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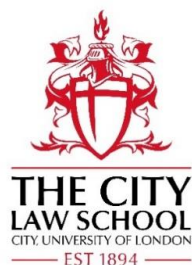
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**Reconsidering the role of the derivative claim in
the United Kingdom. A comparative study with
the United States and New Zealand**

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**Submitted in Fulfillment of Requirement for the Degree of Doctoral of
Philosophy in Law (PhD in Law)**

**School of Law
City University of London
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Abbreviations

ACAS= Advisory, Conciliation and Arbitration Service AGM= Annual general meeting
CA= Companies Act
CLRSG= Company Law Review Steering Group
CSR=Corporate Social Responsibility
FCA=Financial Conduct Authority
EU= The European Union
ILO= International Labour Organization
MED= Ministry of Economic Development
NEDs= Non-executive directors
NYSE= New York Stock Exchange
NZSX=the New Zealand Securities Exchange
NZ= New Zealand
OFR=operating and financial review
OECD= Organization for Economic Co-operation and Development
SEC= Securities and Exchange Commission
SMEs =Small- and medium-sized enterprises
TUPE=The Transfer of Undertakings Regulations
UK= The United Kingdom
US= The United States

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Author's declaration

I declare, except where explicit reference is made to the contribution of others, this thesis is the result of my own work and has not been submitted for any other degree at the City University of London or any other institution.

I also declare that the City University of London has the right to use the thesis for any educational and/or teaching purposes.

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Abstract

This thesis studies the role of derivative claims in the English legal system in the context of protecting the company as a separate legal personality, through both the shareholders and employees acting as the derivative claim applicants.

In spite of the aim of the English Law Commission to change the derivative claim to a more affordable and more accessible mechanism in the UK, still the current overly restricted approach to this mechanism prevents it to play an effective role in protecting the company. The academic literature brings several factors including the availability of other mechanisms of protection for shareholders, the cost of the derivative claim and the ambiguities in the procedural requirements as the reasons for the ineffectiveness of the derivative claim.

This research argues that the derivative claim is the only direct mechanism of protection for the company as a separate legal personality, and that protection of the company extends beyond the protection of its shareholders. Therefore, the hurdles in the way of efficiency of the derivative claim should be removed and it should become a more effective mechanism of protection for the company as a whole.

Although the combination of other mechanisms of accountability for directors¹ could discipline directors and provide an environment, in which the derivative claim is less needed, however, they have been designed to protect the personal interests of

¹ These mechanisms include the market for corporate control, disclosure requirements, non-executive directors also in private companies, unfair prejudice conduct and shareholders agreements.

shareholders in the first instance and might not provide a potent protection for the company in all circumstances. This thesis argues that the derivative claim could work as a complementary mechanism and provide protection for the company in situations that the other mechanisms fail to do so.

In order to enhance the protection of the company through the derivative claim, the thesis proposes that the scope of derivative claims' applicants should be extended to employees. Employees have strong incentive to protect the company because they often invest in a company with their human capital, and are deeply dependent on the company well-being for their livelihoods and their pension benefits. In order to make the derivative claim a more affordable and accessible mechanism, the thesis proposes some reforms to derivative claim procedural requirements, including the shareholders ratification and the derivative claim costs. This thesis is a comparative study. The proposals for the derivative claim procedural requirements have been inspired by the derivative claim structures in the United States and New Zealand. The financial structure of the derivative claim in both countries has reduced the risk of the derivative claim for shareholders. Moreover, studying the role of the derivative claim in these jurisdictions confirms the thesis argument that although the availability of the other mechanisms of accountability could affect the need for the derivative claim, still the derivative claim has a role to play as a complementary mechanism.

Chapter One: Introduction

This thesis develops the arguments for the amendment of the statutory derivative claim in the UK with the view to the interests of the company rather than any stakeholder group. Therefore, before discussing the problems of the derivative claim in the UK, this thesis explores the origin and functions of the derivative claim as the only mechanism of protection for the company as a separate legal personality. It also explores the theories of the company to ascertain what the objective of the company is and for whose benefit the company should be protected through the derivative claim.

1.1 The derivative claim: definition and origin

The proper plaintiff principle is a fundamental principle of English corporate law. It states that if a wrong has been done to the company it is the company that has a cause of action and a primary right to sue in respect of any injury or damage.

The principle was established in *Foss v Harbottle*,² a case in which Mr. Foss and another company shareholder initiated a claim against the directors of the company, alleging loss of the company's property as a result of the company's directors engaging in illegal activities. The court rejected their claim, ruling that with regards to the harm to the company, the company itself is the proper plaintiff in an action. The decision in *Foss v Harbottle* established two main rules, the

² *Foss v Harbottle* [1843] 2 Hare 461

proper plaintiff principle and the internal management principle. According to the proper plaintiff principal, because the corporation itself is a legal entity, it has the initial right to make for itself. Any legal remedy would go to the company, thus individual shareholders only indirectly benefit if the litigation is successful.

Under the internal management rule, it is generally accepted that the courts will not interfere with business decisions because it is believed that it is better if controlling shareholders decide on the internal issues within the company.³

However, the Foss rules raised fundamental questions such as: what would happen if the controllers of the company are involved in the harm that happened to the company themselves and decide not to exercise the company's right to sue the wrongdoers? What if the cause of action is against a person who is the controlling shareholder? How, if at all, would someone outside the wrongdoer team be able to pursue a claim to redress a wrong done to the company? The answer to these questions was established in the common law exceptions to *Foss v Harbottle*.⁴ In fact it was during the nineteenth century that courts started to consider that the Foss rules could produce injustice in some situations. As the result the courts eventually provided that shareholders could bring proceedings on behalf of the company in exceptional situations, in the form of a legal action which is known as the derivative action.

³ *ibid* 490

⁴ In the next chapter I will explain the common law exceptions to the Foss rule in more detail. Briefly, the so-called exceptions are (1) personal rights, (2) illegal or ultra vires acts, (3) majority control and (4) fraud on the minority. However, among these exceptions only majority control and fraud on minority are typically known as exceptions to the *Foss v Harbottle* rules.

1.2 Problems with the traditional definition of the derivative claim

The derivative claim (also known as the derivative suit and the derivative action) generally has two main functions: the compensation role to recover damages for the harm wrongdoers have done to the company, and the deterrence function to prevent further harm to the company.

A derivative claim can be considered by shareholders and, in the context of this thesis, employees where the directors or other wrongdoers or both have abused their position in the company. This could be in the form of directors' opportunistic behaviour, for example when directors divert company assets or opportunities to themselves to obtain personal interest. Alternatively, directors may be negligent in managing the company and their negligence harms the company or takes the company to the verge of insolvency. Hence, the derivative claim is litigation on behalf of the company, which could force the wrongdoers to compensate the harm they have done to the company. Also, its deterrence function could work as a threat to potential wrongdoers and prevent further harm to the company. The deterrence function could work in situations where the claimants become aware of directors' abuse of power through an ongoing transaction or notice any mismanagement, which would harm the company or take the company to the verge of insolvency. In such situations, they could initiate a derivative claim and curtail the ongoing harm through a court order. Even just the threat of the derivative claim might be enough to prevent wrongdoers from continuing their wrong conduct or

make them comply with their duties. However, despite its potential advantage, the traditional concept of the derivative claim limits its functions.

Traditionally, the derivative claim is assumed to reduce agency costs⁵ between shareholders and directors.⁶ Based on this assumption, the derivative claim function is to preserve the company from the wrongdoers' harm for the benefit of shareholders because of the agency costs arising between the shareholders and directors. Hence, only shareholders should have the right to initiate the derivative claim. This definition is based on the shareholder primacy theory and has a limited scope. In the view of this thesis, the derivative claim is the only direct litigation mechanism for protecting the company as a separate legal personality from its shareholders. The protection of the company is important not only because of the interests of shareholders, but also for the sake of other stakeholders whose interests are tied to the long-term function and financial stability of the company. Hence, any harm to the company could put their interests in jeopardy. Therefore, limiting the availability of the derivative claim to shareholders, limits the function of the derivative claim in protecting the company as a whole. Shareholders may not always care about the long-term protection of the company as long as other mechanisms are available to protect their personal interests, and as long as they secure a high financial return on their investments in the short term.

⁵ Agency cost is a type of internal cost in a company, traditionally based on the shareholder primacy theory. The agency cost arises from conflicts of interest between shareholders and directors. For example, shareholders want management to run the company in a way that increases shareholder value but directors may wish to grow the company in ways that maximise their personal power. Another type of agency cost is the one that arises from the conflict of interest between majority shareholders and minority shareholders, known as the horizontal agency cost; see also Daniel R. Fischel and Michael Bradley, 'The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis' (1986) 71 Cornell Law Review 261

⁶ Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Application* (Oxford University Press 2007)

Therefore, focusing on shareholder interests to define the function of the derivative claim would jeopardise companies' long-term sustainability.

To justify why as a mechanism of protection for the company the traditional concept of the derivative claim should change, the thesis explores the concept of the company as a separate legal personality and reviews the different corporate law theories on the objective of the company. The aim is to ascertain for whose benefit the company should be protected and who has the right to make a claim on behalf of the company.

1.3 Corporate separate legal personality

Under the doctrine of corporate separate personality, a company, even if it is a one-man company with one shareholder controlling all its activities, is a separate legal entity, distinct from its shareholders, directors, etc. Shareholders do not own the company property. The company has its own rights and obligations. It could enter into contracts and be a party to legal proceeding and it could sue wrongdoers.⁷

Ireland argues that the doctrine of corporate separate legal personality as a modern doctrine was established following the Companies Act 1862 and developed during the following years.⁸ By the development of the share market from 1870 and the establishment of the share as an autonomous, liquid form of property, the concept of the

⁷ Derek French, Stephan Mayson and Christopher Ryan, *Company Law* (Oxford University Press 2017-2018) 125

⁸ Paddy Ireland, 'Company Law and the Myth of Shareholder Ownership' (1999) 62(1) *The Modern Law Review* 42; Before the ratification of the Companies Act 1862, the concept of the "registered company" was introduced to the UK legal system by the Joint Stock Companies Act 1844. Also in later years the Limited Liability Act 1855 was passed to introduce the concept of limited liability, which provided protection for the personal assets of a company's members.

company as a separate, depersonified entity was gradually formed.⁹ By the development of the market, professional directors started to take control of the company from shareholders. The change in control of the company was complemented by a decline in the right of shareholders to intervene in daily management of the companies, and the shift of power from the shareholders general meeting to the board.¹⁰ As a result of these changes, the role of shareholders changed from active participants in small companies who had the ownership right, to passive investors who have a diversified basket of securities and stand outside the company with a set of certain rights and expectations.¹¹ Therefore, the company eventually became “the sole legal and equitable owner of the firm’s industrial capital” and the separated nature of the company emerged.¹²

The concept of corporate legal personality, which was initially set out under the Companies Act 1862 was formally affirmed as a legal doctrine in the decision in *Salomon v Salomon & Co Ltd*.¹³ The *Salomon* ruling established the principle that a company validly incorporated possesses a separate legal personality regardless of the number of its members. Nevertheless, even before the *Salomon* case the courts through several cases confirmed the separation of company from its shareholders.

In *Bligh v Brent*,¹⁴ for instance, the court considered the share as a personal entitlement to profit but not a claim on the company’s assets. The court held that

⁹ Ireland *ibid*

¹⁰ *ibid* 43

¹¹ *ibid*; also A.A. Berle and G.C. Means, *The Modern Corporation and Private Property* (1932; revised edn, New York: Harcourt Brace 1967) 244

¹² Ireland [n 8]

¹³ *Salomon v Salomon & Co Ltd* [1897] AC 22 (HL)

¹⁴ *Bligh v Brent* [1837] 2 Y&C Ex 268

shareholders had no direct interest, legal or equitable, in the company's property, only a right to dividends and a right to assign their shares for value.

In the context of this thesis' argument, more important than the decision in *Bligh v Brent*, is the court ruling in *Foss v Harbottle*¹⁵ where the court considered the company as a separate legal entity and established the proper plaintiff principle by holding that only the corporation can sue for wrongs done to it, not the shareholders.

In *Metropolitan Saloon Omnibus Co Ltd v Hawkins*¹⁶ the court confirmed that a company can sue directly for any offensive statement made against it as a separate legal personality. That case also affirmed that a company could even sue its own members for libel. The courts have also stated that a company's property belongs to it as a separate legal personality and not to its members.

In *Farrar v Farrars Ltd*¹⁷ the court held that because a company is separate from its members, it could enter into transaction with its shareholders. In *Percival v Wright*¹⁸ the court held that the directors owed the duty to act in the best interest of the company as whole, not just of shareholders. In *Prudential Assurance Co Ltd v Newman Industries Ltd*¹⁹ the court confirmed the corporate separate personality by ruling that: "The rule (in *Foss v. Harbottle*) is the consequence of the fact that a corporation is a separate legal entity. Other consequences are limited liability and limited rights. The company is liable for its contracts and torts; the shareholder has no such liability. The company acquires causes of action for breaches of contract and for torts, which damage the company. No

¹⁵ *Foss v Harbottle* [1843] 2 Hare 461

¹⁶ *Metropolitan Saloon Omnibus Co Ltd v Hawkins* [1859] Hurl & N 87

¹⁷ *Farrar v Farrars Ltd* [1888] 40 ChD 395

¹⁸ *Percival v Wright* [1902] 2 ch App Cas 409

¹⁹ *Prudential Assurance Co Ltd v Newman Industries Ltd* [1982] 1 Ch 204

cause of action vests in the shareholder. When the shareholder acquires a share he accepts the fact that the value of his investment follows the fortunes of the company and that he can only exercise his influence over the fortunes of the company by the exercise of his voting rights in general meeting".²⁰ The *Prudential Assurance* judgment reveals both sides of the corporate separate personality. On one hand, the company assets are separated from the shareholders, and the company as a distinct personality from its shareholders has its own obligations. Therefore, shareholders liability for the company's unpaid debts is limited to the amount of shares they have in the company,²¹ and the shareholder assets are not available to meet the company's debts.²² The company is the legal and beneficial owner of its own property. The shareholders are not the beneficiary owners of the company property.²³ Even the death of its members would not end the legal existence of the company, even if they were the sole shareholders of the company.²⁴ On the other hand, the company has its own separate rights too. Hence, shareholders are not allowed to have a direct remedy in situations that the company is harmed by the wrongdoers' conduct. In such situations, shareholders loss is only reflective of harm to the company for which only company could sue and get a remedy. Even in a situation that shareholders are allowed to initiate a claim on behalf of the company, they could only benefit from the recovery through an increase in their share

²⁰ *ibid* 210-211

²¹ *Salomon v Salomon & Company Ltd* [6]; CA 2006, s 3(2); also Brenda Hannington, *Company Law* (Oxford University Press 2015) 45

²² Hannington *ibid* 46; Kraakman et al., *The Anatomy of Corporate Law* (2nd edn, 2009) 6-10; Hansmann and Kraakman, 'The Essential Role of Organizational Law' (2000) 110 *Yale Law Journal* 387

²³ *The Maritime Trader* [1981] 2 *Lloyds Rep* 153; see also *Ayton Ltd v Popely* [2005] EWHC810 (ch), LTL 19/92005

²⁴ French, Mayson and Ryan [n7] 133; also Australian case *Re Noel Tedman Holding Pty Ltd* [1967] QdR 561

values. The principle known as the “reflective loss” principle²⁵. The rule prevents a person other than the company getting any direct remedy for the harm to the company, even if that person has a separate personal cause of action against the wrongdoer that is different from that of the company.²⁶

Despite the affirmation of the corporate separate personality from its shareholders under the status and the case law,²⁷ the nature of corporate personality and the company objective has always been the subject of some theoretical debates. Contractarians, for instance, believe that company does not exist. It is the product of a contractual agreement between its owners to endorse the power conferred by shareholders on directors.²⁸ The concession theory, on the other hand, argues that the corporate separate personality does exist; however, such legal consideration for corporations could only be created by the act of state and, therefore, the exact content of corporate personality depends on policy considerations.²⁹ The nature entity theory considers that the company and shareholders are fundamentally separate to legitimate limited liability.³⁰ The theory

²⁵ Hannington [n 21] p 46; The reflective loss principle is a common law rule, which was established under *Prudential Assurance Co Ltd v Newman Industries Ltd* [1982]. The rule indicates that shareholders should not get a double recovery for the same harm to the company and to their personal interests.

²⁶ *Day v Cook* [2001] EWCA Civ 781, [2004] EWCA Civ 592, [2002] 1 BCLC 1, 791

²⁷ The only known exception to the corporate separate personality is piercing the corporate veil. In the case of piercing the corporate veil, the rights and liabilities of the company could be attributed to other natural or legal persons. Such circumstances could happen through a contract, or statutory provisions or if the company is agent of its members or in the case of beneficial ownership of trust property. However, in *Prest v Petrodel Resources Ltd* [2013] and *Antonio Gramsci Shipping Corporation v Reoleto Ltd* [2014], the courts have brought the concept of the piercing the corporate veil into questions because of the difficulty of finding any underlying principle for the rule and by holding that it does not necessarily happen that much in practice.

²⁸ Frank Easterbrook and Daniel Fischel, ‘The Corporate Contract’ (1989) *Columbia Law Review* 1416, 1426

²⁹ CD Stone, ‘Should Trees have standing? Toward legal Rights for natural objects?’ (1972) 45 *California Law Review* 450; French, Mayson and Ryan [n 7] 157

³⁰ Mary Stokes, ‘Company Law and Legal Theory’ in William Twining (ed), *Legal Theory and Common Law* (Oxford: Blackwells 1986)

puts the board of directors at the centre of control of the company.³¹ In addition to the mentioned theories, other corporation theories such as economic market, organization and legal model have set explicit or implicit assumptions on what the company is or for whose interest directors should run the company. The detailed discussions of different notions of the company, although interesting, are outside the subject of this thesis. To the extent, which is relevant, this thesis adopts the doctrine of corporate separate personality and argues that based on this doctrine, shareholders are not the owners of the company so they should not be the only group of stakeholders in the UK who have the right to make a derivative claim. The other stakeholders whose interests are tied to the company, in the context of this thesis the employees, should also be able to protect the company from the wrongdoers' harm. The argument is that the Company Act 2006 has recognized the company separate personality by indicating that a director of a company owes his general duties to the company.³² This means that directors' fiduciary duties are to the company as a whole and not to individual shareholders. Nonetheless, the shareholder value principle which has been encapsulated in 172 CA 2006 indicates that 'A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole'. This means that in practice, directors own their duty to the capital rather than the company.³³ Therefore, only shareholders could be involved in the management of the company, and only shareholders could initiate a claim on behalf of the company when

³¹ Stephen Bainbridge, 'Director Primacy: The Means and Ends of Corporate Governance' (2003) 97 North-Western Law Review 547, 550

³² s 170(1) and 170(3) CA 2006

³³ Lorraine Talbot, *Critical Company Law* (Routledge 2015) 128-131

directors are in breach of their fiduciary duties. This approach still roots in the UK corporate law traditional shareholder value attitude and in the view of this thesis is problematic. In the following, I discuss the main theories on company law and also the UK approach to the company's objective to justify my argument that the company should be protected through the derivative claim for the interest of the company itself.

1.4 Shareholder primacy principle

Shareholder primacy theory, which traditionally underpins corporate law in the UK, generally requires directors to act in the interest of shareholders exclusively.

Under the theory, the company should be operated in a way that gives the highest priority to the interests of shareholders. It treats shareholders as the subjects of directors' accountability,³⁴ and the only stakeholder group which has the enforcement power on behalf of the company and could impact in the management of the company.³⁵ One suggestion is that the idea of 'shareholder primacy' could go back to descriptions of early share ownership in corporations where shareholders were legitimately considered as equitable owners of the whole activity.³⁶ However, the theory in its traditional form was eventually created after Adolf Berle and Gardiner Means published their famous ideology of separation of ownership and control and managerial model of

³⁴ For instance, the UK "enlighten shareholder value principle" encapsulated in section 172 of the Companies Act 2006, explicitly provides that directors' duties are to promote the long-term success of the company for the benefit of the members as a whole.

