should be granted at all[84]

[77] *Nurcombe v Nurcombe* [1985] 1 WLR 370, 378, *per* Browne-Wilkinson LJ; *Barrett v Duckett* [1995] 1 BCLC 243.

[78] *Re London School of Electronics* [1986] 1 Ch 211.

[79] The courts' power to grant relief derives from the truth of the facts alleged being established. *Re A Company* (004175 of 1986) [1987] BCLC 574. This rule was not followed in *Re Blow Arrow Plc* [1987] BCLC 585. However, the court may exercise its general jurisdiction and make an interim order for payment to the petitioners, for example, where the parties agreed that the affairs of the company had been conducted in a manner which was unfairly prejudicial and the court had no doubt that the petitioners would be entitled to an order for the purchase of their shares. *Re Clearsprings (Management) Ltd* [2003] EWHC 2516 (Ch) [43].

[80] Consultation Paper, paras 20.32–20.33. But cf s 236(1) of the Australian Corporations Act.

[81] *Seaton v Grant* (1867) LR 2 Ch App 459. The plaintiff must be a shareholder when the action is brought. *Birch v Sullivan* [1957] 1 WLR 1247.

[82] *Re a Company* [1986] 2 ALL ER 253. Prentice submits that the classes of persons entitled to invoke s 459 should be extended to cover, at least, former members of the company, as unfairly prejudicial conduct which occurred when they were members of the company may only come to light after they have ceased to be so. DD Prentice, above n 8, 64. The Law Commission left this question open. Consultation Paper, paras 20.34–20.38.

[83] CPR r 19.9 (3).

[84] s 461 CA 1985. Note also that in practice a large number of the reported cases under s 459 are the result of applications by respondents to strike out petitions under the inherent jurisdiction of the court.

Major differences		
	Derivative action	**The 'unfair prejudice' remedy**
Ratification of a ratifiable wrong	Possible under certain circumstances[85]	Will have no bearing[86]
Group of companies	The idea of 'double' or 'multiple' derivative actions was rejected by the Law Commission[87]	The way in which the affairs of a subsidiary are conducted can constitute unfair prejudice with respect to the parent company's affairs[88]
Relevance of alternative remedies	'The shareholder will be allowed to sue on behalf of the company if no other remedy is available'[89]	In few cases the court refused relief to a petitioner who was complaining about a situation, which he could remedy by using his own votes.[90]
Position in liquidation	There is no need for such a device as the liquidator will have taken control of the company's affairs from the alleged wrongdoers[91]	Not available

7.3.4 The Question of Relief

An important factor in considering the assimilation of the remedies is the question of relief. It will be recalled that if the court is satisfied that a petition under section 459 is well founded, 'it may make such order as it thinks fit for giving relief in

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[85] See discussion in ch 3 under 3.2.2.

[86] *Bhullar v Bhullar* [2003] EWCA Civ 424.

[87] Report para 6.109 discussed in ch 4 under 4.4.4.1 ('B').

[88] *Gross v Rackind* [2004] EWCA Civ 815.

[89] *Barrett v Duckett* [1995] 1 BCLC 243, 250 *per* Gibson LJ. For the Law Commission's proposals see, Report, para 6.15, discussed in ch 3 under 3.4.2.

[90] eg, *Re Legal Cost Negotiators Ltd* [1999] 2 BCLC 17.

[91] *Ferguson v Wallbridge* [1935] 3 DLR 66, 83, *per* Lord Blanesburgh; *Fargro Ltd v Godfroy* [1986] 1 WLR 1134, 1136, *per* Walton J and *Barrett v Duckett* [1995] 1 BCLC 243, 255, *per* Peter Gibson LJ.

respect of the matters complained of' under section 461(1). Although there is a wide range of possible remedies under section 461, the most common relief in practice is a court order for the purchase of the shares of the aggrieved shareholder by other shareholders (generally but not necessarily by the majority) or the company itself.[92] Indeed, the unfair prejudice remedy has in essence become an exit remedy,[93] which ensures that an aggrieved shareholder can leave the company with proper compensation.[94]

There are at least two fundamental problems with this. First, shareholders in listed companies do not generally require a buy-out order, because the market normally enables an exit with reasonable compensation (although the market rate may reflect breaches of directors' duties). Therefore the most common remedy under section 461 is of very limited use for shareholders in such companies.[95] More generally, the exit option might be undesired by or unacceptable to shareholders who want to stay in the company. Recall that at heart the derivative action is a remedy for shareholders who want to *remain* in the company and challenge the wrongdoing by directors.[96] Thus an exit right is (at best) an appropriate and satisfactory remedy for a limited number of shareholders.[97] Finally, selling the shares may not always be the best option, eg if an alleged wrongdoing has resulted

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[92] s 461(2)(d).

[93] Report para.6.11 and Appendix J.