³⁵ Elaine Lynch, 'Section 172: A Ground-Breaking Reform of Director's Duties, or the Emperor's New Clothes?' (2012) 33(7) Company Lawyer 196; Iris Chiu, 'Operationalizing a stakeholder conception in company law' (2016) 10(4) Law and Financial Markets Review 174

³⁶ Samuel Williston, 'History of the Law of Business Corporations Before 1800 Part II (concluded)' (1888) 2(4) Harvard Law Review

the company.³⁷ They acknowledged a very strong management and weak shareholders with small influence.³⁸ To prevent the directors from self-interested conduct, they proposed that directors should have fiduciary duties to the company for the benefit of the shareholders. Although in their paper they did not explicitly promote the idea that the interests of shareholders should be privileged over the interests of other corporate stakeholders, they considered shareholders as important corporate stakeholders in the company.³⁹

During the 1970s, with the rise of the ‘law and economics’ movement,⁴⁰ ‘shareholder primacy theory’ was eventually established. The law and economic theorists generally consider shareholder primacy as a principle for running a business, which gives the interests of shareholders the highest priority over the other stakeholders in the company. Milton Friedman in his paper argues that the only proper aim of a company is the pursuit of profit for the company’s owners, which are the shareholders.⁴¹ He traces the origin of shareholder primacy theory back to Henry Maine, who was one of the leaders of the ‘law and economics’ movement.⁴²

³⁷ Adolf Berle and Gardiner Means, *The Modern Corporation and private property* (Transaction publishers 1991)

³⁸ *ibid* 277

³⁹ Lynn Stout, *The shareholder value myth: How putting shareholders first harms investors, corporations, and the public* (Berrett-Koehler Publishers 2012)

⁴⁰ Lynn Stout, ‘The toxic side effects of shareholder primacy’ (2013) 161(7) *University of Pennsylvania Law Review* 2003-2023

⁴¹ Milton Friedman, ‘The social responsibility of business is to increase its profits’ (2007) *Corporate ethics and corporate governance* (2007) 32

⁴² *ibid* 81; Henry Manne, ‘Mergers and the market for corporate control’ (1965) 73(2) *Journal of Political economy* 110-120; Lynn Stout [n 39]

In 1976, Michael Jensen and William Meckling in their seminal paper⁴³ enhanced ‘shareholder primacy’ to a greater extent. Jensen and Meckling argued that the main problem in companies is pushing wayward managers (agents) to truthfully consider the interests of the owners (shareholders/principals). The model of ‘shareholder primacy’, which Jensen and Meckling promoted, was the ‘nexus of contracts’ model. In their paper, they brought the notion of the company into question. They argued that the company is not an entity in its own right; it is in fact a legal fiction, which comprises of a nexus of contracting individuals. It is a nexus of a set of contracting relationships, which serves as a focus for a complex process in which the conflicting objectives of individuals are brought into equilibrium within a framework of contractual relations.⁴⁴ Just like Friedman, Jensen and Meckling assumed that the shareholders are the company owners and the only residual claimants.⁴⁵ Many ‘law and economy’ scholars later adopted the phrase and the people who adopt the nexus of contracts view are known as ‘Contractarians’. The Contractarians believe that the company itself does not really exist; it is merely the nexus, connection, or link amongst various corresponding relationships, thus it cannot have any social responsibility.⁴⁶ They believe that the rights for which shareholders are eligible come not from their ownership of property but from the terms, they have negotiated. Hence, the whole notion of ownership as entitlement is

⁴³ Michael Jensen and William Meckling, ‘Theory of the firm: Managerial behaviour, agency costs and ownership structure’ (1976) 3(4) *Journal of financial Economics* 305-360

⁴⁴ *ibid*

⁴⁵ Lynn Stout [n 39]

⁴⁶ Frank Easterbrook and Daniel Fischel, ‘The Corporate Contract’ [1989] *Chicago Law Review* 1416, 1426

sidestepped.⁴⁷ For instance, Easterbrook and Fischel regard a company as a set of contracts among managers, workers and the contributors of the capital.⁴⁸ In this regards, company law supplies “terms most venture would have negotiated, where the costs of negotiating at arm’s length for every contingency sufficiently low”.⁴⁹ Bainbridge regards the company as a nexus of contracts that is a combination of different peoples’ efforts coordinating together to provide goods or services.⁵⁰ However, among all people involved in the company, the proponents of the ‘nexus of contracts’ privilege the protection of shareholders because in their opinion shareholders are the central players and the only risk-takers in the company. The reason is that shareholders bring the capital into a firm and because of the insecurity of future return, they bear the most risk. The exception to this is if the company goes into insolvency, when creditors also become the residual claimants. Hence, the shareholders’ situation in the company should be different from other stakeholders and protecting their interests should be privileged above protecting the interests of the other groups.⁵¹ Easterbrook and Fischel argued that the company should be run for the benefit of shareholders as the only residual claimant of the company, because only shareholders have incentives to maximise profits in the company and monitor the other stakeholders, so they are likely to foster economic

⁴⁷ Lorrain Talbot, ‘Why shareholders shouldn’t vote: A Marxist-progressive critique of shareholder empowerment’ (2013) 76 Modern Law Review 791

⁴⁸ Frank Easterbrook and Daniel R. Fischel, ‘Limited liability and the corporation’ (1985) 52(1) The University of Chicago Law Review 89-117

⁴⁹ Frank Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1996) 15

⁵⁰ Stephan Bainbridge, *The new corporate governance in theory and practice* (Oxford University Press 2008) 28-30

⁵¹ Merrick Dodd, ‘For whom are corporate managers trustees?’ (1932) 45(7) Harvard Law Review 1145-1163

efficiency.⁵² Shareholders are the only groups of stakeholders who are completely dependent on the business' success to ensure any return from their contribution to the company's capital. All the other stakeholders such as employees, creditors and suppliers have fixed rights, which have been defined by their contracts with the company. For instance, employment contracts set out employees' wages and salaries. Shareholders, however, have no guarantee of returns to their investment, which come in the form of dividends or increases in the company's share value. Moreover, in the case of the company's insolvency, shareholders will stand last in line to receive any surplus left over after the contractual claims of the other stakeholders have been met.⁵³ On the other hand, the argument is that as residual claimants, shareholders have the best incentives to monitor other stakeholders, maximise the total value of the firm, and thus maximise social welfare. Therefore, residual risk-bearing should be complemented with residual control and the power to change the arrangement of the use of production factors.⁵⁴ Based on this argument, the proponents of shareholder primacy believe that directors are contractually obliged to pursue shareholder value. They would be in breach of their duty if they pursued the interests of other stakeholders, with whom they have no contractual relationship.⁵⁵ Under the nexus of contracts theory, the contract between the shareholders as the owners of the company's capital and directors who make business decisions and run the company on behalf of shareholders knowns as an agency

⁵² *ibid*

⁵³ John Buchanan, Dominic Heesang Chai and Simon Deakin, *Hedge fund activism in Japan: The limits of shareholder primacy* (Cambridge University Press 2012) 43

⁵⁴ Armen Alchian and Harold Demsetz, 'Production, information costs, and economic organization' (1972) 62(5) *American Economic Review* 777-795

⁵⁵ Lorrain Talbot [n 47] 15

relationship.⁵⁶ Nonetheless, the interests of the shareholders are not always in line with the decisions taken by directors as the agent. Since directors may find themselves in situations where their contractual duty to shareholders comes into conflict with their own self-interest, ‘agency costs’ arise between shareholders and directors. In such situations, the incompleteness of the contract between directors and shareholders requires completing by the state of incorporation, which it does by upholding fiduciary duties.⁵⁷ Nonetheless, according to the nexus of contracts theory, companies step in where market contractual arrangement dealings fail. The shareholders, as principals, require additional mechanisms to reduce these co-called agency costs, either through establishment of the proper incentives such as performance-related pay or through disciplining mechanisms such as those provided by the market for corporate control.⁵⁸ Contractarians argue for the governing force of takeovers by emphasising on the ability of the market to hold all available public information in time and reflect this in stock prices.⁵⁹ Managerial ineffectiveness will presumably lower the value of shares in the marketplace, and subsequently create an opportunity for potential bidders to acquire the business. Hence, the market for corporate control assumes to work as a corrective mechanism against directors’ failure to maximise shareholders’ wealth.⁶⁰ However, this argument might not always be correct. Corporate takeovers are extremely expensive, therefore the scale of a manager's wrong must be enormously high in order to affect the

⁵⁶ Jensen and Meckling [n 43]

⁵⁷ Lorrain Talbot [n 47] 16

⁵⁸ Henry Manne, ‘Mergers and the market for corporate control’ (1956) 73(2) *Journal of Political Economy* 110-120

⁵⁹ *ibid*

⁶⁰ *ibid*; also Shuangge Wen, *Shareholder Primacy and Corporate Governance: Legal Aspects, Practices and Future Directions* (Routledge 2013) 17

company's share price or attract a bid for control. The agency cost- related issues might not be large enough to trigger a takeover bid even if they result in a notable reduction in a company's share value. The other argument is that the markets for corporate control may replace wrongdoing directors through the hostile takeover but it would not necessarily punish them for the damages they have done to the company. Because of this reason, the market for corporate control could not substitute the role of the derivative claim for protecting the company as whole.

1.5 The shareholder primacy theory limitations

One dominant view under corporate law is that the 'shareholder primacy' is an economically efficient corporate objective.⁶¹ However, the theory has many limitations. As was discussed above, based on the corporate separate personality doctrine the company does not belong to shareholders and shareholders are not the owners of the company, so the company protection should not be important for preserving the interests of shareholders only.

The problem with the shareholder primacy theory is that it makes the board of directors dependent on the will of the majority shareholders, which might cause profit-seeking in the shareholders' interest, but not necessarily in the company's interest as a whole.⁶² Proponents of 'shareholder primacy' argue that the purpose of corporate law should be reducing agency cost between shareholders and directors. In the view of this research, this argument is not correct because even in terms of protecting shareholders'

⁶¹ Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law' (2001)

89 GEO. L.J. 439, 443–49

⁶² Adolf Berle and Gardiner Means, *The modern corporation and private property* (Transaction publishers 1991) 235–239

interests, shareholder primacy theory might not always protect the interests of minority shareholders. Directors are usually under the influence of institutional shareholders and in some cases, majority shareholders have strong conflicts of interest with the minority shareholders.⁶³ Moreover, the agency costs do not always arise from the conflict of interests between shareholders and directors, they could arise from directors' opportunistic behaviour, which damages the interests of other stakeholders such as employees in the company. In such situations, they should have the equal right to initiate a claim on behalf of the company and protect their own interests. Furthermore, the shareholder primacy principle with its focus on short-term earnings performance of the company fails to maximise social wealth.⁶⁴ Corporate short-termism can produce unpleasant consequences for society.⁶⁵ For instance, directors' opportunistic behaviour or negligence could result in the company's insolvency and as a result employees lose their job in the company. In such a situation, not only employees receive personal harm (including the significant time and cost they should spend to find a new job) but also it could have harmful social effect. The fact is that institutional shareholders may sacrifice other stakeholders' interests while extracting benefits from the company. They may not sue directors for their exploitative behaviour, which harm the company as long as they can extract short-term benefit, produced by those wrongdoers. This opportunistic behaviour could happen in the form of excessive levels of pay to the company's

⁶³ Martin Gelter, 'The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance' (2009) 50(1) *Harvard International Law Journal* 1

⁶⁴ Steven Wallman, 'The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties' (1991) 21 *163 Stetson Law Review* 163 176–177

⁶⁵ Chiu [n 35]; BIS, *The Kay Review of UK Equity Markets and Long-Term Decision Making (Final Report, 23 July 2012)*. http://www.ecgi.org/conferences/eu_actionplan2013/documents/kay_review_final_report.pdf

executives or in the form of dividends or redemption to controlling shareholders. Such wealth transfers might exceed the company's profits or diminish the company's long-term investment capital and consequently take the company into insolvency.⁶⁶ BHS could be a good example in this regard. All the wrong conduct that Sir Philip Green and others have done in BHS are grounds for the derivative claim including the negligence, mismanagement, and misappropriation of the company's assets through dividends and a variety of intragroup transactions. Nevertheless, in BHS – which was a very large private company – there was no shareholder from outside the wrongdoers' team to act as a watchdog and control and stop the wrongdoers' misconduct. Even if BHS was not a private family-run business and there were some outside shareholders with some ability to control the directors' conduct, for the reasons brought in above they might not care about the company employees' pension scheme. Hence, the question is why should only shareholders be able to initiate a claim on behalf of the company? Why not other stakeholders such as employees as well who have more long-term interest in the company and are more willing to protect it. The truth is that the shareholder primacy theory narrows down the company protection by focusing on shareholders' short-term wealth maximisation, and putting the enforcement mechanisms against the wrongdoers in the hands of shareholders who could be indifferent toward the harm to the company. Majority shareholders could encourage the board of director to take excessive risk to maximise their profit in a short time. These short-termism goals could be worsened by

⁶⁶ Chiu *ibid* 174; Anres Ramirez and Nezih Altay, 'Risk and the Multinational Corporation Revisited: The Case of Natural Disasters and Corporate Cash Holdings (2011) at <http://ssrn.com/abstract=1772969>; Ron Blackwell and Thomas Kochan, 'Restoring Public Purpose to the Private Corporation' (2013) at <http://ssrn.com/abstract=2214621>

performance-related remuneration for company management, which is designed to align directors' interests with those of shareholders. Consequently, it would shift the decision-making, which could help the suitability of the company in the long run to the kinds of decisions that would only produce short-term profits desired by shareholders.⁶⁷

Based on these arguments, the shareholder primacy theory fails to provide a balance between the directors' power on the one hand and a long time protection for the company on the other. Therefore, the right to make a claim on behalf of the company should not be limited to shareholders.

1.6 Stakeholder theory

Another important corporate law theory on the objectives of the company is the stakeholder theory. Stakeholder theory provides that the objective of the company is to benefit all stakeholders. Therefore, the company should not be run for the interest of shareholders, but the interests of other stakeholders who can affect or be affected by the actions of a company.⁶⁸ This theory's argument is that in addition to shareholders, other stakeholders should have claims on a company's assets because they contribute to a company's capital.⁶⁹ Like the shareholder theory, there are several concepts involved with the stakeholder theory, which have created different arguments and conclusions mainly on the issue of who the stakeholders are.⁷⁰ For instance, Freeman described

⁶⁷ Lorrain Talbot [n 47] 53

⁶⁸ Edward Freeman, 'A Stakeholder Theory of the Modern Corporation' in Tom L Beauchamp and Norman E Bowie (eds), *Ethical Theory and Business* (5th ed, Prentice Hall 1997) 69; Andrew Keay, 'Tackling the issue of the corporate objective: an analysis of the United Kingdom's enlightened shareholder value approach' (2007) 29 Sydney Law Review 578

⁶⁹ Keay *ibid*; Robert Karmel, 'Implications of the Stakeholder Model' (1993) 61 George Washington Law Review 1156, 1171

⁷⁰ Fabian Brandt and Konstantinos Georgiou, 'Shareholders vs Stakeholders

stakeholders as “any group or individual who can affect or is affected by the achievements of the firm’s objectives”.⁷¹ Still this definition should be narrowed down between different stakeholders since their interests and influence can vary in the company.⁷² I will discuss this later in this chapter.

Overall, the stakeholder theory emphasises organisational success in achieving the corporate objective of profitability through stakeholder management.⁷³ The emphasis on relationships with customers, employees, suppliers and investors means that the proponents of the stakeholder theory argue that corporate governance is more about satisfying all stakeholders’ interests than only satisfying those of the shareholder.⁷⁴

Clarkson defines a company as a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the firm’s activities.⁷⁵ The purpose of the company is to create wealth or value for its stakeholders who play different roles in the company by converting their stakes into goods and services.⁷⁶ Also, the argument is that directors should be required by law to act in the interest of the whole company, so that shareholder maximisation is based on the stakeholder theory that only when all of the other stakeholders’ relationships of the

Capitalism’ (2016) Comparative Corporate Governance and Financial Regulation 10, 6.
Available

http://scholarship.law.upenn.edu/fisch_2016/10

⁷¹ Edward R. Freeman, *Strategic Management* (Cambridge University Press 1984) 25

⁷² Brandt and Georgious [n 70] 7; also Ronald Mitchell, Bradley Agle and Donna Wood, ‘Toward a Theory of Stakeholder Identification and Salience: Defining the Principle of Who and What Really Counts’ (1997) 22(4) *The Academy of Management Review* 853-886

⁷³ Ronald Mitchell et al. *ibid*

⁷⁴ Thomas Clarke, *International corporate governance: A comparative approach* (Routledge 2007)

⁷⁵ Max Clarkson, ‘A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance’ (1995) 20 *Academy of Management Review* 92, 106; Bob Tricker, *Corporate governance: Principles, policies, and practices* (Oxford University Press, USA 2015)

⁷⁶ Clarkson *ibid*

corporation are fully recognised and developed can long-term shareholder value be realised.⁷⁷ The rationale behind stakeholder theory is that corporate governance should promote the success of the company as a whole, because the stakeholders' benefit is vital to the company's overall achievement. This would protect the interests of the company's employees, keep positive business relationships with suppliers and customers, ensure a positive social reputation, and reduce the negative impact on society as a whole.⁷⁸ Therefore, stakeholder theory requires decision makers to identify the legitimate stakeholders and their interests first, then weigh and balance the latter against each other and finally make their choice on that basis.⁷⁹

1.7 Critiques of stakeholder theory

One critique of the opponents of stakeholder theory is that under this theory directors need to consider the interests of all stakeholders. This would cause poor decision-making in the company because directors would be responsible to no one.⁸⁰ The answer could be that directors owe their duties to the company and should be responsible to the company, and that the company is comprised of several groups of stakeholders. Therefore, directors should make decisions which are in the interests of the company. Another argument of the opponents is that stakeholders other than the shareholders are able to protect themselves through the terms of the contracts that they make with the company, while shareholders do not have this kind of protection. Hence, shareholders

⁷⁷ Thomas Clarke [n 74] 281

⁷⁸ *ibid* 283

⁷⁹ Brandt and Georgious [n 69] 7

⁸⁰ The Committee on Corporate Law, *Other Constituency Statutes: Potential for Confusion* (1990) 45 *The Business Lawyer* 2253 226; Andrew Keay [n 68] 585

are vulnerable⁸¹ and they might be at the mercy of the directors. The answer is that no contract is comprehensive to cover all issues and it is virtually impossible to predict all the possible future harms in a contract. Furthermore, in terms of vulnerability, stakeholders such as employees could be far more valuable than shareholders in a company because they normally have only one job and it can be put in jeopardy by the opportunistic behaviour of directors or their negligence. Shareholders, especially in public companies, are arguably able to diversify risk more easily through their profile or they still have the option to sell their shares and get out of the company in case of any harm. In addition to that, other stakeholders might be able to protect their personal interests through the contracts they have with the company to some extent. For instance, in case of a company's insolvency, employees might get some compensation through their contracts or from the various regulations outside the corporate law such as the Redundancy Act. Nevertheless, such protections would not protect the company from directors' opportunistic behaviour harm and consequently would not protect employees' interests, including their job in the company. Hence, while for shareholders removing themselves from the risk of corporate loss in case of harm to the company might be comparatively easier involving selling their shares, the same cannot be said for other stakeholders such as employees. Mitchell argues that employees risk redundancy and will have committed themselves to a geographical location and perhaps spent years accumulating firm-specific skills, which may not be easily transferable.⁸² Therefore, broadening the scope of the derivative claim to other stakeholders would enhance the

⁸¹ Luigi Zingales, 'Corporate Governance' (1998) in the New Palgrave Dictionary of Economics and the Law, available at <https://ssrn.com/abstract=46906>

⁸² Lawrence Mitchell, *Progressive Corporate Law* (Avalon Publishing 1995)

directors' accountability in the company and would protect the other stakeholders' reflective interest in the company.

Based on these arguments, this thesis, in line with the stakeholder theory, argues that the protection of the company is important for the interest of all the stakeholders. Nevertheless, the thesis accepts that there are some flaws in this theory. For example, there is no clear guidance to define who the important stakeholders in the company are. In the context of this thesis, this issue is important in terms of defining the stakeholders who should be empowered with the right to make a claim on behalf of the company. It is not possible to assign such a right to an infinite group of stakeholders as it might open the ground for abuse. The derivative claim right should be given to the stakeholders who have strong incentives to save the company, such as employees.

Since this thesis argument concerns with the protection of the company as a separate legal personality rather than personal interest of constituencies groups, it could not completely rely on the stakeholder theory to justify its arguments for the derivative claim. Therefore, the concept of the company, which this thesis is trying to put forward, is more in line with the Andrew Keay entity maximisation and sustainability model of company. Professor Keay views the company as an entity, which should be able to maximise profit but whose assets should be protected and sustained. This theory focuses on the company as a separate legal entity and argues that the objective of the company is to maximise the wealth of the entity as an entity and, at the same time, to ensure that the company is sustained financially for the benefit of all the stakeholders.⁸³ Hence, the

⁸³ Andrew Keay, 'Ascertaining the Corporate Objective: An Entity Maximisation and

theory argues for the fostering of the company's wealth, which will require directors attempting to increase the overall long-run market value of the company as a whole, taking into account the investment made by various people and groups.⁸⁴ Under the maximisation and sustainability model, the maximisation of the company profits may *inter alia* improve dividends for shareholder, or reduce risk for creditors or improve working conditions, greater job security and bonuses for employees. However, the focus would be on the company itself and its long-term sustainability and what will enhance its position, rather than the focus being on the stakeholders and their personal interests.⁸⁵ In line with this perspective, the thesis argument is that the long-term financial stability of the company should be enhanced. Therefore, in order to increase the company protection, the derivative claim should be more accessible and should be expanded to the other stakeholders. However, as was discussed above, some stakeholders should be prioritized over the others in having the derivative claim because stakeholders do not have the same level of interest in the company. Before discussing which stakeholders have strong incentive to protect the company, since the focus of this research is on the derivative claim in the UK, I explore the English law approach to the issue of the company objective. The aim is to ascertain which stakeholders' interest has been prioritized under the UK corporate law and why this approach should change.

Sustainability Model' (2008) 71(5) *Modern Law Review* 663-98

⁸⁴ *ibid* 685

⁸⁵ *Ibid* 685

1.8 The UK corporate governance and paths to enlightened shareholder value

The most challenging issue for any corporate governance system in the view of this thesis is to keep the balance between the ability of the directors to run the company efficiently, and the protection of the company for the interest of all the stakeholders. Depending on the history, traditions, culture, politics and several other factors, every jurisdiction could have a specific system to achieve the above goal.