[94] In accordance with s 461(2) and the guidance highlighted in *ONeill v Phillips* [1999] 1 WLR 1092. Report para.6.11 and Appendix J.

[95] Above n 14.

[96] See ch 4 nn 60–63 and accompanying text.

[97] H Hirt, above n 26, 110.

in the depression of share values.

7.3.5 The 'Alternative Remedy' Argument Revisited

Recall that the Law Commission Report proposed that the court should take into account any alternative remedy to that available in a derivative claim before granting leave to pursue.[98] While the Law Commission clearly has in mind the alternative of winding up, this might also include section 459 since, in principle, a corporate remedy is obtainable if specifically sought. Although the availability of an alternative remedy is not conclusive on the issue of leave, if section 459 were to be considered an alternative it would mean that, despite complying with notice, leave for the derivative action might be refused and the applicant would have to start again by issuing a section 459 petition.[99] But this should not necessarily be the case. Interestingly, a principal argument raised in *Wilson v Inverness Retail*[100] (a Scottish case) relied heavily on the Court of Appeal decision Barratt v Duckett. [101] The argument made was that shareholders are precluded from bringing an action on the company's behalf where a remedy is available under sections 459–461 CA 1985. However, it is unlikely that *Barratt* will be interpreted as giving rise to such a strict rule, not least because the equitable character of the derivative action gives the court discretion to decide whether a derivative action should be allowed to proceed.[102] Moreover, the Court of Appeal in *Barratt* did not decide that a

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[98] See ch 3 under 3.4.2.

[99] See generally, Consultation Paper, para 5.19; Report, para 6.15.

[100] 2003 SLT 301 (OH).

[101] [1995] 1 BCLC 243, 250.

[102] See further R Goddard 'Reasserting the distinctive character of shareholder remedies in Scotland – Wilson v Inverness Retail & Business Park' (2003) Juridical Review 209.

derivative action should be halted on the basis that a remedy was potentially available under sections 459–461. Instead, the court decided (in what it regarded as the 'unusual' circumstances before it), that the better course of action was for the company to be placed in liquidation in order that the liquidator could decide whether legal action should be taken. It also found that the plaintiff was bringing the action for personal reasons and not bona fide for the benefit of the company. In addition, it is perhaps surprising that no reference was made in *Wilson* to another decision. In *Cooke v Cooke*,[103] a derivative action and section 459 petition were brought in respect of the substantially the same allegations. The derivative action proceedings were stayed because the court believed that the issues would be better dealt with under section 459. It is clear, nevertheless, that what is unifying *Cook* and *Barratt* is the fact that the derivative action was halted because, when compared to another way forward (the section 459 petition in *Cooke* and liquidator instigated litigation in *Barratt*), it is seen as a *less suitable* forum for considering the issues raised. This situation is far removed from the claim that the derivative action is barred where the conduct of which complaint is made would give rise to relief under section 459.[104]

There is a further problem with the argument raised in *Wilson*. It assumes an equivalence between the remedy provided to the company where the derivative action is successful, and that available to the petitioning shareholder under sections 459–461. While it is certainly the case that section 461 permits an action to be brought on the company's behalf, as we saw, the remedy granted in the vast

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[103] [1997] 2 BCLC 28.

[104] R Goddard, above n 102.

majority of cases is the purchase of the petitioning shareholder's shares by the company or the majority shareholders. Where the petitioner's shares are bought, the remedy directly benefits the shareholder. Where an action is brought on the company's behalf, the company directly benefits. This difficulty is only overcome if the above argument is taken to imply that the shareholder cannot bring an action on the company's behalf because an equivalent provision exists under section 461.[105] So there is no surprise that, in *Wilson*, Lord Eassie rejected the above argument, while stressing that the purpose of sections 459–461 was to improve the minority shareholder's position and that '[t]here is nothing in the terms of those sections ... or their predecessors, which removes the derivative action from the aggrieved minority shareholder's forensic arsenal'.[106] This is clearly correct, as is the Lord Ordinary's view that 'Section 459 proceedings and the derivative action are not directly equivalent or co-extensive. The former is wider in scope'. This seems to confirm the view held in previous English decisions that, indeed, a factual overlap is not a functional equivalence.[107] Although there may be more than one legal dimension of the same set of facts, as breaches of duty capable of generating a derivative action may from part of a pattern of unfairly prejudicial conduct, this should not disguise the fact that there is still, nonetheless, a difference of perspective, as the *nature of a complaint* based on unfairly prejudicial conduct and of one which might support a derivative action is different in the two cases, as is the *relief* sought.[108]

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[105] ibid.

[106] 2003 SLT 301, 306J–K (OH).

[107] C Hale, above n 18, 222.

[108] *Re Charnley Davies Ltd (No 2)* [1990] BCC 605, 625F *per* Millett J; *Re BSB Holdings Ltd (No 2)* [1996] 1 BCLC 155 *per* Arden J.