In the UK, corporate governance in public companies is based on shareholder value primacy. Therefore, private ownership rights and shareholders' profit-maximisation is considered as the foundation of UK company law.⁸⁶ Consequently, only shareholders can hold directors accountable to their fiduciary duties through different mechanisms including the derivative claim. In fact several historical, political and economic components have contributed to each other in forming the framework of shareholder primacy in the English legal system. One reason for the rise of shareholder primacy in the UK was the increase in hostile takeovers in the UK in the 1950s, which was partially a consequence of a Labour Government amendment to the Companies Act.⁸⁷ The Companies Act 1948 made the investigation of potential takeover targets easier, requiring companies to disclose information on their current earnings which made them

⁸⁶ John Armour et al., 'Shareholder primacy and the trajectory of UK corporate governance' (2003) 41(3) *British Journal of Industrial Relations* 531-555; David Collison et al., 'Shareholder primacy in UK corporate law: an exploration of the rationale and evidence' (2011), available at < <http://www.accaglobal.com/content/dam/acca/global/PDF-technical/business-law/rr-125-001.pdf> (accessed at 16/5/2017); Shuangge Wen, *Shareholder Primacy and Corporate Governance: Legal Aspects, Practices and Future Directions* (Routledge 2013)

⁸⁷ Christopher Bruner, *Corporate governance in the common-law world: The political foundations of shareholder power* (Cambridge University Press 2013) 147; Andrew Johnston, 'Takeover Regulation: Historical and Theoretical Perspectives on the City Code' (2007) 66 *Cambridge Law Journal* 422, 427

more detectable by outsiders.⁸⁸ Together with that, the 1948 Companies Act reforms gave shareholders power to remove directors without cause by ordinary resolution of a simple majority. Such a right permitted would-be acquirers to achieve substantial governance power through open-market share purchases.⁸⁹ Likewise, the growing assertion of shareholder primacy was related with the rise of increasingly powerful institutional shareholders in the UK. The focus of financial activities in the City of London, the limited role of courts in regulating corporate activity, and the enthusiasm for referring to self-regulation by the major financial trade associations and professional organizations, gave the UK institutional shareholders more possibility to control the company.⁹⁰ Moreover, the institutional shareholders' informal, 'behind-the-scenes' impact on the conduct and policy of listed companies resulted in the growth of a series of self-regulatory codes in the areas of takeover, specifically the City Code on Takeovers and Merger, which gave more weight to the shareholder primacy theory.⁹¹ The regulatory takeover regime has been formally oriented toward shareholders' interest since 1968.⁹² UK Takeover Code is comprised of a series of principles, which gives shareholders strong power in relation to takeover offers. It is one of the main differences between the UK takeover regulation and the US takeover mechanism. In the United

⁸⁸ Bruner *ibid*; also Brian Cheffins, 'Mergers and the evolution of patterns of corporate ownership and control: the British experience' (2004) 46(2) *Business History* 256-284

⁸⁹ Bruner [n 87]; Paul Davies, *Gower & Davies: the principles of modern company law* (Sweet & Maxwell 2008) 389-90

⁹⁰ John Buchanan, Dominic Heesang Chai and Simon Deakin, *Hedge fund activism in Japan: The limits of shareholder primacy: Chapter 4 The rise of shareholder primacy in America and Britain* (Cambridge University Press 2012) 48

⁹¹ *ibid*

⁹² Lorraine Talbot, *Progressive Corporate Governance For The 21st Century* (Routledge research in corporate law 2013) 43

States, as it will be discussed in chapter four, courts in Delaware let the board to take into account the interests of other corporate stakeholders at the time of takeover.

Moreover the rise of institutional shareholder power in the UK could be linked to the post-war policy which was “deprioritization of private shareholders wealth maximization and encouraging the growth of public shareholders in the form of financial institutions such as pension funds”.⁹³ The other reason that gave rise to the UK shareholder-centric corporate governance was the economic industrial crisis in the 1970s. Recession and public debt caused substantial gaps in balance of power between the multilateral powers of unions, management and state. Years of industrial conflict had split traditional political positions and in 1979 the Conservative Party under Margaret Thatcher was voted into government with a new, radical, neo-liberal agenda.⁹⁴ The neo-liberal approach favours the Coase⁹⁵ version of shareholder primacy, which endorses the idea that the market needs to be free from any controls, which do not facilitate bargaining. In the UK, the government’s policy was formed with the aim of steady development, not high profits. The policy also included the privatization of industry. “Nationalised industries were created to provide secure employment for millions and fix prices” and “British industry was crammed with potential value for shareholders”.⁹⁶ Overall, from early 1980 the United Kingdom shifted toward the service industry and that has increased the shareholder value corporate governance goals. The UK corporate

⁹³ *ibid*

⁹⁴ Lorrain Talbot [n 92]

⁹⁵ Ronald Coase, ‘The Nature of the Firm’ in Oliver Williamson and Sidney Winter (eds), *The Nature of the Firm, Origins, Evolution, and Development* (Oxford University Press 1993)

⁹⁶ Lorrain Talbot, ‘Polanyi’s embeddedness and shareholder stewardship: a contextual analysis of current Anglo-American perspectives on corporate governance’ (2011) 62(4) *Northern Ireland Legal Quarterly* 451-468

governance has fundamentally been constructed on the shareholder primacy principle. The Cadbury Report explicitly highlighted the predominance of the principal-agent relationship between shareholders and directors in corporate operations.⁹⁷ Later, the 1998 Hampel Report clarified that the single prevailing objective shared by all listed companies, whatever their size or type of business, is the protection and the greatest practicable enhancement over time of their shareholders' investment.⁹⁸

1.9 The Enlightened Shareholder Value principle and partial consideration of other stakeholders interests

Despite the UK's long-term shareholder primacy approach, until the enactment of the Companies Act 2006, UK corporate law had taken an uncertain approach towards the issue of for whose benefit the company should be run and protected. During the post-war period, there were even some attempts to directly incorporate employees' interests into the UK's corporate legal framework.⁹⁹

However in response to growing pressures from globalisation and the impact of the European Commission company law harmonisation programme, in March 1998 the Department of Trade and Industry initiated a substantial review of company law in the UK with the aim of establishing a framework which was up to date, competitive and

⁹⁷ Adrian Cadbury, 'Report of the Committee on the Financial Aspects of Corporate Governance' (December 1992) Gee para 2.5 < <http://www.ecgi.org/codes/documents/cadbury.pdf> (Accessed 6 May 2017)

⁹⁸ Hampel Committee Report (1998)

⁹⁹ Marc Moore, 'Shareholder Primacy, Labour and the Historic Ambivalence of UK Company Law' (2016) University of Cambridge Faculty of Law Research Paper No. 40/2016 < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2835990 ; The UK attempts to involve employees in the management of the company through the Bullock Report and section 309 CA 1985 will be discussed in chapter seven.

designed for the next century.¹⁰⁰ The comprehensive review that was initiated was to be supervised by a Steering Group that became known as the Company Law Review Steering Group (CLRSG). One of the important considerations in the company law reform process was to add more stakeholder consideration to corporate law. The argument was that the corporate law framework at the time failed to sufficiently recognise that businesses normally best generate wealth where participants operate harmoniously as teams, and that managers should recognise the wider interests of the community in their activities.¹⁰¹ Acknowledging the significance of stakeholder interests, the Company Law Review Steering Group's aim was to define whose interests company law should serve, and the legal means by which to do so.

In order to achieve its aim, the CLRSG proposed two possible approaches: the stakeholder theory (pluralism) approach and the enlightened shareholder value approach. Both proposals were based on the instrumental significance of stable and trusting stakeholding relationships for the overall welfare of the corporation, rather than the normative value presented by Contractarians.¹⁰² However, although the CLRSG recognised the importance of stakeholder interest, it identified a number of problems with regards to the application of the stakeholder principle in the UK corporate law.¹⁰³ The steering group argued that stakeholder protection should generally be pursued

¹⁰⁰ Department of Trade and Industry (DTI), *Modern Company Law for a Competitive Economy* (London: DTI 1998) 1

¹⁰¹ CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (1999) para 5.1.9; also Shuangge Wen, *Shareholder Primacy and Corporate Governance: Legal Aspects, Practices and Future Directions* (Routledge 2013) 102

¹⁰² *ibid*

¹⁰³ CLRSG, *Modern Company Law for a Competitive Economy: The Strategic Framework* (1999) paras 5.1.25–5.1.33

outside corporate law and in other areas of law and public policy, rather than through changes in the framework of company law, as such reform would require an essential change to the current framework and could lead to unpredictable and damaging effects.¹⁰⁴ The CLRSG was also concerned that giving directors discretion to consider stakeholders' interests (other than shareholders' interests) would dangerously distract directors at the expense of economic growth and international competitiveness.¹⁰⁵ The CLRSG considered that the aim of modernising company law was to provide greater clarity on what is expected of directors and make corporate law more accessible.¹⁰⁶ Therefore, considering the aforementioned problems with stakeholder primacy, the CLRSG rejected stakeholder primacy as the objective of corporate law and instead adopted a new approach named as the enlightened shareholder value approach. The CLRSG noted that the practical benefits of adopting the enlightened shareholder value is that it would not involve a fundamental change in the orientation of company law, which is concerned to maximise shareholder wealth. However, it would involve a little modification. The CLRSG continued that the law at the time was 'focused on the short term and narrow interest of members at the expense of what is in the broader and longer term sense of the enterprise,¹⁰⁷ and suggested that this could be addressed by reformulating directors' duties to give effect to the enlightened shareholder value approach. Also, it suggested that the approach would require directors to adopt a

¹⁰⁴ *ibid* para 5.1.27; also Lord Wedderburn, 'Companies and employees: common law or social dimension' (1993) 109 *Law Quarterly Review* 103

¹⁰⁵ *ibid* para 5.1.28

¹⁰⁶ CLRSG, *Modern Company Law for a Competitive Economy The Final Report* (London: DTI 2000) Chapter 3

¹⁰⁷ *ibid* para 39; also Lorraine Talbot, *Critical Company Law* (Routledge Cavendish 2007) 150

broader and longer view of their role.¹⁰⁸ Under the enlightened shareholder value approach, the CLRSg argued that ‘the ultimate objective of companies as currently enshrined in law is to generate maximum value for shareholders which is in principle the best means also of securing overall prosperity and welfare.’¹⁰⁹ The CLRSg stated that a considerable majority of reactions to its earlier consultation paper clearly favoured continuation of the shareholder value approach, but with consideration of a balanced way to promote relationships with stakeholders, such as employees and suppliers.¹¹⁰ Finally, the CLRSg recommendation resulted in the establishment of the enlightened shareholder value under section 172(1) of the Companies Act 2006 as the latest UK company law framework.

1.10 Enlightened Shareholder Value and lack of enforcement power for stakeholders

As mentioned, the UK enlightened shareholder value is now encapsulated in section 172 of the Companies Act 2006. Section 172 is entitled: “duty to promote the success of the company”. However, the new “enlightened shareholder value” considers stakeholder interests only as instrumental to long-term shareholder wealth maximisation.¹¹¹ In fact, the enlightened shareholder value was expected to drive long-term company

¹⁰⁸ *ibid* para 40

¹⁰⁹ CLRSg, *Modern Company Law for a Competitive Economy: The Strategic Framework* (1999) para 5.1.12

¹¹⁰ CLRSg, *Modern Company Law for a Competitive Economy The Final Report* (London: DTI 2000) para 2.11; also Andrew Keay, *The enlightened shareholder value principle and corporate governance* (Routledge 2012) 76

¹¹¹ For a detailed account of the arguments put forward in the debate, see Sarah Kiarie, ‘Crossroads: Shareholder Value, Stakeholder Value and Enlightened Shareholder Value: Which Road Should the United Kingdom Take?’ (2006) 17 *International Company and Commercial Law Review* 329, 338-340, and Brenda Hannigan et al., *The Companies Act 2006 – A Commentary* (Lexisnexis UK 2007)

performance and maximise overall competitiveness, wealth, and welfare for all.¹¹² However, despite such expectation the enlightened shareholder value approach does not put any actual obligation on directors to consider the interest of any other stakeholder group than the shareholders.¹¹³ The biggest problem with section 172 is that stakeholders do not have the right to make a claim on behalf of the company to protect their reflective interests. In fact, the provision grants unrestrained discretion to the directors to act in a way that they consider would most likely promote the success of the company for the benefit of the members.¹¹⁴ While the Company Law Review Steering Group rejected the stakeholders theory based on the argument that it would give directors a wide range of discretion which would be difficult to police¹¹⁵, the current enlightened shareholder value principle's approach has inherited the same problem. The section gives wide discretion to directors without a clear wording in the Act or providing a guideline for directors regarding how and when they should consider the interests of other stakeholders, including employees. The flaws and ambiguities in section 172 Companies Act 2006 which have been identified and discussed by many scholars, have now been identified by the UK Government as well. As a result, the Government recently under the new corporate governance reforms has attempted to clarify these ambiguities. However, the Government has no plan to change the wording

¹¹² Department of Trade and Industry, *Company Law Reform Presented to Parliament by the Secretary of State for Trade and Industry by Command of Her Majesty 20-21* (March 2005)

¹¹³ Geoffrey Morse et al., *Palmer's Company Law: Annotated Guide to the Companies Act 2006* (Sweet & Maxwell 2007) 168

¹¹⁴ Keay [n 110] 107; see also Daniel Attenborough, 'The Company Law Reform Bill: An Analysis of Directors 'Duties and the Objective of the Company' (2006) 27 *Company Law* 162, 167

¹¹⁵ Company Law Review, *Modern Company Law for a Competitive Economy: Strategic Framework* (London 1999) para 5.1.30

of section 172. Instead, it has declared that the GC 100 group of the largest listed companies will be required to prepare guidance on the practical interpretation of the directors' duty under section 172 of Companies Act 2006.¹¹⁶ The practical effect of the proposed guidance would not be clear until the details of this proposal is revealed. In the view of this thesis, the most important criticism of this Act is still the lack of an enforcement mechanism for other stakeholders to enable them to protect the company. The new corporate governance proposal has also failed to consider such a right for other stakeholders. The only group with actual enforcement possibilities remain shareholders under the statutory derivative claim. Ultimately, the law only serves shareholders' interests. However, as has been discussed above, shareholders in many situations have only short-term profit maximisation interest and might only care about their own investing returns in the near future. Hence, they might be reluctant to be involved in corporate governance matters and costly monitoring of directors' conduct. Thus, they may not care if the directors earn profits by breaking the law or hurting the company in the long run.¹¹⁷ Therefore, they might not be eager to make a time consuming claim on behalf of the company to discipline directors for the benefit of other stakeholders.

¹¹⁶ Department for Business, Energy & Industrial Strategy, *Corporate Governance Reform, The Government response to the green paper consultation*, Action 8, para 2.45

¹¹⁷ Lorraine Talbot, 'Why shareholders shouldn't vote: a Marxist-progressive critique of shareholder empowerment' (2013) 76(5) *Modern Law Review* 791-816; Lynn Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (Berrett-Koehler Publishers 2013); Aidan O'Dwyer, 'Corporate Governance after the financial crisis: The role of shareholders in monitoring the activities of the board' (2014) 5 *Aberdeen Student Law Review* 115 112

1.11 Without a derivative claim right for other stakeholders, the new corporate governance reform would not enhance the company's protection

In order to support companies to take better decisions for their own long-term benefit and that of the economy overall, the UK Government published a Green Paper on November 2016 to set out a new and better corporate governance framework. The purpose for publishing the Green Paper was to ‘stimulate a debate on a range of options for strengthening the UK’s corporate governance, including options for increasing shareholder influence over executive pay and strengthening the employee, customer and supplier voice at boardroom level’.¹¹⁸ In response to its Green Paper, in August 2017 the Government published a package of corporate governance reforms.¹¹⁹ The proposed reforms cover three main areas of executive pay, greater employee and other stakeholder engagement at board level and corporate governance in large privately companies. I will explore the proposed reforms in detail in chapter seven where I will argue for the employees’ derivative claim right. However, as a brief explanation here, my argument is that although the UK Government package of reforms is a positive move in enhancing company protection, still it would not increase the overall protection of the company especially in the long run. The key problem is that under these reforms the Government still assumes that shareholders are the only important group of stakeholders in the company. It fails to address deep-rooted problems of short-termism,

¹¹⁸ Department for Business, Energy & Industrial Strategy, *Corporate Governance Reform Green Paper* (29 November 2016), available at <https://www.gov.uk/government/consultations/corporate-governance-reform> (visited 24/11/2017)

¹¹⁹ Department for Business, Energy & Industrial Strategy, *The Government response to Green paper consultation* (August 2017), available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/640470/corporate-governance-reform-government-response.pdf (last visit March 2018)

unjustifiable pay differences, and the lack of consideration of the other stakeholders' interests in the running of their company in a proper way. Still only shareholders will receive a report on executive pay, and only shareholders have the right to make a claim on behalf of the company. Even in terms of strengthening the employees' voice, shareholders would still have more rights than the employees themselves. Directors should still report to shareholders on how they comply with their duty to consider the employees interest in the company. Also, it is very plausible that shareholders play a greater role in forming the proposed advisory council and choosing the employees' director than the employees in the company. For the reasons that I have discussed before, it is a problematic approach. Shareholders may not have a long-term interest especially in public companies. They may not have concern about giving extraordinary rewards to executives as long as they receive quick and big returns for their financial investments. They may not care when directors harm the company assets with their opportunistic behaviour and put the other stakeholders' interests, such as the employees' jobs, in jeopardy as long as they are benefiting from their short-term investment in the company. In terms of private companies, due to the lack of external mechanisms such as market regulators scrutiny, the wrongdoers' abuses remain unchecked and it is very unlikely that the proposed corporate governance code would affect the internal management of these types of companies. In private companies like BHS, there is no shareholder outside the wrongdoers' team to monitor their compliance with their fiduciary duties or with the proposed corporate governance code. Hence, to increase the accountability of directors and controlling shareholders toward the company, as a

complementary to the proposed reforms the right for initiating the derivative claim should be broadened to other stakeholders. The need for broadening the derivative claim right to other stakeholders in the company was mentioned by some of the respondents to the Government Green Paper as well.¹²⁰ This thesis argues that the derivative claim could be an effective mechanism for sanctioning directors where they fail to comply with their duties and in situations that the other mechanism of corporate governance fails to hold them accountable. Therefore, the problem with the derivative claim procedural requirements, including the problem of derivative claim costs, should be solved; also, the scope of the derivative claim applicants should be broadened to the other stakeholders.

1.12 Who should have the derivative claim right to protect the company?

Although the protection of the company is important for the benefit of all the stakeholders whose interests are tied to the company's stability, granting the derivative claim right to wide undefined groups of stakeholders could increase the risk of abuse of litigation. The reason is that stakeholders have different types of interests in the company and not all of them have strong incentives and engagement with the company to initiate a time consuming and expensive claim on its behalf against the wrongdoers. Therefore, key stakeholders in the company should be identified. As was mentioned before, different stakeholder theorists suggest different approaches to identifying the key stakeholders.¹²¹ Freeman, for instance, considers "owners, managers, local

¹²⁰ *ibid* para 4.7 p 44

¹²¹ Chiu [n 35] 177

community, employees, suppliers and customers” as key stakeholders.¹²² Donaldson and Preston’s approach of identifying is whether stakeholders are important for normative, instrumental or descriptive reasons,¹²³ and Gao and Sirgy classify stakeholders as “internal”, “external” and “distal” stakeholders which have different levels of engagement to the company.¹²⁴ However, in defining who should, in addition to shareholders, have the right to initiate the derivative claim, this thesis relies on Company Act 2006 itself. Under the factors listed in paragraphs (a) – (f) of section 172(1) CA 2006, directors are required to consider the interests of employees. In fact, the only groups of corporate stakeholders whose interest in the company has been clearly recognized are employees and creditors.¹²⁵ For the other groups, section 172 requires directors “to foster the company's business relationships with suppliers, customers and others”.¹²⁶ In addition to that, under the new corporate governance proposals, the Government has proposed three voluntary mechanisms for engaging employees with the board, these being a designated non-executive director, a formal employee advisory or a director from the workforce. This thesis criteria for choosing which stakeholders should have the derivative claim right is not that whose stakeholder interest is more important but that which stakeholder is in a better position to protect the

¹²² Ronald Freeman, ‘A Stakeholder Theory of the Modern Corporation’, in MBE Clarkson (ed), *The Corporation and Its Stakeholders* (University of Toronto Press, 1998) 125

¹²³ Thomas Donaldson and Lee Preston, ‘The Stakeholder Theory of the Corporation’ (1995) 20 *Academy of Management Review* 65

¹²⁴ Tao Gao and Josef Sirgy, ‘Revisiting Sirgy’s Corporate Performance Measurement Model: Towards a Management Audit that Captures Corporate Social Responsibility and Beyond’, in Jose Allouche (ed), *Corporate Social Responsibility, vol 2* (London, Palgrave Macmillan, 2006) 154

¹²⁵ Section 172(1)(b) of the Companies Act 2006 clearly requires directors in promoting the success of the company to have regard to the interests of the company's employees. Also section (172)(3) gives a separate emphasis on the interest of creditors in certain circumstances, which have been interpreted as the situations that the company is close to insolvency.

¹²⁶ Section 172(1)(c)

company. Although protecting the company from wrongdoers' harm could be very important for the creditors as well, due to the limited scope of the thesis I prefer the employees' derivative claim right for the following reasons. First, employees are arguably in a better position than other stakeholders, even shareholders, to be aware of the directors' misconduct and possibly prevent it through the threat of a derivative claim or an actual initiation of the claim. They are working in the company and could have better access to the company's documents or even by word of mouth be aware of directors' wrong conduct that harms the company. More important than that, the employees 'economic fortune is tied to the company's fate and they could be affected by the directors' bad decision or opportunistic behaviour that harms the company.¹²⁷ They have strong interests and incentives, even more than shareholders, to protect the company from the wrongdoers' harm because they typically have only one job. If the company goes insolvent and they lose their job, it puts a very significant impact on their ability to earn a livelihood. In addition to that, broadening the derivative claim right to employees would be a threat to potential wrongdoers in the company who in turn might be more cautious about the consequences of their misconduct. They would be warned that even if there is no shareholder outside their team to monitor their conduct, still the company employees could challenge their opportunistic behaviour, which harms the company. Therefore, the employees derivative claim right could enhance the company protection for the benefit of all the other stakeholders by holding directors more accountable toward the company. I will discuss this issue further in chapter seven, and

¹²⁷ Margaret Blair and Lynn Stout, 'Director Accountability and the Mediating Role of the Corporate Board' (2001) 79 Wash U L Q 403, 404

also explain why the Government proposed options for engaging the employees with the board are not sufficient.

1.13 How could the derivative claim enhance the protection of the company?

Now that the reasons for broadening the derivative claim scope to employees in the UK have been discussed, it needs to be explained how and when the derivative claim could save the company.