7.3.6 Both Remedies can Operate together to Ensure Added Value for the Aggrieved Shareholder and the Company

To highlight the difference of the derivative action vis-à-vis section 459 and the utility of the former, consider the following scenario.[109] A minority shareholder of a company is seeking an order for the majority shareholder to buy his shares under section 461 CA where a significant loss has been sustained by the company as a result of the actions of the majority. Assume further that the company has been deprived of the benefit of, say, £10 million to which it would have been legally entitled but for the actions of the wrongdoer. This will obviously have an appreciable effect upon the value of the company and its shares. Therefore it is safe to say that if a legal adviser counsels the minority shareholder simply to present a petition under section 459 for their shares to be bought out by the majority, they would be doing their clients a great disservice, depriving them of the uplift in the capital value of the shares that would be secured as a result of a successful derivative action.[110] Therefore the counsel of perfection would be to raise a derivative action and present a petition under section 459 for a wrongdoer 'call' order under section 461. The latter proceedings could be stayed pending resolution of the derivative action, which, if successful, would result in ordering the directors or controlling (offending) shareholders to reimburse the company in respect of that loss. The staying on the section 459 proceedings could then be lifted, safe in the knowledge that the capital uplift in the value of the minority shareholder's shares secured as a result of the successful derivative action would be captured in any

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[109] D Cabrelli 'Derivative Actions: Part of the Minority Shareholder's "Forensic Arsenal" in Scotland' (2003) Scots Law Times 73, 74.

[110] ibid.

valuation of the shares ordered by the court as a result of any successful section 459 petition.[111] In the example above, a successful derivative action clearly injects value into the hands of the company and a successful section 459 petition (in the main) injects value into the hands of the shareholder on the transfer of his shares. This fluidity highlights the difference between the two remedies, which though similar, can operate *together* to ensure added value for the minority/aggrieved shareholder and the company.[112] Given the myriad of cases brought under section 459 CA, it is perhaps unfortunate then that the usefulness of the derivative action as a remedy per se has been overlooked in recent times.

7.3.7 Comparative Perspective

Section 459, or variants of it, is part of the legislation in virtually all commonwealth countries. That the derivative action is a different creature from section 459 can also be seen in Canada and New Zealand. In spite of calls to unite the remedies,[113] the two separate forms of action have been retained in these jurisdictions and it would be surprising, and out of tune with international developments, if the UK had chosen to depart from this position. More importantly, although there has not been an abundance of derivative action cases in Canada, there have been some important cases in which such proceedings prove justified as a technique of redressing serious corporate abuse. Canada has differed from

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[111] ibid, 75.

[112] As Lord Eassie stated in *Wilson v Inverness Retail* 2003 SLT (OH) 308B–C: '[the] consequent restoration to the company of its entitlement to its share of the profits ... does not necessarily resolve the issues of unfairness to the minority extensively canvassed in the [other s 459 CA] proceedings. Reduction is not a remedy available in those proceedings.'

[113] See above under 7.2.2.

England by its enactment of a virtual 'bill of remedies'.[114] The presence in Canada of the statutory derivative action and the oppression remedy (the parallel to the unfair prejudice remedy) has raised the question of the interrelationship between the remedies and in particular whether both personal and derivative actions are available under the oppression remedy. Arguably, the derivative action could exclusively be available under legislation pertaining to the statutory derivative action, and the oppression remedy should be linked solely to personal wrongs against minority shareholders.[115] The Dickerson Committee[116] considered that the objective of the statutory derivative action was to remedy wrongs to the corporation, whereas the oppression remedy would generally be invoked by minority shareholders in a close corporation.[117] The committee also recognized that in some situations actions may constitute a wrong to the company and a wrong to minority shareholders. In such a case 'the aggrieved person may select the remedy that will best resolve his problem ... [and] the courts should have very broad discretion, applying general standards of fairness, to decide these cases on their merits'.[118] The Dickerson Committee believed therefore that the two pieces of legislation could live side by side.

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[114] Which includes the statutory derivative action, the oppression remedy (the equivalent to the unfair prejudice remedy), various restraining orders, an appraisal remedy and, as in England, just and equitable winding up. For a survey of the scope and historical evolution of the oppression remedy under Canadian law see S Copp 'Protecting Shareholder Expectations: A Comparison of UK and Canadian Approaches to Conduct Unfairly Prejudicial to Shareholders: Part 1' (2000) ICCLR 184.

[115] L Griggs and J Lowry 'Minority Shareholder Remedies: A Comparative View' (1994) JBL 463, 475.

[116] Proposals for a New Business Corporation Law for Canada (Ottawa 1971).

[117] P Anisman, 'Majority–Minority Relations in Canadian Corporations Law; An Overview' (1986–1987) 12 Canadian Business Law Journal 473, 476.

[118] Dickerson Committee, above n 116, para 484.

There is another crucial element to add to this. Recall that section 459 is likely to remain a far more attractive and convenient remedy for shareholders in private companies. Recall also that this remedy offers advantages which should ensure that it remains the remedy of choice among shareholders. Yet, in spite of these factors, the evidence emerging in Canada reveals a somewhat surprising practice: most of the decisions involving the statutory derivative action have involved closely held companies,[119] a point which has left some scholars puzzled.[120] Whatever the case may be, it does mean, however, that the derivative action is not solely a theoretical remedy in private companies. This is all the more important when we bear in mind that in the UK private companies constitute the vast bulk of companies[121] and accordingly most minority shareholder legal actions tend to arise from the private end of the company spectrum. Also, from a practical viewpoint, a minority shareholder in a private company is better positioned to seek relief in the courts than is his counterpart in a listed company.[122]

Turning to New Zealand, the 'oppression remedy' (the equivalent to the unfair prejudice remedy) is found in section 174 of the Companies Act 1993.[123] It

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[119] ch 4 under 4.3.1.

[120] BR Cheffins, above n 6, 241–242.

[121] See ch 4 n 36.

[122] In a private company, a shareholder will usually find it considerably easier to establish 'wrongdoer control', because those who manage the business usually own a substantial percentage of the equity. This means that those in charge will often have the votes required to pass a resolution purporting to terminate any litigation. See further BR Cheffins, above n 54, 465–466, 305 and accompanying text; J Freedman and M Godwin 'The Statutory Audit and Micro Company – An Empirical Investigation' [1993] JBL 105, 108–109. But see also *Breckland Group v London and Suffolk* [1989] BCLC 100.

[123] In the past, the provision has been interpreted very narrowly, and only a handful of successful actions were brought between 1955 and 1981. However, amendments in the early 1980s have resulted in a significant liberalization of the courts' approach to the oppression remedy. M Berkahn 'The Derivative Action in Australia and New Zealand: Will the Statutory Provisions Improve

sits side by side with a statutory derivative action[124] and is conceived as a supplement to, rather than a replacement of, other remedies which the shareholder might utilize.[125] The liberal approach currently favoured in the interpretation of the oppression remedy has made it a very effective remedial tool for minority shareholders.[126] Interestingly, the 1980 amendment to the Companies Act 1955 included the addition of paragraph (d) to the orders set out in section 209(2). Paragraph (d) provided that the court could make an order 'authorising a member or members of the company to institute, defend, or discontinue court proceedings in the name and on behalf of the company'. However, it has been observed that this provision did not fit neatly within section 209. The oppression remedy is concerned with conduct of the company that adversely affects shareholders, rather than with wrongs done to the company itself.[127] Thus, while the current liberalization of the courts' attitude to the oppression remedy has enhanced the rights of shareholders to remedy personal wrongs, its effect on shareholders' ability to enforce corporate causes of action was far from significant.[128]

Shareholders Enforcement Rights?' (1998) 10 Bond Law Review 74, 90; A Borrowdale 'Shareholder's Protection: The Section 209 Remedy – A Survey' (1988) New Zealand Law Journal 196.

[124] Under s 165 of the Companies Act 1993.

[125] See eg L Thai 'How Popular are Statutory Derivative Actions in Australia? Comparisons with United States, Canada and New Zealand' (2002) 30 Australian Business Law Review 118; JG Macintosh 'The Shareholders' Appraisal Right in Canada' (1988) 13 Canadian-United States Law Journal 299.

[126] M Berkahn, above n 123, 90.

[127] This conclusion is supported by the fact that, during the period in which s 209(2)(d) was in force (1 April 1981 – 30 June 1994), there were *no* reported cases in which the court made such an order. See also G Stapledon 'Use of the Oppression Provision in Listed Companies in Australia and the United Kingdom' (1993) 67 Australian Law Journal 575, 584–585; G Shapira 'Minority Shareholders' Protection – Recent Developments' (1982) 10 New Zealand Universities Law Review 134, 159.

[128] M Berkahn, above n 123, 90.

7.4 THE WAY FORWARD—PRACTICAL STEPS

Thus far we saw that there is clearly a case for having two separate statutory minority remedies. But that is not to say that the unclear interaction between the two remedies could not be improved. Two such ways are examined and assessed next.

7.4.1 Redressing the Balance—The Case for Duality

We have seen that there is no doubt that in some situations actions may constitute a wrong to the company and a wrong to minority shareholders.[129] It is proposed therefore that to reflect the extent of inherent duality which seemingly exists within the majority of minority claims, an applicant should have the right to choose whether to bring a derivative action or proceedings under section 459, or cumulative claims under both.[130] At the same time, in order to maintain consistency of principle, in such a case: (1) the aggrieved shareholder may select the remedy that will best resolve his problem; and (2) the courts should have very broad discretion, applying general standards of fairness, to decide these cases on their merits.[131] For example, in cases where applicants seeking personal relief under section 459 (for example, a buy-out order) in circumstances where the facts of the

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[129] So it may be difficult to determine whether an action should be personal or derivative in from. A classic example is *Marx v Estates and General Investments Ltd* [1976] 1 WLR 380.