To the great extent, the rationale behind the derivative claim depends on the role that the derivative claim is expected to play. Those who focus merely on the financial compensatory role of the derivative claim would find few justifications for this mechanism. Obviously, the compensatory function has limitations. The potential compensation may be too small to make spending money and taking up the directors' time in a legal action worthwhile for the corporation.¹²⁸

In terms of minority shareholders acting as the applicant in a derivative claim, they might have owned shares when the defendant's wrongdoing occurred, but they may have sold their shares by the time of the court order for recovery. Therefore, while the applicant would not benefit from the compensation, the incoming shareholders would receive a windfall gain.¹²⁹ It would be the same for employees as the applicant that, while they could have strong reasons to sue directors and bring financial compensation to the company to keep the company financially stable, still they would also be more willing to have the power to stop the harm to the company in the first instance. Therefore, the mere monetary compensation function cannot completely justify the role

¹²⁸ Roberta Romano, 'The shareholder suit: litigation without foundation?' (1991) 7(1) *Journal of Law, Economics, & Organization* 62

¹²⁹ John Coffee and Donald Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform' (1981) *Columbia Law Review* 302-309; also Arad Reisberg, 'Shareholders' Remedies: The Choice of Objectives and the Social Meaning of Derivative Actions' (2005) 6(2) *European Business Organization Law Review* 248

of the derivative claims in protecting the company and the rationale says that the deterrence role should be as important. The deterrence role of the derivative claim is traditionally overtaken by the financial compensatory role. However, in the view of this thesis, in addition to the compensation role the deterrent aspect of derivative litigation can play a significant role in preventing harm to the company and holding directors accountable for breach of their fiduciary duties. In the context of misconduct, which has harmed the company, the derivative claim may validly generate intangible (non-monetary, yet valuable) relief for companies in the form of a court order that would stop wrongdoers from continuing their misconduct. It may also bring changes to the company's board structure through a settlement, which would prevent further harm to the company. These changes could happen in different forms. From the nullification of an election of negligent or opportunistic directors, to an injunction to stop the director from carrying out or continuing with a termination of a detrimental transaction, which would take the company to the verge of insolvency. Especially in relation to private companies, the deterrence role of the derivative claim and consequently the non-monetary benefit could be very important. Since private companies usually have fewer shareholders and the ownership and control is more concentrated, it would be difficult for the minority shareholders or employees to dismiss a wrongdoing majority from the company. If we only consider the possibility of financial relief, it must be remembered that monies recovered still go back under the wrongdoers' control in the company and they would also indirectly benefit from the compensation based on the shares they owned. However, non-monetary benefits of the derivative claim, such as terminating a

self-dealing transaction which is harmful for the company, through a court order or settlement can be helpful in stopping the wrongdoers' misconduct and preventing further harm to the company. Hence, the deterrence role of a derivative claim could even be more important than the compensation role for both minority shareholders and employees as the applicants. Arguably, even just the threat of the derivative claim (rather than an actual derivative litigation) might be enough to prevent wrongdoers from continuing their incorrect conduct or make them comply with their duties. Therefore, the deterrence function could potentially improve the corporate governance of the company in situations that minority shareholders and employees do not have enough power to make those corporate governance changes and prevent harm to the company through the other mechanisms. In addition to preventing the current misconduct, a successful derivative litigation is assumed to deter misconduct by potential wrongdoers, who are in similar situations at other companies too.¹³⁰

Reisberg notes that the deterrence role of the derivative claim works both *ex ante*¹³¹ and *ex post*.¹³² The *ex ante* aspect involves the likelihood and the magnitude of the threat of liability for those who decide to engage in wrongdoing, and *ex post* is actual liability for the whole harm they cause.¹³³ Reisberg argues that the deterrent value of derivative litigation is tied to the social value of such litigation. In fact, the deterrence function is linked to the social opprobrium that

¹³⁰ Steven Shavell, 'The social versus the private incentive to bring suit in a costly legal system' (1982) 11(2) *The Journal of Legal Studies* 333-339

¹³¹ *Ex ante* means looking at future events based on possible predictions, the word is derived from the Latin word for 'before the event' and it refers to the future prospects of a company.

¹³² *Ex post* is the Latin word for 'after the event'.

¹³³ Arad Reisberg [n 139] 241

wrongdoers receive as the consequence of being sued in a derivative claim.¹³⁴ Reisberg correctly reasons that since the days when Wigram V-C described the corporation as a ‘private partnership’ in *Foss v Harbottle*, corporate activities, specifically directors’ business decision-making, have become more of a ‘public’ concern. Consequently, in most derivative litigation the norm invoked has a substantial, public source.¹³⁵ The higher the society regards the derivative claim role, the more efficient will be the deterrent role of the claim. Therefore, directors’ misconduct in a company will fail to deliver social condemnation if the derivative claim merely appears to be a financial remedy for a private group.¹³⁶ Hence, Reisberg concludes that the derivative claim does not accomplish its complete efficiency in controlling directors’ behaviour in the UK because the English system still considers derivative claims to be a remedy for private disputes and so the deterrence role, and consequently the social effect of derivative claims, is ignored.¹³⁷ Reviewing the case law in the UK confirms Reisberg’s allegation by revealing that courts consistently consider the probable financial return to the company as the only basis for procedural rulings in derivative litigation.

In line with Reisberg’s opinion, this thesis takes the view that such an approach should change. In this regards the broadening of the derivative claims right to employees, which is one of the research proposals, could enhance the deterrent

¹³⁴ *ibid* 257

¹³⁵ Reisberg *ibid* 260; also Stephen Bottomley, ‘Shareholders’ Derivative Actions and Public Interest Suits: Two Versions of the Same Story?’ (1992) 15 University of New South Wales Law Journal

¹³⁶ *ibid* 258

¹³⁷ *ibid* 268

role of the derivative claim and would add to the social impact of it. The more voices raise the issue of wrongdoer malpractice in the company the more society would be aware of the issue, and consequently the more cautious would be the potential wrongdoers about the consequences of their misconduct. Also, to enhance the deterrence function of the derivative claim this thesis proposes that in issuing the indemnity costs order for the derivative claim applicants, the court should consider the non-monetary but substantial changes that a derivative claim could bring to the company. The consideration of the non-monetary aspect could add to the derivative claim requirement under the statutory derivative claim provisions. Such consideration is important in terms of giving the minority shareholders and employees the power to be involved in the management of the company. This is the power that in an ordinary situation they would not have. I will discuss this issue further in chapter six.

1.14 The derivative claim: an exceptional but effective remedy

The important point which needs to be clarified by this thesis is that the derivative claim is not a mechanism which should be frequently in use. As stated earlier in this chapter, the derivative claim was established as the exception to the general proper claimant principle. The proper claimant principle, which is a leading English precedent rule in corporate law, indicates that in ordinary situations if any wrong has been done to a company, the proper claimant is the

company itself. Only in very exceptional circumstances where the board of directors refuses to prosecute the wrongdoers (because for example wrongdoers are in control of the board), the derivatives claim becomes applicable. Therefore, by nature, the derivative claim is an exceptional remedy and something of last resort, which is not supposed to be frequently used by shareholders or other stakeholders, which in the context of this research are limited to the company's employees.

The reason is clear, like any other mechanism of protection, the derivative claim has both benefits and limitations and over-referring to it may not always benefit the company.¹³⁸ Therefore, the role of procedural requirements and the court scrutiny are important for protecting the company from vexatious claims. However, the mentioned risk of abuse does not bring the potential benefits of the derivative claim into question. While on the one hand derivative claims should be under control to not allow troublesome claimants to impede the carrying on of the proper business of the company, on the other hand they could still serve as a supplement to other mechanisms that operate to hold directors accountable toward their fiduciary duties.¹³⁹

¹³⁸ Paul Banta, 'The New Indiana Business Corporation Law: Reckless Statute or New Standard' [1987] Colum. Business Law Review

¹³⁹ In terms of protecting the company through shareholders, as the applicant these mechanisms include: shareholder voting power, market for corporate control, independent directors on the board, disclosure provisions under company law and listing rules etc. However, as will be explained later in the thesis, all of these so-called mechanisms have their flaws and limitations and are not appropriate in all circumstances, also some of these methods such as independent directors are not applicable to private companies.

As Reisberg argues, none of the so-called mechanisms of accountability are optimal under all circumstances.¹⁴⁰ I add to the Reisberg argument that the other corporate governance mechanisms of accountability might not always be optimal for protection of the company because they have been established to protect the interest of shareholders in the first instance. Hence, they protect the company to the extent that the shareholders (particularly institutional shareholders) care about the protection of the company as a whole. Therefore, derivative claims can play an efficient role in situations where those other mechanisms fail to detect or curb wrongdoers' misconduct in the company. The thesis argument is the efficacy of the derivative claim demonstrates by not the quantity of the claim but by the quality of the rules governing the derivative claim procedure. Based on this argument, regardless of how much in practice the derivative claim might be needed, under the law the derivative claim should be an accessible and affordable mechanism to the extent that in exceptional circumstances, it becomes worthwhile pursuing a claim.

1.15 The current situation of the derivative claim in the UK

The UK statutory derivative claim scheme, which has been based on the recommendations of the English Law Commission, has been arguably one of the most debated reforms introduced by the Companies Act 2006. The new statutory

¹⁴⁰ Reisberg, [n 129]

criteria have been set out under sections 261-263 of this Act.¹⁴¹ In comparison to common law derivative action, under the statutory regime, theoretical grounds for bringing the derivative claim have been extended to negligence from which directors do not benefit, as well as for other breaches of duty by directors. Moreover, pre-existing concepts of ‘fraud on the minority’ while ‘wrongdoers are in control’ have been removed.

Also, since the introduction of the statutory derivative claim, in sections of the Act relating to proceedings in England, Wales and Northern Ireland, the term ‘derivative action’ has changed to the term ‘derivative claim’. The Scottish action is still called a derivative ‘action’.¹⁴² However, since the enactment of the Companies Act 2006, the statutory derivative claim has been the centre of ongoing academic debate on its efficacy in holding directors responsible for carrying out their fiduciary duties.¹⁴³

¹⁴¹ For ease of exposition this research mainly focuses on the statutory derivative claim proceedings in England, Wales or Northern Ireland. However, the provisions applying to Scotland under sections 264 to 269 CA 2006 are very similar.

¹⁴² Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Application* (Oxford University Press 2009) 133

¹⁴³ David Gibbs, ‘The Statutory Derivative Claim: A Case Based Analysis-Has the Statutory Derivative Claim Fulfilled Its Objectives?’ (2011) UEA LAW Working Paper No. 2011-DG-1 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1763188; Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Application* (Oxford University Press 2009); John Armour et al., ‘Private enforcement of corporate law: an empirical comparison of the United Kingdom and the United States’ (2009) 6(4) Journal of Empirical Legal Studies; Andrew Keay and Joan Loughrey, ‘An assessment of the present state of statutory derivative proceedings’, in Joan Loughrey (ed), *Directors' duties and shareholder litigation in the wake of the financial crisis* (Edward Elgar Publishing 2012) 187-228; Julia Tang, ‘Shareholder Remedies: Demise of the Derivative Claim’ (2012) 1UCLJLJ 1 178; Christopher A Riley, ‘Derivative claims and ratification: time to ditch some baggage’ (2014) 34(4) Legal Studies 582-608; Andrew Keay, ‘Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006’ (2016) 16(1) Journal of Corporate Law Studies

The main argument among scholars is that in comparison to the previous position under the common law, the new statutory scheme has brought no change in terms of accessibility to derivative claims for shareholders and the remedy is still rarely used in England. Several reasons have been given for the paucity of derivative litigation in the UK, such as flaws and ambiguities in the statutory derivative claim provisions,¹⁴⁴ the costs of derivative litigation for shareholders,¹⁴⁵ the availability of other mechanisms of accountability for directors¹⁴⁶ and the English legal system's traditional approach to shareholder litigation.¹⁴⁷ Overall, the common agreement among the UK corporate law scholars is that the statutory derivative claim under the Companies Act 2006, as it stands, has not achieved the English Law Commission's ambition of making the derivative process a more accessible and affordable mechanism.

This research attempts to move away from the given arguments and extend the discussion on the role of derivative claims beyond its current scope. In this regards, the research analyses the function of the statutory derivative claim in the UK in the context of a mechanism for protecting the company as a separate personality from its shareholders, and the view of both minority shareholders and employees as the applicants. The research argues that the biggest problem with the derivative claim in the UK is that the current structure has been based on shareholder value

¹⁴⁴ David Gibbs *ibid*

¹⁴⁵ Arad Reisberg *ibid*

¹⁴⁶ Armour et al. *ibid*

¹⁴⁷ Arad Reisberg, 'Theoretical Reflections on Derivative Actions in English Law: The Representative Problem' (2006) 3(1) *European Company and Financial Law Review* 69-108

principle. In order for the derivative claim to be an efficient mechanism for protection of the company as a whole, the current structure should be changed.

1.16 The research objective

The objective of this research is to propose reforms that would help the statutory derivative claim work better in protecting the company as a whole, and in holding directors of UK companies accountable for their fiduciary duties toward the company as a separate legal entity.

1.16.1 The main critiques:

In the view of this thesis, there are two main critiques to the current role of the derivative claim in the UK. The first is that in spite of the reforms to the common law derivative actions, the approach to the derivative claim is overly restricted. It means that the statutory derivative claim fails to set smooth, clear procedural requirements. The problem arises from the ambiguities with the procedure requirements including the difficulties with the *prima facie case*, the role of the shareholders ratification and disinterested member's view towards the claim and the derivative litigation costs. The second critique is that the scope of the derivative claim applicants is limited to shareholders.

1.16.2 The thesis arguments:

The thesis arguments are as follows:

- (1) The company is a separate legal personality, which should be protected for the interest of all the stakeholders in the long run. Therefore, the role of derivative claim as the only mechanism of the protection for the company itself should be reconsidered.
- (2) The efficiency of the derivative claim stands from not the quantity number of the derivative claim cases but the quality of the law that rules the derivative claim procedure. Therefore, under UK corporate law the derivative claim should be an affordable and accessible mechanism for the circumstances that it is needed. The derivative claim could still have a deterrent effect even if it is litigated a few time.
- (3) The availability of the other mechanisms of accountability for directors in private and public companies could provide an environment in which the derivative claim is less needed. However, these mechanisms have been established to protect the interests of shareholders in the first instance. They protect the company to the extent that shareholders care. So the protection of the company through these mechanisms might not be optimal in all circumstances.
- (4) Shareholders might not care about the protection of the company as a whole as long as the other mechanisms of protection preserve their personal rights or

they can receive profits for their investment in the short term. Therefore, to enhance the protection of the company, the scope of derivative claim applicants should be broadened to the other stakeholders.

- (5) In addition to shareholders, employees should have the right to make the derivative claim. They invest in the company with their skill and their economic fortune is tied to the company's well-being. Therefore, they have strong incentive to protect the company from the wrongdoers' harm.

1.16.3 What should be reformed in the current statutory derivative framework?

The originality of the thesis comes from the proposals for changing the shareholder-based structure of the statutory derivative claim. These proposals include broadening the scope of the derivative claim applicants to the employees, as well as reforms to the derivative claim procedure requirements. The thesis argues that the ambiguities with the *prima facie* case should be solved. One suggestion is to making the two-stages procedure into one. Moreover, the role of shareholder ratification in the context of derivative claim should be clarified. The suggestion is that the ratification should be taken into account by the court as a subsidiary consideration and only in the context of shareholders derivative claim.

In terms of the reforms to the litigation costs, the research argues that the cost of the derivative litigation is a major hurdle in the way of derivative claims in the UK. The thesis proposes a blended approach, which has been inspired from the United States and New Zealand derivative claim financial structures. The general proposal is that the company should bear the costs of the litigation in the first

instance. Also, in issuing the cost order, the possibility of non-pecuniary benefits of the derivative claim should be considered. The detailed proposals for the role of ratification and the litigation costs will be discussed in chapter six.

1.17 Would the research proposals increase the risk of vexatious claims against the company?

In the view of this research, the risk of abuse of the derivative claim has been over-estimated. The derivative claim is a claim on behalf of the company and the grounds for bringing the claim are limited to the specific wrongs, which damage the company. Also, all the probable benefits go back to the company. There is low possibility that shareholders or employees make a time-consuming and risky litigation from which they would not get any personal benefit only with the aim of abusing the directors. Additionally, the derivative claim's procedural requirements and the court's scrutiny provide sufficient safeguards to prevent any probable vexatious claim. Lastly, directors are usually protected by liability insurance for their business decisions. The company takes out the insurance to cover the costs of any probable litigation against them. It would be unfair if minority shareholders and employees, who are exposed to the opportunistic behaviour of company directors, would not have a fairly accessible and affordable remedy to protect their reflective interests in the company against the wrongdoers' harm.

1.18 The comparative aspects

This research is a comparative study between the UK, the United States and New Zealand. The comparative aspects are mainly on the shareholders acting as the applicants for derivative claims because just like in the UK, in both of the other jurisdictions only shareholders can initiate a claim on behalf of the company. However, since the aim of this research is to improve the statutory derivative claim framework in the UK as a mechanism for protecting the company itself, regardless of who acts as the derivative claim applicant, the United States and New Zealand derivative claim structures could still be inspiring.

The reason for studying derivative suits in the United States is mainly the financial structure of the American derivative suits, which through contingency fee agreements and its supporting doctrines reduces the risk of litigation costs for the shareholders' meritorious derivative suit. The research suggests that the US consideration of the non-monetary benefits of derivative suits under the corporate benefit doctrine could be inspiring and would enhance the deterrence function of the derivative claim in the UK. The US derivative suits also confirm this thesis' argument that a high quantity of derivative claims is not necessarily a sign of the efficacy of this mechanism, and not all of those claims bring benefit to the company. The reason for comparing New Zealand is that its corporate governance system shares many similarities to the corporate governance system in the UK; however, under the New Zealand law, the derivative action provisions have made a more affordable and accessible derivative action framework, which, in terms of

procedural requirements and derivative litigation costs, could be inspiring for the UK. In addition, in terms of availability of the regulations, New Zealand provides a good balance between different mechanisms of accountability for directors.

In the context of the employees' derivative claim, like in the UK there is no comparative ground with the United States and New Zealand. However, the consideration of the other stakeholders' interests have been manifested in terms of hostile takeovers in the United States where the Delaware courts in several cases have given priority to the interest of the company as a whole. The research has found similar attitudes in empowering other stakeholders, including the creditors and employees, in other jurisdictions such as Canada and South Africa. In chapter seven I will refer to these jurisdictions' approach.

1.19 Research methodology

It is usually the aim of the research that determines which methods could be useful.

This research mainly aims to make the derivative claim a more efficient mechanism in protecting the company alongside the other mechanisms of accountability for directors in the UK.

The research has been based on the black letter law methodology. This means the research arguments are based on analysing the derivative claim statutory provisions under the Companies Act 2006 and the relevant cases; the wording and

interpretation of the derivative claim statutory provisions, as well as existing literature. The same methodology is used to analyse the other mechanisms of accountability for directors such as the unfair prejudice conduct, public enforcement and non-executive directors. The black letter methodology forms the epistemological basis for the research. It provides a proper evaluation of the role that the derivative claim could play in the UK alongside the other mechanisms. In addition to that, the research is also a comparative legal study.

The thesis adopts a comparative method to assess the function of the derivative claim in other jurisdictions. The research looks at the United States and New Zealand derivative claim statutes; the law reports, case law and the existing literature to determine how these jurisdictions approach the derivative claim. The information in this research has been gathered from primary resources such as case law, statutory codes, and Government policy documents such as the parliamentary reports in the UK, the United States and New Zealand. This research also draws from secondary resources such as books, journal articles, online articles, Law Reports, working papers and other online resources in all three jurisdictions.

The arguments in this research have been based on the availability and clarity of the derivative claim regulations, rather than the statistical and empirical data. This methodology is in line with the thesis argument that regardless of how much the derivative claim might be needed in practice, it should be an affordable and accessible mechanism under the law. Therefore, the efficiency of the derivative claim depends on how much the law makes it a comprehensible and accessible

mechanism that is worth pursuing in exceptional situations. The argument is that reliance on the empirical data to show the efficiency of the derivative claim might not always be accurate. The need for using the derivative claim depends on the many political, cultural and economic elements and could be varied from time to time and jurisdiction to jurisdiction. The other argument is that the deterrence function of the derivative claim, which could play an important role in preventing harm to the company, could not be measured under the statistics. The empirical data could not estimate how much in practice the deterrence function of the derivative claim could work as a threat and prevent the wrongdoers from damaging the company. While the thesis does not rely on statistical and empirical information, it refers to some anecdotal experience (an example or a case) to discuss the role of the derivative claim in other jurisdictions.

1.20 The thesis structure

The arguments of this research which have been discussed in this chapter are going to be addressed throughout the thesis as follows.

Chapter two reviews the origin of the derivative claims in the UK, problems with the derivative action under the common law, and the English Law Commission proposals for the reform. The chapter then discusses the current problems with the procedure requirements and proposes some reforms.

Chapter three reviews the limitations of the other mechanisms of accountability for directors in protection of the company as a whole. The chapter argues that these

mechanisms have been formed to protect the shareholders' interest and might not provide a long-term protection for the company in all circumstances. Therefore, the derivative claim could work as a complementary to these mechanisms to enhance the company's protection.

Chapter four examines the financial structure of the derivative suits in the United States to gain inspiration for the derivative litigation costs in the UK. However, the chapter also explores the reasons for the frequency of the derivative suits in the United States and argues why too much incident of derivative suits is not a good thing.

Chapter five studies the role of derivative claims (known as derivative actions) in New Zealand. The chapter explains how in terms of procedural requirements and the approach to the derivative litigation costs, New Zealand could be inspiring for the UK. In addition to that, the chapter shows how under the law New Zealand has kept a balance between different mechanisms of accountability for directors.

Chapter six discusses the research proposals for ratification and derivative claims costs in the UK. The chapter proposes reforms to the role of the ratification. It also reviews the current available funding mechanisms for derivative litigation costs and their shortcomings, and proposes a blended approach, which has been inspired by both the United States and New Zealand.

Chapter seven discusses the proposal for expanding derivative claim rights to employees. It reviews the UK's historical attempts in considering the employees' interests under company law. It also reviews the recent corporate governance proposal

for involving employees in the management of the company and brings the reasons why employees still need to have the derivative claim right to protect the company.

Chapter eight is the thesis conclusion, which includes a summary of the research arguments, an outline of the proposals for reforms and gives some recommendations for future research.

Chapter Two: Derivative claims in the UK

2.1 Introduction

This chapter deals with research critique to the current structure of the statutory derivative claim.

Before the ratification of the statutory derivative claim under the Companies Act 2006, the derivative action in the UK was ruled under the common law. The common law had limited the minority shareholders' ability to sue derivatively by requiring them to prove the fraud on the minority while wrongdoers were in control of the company. However, the minority shareholders' difficulty with common law derivative action finally came to the attention of the English Law Commission. The English Law Commission acknowledged at the time that the aspiration was to provide a cost-effective mechanism and give derivative actions a greater transparency, making the derivative procedure a more accessible and affordable mechanism.¹⁴⁸ The UK Government later implemented the English Law Commission's recommendations for the derivative action in the statutory derivative claim under the Companies Act 2006.