[130] This would be in line with the proposals of the Consultation Paper para 16.4. Griggs and Lowry have argued that a demarcation of actions would represent a valid alternative to a single form of action, suggesting that if there was any doubt as to the appropriate form of action 'either party could seek directions of the court as to the appropriate course to take'. This solution would avoid any 'radical reappraisal of the remedies' while providing appropriate means of redress for minority shareholders. L Griggs and J Lowry, above n 115, 475–477.

[131] cf Dickerson Committee, above n 116, para 484.

case would justify relief for the company (for example, the return of company property), the courts should have adequate powers to order issues to be tried separately and, in the case of duplication of remedies, to require election between them.[132]

It is further suggested that an entertaining of a section 459 petition, in a case where a derivative action could have been brought, should prima facie lie in fulfilling the screening tests as set out above as part of the FFM.[133] In appropriate cases, the courts would not have a problem in granting relief under section 461 against third parties,[134] a relief which could equally be granted in a separate derivative action.[135] Equally, where such a party, irrespective that he is a member, has personal rights against a company and these rights are invaded, courts would not have a problem finding that the rule in *Foss v Harbottle* is irrelevant, as observed (obiter dictum) by Lord Cooke in *Johnson v Gore Wood & Co.*[136] In the later case situation, a section 459 petition would be entertained as a practical

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[132] Consultation Paper para 16.6 and *Slough Estates Ltd v Slough Borough Council* [1968] Ch 299. Arguably, the court should also have the power to make an order in favour of the company, even where such an order is not sought by the applicant if that proves to be in the company's best interests.

[133] See ch 4 under 4.4.4.4.

[134] Equally, where the petitioner does not satisfy these tests, the court should strike out the petition, which in turn would force petitioners of unmeritorious claims to seek alternative settlement routes other than wasting the court's time. This seems to have been the approach in *Stein v Blake* [1998] BCC 316, 317F, where the plaintiff had brought a personal claim against the defendant, and on analysis of the facts, it was held that the proper claimant was the company itself, by then it was a matter exclusively for the liquidator to bring proceedings. See further J Mukwiri 'Using Section 459 as an Instrument of Oppression?' (2004) 25 Company Lawyer 282.

[135] *Clark v Cutland* [2003] EWCA Civ 810.

[136] [2001] 1 All ER 481, HL discussed above under 7.3.2.

consequence that the threshold of the FFM would not fairly provide a remedy route.[137]

7.4.2 A New Test for Obtaining Costs Orders

In parallel, a new test should be introduced for deciding the issue of funding the application, as the writer has explained elsewhere.[138] Recall that, pre-*Cutland*, the court had normally no jurisdiction in proceedings under section 459, unlike with derivative actions, to grant the petitioner in advance an order requiring the company to indemnify him as to costs.[139] Post-*Cutland*, it is clear that even in situations where the relief sought is claimed under section 461 CA 1985, the important factor for the purpose of determining where the costs should fall is *for whose benefit the relief is sought*. If, as in *Cutland*, it is the company then it is open for a shareholder to seek a recovery order against the company for payment to him of any cost incurred by him (essentially importing the *Wallersteiner* procedure into section 459 proceedings). But was the court correct? Or in a wider context, what should be the critical factor or factors that should determine whether a petitioner in a section 459 petition should be entitled to an indemnity cost order?

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[137] See ch 4 under 4.4.4.4.

[138] A Reisberg 'Indemnity Costs Orders under Section 459 Petition?' (2004) 25 Company Lawyer 118.

[139] *Re Sherborne Park Residents Co Ltd* [1987] BCLC 82; *Re a Company* [1986] 1 WLR 281. The ban on using company funds with respect to s 459 is not absolute, but the burden of justification for such expenditure will be a heavy one. Cogent and compelling evidence will be needed to justify such expenditure in advance. *Re A Company* (No 1126 of 1992) [1994] 2 BCLC 126.

A plausible alternative is that the critical factor should be *the nature of the wrong alleged* rather than the nature of the remedy sought, as in *Cutland.*[140] The reason is that under section 461 a petitioner who proves unfair prejudice that involves a wrong to the company can nevertheless obtain a remedy that is personal in form. And in such a case there is no reason for the company to indemnify him as to costs, because the relief is given directly to the member.[141] So that, in fact, the question for whose benefit the relief is sought for may not invariably help indicate the true nature of the action, as it can be personal, derivative or even combined. This may ultimately blur (or in fact collapse) the distinction between personal and derivative actions, as there would be no substantial difference between them. As the law currently stands this is simply not the case.[142] But more importantly, where a petition under section 459 alleges wrongs that are both personal and derivative (as, indeed, seems to be the case in *Cutland)* should the indemnity costs order be also available? And if so, would the test of *for whose benefit the relief is sough* be of any assistance?

On the one hand, there is nothing in nature of the *Wallersteiner* procedure that necessarily makes it unavailable where a shareholder joins a derivative action with a personal cause of action. At worst this would involve *de minimis* departure from principle.[143] On the face of it, there is no good reason why a petitioner who

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[140] DD Prentice, above n 8, 67.

[141] For example, where the unfairly prejudicial conduct takes the form of payment of excessive salaries, the court may order the oppressors to purchase the petitioner's shares. *Re Abraham and Inter Wide Investments Ltd* (1985) 51 OR (2d) 460; Indeed, the High Court in *Cutland* ordered a purchase by Mr Clark of Mr Cutland's remaining shares.

[142] DD Prentice, above n 8, 66.

[143] DD Prentice, above n 8, 67.

invests financial resources, time and effort should not obtain an indemnity order as to costs, when the company and all other shareholders may enjoy the fruits of his initiative.[144] The fact that the High Court judge in *Cutland* ordered a purchase by Mr Clark of Mr Cutland's remaining shares (essentially a personal relief) did not seem to prevent the Court of Appeal from reaching its conclusion that the petitioner could nevertheless obtain an indemnity order as to costs as well as obtaining a remedy that is proprietary in nature. On the other hand, as a matter of policy this may entail an adverse effect on the use of derivative actions. It is likely that the possibility of obtaining such orders under section 459 petitions would make (perhaps unintentionally) derivative actions even more unattractive than they already are. Shareholders would think twice before pursuing the separate and risky route of derivative actions, when it is possible for them now to obtain a similar recovery order for costs under section 461 when the relief sought is for the benefit of the company. The opportunity to gain an order for costs was up until now one of the very few advantages the derivative action had over the section 459 petition (from the viewpoint of funding).[145]

Although in section 459 proceedings the company is not usually ordered to pay any of the costs, there are circumstances under which granting such an order would be justified. Since the relief sought in *Cutland* was sought for the benefit of the company, there was no good reason why a petitioner should not obtain an

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[144] See further A Reisberg 'Funding Derivative Actions: A Re-examination of Costs and Fees as Incentives to Commence Litigation' (2004) 4 JCLS 345, 373–378.

[145] Which, as we saw in chs 5 and 6, is a pivotal factor when a member has to decide whether to opt for litigation (whether by means of derivative actions or through s 459 proceedings).

indemnity order with respect to costs.[146] But the test applied by the court tells us very little of the nature of the wrong alleged, when proceedings involve both personal and derivative causes of actions. Perhaps a better approach would be then to require, in such circumstances, that both the *nature of the wrong alleged* and the *nature of the remedy sought* would be the critical factors that should determine whether a petitioner should be entitled to an indemnity order under section 459 proceedings. This may help maintain the important distinction between personal and derivative actions.

Although it is now clear that it is possible to obtain a recovery on behalf of the company through a section 459 petition,[147] it is, nonetheless, important as a matter of policy to maintain a doctrinal distinction between the two remedies. Otherwise, there is a danger that derivative actions will be made redundant. Accordingly, and in line with previous cases, it is important to require that both the *nature of the wrong alleged* and the *nature of the remedy sought* would be the critical factors that should determine whether a petitioner should be entitled to an indemnity order.[148] Only if the two are corporate in nature (ie if the action is, at least partly, derivative in form and for the benefit of the company) could the petitioner then obtain an indemnity order as to costs. This could work as a two-stage test. When deciding on whether to grant an indemnity costs order, the court should initially inquire as to whether the alleged wrongs are personal, derivative or

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[146] And, of course, s 461(2)(c) expressly empowers the court to grant a successful petitioner an order authorizing a derivative action to be brought on behalf of the company.

[147] See also *Anderson v Hogg* 2002 SLT 354 (IH).

[148] *Re Charnley Davies Ltd (No 2)* [1990] BCC 605, 625F *per* Millett J; *Re BSB Holdings Ltd (No. 2)* [1996] 1 BCLC 155 *per* Arden J.

combined. If the answer is that they are either derivative or combined, then the court should proceed to the second question, namely what is the nature of the remedy sought (in other words, for whose benefit it is brought—that of the company or that of the member personally?). If it is mainly for the company, then, the argument runs, the company should be made to pay for it. Conversely, if the remedy is chiefly personal in form, then a member should normally be denied such costs orders as the rationale for such orders falls. This is a fairly straightforward test to apply. The court invariably deals with these questions in cases of this sort. More importantly, besides the positive practical effect this may have on the use of derivative actions, as explained above, this may also help maintain much clarity. When it is clear now that it is possible to obtain a recovery on behalf of the company through a section 459 petition, it should be likewise clear under what circumstances an indemnity order should be available. If the test provided above is followed, it is submitted, the necessary consistency and clarity may be restored.