However, this thesis argues that in spite of the reforms to the common law derivative actions, the approach to the derivative claim is still overly restricted and that the statutory derivative claim fails to set smooth, clear procedural requirements for the derivative claim. In addition, the main critique to the

¹⁴⁸ The Law Commission Final Report 246, Cm 3769, October 1997, para para 6.9

derivative claim reforms is that the Law Commission failed to clarify the concept of derivative claim as a remedy for the company as separate legal personality. In fact, the Law Commission, based on the traditional shareholder value beliefs, reviewed the amendments to the derivative action in the context of shareholders remedies. The Commission failed to properly convey the principle of corporate separate personality, which was emphasized by the court in *Foss v Harbottle* and clear the boundary between the shareholders personal remedies and the company remedies. Consequently, such an approach resulted in ambiguities in the English Law Commission's proposed reforms. These ambiguities have now been transferred to the statutory derivative claim provisions. This chapter reviews the development of the derivative claim from common law to the statutory derivative claim and discusses the current problems in the statutory framework and proposes some reforms.

2.2 The common law derivative action and the exceptions to the Foss principles

The common law derivative action was established under the so-called ‘exceptions’ to the *Foss v Harbottle* rule during the latter half of the nineteenth century. English courts generally accepted four exceptions to the *Foss v Harbottle* rule. Those ‘exceptions’ were: (1) personal rights, (2) illegal or ultra vires acts, (3) the special majority requirements, and (4) fraud on the minority. A fifth exception, the interest of justice was also suggested in the case of *Edwards v Halliwell*, but it was not generally recognised by later courts. In the words of Jenkins LJ:¹⁴⁹ ‘the rule is not an inflexible one and will be relaxed when necessary in the interests of justice’.

The exceptions are explained below.

2.2.1 Personal rights

This ‘exception’ stated that if the alleged wrong was a breach of shareholders’ personal rights, and therefore could be remedied by a personal action, then the claim on behalf of the company does not apply.

In fact, the personal right exception was not really an exception to the Foss rules, but rather indicated circumstances under which a claim on behalf of the company does not apply. In *Edwards v Halliwell*, Jenkins LJ stated that¹⁵⁰: ‘Any member who wished to sue in such a case was free to do so, not in the right of the company but in their own right, to protect from invasion their individual rights as members’. The reason that the personal right was recognised as an exception to

¹⁴⁹ *Edwards v Halliwell* [1952] 2 All ER 1064 1067

¹⁵⁰ *ibid*

the Foss rule could be because of the confusion shown regularly by the courts regarding the true nature of derivative action,¹⁵¹ or perhaps because of the uncertainty regarding the company's separate legal personality and the distinction between personal and company rights. What is the source of this confusion? The answer is as follows.

2.2.1.1 Blurred interaction between personal claims and the corporate claim

Shareholders personal claims are claims in which the wrongdoing directors or controlling shareholders harm the personal interests of shareholders in the company. The shareholder personal rights in the company include the right to dividends, payment on the winding-up of the company and participation in meetings of the company. The violation of any of these personal rights could result in shareholder personal claims, which occur in several forms. One personal claim is personal action under section 33 Companies Act 2006 for breach of the statutory contract between the company and the shareholder. The shareholder has the personal right to have the company's constitution complied with by the company and can sue the company personally to ensure that. The other important personal claim is 'unfair prejudice conduct', where shareholders have the right to make a claim in the circumstances that the company's affairs are being conducted in a manner that is unfairly prejudicial to the members' interests.¹⁵² The other form of

¹⁵¹ In *Wallersteiner v Moir* (No 2) [1975] QB 373, 391, Lord Denning stated that the plaintiff claim on behalf of himself and all the other shareholders, gave a misleading impression of what really occurs in a derivative action: 'in a derivative action the plaintiff shareholder is not acting as a representative of the other shareholders, but as a representative of the company'.

¹⁵² Companies Act 2006 s 994

shareholders personal claim is the ‘just and equitable winding up’, which happens if shareholders are discontented with the way the company is being run.

However, the boundary between personal rights and the corporate right is not always clear to the courts. The company’s claims are the claims in which the directors’ act or omission involves negligence, default, breach of duty or breach of trust to the company.¹⁵³ It could include the situation that a director diverts company property to himself, or gains a benefit in expense of harm to the company or is negligent in managing the company.

On some occasions, directors’ breach of duty violates both shareholders’ personal right and the right that belongs to the company. Considering the role of the ‘reflective loss principle’¹⁵⁴ such a situation could cause confusion for the courts in deciding which remedy they should order the wrongdoing directors to pay.¹⁵⁵ The confusing interaction between the unfair prejudice claim and the derivative claim will be further discussed in chapter two.

In the view of this thesis, the main reason for the courts’ confusion between the personal rights and company rights arises from the fact that shareholders are still traditionally considered as the only beneficiaries of the company under English law. Therefore, the company’s remedy is still considered being the same as the shareholders remedy because only shareholders benefit from these remedies. Broadening the derivative claim to the employees could help in changing this

¹⁵³ Companies Act 2006 s 260(3)

¹⁵⁴ The reflective loss principle is a common law rule, which indicates that shareholders should not get a double recovery for the same harm to the company and to their personal interests.

¹⁵⁵ Len Sealy and Sarah Worthington, *Cases and Materials in Company Law* (10th edn, Oxford University Press 2013) 703

attitude to the companies claim. It would make the concept of corporate separate personality more clear by indicating that shareholders are not the only stakeholders who have the rights and benefits in the company.

2.2.2 Illegal or ultra vires acts

In addition to the personal right, the *Foss v Harbottle* principle could not be applied to the action of directors which is illegal¹⁵⁶ or wholly *ultra vires*¹⁵⁷ to the company nor could they be applied to conduct which needed to be validly committed or ratified by a special majority of the shareholders only. This is because the Companies Act and/or the constitutional documents of the company state in certain instances that a simple majority of shareholders could not confirm or ratify a transaction, which needed a greater, specified majority. The former is called the ‘illegal or *ultra vires* act’ exception and the latter the ‘special majority’ exception. Such illegal acts could not be authorised or ratified. There was no right at common law to approve illegality. The position is similar under common law for acts *ultra vires* to the capacity of the company.¹⁵⁸ Thus, there was no room for the operation of the rule in *Foss v Harbottle* if the alleged wrong was either *ultra vires*

¹⁵⁶ *Northwest Transportation Co Ltd v Beatty* [1887] 12 App Cas 589

¹⁵⁷ *Hutton v West Cork Railway Ltd* [1883] 23 ChD 65; *Devlin v Slough Estate Ltd* [1983] BCLC 49

¹⁵⁸ The company’s capacity was generally restricted by the mandatory clauses set out in its memorandum of association.

the company or agreed by less than the requirement¹⁵⁹ because the majority of members could not confirm such a transaction. In fact, not even a unanimous resolution of all the shareholders could authorise or ratify such an act. There was also no room for the operation of the rule if the transaction complained of could be accurately done or sanctioned only by a special resolution or the like, such as imposing some different threshold in order to pass the resolution, because a simple majority could not confirm a transaction which required the agreement of a greater majority.¹⁶⁰ Just like personal right, the illegal or *ultra vires* acts were not exceptions to the Foss rules, they simply indicated the situations in which the *Foss v Harbottle* rule did not apply. Therefore only “fraud on minority where wrongdoers were in control” was truly known as an exception to the Foss principles.

2.2.3 Fraud on the minority where wrongdoers are in control

For the ‘fraud on the minority’ to be an exception to the *Foss v Harbottle* rule, two criteria needed to be fulfilled: ‘proof of fraud’ and that ‘wrongdoers were in control of the company’. The main problem was that in the common law, the criteria for proving fraud on the minority were a broadly interpreted concept and it was difficult for shareholders to prove it. For instance, Lord Davey in *Burland v Earl* defined the traditionally concept of the fraud on the minority as when: “the majority is endeavoring directly or indirectly to appropriate to themselves money,

¹⁵⁹ In corporate law, the act is *ultra vires* when the company performs acts which are beyond its powers. Such actions may include acts which are specifically prohibited by the company’s articles or memorandum or excessive use of corporate power that has not been granted to the company

¹⁶⁰ *Prudential Assurance Co Ltd v Newman Industries Ltd* [1982] 1 Ch 204 210-211

properties or advantages which belong to the company or in which other shareholders are entitled to participate”.¹⁶¹ However, in cases such as *Cook v Deeks*¹⁶² and *Pavlides v Jenson*¹⁶³ the court considered the fraud on the minority to only include the actual fraud such as dishonesty¹⁶⁴ or bad faith.¹⁶⁵ Therefore, negligence and even gross negligence was not sufficient to give standing to minority shareholders to bring a derivative action.

In *Daniels v Daniels*, on the other hand, Templeman J held that¹⁶⁶: “it would seem to me quite monstrous particularly as fraud is so hard to plead and difficult to prove if the confines of the exception to *Foss v. Harbottle* were drawn so narrowly that directors could make a profit out of their negligence.” Therefore, the court in this case extended the interpretation of fraud on minority and despite no claim for actual fraud, Templeman J held that negligence or a breach of duty, which not only harmed the company but also resulted in a profit to a director did amount to a fraud on minority. In *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*,¹⁶⁷ Vinelott J held that it was not necessary for the plaintiff to allege and prove that a defendant, in breaching a duty to the company, acted ‘with a view’ to benefiting him or herself at the company’s expense. Moreover, over time, the fraud exception was extended from common law fraud to cases where the facts amounted to fraud

¹⁶¹ *Burland v Earle* [1902] AC 83 93-4

¹⁶² *Cook v Deeks* [1916] 1 AC 554

¹⁶³ *Pavlides v Jenson* [1956] Ch 565

¹⁶⁴ *Arwood v Merryweather* [1867] L.R. 5 Eq. 464

¹⁶⁵ *Menier v Hooper's Telegraph Works* [1874] 9 Ch. App. 350

¹⁶⁷ *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257, overruled in part by the Court of Appeal [1982] Ch 204

in equity as well. Unlike in common law, fraud in equity is a broad concept. Equitable fraud includes not only unconscionable transactions, but also any behaviour which is unjust, unfair or which breaches equitable principles. It would include oppressive discriminatory conduct. In *Estmanco (Kilner House) Ltd v Greater London Council*, the court held that:¹⁶⁸ “It does not seem to have yet become very clear exactly what the word “fraud” means in this context; but I think it is plainly wider than fraud at common law, in the sense of *Derry v. Peek*¹⁶⁹... Apart from the benefit to themselves at the company's expense, the essence of the matter seems to be an abuse or misuse of power. “Fraud” in the phrase “fraud on a minority” seems to be being used as comprising not only fraud at common law but also fraud in the wider equitable sense of that term, as in the equitable concept of a fraud on a power.”

*Vatcher v Paull*¹⁷⁰ and *Clemens v Clemens Bros Ltd*¹⁷¹ are two more cases in which the court applied the equitable concept of fraud on a power. Another difficulty for shareholders to prove fraud on the minority under the common law was the necessity to prove that wrongdoers were in “control” of the company.¹⁷²

In terms of majority control at the time of fraud, the early cases interpreted control only to the actual control of voting rights.¹⁷³ In *Pavlides v Jenson*¹⁷⁴ the

¹⁶⁸ *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 All ER 437 445

¹⁶⁹ *Derry v Peek* [1889] 14 App. Cas. 337

¹⁷⁰ *Vatcher v Paull* [1915] AC 372

¹⁷¹ *Clemens v Clemens Bros Ltd* [1976] 2 All ER 268

¹⁷² Paul Von Nessen, Say H GooGoo and Chee Keong Low, ‘The Statutory Derivative Action: Now Showing Near You’ [2008] *Journal of Business Law* 627

¹⁷³ *Burland v Earle* [1902] AC 83 93

¹⁷⁴ *Pavlides v Jenson* [1985] 577

court rejected the shareholder's derivative claim based on the ground that the wrongdoers had only *de facto* control of the company rather than *de jure* control. Therefore, the claim did not fall within the *Foss v Harbottle* exceptions. Nonetheless, the later cases consider the control requirement to be satisfied not only in cases where the defendants themselves had the majority of voting rights, but also in any other situation where the company has in fact been controlled by the wrongdoers. For instance, in situations that a majority of shares were held by nominees, bound to vote in accordance with the defendants' instructions, or in circumstances where shareholders were lured to vote in favour of the wrongdoers¹⁷⁵ or where the wrongdoers were able to control the outcome of a shareholder resolution in their own favour by the use of proxy votes.¹⁷⁶ However, still proving fraud on the minority while directors were in control of the company was a significant hurdle in the way of shareholders' actions on behalf of the company.

2.3 The English Law Commission's critiques to derivative actions and recommendations for reform

The difficulties with common law derivative action finally came to the attention of the English Law Commission. In 1995, the Lord Chancellor and the President of the Board of Trade required the Law Commission¹⁷⁷ to review the shareholder

¹⁷⁵ *Arwood v Merryweather* [1867] L.R. 5 Eq. 464

¹⁷⁶ *Prudential Assurance Co Ltd v Newman Industries Ltd* [1982] 1 Ch 324

¹⁷⁷ The Law Commission is an independent statutory body, which was created by the Law Commission Act 1965 to keep the law of England and Wales under review and to recommend reform where it is needed. < <http://www.lawcom.gov.uk>

remedies with particular reference to the rule in *Foss v Harbottle* and its exceptions; sections 459 to 461 of the Companies Act 1985; and the enforcement of the rights of shareholders under the articles of association; and to make recommendations.¹⁷⁸ Upon the request, the Law Commission conducted a widespread review of shareholder remedies under the common law, including derivative action, between the years 1995 to 1997.¹⁷⁹

2.3.1 Identifying the problem

On its examination of common law derivative action, the Law Commission described the law governing derivative action as “inflexible” and “outmoded” and noticed four major problems that should be addressed.¹⁸⁰ First, that the *Foss v Harbottle* rule could not be found in rules of court, but only in case law, and much of it had been decided many years ago. Second, the derivative action was an ineffective mechanism as no action to recover damages suffered by a company could be brought unless the wrong conduct had been considered as a fraud and the wrongdoers had control of the company.

The law as to the meaning of “control” in these circumstances was unclear. It was not restricted to situations where wrongdoers had voting control, but its applicability outside these circumstances was in doubt. The Law Commission found it problematic, in particular, in larger companies where, in practice, directors

¹⁷⁸ The Law Commission Final Report 246, Cm 3769, October 1997, para 1.1 available at <
<http://www.lawcom.gov.uk/project/shareholder-remedies> (visited 6/5/2017)

¹⁷⁹ Law Commission Shareholder Remedies (Consultation Paper No 142, 1996)

¹⁸⁰ *ibid* para 14.1

exercise control with less than a majority of the votes.¹⁸¹ Third, minority shareholders could not bring an action to recover damages suffered by a company by reason of the negligence of a director unless they could prove that the negligence confers a benefit on the controlling shareholders or that the failure of the other directors to bring an action constitutes a fraud on the minority.¹⁸²

Fourth, the standing of the member to bring a derivative action had to be established as a preliminary issue by evidence, which showed a *prima facie* case on the merits. However, neither in applications for leave nor in the courts' judgments, it was clear what precisely an applicant must do to form a *prima facie* case. The Law Commission mentioned that it could cause the preliminary stage to be excessively lengthy and expensive.¹⁸³

2.3.2 The recommendations

In its approach to solving the common law shareholder remedies problems, English Law reached three conclusions. First, within proper boundaries, the rule in *Foss v Harbottle* should be replaced by a simpler and more modern procedure. Second, the court must have all necessary powers to rationalize minority shareholder litigation so that it is less costly and complicated. Third, a 'self-help' remedy (or range of remedies) should be provided to avoid the need for shareholders to resort to the court to resolve disputes.¹⁸⁴ Later, the Law

¹⁸¹ *ibid* para 14.2

¹⁸² *ibid* para 14.3

¹⁸³ *ibid* para 14.4; also I will explain in the next section that ambiguities on establishing the *prima facie* case still remain under the statutory derivative scheme.

¹⁸⁴ *ibid* para 14.13

Commission's Final Report on Shareholder Remedies¹⁸⁵ completed the task begun by their Consultation Paper¹⁸⁶ and proposed a statutory derivative claim in the UK. The aim of the new proposed scheme was to set a more modern, flexible and accessible criteria for shareholders' derivative actions.¹⁸⁷ The English Law Commission's efforts to reform the derivative actions was later assessed and improved through the considerations of the Company Law Review Steering Group.¹⁸⁸ This steering group confirmed the Law Commission's proposals regarding derivative claims and agreed that the derivative claim should be established under a statutory scheme, restricted to breaches of directors' duties, including the duty of care and skill, and should not be confined to cases of self-serving negligence or worse (for example fraud).¹⁸⁹

Subsequently the proposed reforms were authorised by the Government and were implemented in the statutory derivative claim provisions of the Companies Act 2006.

¹⁸⁵ The Law Commission Final Report 246, Cm 3769, October 1997

¹⁸⁶ (No. 142) of 1996

¹⁸⁷ The Law Commission 246, Cm 3769, October 1997 para 6.15

¹⁸⁸ Company Law Review Steering Group, 'Modern Company Law for a Competitive Economy: Final Report' (July 2001) URN 01/942 (CLR Final Report) at para s 7.46-7.51

¹⁸⁹ CLR Developing the Framework para 4.127; CLR Final Report para 7.46; Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Application* (Oxford University Press 2007)

2.3.3 Keeping the restrictive approach toward the derivative claim

The most important point about the recommendation is that despite the recommendations for a new procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue the derivative action,¹⁹⁰ still the Law Commission policy toward derivative action was based on a restrictive approach. The Law Commission was of the belief that in an age of increasing globalization of investment and growing international interest in corporate governance, greater transparency in the requirements for a derivative action is highly desirable.¹⁹¹ However, the intention was to introduce a new scheme, which keeps a balance between the ability of the company to function efficiently without the unnecessary interference of challenges from shareholders, and the need to protect minority shareholders and enhance shareholder confidence by providing shareholders with a route for redress in certain circumstances.¹⁹² Therefore, the English Law Commission's policy was that derivative actions should remain as an exceptional remedy¹⁹³ subject to tight judicial control at all

¹⁹⁰ The Law Commission Final Report, para 6.15

¹⁹¹ *ibid* para 6.9

¹⁹² *ibid* para 1.9

¹⁹³ The Law Commission Consultation Paper para 4.6; Final Report para 6.4, the Law Commission considered it important that in public companies, derivative action should not be too readily available as that may lead directors to favour a course which provides benefits to shareholders rather than make a more balanced judgment and take a decision which they would otherwise feel free to take. The Law Commission's emphasis was that in the larger companies, derivative action should be seen in the context of a complex web of control mechanisms, which include regulatory action, institutional investor attitudes, DTI inquiries, and so on (Final report para 1.12).

stages,¹⁹⁴ and it did not anticipate derivative actions to be significantly increased¹⁹⁵ or intend to encourage derivative actions.¹⁹⁶ Still it considered that where litigation is brought, the new procedure would assist in making sure that it is dealt with fairly and efficiently. In addition to that, during the Parliament Grand Committee stage for codifying the Companies Act 2006, one of the arguments was that broadening the directors' duties under the Companies Act 2006 and at the same time, widening the scope of the statutory derivative claim would make it easier for shareholders to commence litigation against directors.¹⁹⁷ The fear was that it would reduce the number of people willing to take directorships in companies.¹⁹⁸

In response, the Government guaranteed that the derivative claim would remain as a 'weapon of last resort',¹⁹⁹ and it would provide sufficient safeguards for the new statutory regime to protect against the increase of a litigation culture.²⁰⁰

¹⁹⁴ Final Report para 6.6

¹⁹⁵ Law Commission, *Shareholder Remedies: Report on a Reference under section 3(1)(e) of the Law Commissions Act 1965* (Law Com, No 246, Cm 3769) (London, Stationery Office 1997) paras 6.12–6.13

¹⁹⁶ Arad Reisberg, 'Derivative claims under the Companies Act 2006: much ado about nothing?' In: John Armour, Jennifer Payne (eds.) *Rationality in Company Law* (Hart Publishing 2009) pp. 17-56; Andrew Keay and Joan Loughrey, 'An assessment of the present state of statutory derivative proceedings. In Joan Loughrey, (ed), *Directors' duties and shareholder litigation in the wake of the financial crisis* (Edward Elgar Publishing 2012) p 189

¹⁹⁷ For instance, Lord Hodgson raised the concern over the double-whammy effect of codifying directors' duties and at the same time creating a statutory basis for members to bring a claim against company directors. See, *Hansard* HL Vol 679, Official Report, 27/2/06, col GC2; see also Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Application* (Oxford University Press 2007) p136

¹⁹⁸ *Hansard* HL Vol 679, Official Report, 10.5.2017 col GC3

¹⁹⁹ *Hansard* HL Vol 681, Official Report, 10.5.2017, col 88 where Lord Goldsmith provides that 'we have put forward a package that strikes the right balance between a degree of long-stop accountability for the directors—which is what derivative action is, not a first resort but the last—and freedom from frivolous claims'.