7.5 CONCLUSION

It has been argued in this chapter that the derivative action has sufficient relevance to merit independent existence. The benefits of retaining the derivative action would outweigh the gains from dispensing the derivative action in favour of a single form of action under section 459. This could also leave a gap in the enforcement apparatus of corporate governance. Although section 459 could be developed to meet this need, section 459 has had limited success in public companies. In addition, section 459 itself is not beyond criticism, a point highlighted by the Law Commission. But irrespective of the ways in which section 459 might be improved and despite the flexibility that the courts have demonstrated in relation to remedies once unfair prejudice has been established, fundamentally section 459 is a remedy for shareholders who have suffered personal harm amounting to unfair prejudice. The derivative action is simply a different apparatus: under a derivative action the issue for the court is doing justice to the company, ie the shareholders as a whole in a solvent company, and not to the petitioning shareholder.

There is no denying that as it presently stands the derivative action does not offer an effective or an attractive weapon to shareholders, as does section 459. Indeed, it seems the judiciary has been more willing to apply section 459 to derivative-type actions, because they too wish to avoid the complexities surrounding derivative action litigation. But surely formulating a focused and effective derivative action remedy as put forward by the FFM above would also

mean that (1) there would be less need to resort to the less adequate section 459 remedy in cases where a corporate remedy in response to a corporate wrong is required; and (2) it could potentially enhance the capabilities of other mechanisms of accountability, not least section 459, as members may be encouraged to bring this claim rather than the wide-ranging proceedings under section 459, and accordingly this will shift some of the burden from section 459. Be that as it may, the presence of the unfair prejudice remedy and the unclear interaction between the two remedies could be improved. In order to remedy these defects two proposed ways were examined and assessed. If these measures are followed, perhaps the necessary consistency and clarity can be restored.

CONCLUSION

The aim of this thesis was to advance and extend the scope of current discussions on the law relating to derivative actions. First, the thesis attempted a fundamental rethink of the content of the derivative action and its objectives. It expressed a view of the derivative action's grand mission in order for it to meet corporate governance realities and address the concerns of a swiftly changing corporate world. It attempted to clarify the nature of the action, the circumstances where its application might be deemed propitious and to identify problems that might arise in the pursuit of the derivative action. The thesis then focused on and examined the conditions that might produce positive inducements to litigate. It expressed a view on what might be the optimal level of such litigation with a view to enhancing the potential effectiveness of the action as a controlling mechanism, and proposed means to assist in achieving that level. Crucially, the thesis strongly linked the actual viability of derivative actions to funding mechanisms, namely developing adequate means to fund derivative actions so as to make them worthwhile financially. Otherwise, it is submitted, the entire discussion on derivative actions will remain academic. Finally, the thesis showed that the derivative action has sufficient relevance to merit independent existence, as the benefits of retaining the derivative action would clearly outweigh the gains from dispensing the derivative action in favour of a single form of action under section 459 CA 1985.

More specifically, the thesis calls for action on three complementary levels, namely, *conceptual*—the adoption of a new framework in the guise of the

Functional and Focused Model ('FFM') to govern derivative action litigation; *strategic*—the employment of appropriate incentives and fee rules which advance the premises behind the FFM; and *maintaining doctrinal consistency*—by clarifying the interaction between the derivative action and the unfair prejudice remedy.

At the *conceptual* level, the thesis advocates the introduction of the FFM. Its core idea can be best expressed in the negative. Some may argue that litigation is just another corporate asset—no more, no less. It is not. At least when serious breaches of duty involving directors are at stake, the derivative action is a mechanism of corporate accountability. Admittedly, it is an imperfect and flawed mechanism, but so are most others. The FFM is an attempt to preserve this mechanism of accountability and to address its major flaws. The FFM does not place its primary reliance on courts or litigation. Instead, its starting premise is that litigation is a failsafe remedy, a safety net for instances when other mechanisms of accountability fail. Under the FFM, the derivative action is essentially confined to those instances which can be best described as 'functional' and 'focused'. It is functional, for the derivative action should be used only if it serves one of its prime functions, namely deterrence and compensation. By this the writer means that the model highlights the *functional logic* behind the derivative action. This 'functional' aspect of the inquiry also involves closely harnessing the derivative action to the corporate interest it represents by inviting the court to consider the *public character* of the norms raised by the derivative action as set out above, so that the action is more likely to be viewed as an instrument that affirms desirable norms in the corporate setting. The framework that the model developed is also 'focused' in the

sense that the litigation should be focused on: (1) those *areas* or instances in which other mechanisms of accountability fail; and (2) the *nature* of the inquiry conducted in court as set out above by the FFM. In essence, this defines when the safety net is needed. The case for shareholder intervention is based on the value to shareholders of having this 'weapon of last resort' which could benefit them both in the rare instances in which it would be actually used and, more importantly, in the instances in which its mere existence would induce management to act in shareholders' interests. Given that shareholders will not constantly use the power to intervene even if it is available, they should not be practically deprived of the power ever to intervene.