²⁰⁰ *Hansard* HC Vol 450, Official Report, 10.5.2017 col 832

2.3.4 The thesis critiques to the Law Commission recommendations and the Government approach

Before reviewing the statutory derivative claim provisions, it is necessary to discuss the main problem with the Law Commission recommendations and consequently with the Government approach to the statutory derivative claim. The initial problem arises from the Law Commission's wrong approach in reviewing the common law derivative claims in the context of the shareholder remedies rather than the company as a separate legal personality. In fact, the aim of the Law Commission was to protect minority shareholders and enhance shareholder confidence by providing shareholders with a route for redress in certain circumstances.²⁰¹ There is no need to mention again that the derivative claim is a remedy for the protection of the company as a separate legal personality from its shareholders, and reconsideration of its role in the context of shareholder remedies was a wrong approach by the English Law Commission and later by the Company Law Steering Group and the Government. The consideration of the derivative action in the context of shareholder remedies was clearly rooted in the traditional shareholder value principle, which views shareholders as the only beneficiaries of the company. Nevertheless, such an approach is in conflict with the legal principle under the *Foss v Harbottle* case, which clearly refers to the company's separate personality by establishing the proper plaintiff principle. In addition to that, the Law Commission recommendations are also in conflict with each other. On the one hand, the English Law Commission refers to the proper claimant principle and the fact

²⁰¹ *ibid* para 1.9

that in respect of a wrong done to the company, the company itself should sue the wrongdoers. On the other hand, it recommends that a 'self-help' remedy (or range of remedies) should be provided to avoid the need for shareholders to resort to the court to resolve disputes true the derivative claim.²⁰² Taking such a conflicted approach has resulted in confusion in the Law Commission recommendations and consequently ambiguities in the statutory derivative claim framework under the Companies Act 2006. The question which emerges is why should the availability of other remedies, which initially have been designed to protect interests of shareholders, should be considered to cover the role of the derivative claim? One argument could be that those so-called remedies through the shareholders would hold directors accountable to their fiduciary duties and consequently would protect the company as a whole. In the view of this thesis, such an argument could be acceptable if the protection of the company as a whole would be achieved through these other so-called mechanisms. However, as I have already reasoned, shareholders may not always care about the long-term protection of the company; therefore, these mechanisms would not be optimal in protecting the company, even for the interest of minority shareholders, in all circumstances. This issue will be discussed in the next chapter in more detail.

²⁰² *ibid* para 14.13

2.4 The statutory derivative claim

The new statutory scheme which has come into force since October 2007 provides that derivative claims may only be brought under the Companies Act 2006, Part 11, Chapter 1²⁰³ or pursuant to a court order under section 996(2)(c) in the context of the unfair prejudice claim.²⁰⁴ Section 260(1) gives the standing to bring the derivative claim only to the members of the company (shareholders). In this respect, ‘member’ includes a person who is not a member but to whom shares in the company have been transferred or transmitted by operation of law,²⁰⁵ which would be a personal representative of a deceased member or the trustee of a bankrupt member.²⁰⁶

The statutory derivative claim may be brought only in respect of a cause of action specified in section 260. The cause of action must be vested in the company.²⁰⁷ The grounds for bringing the derivative claim is no longer limited to the proof of fraud on minority when wrongdoers are in control of the company, and the cause of action now arises from an actual or proposed act or omission which involves negligence, default, breach of duty or breach of trust by a director, former director or shadow director of the company.²⁰⁸

²⁰³ s 260-264

²⁰⁴ s 260(2) CA 2006, the unfair prejudice claim and its interaction with the derivative claim will be discussed in chapter three.

²⁰⁵ s 260(5)(c)

²⁰⁶ Stuart Sime and Derek French (eds), *Blackstone's Civil Practice* (Oxford University Press 2017) Ch 14 p 269

²⁰⁷ s 260(1)

²⁰⁸ s 260(3) and (5)(a) and (b)

The extension of the derivative claim grounds to negligence was a Law Commission proposal. The intention was that while investors take the risk that those who run companies may make mistakes, they do not have to accept that directors will fail to comply with their duties toward the company.²⁰⁹ Moreover, the cause of action could be against a director, or another person or both²¹⁰ and it may have arisen before the claimant became a member of the company.²¹¹

A derivative claim may be brought in relation to a foreign company as well. However, the appropriate forum for such a claim is likely to be the country of incorporation.²¹² The statutory derivative claim has failed to set any provision for multiple derivative claims and this would cause problems where groups of companies are involved. However, in *Universal Project Management Services Ltd v Fort Gilkicker Ltd & ors*,²¹³ Briggs J held that double derivative claims still exist and are governed by common law principles. The court cited a number of cases, including *Wallersteiner v Moir*,²¹⁴ in which the court seemed to have accepted, albeit without discussion of the point, that where the wrongdoers were in control of both the subsidiary and its parent, a shareholder of the parent had standing to bring a derivative action on behalf of the subsidiary. Regarding to double derivative claims under the statutory scheme, Briggs J held that the aim of the statutory derivative claim was to establish a clear set of rules to control derivative actions.

²⁰⁹ s 260(3) and 5(a) and (b)

²¹⁰ s 260(3)

²¹¹ s 260(4)

²¹² Stuart Sime and Derek French, *Blackstone's Civil Practice* [n 206] 272

²¹³ *Universal Project Management Services Ltd v Fort Gilkicker Ltd & ors* [2013] All Er (D) 313

²¹⁴ *Wallersteiner v Moir* [1975] 1 QB 373

He observed as follows:²¹⁵ "A conclusion that what Parliament in fact achieved in 2006 was to place a statutory code for derivative claims by members of the wronged company alongside a continued obscure, complicated and unwieldy common law regime for derivative claims by others does not commend itself as an exercise in common-sense". However, the Briggs J opinion raises a general question concerning the issues. The question is, whether such issues should still be governed by the common law rules or would it be better if they were covered under the statutory regime? In terms of clarity, the latter seems to be a better solution, as it would create less confusion for the claimants and the courts.

2.4.1 Problems with the *prima facie* requirement

A member of the company who brings a statutory derivative claim must apply to the court for permission to continue the claim.²¹⁶ In addition, the company must be joined as co-defendant in the derivative application so that if its rights are vindicated it will be able to enforce the judgment.²¹⁷

Section 261 provides that the court should consider an application for permission to continue a derivative claim in two stages. In the first stage, the court should consider whether evidence presented by the claimant provides a *prima facie* case. The court should dismiss the application if the evidence does not provide the *prima facie* case for giving permission.²¹⁸ The *prima facie* case should show that

²¹⁵ *Universal Project Management Services Ltd v Fort Gilkicker Ltd & ors* [2013] All Er (D) 313

²¹⁶ s 261(1)

²¹⁷ Civil Practice Rule 19.9(3)

²¹⁸ s 261(2)

the company has a good cause of action and the cause of action arises out of the directors' default, negligence, breach of duty and breach of trust.²¹⁹ If the court decides that the *prima facie* case has been established, the application will proceed to the second stage in which the court would ask the company to provide evidence for a contested hearing of the application.²²⁰ Although one of the Law Commission critiques of the common law derivative action was that it was unclear what would establish the *prima facie* case,²²¹ the problem remains under the statutory provision as the Act fails to make it clear how the claimant should prove the *prima facie* case. The courts have taken different approaches to this issue.

In *Iesini v Westrip Holdings Ltd*,²²² Lewison J held that the applicant had to make a *prima facie* case that the company has a good cause of action and that it arose out of a director's breach. He confirmed that it was the same common law approach as the Court of Appeal required in *Prudential Assurance Co Ltd v Newman Industries Ltd*.²²³ In *Stainer v Lee*²²⁴ the court considered the standard to be applied when considering the provisional merits of the cause of action against the respondents. If the case seemed very strong, it might be appropriate to continue even if the sums at stake were not large. The court did not mention what would make a strong *prima facie* case. On the other hand, in *Hughes v Weiss*²²⁵ the court ruled that when the sum at stake is very large it might be in the company's interest

²¹⁹ *Iesini v Westrip Holding Ltd* [2009] EWHC 2526 (Ch)

²²⁰ s 261(3)

²²¹ Law Commission Shareholder Remedies (Consultation Paper No 142,1996) para14.4

²²² *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526; [2010] BCC 420 at [79]

²²³ *Prudential Assurance Co Ltd v Newman Industries Ltd* [1982] Ch 204

²²⁴ *Stainer v Lee* [2010] EWHC 1539(ch), [2011] 1BCLC 537

²²⁵ *Hughes v Weiss* [2012] EWHC 2363 (ch) LTL 28/9/2012

that the derivative claim be continued even if the court formed the provisional view that the claim was not a strong one.

In some cases, the *prima facie* case may be established if the defendant's evidence is ignored, but would fail at the trial if the defendant's evidence is accepted. In such cases, it is open to the court to hold that the claimant had established a *prima facie* case because it might not be possible to predict whether the defendant's evidence would be accepted at the trial.²²⁶

The problem is that lack of clarity under the statutory provisions have resulted in courts having not taken a clear or consistent approach on their interpretation of the *prima facie* requirement, and this has made the situation confusing for the claimants. Therefore, the recommendation is that in order to solve the confusion for claimants, section 261 should set clearer criteria for establishing the *prima facie* case. One suggestion would be that the legislator combined both stages into one as it has already happened in some cases upon the agreement of the parties.²²⁷

The reason is that although the Act requires the court to consider the factors set out in section 263(2), (3) and (4) only in the second stage, in practice it seems to be inevitable for the court to evaluate the *prima facie* case in the first stage, without considering those factors. This might create confusion for a claimant on how far he is required to develop a case before seeking permission.

²²⁶ *Bhullar v Bhullar* [2015] EWHC 1943 (ch), [2016] 1 BCLC 106

²²⁷ *Mission Capital plc v Sinclair; Franbar v Holding Ltd v Patel*

In *Stainer v Lee*,²²⁸ Roth J ruled that a court is able to revise its view as to a *prima facie* case at the second stage, once it has received evidence and argument from the respondents. If this were the case, then it might be better that, in order to save time and money for claimants in a derivative litigation, the legislator put both stages into one because the rationale behind the first stage acting as a screening mechanism could be achieved in the second stage as well. It was also the main reason that the Law Commission did not recommend a two-stage procedure as it was concerned that ‘the inclusion of an express test would increase the risk of a detailed investigation into the merits of the case taking place at the leave stage, and that such a “mini-trial” would be time-consuming and expensive.’²²⁹ The two-stage procedure was the innovation of the legislator, which was in the belief that the courts should be able to dismiss frivolous claims without the involvement of companies and at the earliest possible opportunity.²³⁰

However, it seems that the *prima facie* requirement as it stands in its present form would create more confusion for legitimate applicants rather than curbing troublesome derivative claims. Another difficulty for derivative claim applicants is in obtaining evidence to prove the *prima facie* for a derivative claim. Both minority shareholders and employees have very little to do with the internal governance of the company and neither have the right to investigate the company’s documents. In the context of shareholders as an applicant, they only could investigate the company documents if directors authorise them or the company

²²⁸ *Stainer v Lee* EWHC 1539(ch), [2011] 1BCLC 537

²²⁹ The Law Commission 246, Cm 3769, October 1997 para 6.71

²³⁰ House of Lords Debates Hansard publication [9 May 2006] vol 681, col 883 (Lord Goldsmith)

constitution provides a right of discovery for them. The alternative would be to apply to the court for inspection of company books and documents pre-trial. However, getting the court permission for investigation of the company document is not a smooth process, as the court would reject their request if they could not provide the need for inspection. Moreover, directors who are in control of the company can always find ways to prevent or to delay the release of the company's sensitive information or information that would be damaging to their position. In regards to the employees as the derivative claim applicant, they do not have the legal right to investigate the company's documents either. However, in the view of this thesis they are arguably in a better position to learn about the directors' wrong conduct or having access to the document which harms the company because they are working in the company. Overall, the argument still is that putting the two stages of the derivative claim procedure into one would help the applicants to more easily prove the merits of their claim. As was mentioned above, the screening of the vexatious claims could be achieved in the second stage as well without necessarily increasing the time and costs of the litigation.

2.4.2 Second stage: mandatory and discretionary factors

The second stage involves the courts considering the list of factors under Companies Act 2006 sections 263(2) and (3). Section 263 provides the list of

matters which should be taken into account by the court when deciding whether to give permission to a derivative claim. These important matters are:²³¹

- (1) The good faith of the derivative claim's applicant²³²
- (2) Whether a person acting in accordance with the duty to promote the success of the company would continue the claim²³³
- (3) Whether there has been or could be authorization or ratification of the act or omission giving rise to the claim²³⁴
- (4) Whether the company has decided not to pursue the claim²³⁵
- (5) Whether the claim is one which the member could pursue in his own right rather than on behalf of the company²³⁶
- (6) The disinterested member's view towards the claim²³⁷
- (7) Whether the claim would promote the company's success²³⁸

The factors listed under section 263(2) have a mandatory nature, yet the matters that the court should consider under section 263(3) are discretionary. The mandatory factor has been established to shut out vexatious cases²³⁹ while the discretionary factor allows courts to formulate specific factors, which a hypothetical director would consider

²³¹ Stuart Sime and Derek French, *Blackstone's Civil Practice* [n 206] 269

²³² s 263(3)(a)

²³³ s 263(3)(b)

²³⁴ s 263(2)(b) and (c) and (3)(c) and (d)

²³⁵ s 263(3)(e)

²³⁶ s 263(3)(f)

²³⁷ s 263(4)

²³⁸ s 263(2)(a) and (3)(b)

²³⁹ *Franbar* [2008] EWHC 1534 (Ch), [2008] BCC 885 [30]

important, appropriate to each particular case so as to imbue a 'sense of reality'.²⁴⁰ Section 263(2)(a) provides that permission to continue derivative proceedings must be refused if a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim. In addition to that, section 263(3)(b) indicates that the court should take into account the importance a person acting in accordance with section 172 would attach to continuing the claim. If the hypothetical director would undoubtedly not attach much importance to the claim, it will be refused.²⁴¹ Section 263(4) requires that in considering whether to give permission (or leave) the court shall have particular regard to any evidence before it as to the views of members of the company who have no personal interest, direct or indirect, in the matter.

In implementing this subsection, Lord Goldsmith states that ‘‘courts should decide how to implement it. For example, if the courts knew that there was a substantial and highly respectable institutional investor who knew what the circumstances were and thought that the directors were doing the right thing in not pursuing the claim, then that would be influential with the court.’’²⁴² Nonetheless, Lord Goldsmith fails to indicate how the court should understand whether the person has a personal interest in the issue or even care about the protection of the company at all. Considering the previous discussions on shortcomings of reliance

²⁴⁰ House of Lords Debates Hansard publication [27 February 2006] vol 679, col GC26 (Lord Goldsmith); Julia Tang, ‘Shareholder Remedies: Demise of the Derivative Claim’ (2012) vol 1(2) UCL Journal of Law and Jurisprudence 190

²⁴¹ *Mission Capital plc v Sinclair* [2008] EWHC 1339 (ch), [2008] BCC 866; *Iesini v Westrip Holding Ltd* [2009] EWHC 2526 (ch), [2011] 1BCLC 498; *Simpson v Southern Private Landlords Associations*; *Bridge v Daley* [2015] EWHC 2121 (ch) LTL 24/8/2015

²⁴² Hansard HL Vol 681, Official Report, 9/5/2006, col 888

on institutional shareholders, such consideration is particularly debatable. Like the role of ratification, such consideration would also be particularly unfair to employees' derivative claims as well. Shareholders and employees could have different interests in the company from each other and, therefore, the opinion a company member should not be influential on the court in deciding about the employees' derivative litigation.

In *Bridge v Daley*²⁴³ the claim was made on behalf of a company listed on the Alternative Investment Market. The court dismissed the claimant's application for permission to bring a derivative action on the basis that any benefit that it might have brought to the company was insufficient, or insufficiently clear, to outweigh the costs and disruption that it would entail. The court held that no director acting in accordance with section 172 would continue the claim. Also it was not an action that had gained the support of the company's members, even those disinterested members. The relation between section 263(2)(a) and section 263(3)(b) was considered in *Iesini v Westrip Holding Ltd*,²⁴⁴ as well where the court held that section 263(2)(a) applies only where the court is satisfied that no director acting in accordance with section 172 would seek to continue the claim. If some directors would and others would not seek to continue the claim, then section 263(3)(b) should be applied. The judge considered the case of the applicant was so weak that he was of the view that no director would seek to continue the claim. A considerable point in the *Iesini* judgment is that in determining whether to proceed

²⁴³ *Bridge v Daley* [2015] EWHC 2121

²⁴⁴ *Iesini v Westrip* [2011] [n 161]

with the claim, Lewison J said that: ‘the weighing of these considerations is essentially a commercial decision, which the court is ill-equipped to take, except in a clear case’. However, the court gave no indication as to what would be a clear case. In *Franbar Holdings Ltd*²⁴⁵ the deputy judge held that he believed a court would need to consider the following matters in assessing whether a hypothetical director acting in accordance with section 172 would continue the claim. The factors were: the prospects for success of the claim; the ability of the company to recover any damages award; the disruption caused to the development of the company’s business by having to focus on the claim; the costs involved; and any possible damage that might be done to the company’s reputation. The court concluded that since, in addition to the application for permission, a claim for unfair prejudice under section 994 of the Act has been instituted and an offer to buy-out the claimant has been made, a hypothetical director would be less likely to attribute importance to the continuation of the derivative proceedings.²⁴⁶ The appeal court in *Wishart*²⁴⁷ considered other issues such as the amount at stake,²⁴⁸ and the prospects of getting a satisfactory result without litigation as reasons that the hypothetical director would not continue the claim. In addition, in *Langley*

²⁴⁵ *Franbar Holdings Ltd* [2008] EWHC 1534 (Ch); [2008] BCC 885

²⁴⁶ *ibid* [37]

²⁴⁷ *Wishart* [2009] CSIH 65; 2009 SLT 812 [37]

²⁴⁸ However, in *Stainer v Lee* [2010] EWHC 1539 (Ch), [2011] BCC 134 [29] Roth J held that the amount of the recovery might be small where the applicant’s case was strong as he felt that such a claim might stand a good chance of provoking an early settlement or leading to summary judgment.

Ward Ltd v Trevor,²⁴⁹ the court held that the potential winding up of the company could influence a hypothetical director in some cases, such as the case before him.

These cases demonstrate the need for strengthening the deterrence function of the derivative claim and the consideration of the non-pecuniary benefits of the derivative claim by the legislator.

In *Kiani v Cooper*²⁵⁰ the court found that a director acting in accordance with section 172 would decide to continue the proceedings, at least up to disclosure stage, on the basis that a hypothetical director would consider important the size of the claim, approximately £296,000, which if successful would ensure full return for all creditors. In *Stainer v Lee*,²⁵¹ Roth J held that there was no particular standard of proof that has to be satisfied. The court gave permission subject to some control, namely that permission would be limited to the conclusion of disclosure and terms as to costs pursuant to section 261(4) of the Act. Also, permission must be refused where the cause of action has arisen from an act or omission yet to occur and that act or omission has been ratified by the company, or is in relation to past acts and omissions which were authorised by the company before they occurred or have been subsequently ratified by the company.²⁵²

In *Re Singh Brothers Contractors (North west) Ltd*²⁵³ the court by applying the mandatory bar in section 263(2)(c) refused to give permission to continue a

²⁴⁹ *Langley Ward Ltd v Trevor* [2011] EWHC 1893 (Ch) [14]

²⁵⁰ *Kiani v Cooper* [2010] EWHC 577 (Ch); [2010] BCC 463

²⁵¹ *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] BCC 134

²⁵² s 263(b)(b) and (c)

²⁵³ *Re Singh Brothers Contractors (North west) Ltd* [2013] EWHC 2138 (ch), LTL 22/8/2013; [2014] EWCA Civ 103

derivative claim on the grounds that the directors conduct had been authorised by the company. The court held that the real motivation behind the claim was animosity between the parties following a family dispute and which also justified a refusal of permission under section 263(3)(a).

2.4.3 What is wrong with the statutory derivative claim?

Now, after reviewing the statutory derivative claim provisions and the courts' approach to the derivative claim, it is time to discuss that what is wrong with the statutory derivative claim framework in the UK. As was reviewed above, since the ratification of the statutory derivative claim, courts have taken a cautious and restrictive approach to derivative litigation. Part of this approach arises from the Government's policy of keeping a restrictive approach towards derivative claims. The main reason, however, is the ambiguities and flaws in the statutory derivative claim framework. The other problem is that the legislator has not clarified the boundaries between the common law derivative action and statutory derivative claim. To overcome the ambiguities in the statutory framework, the courts still rely on the common law approach to the derivative action. It has resulted in confusions for the courts and the derivative claim applicants. The overly restricted approach to the statutory derivative claim is in conflict with the Lord Goldsmith's assentation in introducing the new statutory regime, where he mentioned: "we have to strike a careful balance between protecting directors from vexatious and frivolous claims and protecting the rights of shareholders. It would be dangerous to move too far

against either of those interests.”²⁵⁴ So, the question is whether that balance has been kept, or if the current statutory derivative claim would protect the company as whole.

The low number of cases which have been initiated during 10 years (only 22 cases according to Professor Keay’s empirical research²⁵⁵) might not per se be the evidence that the balance has been disturbed. Nevertheless, it could be an indication that the flaws and ambiguities in the procedure requirements, and the costs of the derivative litigation, have made the shareholders reluctant to initiate a derivative claim. It is not surprising that any rational derivative claim applicant would refrain from initiating a derivative claim under the current statutory scheme, even if they have good knowledge of the directors’ wrong conduct that harms the company. In fact, since the early days of the introduction of statutory derivative claims, many scholars have triggered the alarm that the new statutory regime would not achieve the balance between the directors’ functions and shareholders’ protection as the pendulum is swinging towards the benefit of directors. Reisberg, who has conducted an extensive assessment on the impact of the statutory derivative scheme in his book published in 2007,²⁵⁶ raises several issues. Reisberg rightly argues that the reform’s success should be judged not by the quantity of the case law produced under the new regime but by whether the rules governing the circumstances in which such an action may be brought have become more

²⁵⁴ Hansard HL Vol 679, Official Report, 27/2/06, col GC4–5

²⁵⁵ Andrew Keay, ‘Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006’ (2016) 16(2) *Journal of Corporate Law Studies* 22

²⁵⁶ Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Application* (Oxford University Press 2007)

comprehensible and accessible to the extent that in exceptional circumstances, the derivative claim becomes a remedy worth pursuing.²⁵⁷ Nevertheless, at the time he was concerned that the statutory provisions may not be sufficiently detailed to prevent the courts from relying on existing case law in the absence of a more substantial codification and clarification of the regime. The discretion delegated to the courts may continue to impose the same obstacles to derivative claims as previously existed under the common law.²⁵⁸ Reisberg warned that the danger might be that the judiciary would adopt an excessively restrictive approach to statutory derivative claims in order to preserve the exceptional nature of derivative action. He concluded that the ambiguities under the statutory provisions, mainly with regards to the ratification of directors' breach of duty and uncertainty surrounding the scope of section 172 (duty to promote the success of the company), would cause confusion in derivative litigation procedures. In addition to that, shareholders' difficulty in obtaining the company's information to reinforce their claim and lastly the cost of the litigation would still prevent a legitimate shareholder from initiating a claim on behalf of the company.

Reisberg is not the only scholar who brings the efficacy of the reforms into question. Andrew Keay also in part of his latest research on assessing the statutory derivative claim²⁵⁹ reviews the judicial approach and confirms that Reisberg's view in the early days, that the traditional suspicion of the English courts towards derivative actions will continue especially now that they are 'armed' with a very

²⁵⁷ *ibid* 159

²⁵⁸ *ibid* 162

²⁵⁹ Andrew Keay [n 255]

restrictive legislation to ‘justify’ their attitudes, was correct.²⁶⁰ Keay argues that despite the fact that statutory provisions still require courts to make judgments concerning the interests of the company, there are some judicial decisions in which the courts refused to intervene in directors’ commercial decisions. They dismissed the claim for the reason that the courts are ill-equipped to review such commercial matters.²⁶¹ Also because they relied on the view of two directors of the company that continuing the claim is not in the interest of the company, despite the fact that the applicant argued, perhaps with some validity, that those directors were not independent enough.²⁶²

In line with these academic arguments, this thesis argues that the current approach to the derivative claim in the UK is problematic. The main problem is that while the derivative claim is a mechanism for protecting the company as a separate legal personality, the statutory derivative claim in the UK has been established on the traditional shareholder value view and with the aim of protecting the interest of shareholders only. In the view of this thesis, the objective of the company is to maximise the wealth of the entity and at the same time, to ensure that the company is sustained financially for the benefit of all the stakeholders in long run. The current structure of the derivative claim would not achieve such an objective. The critiques to the statutory derivative scheme are the lack of clarity in the derivative claim procedural requirements, the problem with

²⁶⁰ *ibid*; also Arad Reisberg, ‘Shadows of the Past and Back to the Future: Part 11 of the UK Companies Act 2006 (in) action’ (2009) 6(2-3) *European Company and Financial Law Review*

²⁶¹ *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] BCC 420

²⁶² *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch) [45]–[68]

the derivative litigations cost and the role of shareholder ratification and the limiting of the scope of the derivative claim to shareholders. In terms of the reforms to the procedural requirements, this research argues that the ambiguities on the *prima facie* requirement have created confusion for the applicants and the courts. Therefore, the research suggests that in order to solve the confusion, the Act should clarify how the applicant should prove a *prima facie* case in the first stage. Alternatively, the legislator might integrate the two stages into one as has already happened in practice in some cases upon the agreement of the parties. The other problem is with consideration of the view of disinterested shareholders under 263(4). The section fails to indicate how the court should understand whether the person has a personal interest in the issue or even care about the protection of the company at all. This issue is particularly important in the context of the employees' derivative claim. Therefore, the thesis argues that first the criteria for such a consideration should be clear. Second, the consideration of disinterested shareholders should not apply to the employees' derivative claim. The reason is that the interest of employees and shareholders are not always in line with each other and such consideration could be unfair to the employees. The other proposals for reform to the statutory derivative claim will be discussed in chapters six and seven.

2.5 Conclusion

This chapter reviewed derivative action under the common law and the reasons that caused the English Law Commission and subsequently the Government to reform the derivative action mechanism in the UK.

The chapter also reviewed the statutory derivative claim regime under the Companies Act 2006 sections 260 to 264. Exploring the statutory provisions revealed that there are still some ambiguities under the Act, which could cause confusion for both the derivative claims applicants and the judicial system. Moreover, some procedural requirements such as shareholders's ratification of wrongdoers' conduct, the consideration of the view of disinterested shareholders and the costs of the derivative claim could stop applicants to make a meritorious claim on behalf of the company. These requirements would also be unfair to employees if they act as the applicant for the derivative claim. In order to improve the function of the derivative claim the thesis proposes some reforms to the procedure requirements, including reforms to the *prima facie* case and the role of the disinterested shareholder under section 263(4).

Chapter Three: Is there any alternative mechanism to the derivative claim in the UK?

3.1 Introduction

The previous chapter argued that the role of the derivative claim should be reconsidered in the English legal system because the derivative claim is a mechanism of protection for the company as a distinct personality from its shareholders, and the company needs to be protected for the sake of all the stakeholders. However, such an argument would be unfounded if there is proof that the role of the derivative claim could be substituted by other mechanisms of accountability. One general view is that the different mechanisms of accountability can complement and substitute for one another.²⁶³ Based on this view, in the UK because of the availability of different corporate governance mechanisms and the costs of judicial intervention, there is no need to resort to shareholder private litigation including the derivative claim as a means of protection against the wrongdoing directors.²⁶⁴ This view has been put forward by referring to the power of shareholders under UK corporate law which gives them the right to review the annual reports and accounts as well as vote on managers' remuneration packages at

²⁶³ Anup Agrawal and Charles Knoeber, 'Firm performance and mechanisms to control agency problems between managers and shareholders' (1996) 31(3) *Journal of financial and quantitative analysis* 377-397

²⁶⁴ Luca Enriques, 'The law on company directors' self-dealing: A comparative analysis' (2000) 2(3) *International and Comparative Corporate Law Journal*; John Armour et al., 'Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US' (2009) Vol 6 *Journal of Empirical Legal Studies* 687-722

the AGM.²⁶⁵ In addition, they have the statutory power to dismiss directors even without cause.²⁶⁶

Moreover the market for corporate control which through the 'City Code on Takeovers and Mergers'²⁶⁷ disciplines directors' conduct, and non-executive directors (NEDs), are playing an important role in encouraging the proper conduct of company affairs especially in public companies. In addition to the above mechanisms, auditors owe a duty to ensure that company accounts reflect a true and accurate view of the company's financial position.²⁶⁸

In private companies also, the unfair prejudice conduct and shareholders agreements are known as the common methods of protection for minority shareholders. However, as it has already been argued several times in this thesis, these so-called alternative methods to the derivative claim have been based on the shareholder primacy principle. They have been established to protect the interest of shareholders when there is a conflict of interest between shareholders and directors, and only shareholders have the ultimate power to use them against the wrongdoing directors. Even in terms of protecting shareholders, these mechanisms may not be optimal in all circumstances for the protection of minority shareholders. One apparent reason is that these mechanisms are normally in the

²⁶⁵ Companies Act 2006 ss 281-361

²⁶⁶ Companies Act 2006 s 168 provides that directors can be removed without cause by an ordinary resolution of simple majority.

²⁶⁷ The City Code on Takeovers and Mergers
<<http://www.thetakeoverpanel.org.uk/new/codesars/DATAIcode.pdf>

²⁶⁸ The UK Corporate Governance Code section C.3.2 assigns the audit committee the task 'to review and monitor external auditors' independence and objectivity' and 'to develop and implement policy on the engagement of the external auditor to supply non-audit services'.

control of majority shareholders such as institutional shareholders, and the interest of majority shareholders could be in conflict with the interest of minority shareholders.²⁶⁹ In contrast, the derivative claim is a mechanism for protecting the company itself, which is more likely to be used by minority shareholders and, in the context of this thesis, employees in situations that they have no other option to protect their reflective interest in the company. The argument in this chapter is that although the availability of other mechanisms of accountability could provide an environment in which the derivative claim might be less needed, nevertheless the derivative claim could still play a role alongside these mechanisms to provide a full protection for the company as a whole. Therefore, under the law it should be a more affordable and accessible mechanism. The chapter examines different mechanisms of accountability to find to what extent these mechanisms are effective in holding directors accountable towards the company as a whole. To find the answer the chapter reviews these mechanisms in the context of private companies and public companies. The chapter first explores the role of the derivative claim in UK private companies and reviews the so-called alternative mechanisms to derivative claims such as unfair prejudice claims, and shareholders' agreements in this type of companies. In the next stage the chapter looks at the role of the derivative claim in public companies and explores the functions and

²⁶⁹ One type of agency cost is the one that arises from the conflict of interest between majority shareholders and minority shareholders known as the horizontal agency cost; see also Daniel R. Fischel and Michael Bradley, 'The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis' (1986) 71 Cornell Law Review 261

limitations of these so-called mechanisms of accountability for directors, which have been established under UK corporate governance.

3.2 So called alternatives to the derivative claim in private companies

According to the UK Government's recent Green Paper, the United Kingdom is home to a significant number of large, private companies and limited liability partnerships (LLPs). There are, for instance, nearly 2,500 private companies and 90 LLPs with more than 1,000 employees.²⁷⁰ Therefore, private companies are a fundamental part of the UK economy. These companies, either large or small, are not required to follow formal corporate governance and reporting standards as are publicly listed companies; however, the consequences of controlling shareholders' conduct can be equally severe for minority shareholders and other stakeholders. Under the recent corporate governance proposals, the UK Government intends to encourage a set of corporate governance principles suitable for the ownership structures of large private companies. However, this research argues that the proposed corporate governance code would not increase the accountability of directors in private companies. Firstly, adoption of these principles will be voluntary for private companies and they will be allowed to adopt, or continue to use their own preferred approaches.²⁷¹ Secondly, the proposed corporate governance code would only apply to private companies of specific size and with a certain amount of employees. Thirdly, in some private companies like BHS, there

²⁷⁰ Department for Business, Energy & Industrial Strategy, *Corporate Governance Reform, The Government Green Paper* (November 2016) 43 para 3.2

²⁷¹ Department for Business, Energy & Industrial Strategy, *Corporate Governance Reform, The Government Response to the Green Paper Consultations* (August 2017) 41

is no shareholder outside the wrongdoers' team to discipline directors through the proposed code.

Back to the subject of the thesis, since the enactment of the statutory derivative claim, shareholders in private companies in the UK have initiated the majority of the derivative litigation. The reason that derivative litigation potentially plays a more vital role in private companies is because minority shareholders and employees²⁷² in these types of companies are more exposed to an opportunistic conduct of majority shareholders, which ruins the company and puts their respective interests in danger. With regards to shareholders as the applicants, usually in private companies there is no separation between ownership and control, and shareholders are also directors of the company. However, due to the role of the majority rule principle, minority shareholders have no power to protect their interests in the company when controlling shareholders harm the company by their opportunistic behaviour, their negligence, and mismanagement of the company and misappropriation of the company assets. In the event of majority shareholders' abuse of power in private companies there is no market available to minority shareholders comparable to that available to shareholders in public companies to sell their shares and prevent further harm to their interests. Even if a buyer were to be found for their shares, still there might be some restrictions on the transfer of shares in the articles of association of private companies. Therefore, the most

²⁷² Since in private companies there are fewer mechanisms of accountability for controlling directors' conduct in comparison to public companies, as with shareholders in these companies the employees are also at more risk of being harmed by director wrongdoings. This chapter deals with the interest of minority shareholders, whilst the problem of employees will be discussed in chapter seven.

likely option for minority shareholders when the company is harmed might be to sell their shares, often at a reduced price, to controlling shareholders themselves.

Accordingly, in terms of protecting the company itself, derivative claim is the main available mechanism in private companies to protect the company and shareholders against the exploitation of majority shareholders. The argument is that the other mechanisms such as the unfair prejudice claim could not cover the role of the derivative claim in protecting the company. I review these mechanisms to demonstrate that they could not provide the protection for the company in all circumstances.

3.2.1 The unfair prejudice claim and the blurred interaction with the derivative claim

Among the different mechanisms that have been named by academics and practitioners as alternatives to the derivative claim in the UK, the unfair prejudice conduct petition seems to play the most substantial role. The main reason is section 260(2) of Companies Act 2006 provides that a derivative claim may be brought either under the statutory derivative claim provisions or in pursuance of an order of the court under the section 994 proceedings for protection of members against unfair prejudice conduct.²⁷³ The reference in the Act is to section 996(c) of the Companies Act 2006. Under section 996(c) the court may authorise civil

²⁷³ s 260(2)(b)

proceedings in the name and on behalf of the company. Hence, shareholders could either make a claim on behalf of the company or choose a personal remedy. In *Franbar Holdings*²⁷⁴ the deputy judge confirmed the counsel's argument that where a claim for unfair prejudice has been initiated, in addition to the derivative claim, and an offer to buy-out has been made to the claimant, a hypothetical director would be less likely to agree with the continuance of the derivative claim.²⁷⁵ Also, in *Kleanthous v Paphitis*,²⁷⁶ the court used the fact that the shareholder had initiated a claim under section 994 proceedings as a ground to refuse permission. The possibility of pursuing corporate wrongs under the unfair prejudice conduct petition²⁷⁷ has caused long debate among academics and practitioners as to whether this mechanism can overtake the role of the derivative claim.²⁷⁸ One suggestion could be that the scope of remedies available under the unfair prejudice claim has made it an attractive remedial mechanism for shareholders in the UK. Reisberg argues that the flexibility of remedies under the unfair prejudice claim in comparison to the derivative claim, also the blurred interaction between the unfair prejudice conduct and the derivative claim have cast

²⁷⁴ *Franbar Holdings* [2008] EWHC 1534 (Ch); [2008] BCC 885 [30]

²⁷⁵ *ibid* [37]

²⁷⁶ *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch) 80

²⁷⁷ Companies Act 2006 s 996(2)

²⁷⁸ Rita Cheung, 'Corporate wrongs litigated in the context of unfair prejudice claims: reforming the unfair prejudice remedy for the redress of corporate wrongs' (2009) 29(4) *Company Lawyer* 29; Brenda Hannigan, 'Drawing boundaries between derivative claims and unfairly prejudicial petitions' (2009) 6 *Journal of Business Law* 606-626; Andrew Keay, 'Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006' 16(1) *Journal of Corporate Law Studies* 39-68; Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Application* (Oxford University Press 2009)

an uneasy shadow, which in return affects the viability of derivative actions.²⁷⁹ In particular, unlike the derivative claim, shareholders do not need to make an application for leave and go through a difficult two-staged leave procedure to bring an unfair prejudice petition. However, the question which emerges is while these two mechanisms are different in nature (the unfair prejudice claim is a personal remedy for shareholders and the derivative claim is a mechanism to redress the company's wrong), why does the Companies Act allow the possibility of initiating a claim on behalf of the company in connection with unfair prejudice proceedings? The obvious reason could be that the regulator has considered shareholders as the ultimate beneficiaries of both claims. Therefore, they could choose either of sections 260 or 996(1). Nonetheless, such a consideration is problematic because the derivative claim is a claim on behalf of the company and the company does not belong to shareholders. Therefore, a shareholder's personal claim could not take the role of a claim which belongs to the company as separate legal personality from its shareholders. To discuss this issue further this section is going to explore the remedies available under the unfair prejudice claim, and will review the judicial and the academic approaches to the issue of corporate wrongs litigated in the context of unfair prejudice claims.

3.2.1.1 What is unfair prejudice conduct?

An unfair prejudice petition is a personal remedy for shareholders. The remedy has been initially designed to redress the shareholders when the company affairs

²⁷⁹Arad Reisberg ibid 274

are being or have been conducted in a manner which is unfairly prejudicial to the interests of members generally, or some part of its members or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.²⁸⁰

Under the Companies Act 2006, the claimant in an unfair prejudice claim normally seeks a personal relief. However, section 996 also provides the ground for shareholders to pursue relief for the company in the context of the unfair prejudice claim. Section 996(1) provides as follows: ‘If the court is satisfied that a petition under this Part is well founded, it may make such order as it thinks fit for giving relief in respect of the matters complained of’. Section 996(2) provides a broad range of remedies including authorising the claimant to bring a civil proceeding in the name and on behalf of the company by such person or persons and on such terms as the court may direct.²⁸¹

The possibility of pursuing the wrongs to the company under section 996, along with the wording of section 261(2)(b) which states that a derivative claim could be brought either under the derivative claim provisions or under section 996 (c), has created the assumption that the unfair prejudice claim could be an alternative remedy to the derivative claim. The legislator’s failure in clarifying the circumstances that corporate wrongs should be litigated in the context of an unfair prejudice claim by shareholders also reinforces this allegation. To add these ambiguities, section 263(f) requires the court, in permission hearings for a

²⁸⁰ Companies Act 2006 s 94(1) and 995(2)

²⁸¹ Companies Act 2006 s 996(2)(c)

derivative litigation, to consider whether the action which is the subject of the derivative claim could be pursued by the member in his or her own right.

The statutory ambiguity in the interaction between the derivative claim and the unfair prejudice claim has caused different judicial approaches toward the remedies available under the unfair prejudice claim, which as a result has created confusion for the shareholders as well. I review the courts approach to the company's claim in the context of unfair prejudice conduct to better illustrate this confusion.

3.2.1.2 Judicial approaches toward the issue of corporate wrongs litigated in the context of unfair prejudice claims

The flexibility of remedies under the unfair prejudice claim has caused the courts to have different and sometimes contradictory interpretations of section 996 of the Companies Act 2006. Some courts have shown their support in using the unfair prejudice provisions to redress the corporate wrongs for breaches of directors' fiduciary duties. In *Re Saul D Harrison*,²⁸² Judge Hoffmann ruled that: 'enabling the court in an appropriate case to outflank the rule in *Foss v Harbottle* was one of the purposes of section 459 (now section 994)'. Some later English courts showed more support for the issue of the company being reimbursed in the context of the unfair prejudice claim. In *Anderson v Hogg*,²⁸³ *Bhullar v Bhullar*,²⁸⁴ *Clark v Cutland*,²⁸⁵ *Re Brightview Ltd*,²⁸⁶ *Franbar Holdings*,²⁸⁷ *Iesini*,²⁸⁸ *Kleanthous v Paphitis*²⁸⁹ and *Gamlestaden Fastigheter AB v Baltic Partners Ltd*²⁹⁰ the courts ruled that the unfair prejudice remedy could substantially substitute the derivative claim. In *Re Saul D Harrison & Sons plc*,²⁹¹ the court held that allowing the court in an appropriate case to outflank the rule in *Foss v Harbottle* was one of the purposes of CA 2006 section 994.

²⁸² *Saul D Harrison* [1995] 1 B.C.L.C. 14 18

²⁸³ *Anderson v Hogg* [2002] B.C.C. 923

²⁸⁴ *Bhullar v Bhullar* [2003] EWCA Civ 424

²⁸⁵ *Clark v Cutland* [2003] EWCA 810

²⁸⁶ *Re Brightview Ltd* [2004] 2 B.C.L.C. 191

²⁸⁷ *Franbar Holdings* [2008] EWHC 1534 (Ch); [2008] BCC 885 [30]

²⁸⁸ *Iesini* [2009] EWHC 2526; [2010] BCC 420 [86]

²⁸⁹ *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch) [81]

²⁹⁰ *Gamlestaden Fastigheter AB v Baltic Partners Ltd* [2007] UKPC 26, [2007] Bus LR 1521

²⁹¹ *Re Saul D Harrison & Sons plc* [1994] BCC 475

In *Kleanthous v Paphitis*, the court came to the conclusion that the applicant had brought the derivative claim only to obtain the benefit of a costs indemnity order and in that case the section 994 claim where the shareholder should bear his own costs was more appropriate.²⁹² Nevertheless, despite the mentioned judicial support for compensating the company under the unfair prejudice claim, still some courts have been either cautious or reluctant in using the unfair prejudice petitions for wrongs, which happened to the company. In *Re Charnley Davies Ltd (No.2)*,²⁹³ Millett J made it clear that the distinction between “misconduct” and “unfairly prejudicial management” does not lie in the particular acts or omissions of which complaint is made, but in the nature of the complaint and the remedy necessary to meet it. He acknowledged that there may be more than one legal dimension to the same set of facts and came to the conclusion that if the essence of the complaint was not of mismanagement of the company but was directors’ breaches of fiduciary duty by or other misconduct actionable by the company, in such a case a derivative claim rather than unfair prejudice action should be the appropriate means for relief.²⁹⁴ In *Lowe v Fahley*²⁹⁵ the court held that where a breach of directors’ fiduciary duties involves a loss to the company, such as a diversion of company funds, the petitioner is entitled as a matter of jurisdiction to seek repayment by the wrongdoers to the company through a derivative claim.²⁹⁶ In

²⁹² *ibid* [81]

²⁹³ *Re Charnley Davies Ltd (No.2)* [1990] B.C.L.C. 760

²⁹⁴ *ibid* 783

²⁹⁵ *Lowe v Fahley* [1996] 1 B.C.L.C. 262)

²⁹⁶ *ibid* 268

*Wishart*²⁹⁷ the court did not consider it to be grounds for refusing permission because proceedings under s.994 would constitute an indirect means of achieving what could be achieved directly through the use of a derivative claim.

In other cases like *Kiani v Cooper*,²⁹⁸ *Ritchie v Union of Construction, Allied Trades and Technicians*,²⁹⁹ *Parry v Bartlett*,³⁰⁰ and *Stainer v Lee*³⁰¹ the courts did not consider the availability of the unfair prejudice claim as a ground for rejecting the derivative claim. One important relevant issue with regard to litigating company wrongs in the context of the unfair prejudice claim is the reflective loss principle and its role in preventing unjust enrichment by shareholders. The reflective loss rule, which was established under the *Prudential Assurance Co Ltd v Newman Industries Ltd (No2)*³⁰² is based on the need to avoid double recovery for shareholders.