Turning to the *strategic level*, the thesis calls for the employment of appropriate fee rules which advance the premises behind the FFM. The thesis examined and assessed four financial strategies to resolve the funding problem. Although it is still early days, the thesis concludes that the current introduction of conditional fee agreements backed by insurance is an ingenious response to the need to protect plaintiffs from costs. Also, with the two-way fee shifting system, the allowance of the conditional fee agreement offers only a partial solution to the problem of over-deterrence, as a losing party will remain liable for the opposite party's costs. Unless some sort of mechanism is to supplement this, conditional fees are not likely to make much of an impact on derivative action litigation. Similarly, making a mandatory requirement for the company to pay the costs of litigation may provide more security to shareholders, but ultimately may not alter the perverse incentives of potential derivative action litigants.

By contrast, rewarding plaintiffs in monetary terms by providing them with part of the proceeds of a successful derivative action may bolster the incentives of potential derivative action litigants. In the short term and until US-style contingency fees are allowed in the UK, this may prove to be the most beneficial way towards resolving the funding problem. It is also straightforward and easy to implement. But, in the long run, unless the American type of contingency fee agreements together with supporting mechanisms are adopted to the English system (accompanied by proper safeguards as proposed above), it is unlikely that any reform will make the remedy more accessible. This will make litigation far more likely because it means that no individual shareholder need invest the emotional resources or time usually needed to pursue litigation, let alone the financial resources. This is clearly also warranted by an understanding that contingency fee agreements are more compatible with derivative actions as well as more advantageous than indemnity costs orders or conditional fees agreements. Instead of re-inventing the wheel, the thesis calls for the UK to adopt a US model for derivative action and see whether over a ten-year period the benefits are clearly outweighed by any evils that may be perceived in that time. If so, one of the major hurdles to the use of derivative action as highlighted by the FFM, that of financing the litigation, can be lifted.

Finally, at the *doctrinal level*, the thesis showed that the benefits of retaining the derivative action would outweigh the gains from dispensing of the derivative action in favour of a single form of action under section 459. This could, ultimately, leave a gap in the enforcement apparatus of corporate governance. Be that as it may, the thesis calls for the restoration of the necessary doctrinal

consistency and clarity with respect to the interaction between the two remedies. The thesis examined and assessed two strategies that may be employed for that purpose. These strategies not only may help preserve the derivative action and enhance its roles as explained above, but could simultaneously enhance the capabilities of other mechanisms of accountability, not least section 459, as members may be encouraged to bring this claim rather than the wide-ranging proceedings under section 459, and accordingly this will shift some of the burden from that section.

On the whole, the FFM developed in this thesis offers a methodologically-organized and conceptually-inclusive approach to thinking about derivative actions in general. It seems to have accomplished a threefold objective. First, it responds to and, indeed, fills the critical shortcoming of the academic literature on derivative actions by providing a *theoretical structure* of derivative action as a law enforcement mechanism in the corporate governance context. Equally important, the FFM advances a conceptually *analytic framework* and offers insights that, taken together, provide the requisite underpinnings for *policy* analyses of the derivative action. Finally, the FFM sets guidelines for designing *effective regulatory measures* where derivative actions are used to enforce the law.

A final note of caution must be sounded. The writer believes that the real novelty in the project of this thesis is that it shows and deals with the challenges facing the derivative action as a *coherent whole*. And, more importantly, it argues that these challenges should be tackled simultaneously—by adopting a *comprehensive* set of strategies, each designed to respond to different sets of

problems it presents. Herein lies the key aspect of understanding the aim of this thesis. The attitude taken in this thesis is that although there is no doubt that each of the above three components is capable of being introduced independently, we cannot look at individual problems in isolation, but should instead survey the entire landscape, and examine and repair the derivative action in its entirety. If this approach is followed, it is likely that the derivative action will be perceived as a potent threat that may operate on the minds of those involved in corporate governance and, over the long run, may change their values and the ways in which they go about their tasks. This will also mean that it is likely that future discussions on derivative actions will not remain solely academic.

Madison has been cited as saying that 'some degree of abuse is inseparable from the proper use of everything'.[1] There is no doubt that there will always be fraud and corporate malpractice. The law has not eliminated these, nor will derivative actions or any other mechanism of corporate governance. But there will be cases, as occur in the US, Canada and Australia, where the derivative action proves to be justified as a mode of redressing serious corporate abuse.

It is hoped that the theoretical inquiry developed in this thesis contributes towards the aim of providing a new conceptual framework for subsequent discussions and directions for the future study of derivative actions in English law. This thesis, though conceived of and executed as a self-standing project, can be regarded thus as the first part of a work in progress.

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[1] *New York Times Co v Sullivan* 376 US 254, 271 (1964) (quoting Elliot's Debates on the Federal Constitution 571 (1876)).

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