In *Johnson v Gore Wood Lord*,³⁰³ Lord Bingham summarised the reflective loss principle as follows: ‘(1) Where a company suffers loss caused by a breach of duty owed to it, only the company may sue in respect of that loss. No action lies at the suit of a shareholder suing in that capacity and no other to make good a diminution in the value of the shareholder's shareholding where that merely reflects the loss suffered by the company. (2) Where a company suffers loss but has no cause of action to sue to recover that loss, the shareholder in the company may sue in

²⁹⁷ *Wishart* [2009] CSIH 65; [2009] SLT 812 [46]

²⁹⁸ *Kiani v Cooper* [2010] EWHC 577 (Ch); [2010] BCC 463

²⁹⁹ *Ritchie v Union of Construction, Allied Trades and Technicians* [2011] EWHC 3613 (Ch)

³⁰⁰ *Parry v Bartlett* [2011] EWHC 3146 (Ch) [88]–[92]

³⁰¹ *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] BCC 134 [52]

³⁰² *Prudential Assurance Co Ltd v Newman Industries Ltd (No2)* [1982] 1 All E.R.354 366-367

³⁰³ *Johnson v Gore Wood Lord* [2001] 1 B.C.L.C. 313

respect of it. (3) Where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss separate and distinct from that suffered by the company caused by breach of a duty independently owed to the shareholder, each may sue to recover the loss caused to it by breach of the duty owed to it but neither may recover loss caused to the other by breach of the duty owed to that other.’ One of the issues, which the court dealt with in this case, was ensuring that the company's creditors are not prejudiced by the action of individual shareholders and ensuring that a party does not recover compensation for a loss, which another party has suffered. Lord Bingham clearly ruled “a shareholder cannot sue to make good a loss which would be made good if the company's assets would be replenished through action against the party responsible for the loss, even if the company has declined or failed to make good that loss.”³⁰⁴

However, some other English courts have taken different approaches toward the applicability of the reflective loss principle in unfair prejudice claims.

The Court of Appeal in *Clark v Cutland*³⁰⁵ considered the unfair prejudice petition as if it was a derivative claim. In this case Lady Justice Arden held that the breadth of the discretion of the court in unfair prejudice proceedings would have enabled the court to grant the same relief as would have been granted in a derivative claim. Also without specifying any reason, she ruled that the reflective

³⁰⁴ *ibid* 337f-338b per Lord Bingham

³⁰⁵ *Clark v Cutland* [2003] 2 B.C.L.C. 393

loss principle is not applicable in the context of unfair prejudice claims. Her judgment is considered to have established a new trend in company law.³⁰⁶

Later in *Re Brightview Ltd*,³⁰⁷ the *Clare v Cutland*³⁰⁸ judgment was confirmed when Judge Jonathan Crow took a similar approach in ordering corporate relief under unfair prejudice litigation. In this case the court rejected the reflective loss principle as having any application in the context of unfair prejudice claims. However, just like the court in *Clare v Cutland*, Judge Crow did not provide a substantial and clear reasoning for his decision.

This thesis argues that such concern is rational. The allegation that the reflective loss principle does not apply to the unfair prejudice claim would bring the corporate separate personality principle, which was established under *Foss v Harbottle*, into question. Corporate separate personality is the fact stated by the law that a company is recognised as a legal entity distinct from its members. Therefore, when a company suffers loss due to a wrongful act happening against it, it should be only the company that should initiate the claim against the wrongdoers. On the other hand, the reflective loss principle rules that in such a situation the loss that the shareholder suffers is only reflective of the harm to the company (for example, where the value of their shares or dividends decreases). Thus, a shareholder cannot sue to recover damages for themselves in relation to wrongs done to the company and the company's claim should take precedence over the shareholder's personal claim. Revoking the reflective loss principle in

³⁰⁶ Rita Cheung [n 278] 4

³⁰⁷ *ibid* n 287

³⁰⁸ *ibid* n 286

unfair prejudice claims and permitting shareholders to both recover from the harm, which have happened to the company, plus receiving compensation for their personal harm would create double recovery, which would unfairly enrich the shareholders. It would also be unfair to the other stakeholders as the derivative claim applicant, in the context of this thesis the employees, because they would not have the equal right to initiate a derivative claim on behalf of the company both under the statutory derivative claim and the unfair prejudice claim. Moreover, if we allow the reflective loss principle to still apply to unfair prejudice claims, it would mean that shareholders should choose to either request an order to compensate the company's harm (under section 996(c) or apply to receive a recovery for their personal harm, in situations that both harm to the personal interest and the company has arisen from one cause of action. Since the unfair prejudice claim is essentially a personal claim, there would be a great possibility that shareholders prefer their personal harm to be compensated particularly in the form of a buy-out order in private companies.³⁰⁹ Even if shareholders decide to seek a corporate relief for misconduct by directors under an unfair prejudice claim, it would still be a challenging issue because the court should scrutinise the request to decide whether the cause of action is a matter for a derivative litigation or for a claim under section 996(2)(c). If the court recognises the claim should be litigated in the context of the derivative claim, then the petition should be struck out.

³⁰⁹ Companies Act 2006 s 996(2)(e)

Considering that recompensing the company in the context of an unfair prejudice claim requires applicants to initiate two separate applications and going through an extremely expensive procedure, the possibility that the company would be reimbursed under an unfair prejudice claim is likely to be small. Unless, that is, the court itself decides to order for the company to be remunerated along with the personal remedies to shareholders. Based on these arguments, the unfair prejudice claim cannot be considered a substitute to derivative litigation to compensate for the wrongs to the company, unless the cause of action gives rise to common grounds for both an unfair prejudice claim and corporate misconduct and it is not clear what role the reflective loss principle should play in such situations. Hence, reverting to the argument at the beginning of this section, the legislator ought to clarify the boundaries and the extent of the unfair prejudice remedy and the derivative claim and solve the ambiguities on this matter for the courts.

3.2.1.3 Academic debates on whether the use of the unfair prejudice claim would overtake the role of the statutory derivative claim

Just like the courts, academic scholars have also given different opinions on the issue of corporate remedies in the context of the unfair prejudice claim.

Some scholars such as Payne suggest that the unfair prejudice petition effectively overtakes derivative claims.³¹⁰ However, others like Haniggan have a different idea. She believes that cases like *Clare v Cutland* and *Gamlestaden Fastigheter AB v Baltic Partners Ltd* are limited in reality and even argues that they were fundamentally classic derivative claims, not unfair prejudice petitions.³¹¹ She argues that courts should be ‘very cautious about allowing corporate relief to be sought and granted on an unfair prejudice petition.’³¹² Some scholars³¹³ argue that both derivative claims and unfair prejudice claims should be combined into a single provision, which covers all forms of shareholders’ claims on behalf of the company.³¹⁴ The argument is that it would solve the procedural differences between the derivative claim and the unfair prejudice claim.³¹⁵ Additionally, a single, wide scope provision would solve the debates regarding the dual or simultaneous claims and the reflective loss principle under the unfair prejudice

³¹⁰ Jennifer Payne, ‘Sections 459–461 Companies Act 1985 in Flux: The Future of Shareholder Protection’ (2005) 64(3) *The Cambridge Law Journal* 647-677

³¹¹ Brenda Hannigan [n 278] 606-626

³¹² *ibid* 626

³¹³ Arad Reisberg [n 278] 278-279

³¹⁴ Christopher Hale, ‘What's Right with the Rule in *Foss v Harbottle*’ (1997) 1 *Company Financial And Insolvency Law Review* 219-226

³¹⁵ Sarah Watkins, ‘The Common Law Derivative Action: An Outmoded Relic’ (1999) 30 *Cambrian L. Rev* 40

claim.³¹⁶ In the view of thesis and considering corporate separate personality, such arguments are not correct because the remedy which belongs to the company could not be combined with a personal remedy for shareholders. In addition to that, the English Law Commission in the Consultation Paper has clearly rejected the option of channelling the derivative claim into section 459 (now section 994). The Law Commission brings some good reasons such that: “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”.³¹⁷ In addition, it reasons that “there may be circumstances where a derivative action can be brought but unfair prejudice proceedings cannot. A breach by a director of his duty of skill and care involves a wrong to his company but it will not amount to unfairly prejudicial conduct unless there is serious mismanagement. An applicant under section 459 (section 994) may be able to obtain an order under section 461(2)(c) now section 996(2)(c) if he can show that the company’s failure to sue the director is unfairly prejudicial conduct”. However, the consideration was that an applicant should not have to expend time and money in going through two sets of proceedings where, if a derivative action exists, only one is required.³¹⁸

³¹⁶ *ibid*

³¹⁷ The Law Commission consultation paper no.142 on shareholder remedies, paras 16.4, 16.2(i) and 16.2(ii)

³¹⁸ *ibid* para 16.4(iii)

3.2.1.4 The unfair prejudice claim is not an ultimate substitute to the derivative claim

Considering the academic discussion and the courts' approaches toward the issue of corporate relief under the unfair prejudice claim, for the reasons given below this research argues that the unfair prejudice claim should not be considered as an alternative to derivative litigation.

First, although the Jenkins Committee, whose report recommended the introduction of the statutory unfair prejudice remedy, envisaged that it would have a role in relation to wrongs done to the company,³¹⁹ the legislator never intended to replace the derivative claim with the unfair prejudice remedy. In fact, the unfair prejudice claim was initially established to give the courts more flexibility and was aimed to be an alternative to the just and equitable winding up remedy to avoid the drastic consequences of a winding up order.³²⁰ To cut the costs and length of unfair prejudice petitions, the Law Commission recommended 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 996 of the Companies Act 2006, and accordingly this will shift some of the burden from the unfair prejudice remedy.³²¹ Hence, the Law Commission considered that two distinct remedies should be preserved. The argument is that the unfair prejudice petition has largely been seen as a remedy for exiting the company

³¹⁹ The Company Law Committee Report (Cmnd 1749) (1962) para 206

³²⁰ Law Commission Shareholder Remedies (Consultation Paper No 142, 1996) para 7.5

³²¹ *ibid*

because the common order under section 996 is that the respondent purchases the shares of the petitioner.³²²

Second, in order for the company to be compensated under the unfair prejudice claim, the shareholder should initiate a new claim in the company's name, in addition to the one that has already been sought for the personal relief. Considering these two sets of proceedings, the costs and the amount of time that the complainer would be required to commit would be much more than using a derivative claim application. Moreover, the role of the 'reflective loss principle' is to distinguish between the company remedy and the shareholders personal remedies, and prevent shareholders from recovering both in relation to the harm to the company and personal harm at the same time. Therefore under an unfair prejudice claim shareholders should decide to whether sue directors for the personal harms or the harms to the company. There is no guarantee that shareholders prefer the company remedy to their personal remedies under the unfair prejudice conduct if they would have to choose.

Third, directors owe their fiduciary duties to the company, not shareholders,³²³ therefore, normally, breaches of fiduciary duty by directors should be litigated on behalf of the company as a separate legal personality from its shareholders and through a derivative claim. The nature of the two remedies is different in essence. The unfair prejudice claim is essentially a personal claim, which should be initiated in a situation that the company's affairs have been conducted in a manner

³²² *ibid*

³²³ Companies Act 2006 s 170(1)

which is unfairly prejudicial to the interests of members. In contrast, the derivative claim is litigation on behalf of the company as separate personality from its shareholders, which should only be brought under sections 260-264 of the Companies Act 2006 in the exceptional situations that the company is harmed by the wrongdoers opportunistic behaviour or mismanagement or negligence, and where the board of directors refuses to pursue the wrong conduct. Considering all the procedural restrictions that the legislator has established in the way of a derivative litigation to protect the company by preventing vexatious claims, it would not be rational to assume that the unfair prejudice claim has been designed for the shareholder to avoid the procedural hurdles of a derivative litigation and compensate the company's loss. With unfair prejudice petitions there is no judicial control and scrutiny. While the permission hearing process in derivative litigation has its flaws, still it has a vital role in controlling unmeritorious claims and the claims relevant to the company should be filtered through that control.

Given all these arguments, in the view of thesis, the unfair prejudice claim could not be an alternative to the derivative claim. Even if the unfair prejudice conduct is supposed to compensate the company's harm through the shareholders as the applicant in some circumstances, the Government should clarify what those circumstances are. It should be clarified that how those circumstances differ from the grounds under section 261 and whether employees as the derivative claim applicant could have similar opportunity.

3.2.2 *Ex ante* protection through shareholder agreements

In addition to the unfair prejudice claim, another method of protection in private companies is the shareholder agreement. Shareholder agreements govern the relations among shareholders in private companies. In fact, shareholder remedies in the context of shareholder agreements have created a new angle on the issue of shareholder remedies. Through these agreements, shareholders can potentially anticipate how the company would be managed and how conflicts would be resolved in the future. Minority shareholders can try to protect themselves against abuses of majority shareholders by bargaining for suitable protections in the articles of association or in separate shareholder agreements.³²⁴ Therefore, like the other mechanisms, shareholder agreements could in fact work as a mechanism of protection for shareholder personal interests in the company, not necessarily for the company as whole.

The most important benefit of the shareholder agreement for minority shareholders is that, unlike the company articles, these agreements cannot be changed by the majority shareholder power through a special resolution. Changing the terms of shareholder agreements needs the approval of all the parties to the agreement. Hence, minority shareholders in private companies, in addition to the rights they have under the articles of association, can increase their protection from

³²⁴ Stephen Copp, 'Company Law and Alternative Dispute Resolution: An Economic Analysis' (2002) 23 *The Company Lawyer* 361-75

the abuses of controlling shareholders through the negotiation of shareholder agreements.

Within the boundaries set by general law, shareholders are free to agree whatever terms they wish in their agreements.³²⁵ For instance, they might be able to prevent disputes in these companies by agreeing in advance the ways the business will be conducted.³²⁶ Some important factors, which can be included in shareholder agreements, are: providing management information to shareholders, paying dividends and dispute resolution procedure. The question is whether these agreements could protect private companies from the majority shareholders' harm and if so to what extent?

3.2.2.1 The limitations on shareholder agreements

Although shareholder agreements could play an important role in protecting minority shareholders' personal interests in private companies, nevertheless there are some restrictions on these agreements, which could prevent their absolute utility. The first problem is that the validity of these agreements depends on whether all shareholders in the company have agreed to the agreement or not.

If all shareholders are parties to the agreement, it might be effective. If, however, less than all of the shareholders are parties to the agreement, then its validity could be endangered depending on which goals it aims to attain. For

³²⁵ Muhammed Asim Iqba, 'The effectiveness of shareholder dispute resolution in private companies under UK companies legislation: an evaluation' (Doctoral dissertation, Nottingham Trent University 2008)

³²⁶ Elizabeth Jane Boros, *Minority shareholders' remedies* (Clarendon Press 1995); Sean FitzGerald and Graham Muth, *Shareholders' Agreements* (Sweet & Maxwell 2012)

example, the agreement could be vulnerable to attack by other minority shareholders if it attempts to change the current policy in the company in the form of electing or removing directors, and those other shareholders who are not parties to the agreement are opposed to this change. The other restriction is that the agreement provisions might have been drafted in a way that serve the personal interests of individual shareholders rather than considering the best interests of the company, so such agreements would not be effective in protecting the company as a whole against the wrongdoers.

The third problem is that, like any other contract, these agreements have a limited nature; hence, in practice it would be impossible that the drafters of the agreement would be able to foresee all the potential problems in their relationship with the directors, or predict all the possible future misconducts of the majority shareholders. Lastly, the agreement's provision is not effective without an enforcement mechanism. This depends on what has been defined in the shareholders agreement, and could be through the courts or through arbitration. However, in most situations, disputes in connection with shareholder agreements go beyond contractual disputes under the shareholders' agreement and happen in the form of the more traditional company law shareholders' remedies such as unfair prejudice claim, winding up or derivative claims.³²⁷

Over all, shareholder agreements are a valuable instrument to preserve the interests of shareholders and even the company might be protected to some extent

³²⁷ *ibid* 27

against the majority shareholders' opportunistic behaviour through these agreements. However, based on the mentioned shortcomings, these agreements could not prevent the misconduct of majority shareholders to the company in all situations. Therefore, the derivative claim is still the main means of protection for the company itself in private companies.

3.3 Mechanisms of accountability in public companies

Although under the Companies Act 2006, statutory derivative claim provisions apply equally to shareholders in private and public companies, a common assumption in the English legal system is that the derivative claim is a remedy for shareholders in private companies. One common argument is that shareholders in public companies do not need to refer to derivative claims, because the combination of several *ex ante* mechanisms provide potent protection for shareholders to the extent that shareholders do not need to refer to litigation mechanisms to be protected. These mechanisms are the shareholders' corporate rights, which have been supplemented by the mandatory disclosure requirements for directors, the market for corporate control, the role of non-executive directors and institutional shareholders and, finally, public authorities. Scholars have brought the low incidence of derivative claims in public companies as evidence for their argument.³²⁸ As was discussed in the introduction, the main critique to these arguments is that the derivative claim is not a remedy for shareholders. It is mechanism for protection of the company. The *ax ante* mechanisms of corporate governance are the mechanisms which are used mainly by institutional shareholders to protect their personal interests in the company. Institutional shareholder might not always be concerned about the long-term protection of the company for the interests of all. The derivative claim could work as a complementary mechanism to enhance the protection

³²⁸ Christopher Bruner, *Corporate governance in the common-law world: The political foundations of shareholder power* (Cambridge University Press 2013); John Armour et al., 'Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US' (2009) 6 *Journal of Empirical Legal Studies* 687-722; Luca Enriques, 'The law on company directors' self-dealing: A comparative analysis' (2000) 2(3) *International and Comparative Corporate Law Journal*

of the company as a whole in situations that the other mechanisms of corporate governance fail to do so. To illustrate the limitations of the *ex ante* mechanisms in protection of the company as whole, this section reviews the function of these mechanisms in detail.

3.3.1 Shareholders' rights and power

Under company law, the main protecting mechanism for UK shareholders' interests is shareholders' corporate rights. The argument is that British shareholders, specifically in public companies, have considerable power to define the rules of corporate governance. In fact, UK corporate governance in essence has been established on the basis of shareholder governance authority.³²⁹ Shareholders have a veto right over a range of potentially problematic transactions, such as managerial services contracts of greater than two years in duration, substantial property transactions between a director and his company, loans and remuneration to directors, amongst others.³³⁰ Additionally, shareholder approval is essential for conflicts of interest transactions and it is compulsory for particularly substantial property transactions.³³¹ Shareholders have the right to have a copy of the company annual accounts³³² as well as voting on directors' remuneration.³³³

³²⁹ Bruner *ibid* 29

³³⁰ Companies Act 2006 ss 188, 190, 197, 366

³³¹ *ibid* ss 90-196

³³² *ibid* s 431

³³³ *ibid* ss 281-361

Moreover, shareholders have a very direct power over the company governance arrangements. For instance, they can by special resolution of 75 percent majority amend the articles of association.³³⁴ They may also by special resolution require the directors to take particular action or stop them from carrying out certain transactions.³³⁵ Furthermore, the Companies Act 2006 gives great power to shareholders to define the structure of the board of directors. Shareholders with five percent voting power can demand a meeting at any time, at which by ordinary resolution of a simple majority a director can be removed without any cause. However, it should be noted that the director 'is entitled to be heard on the resolution at the meeting'.³³⁶ The Companies Act 2006 provides shareholders with the right to approve secondary share offerings by ordinary resolution (for example 50 per cent of voting shares) and in any event they have statutory pre-emption rights on all secondary share offerings for cash, although they can approve the disapplication of these pre-emption rights by special resolution (for example 75 per cent of voting shares). Bruner considers the contractual nature of UK corporations as a reason for the highly important role of shareholders in UK corporate governance.³³⁷ He refers to section 33 of the Companies Act 2006 which provides that the company, or more precisely its constitution, is to be treated as a contract.³³⁸ Consequently, the board's power in a UK company has been passed on

³³⁴ Companies Act 2006 s 17 and 18

³³⁵ Companies (Model Articles) Regulations 2008, S.I.2008/3229, sched. 3 (art. 4(1))

³³⁶ Companies Act 2006 ss 168–69, 282, 303 & 304

³³⁷ Bruner [n 328]

³³⁸ Companies Act 2006 Section 33(1) provides that: 'the provisions of a company's constitution bind the company and its members to the same extent as if there were covenants on the part of the

to them by the shareholders, in the manner of a contractual delegation through the articles of association, and shareholders can unilaterally determine the terms of this contract. John Armour also argues that the power shareholders have over key decisions in the company likely serve as a substitute for formal civil enforcement in the United Kingdom. He argues that governance rights can reduce managerial agency costs by giving shareholders the power to remove directors who do not act in shareholders' interests, as well as *ex ante* decision rights for transactions that could harm shareholders' interests.³³⁹ Paul Davis argues that the power of shareholders to remove directors gives the directors the message that 'if you choose not to follow our views, we will by ordinary majority seek to remove you from office'. He argues shareholders' removal power can be a strong inducement for directors to obey the shareholders' wishes.³⁴⁰

In practice, however, there are several limitations on these corporate rights.

3.3.2 Shareholder voting right limitations

Considering all the arguments in favour of shareholders' rights and power under the UK corporate governance, the question which emerges is to what extent shareholders' voting rights are effective in preventing directors from self-serving

company and of each member to observe those provisions,' and 33(2) states that 'Money payable by a member to the company under its constitution is a debt due from him to the company'. In England, Wales and Northern Ireland it is of the nature of an ordinary contract debt.

³³⁹ John Armour [n 328] 718

³⁴⁰ Paul Davies, *Gower and Davies, Principles of Modern Company Law* (Sweet & Maxwell 2008)

opportunistic behaviours which could result in misappropriation of company assets and damage to the company?

Although shareholders under the law have strong power in holding directors accountable to the company, in practice there are several limitations. For instance, in applying their voting rights, shareholders must first know in detail about the company's affairs. In order to consider the proper course of action, which could include the veto of a potential harmful transaction to the company or when the harm is done to remove directors through a resolution, shareholders must first learn about the directors' mismanagement or misconduct. Nevertheless, with public companies, because of the separation of ownership and control, shares are very widely dispersed and minority shareholders may not even be aware of the directors' mismanagement or wrongful conduct to prevent it. Also, to be aware of the details of the company management and to vote logically, shareholders are required to devote a reasonable amount of time to becoming familiar with the company's activities, which in practice may not always happen for shareholders in public companies. One reason for this could be that voting is not mandatory and many shareholders who do not own a substantial amount of shares may be reluctant to participate in general meetings and vote. Attending a meeting in person could be expensive especially if the shareholder is living in another city or even another country. Even if they attend the meeting, another difficulty for minority shareholders is being able to get sufficient numbers at the meeting to pass a resolution, stop a transaction or remove directors, for example. Thus, shareholders

might have few incentives to participate in general meetings and vote. Even in situations in which shareholders' participation has been facilitated by electronic means of voting, they might not exercise their right. This phenomenon is known as 'rational apathy' among academics.³⁴¹ They argue that as the result of the dispersed capital market in the UK and the cost of becoming aware of the company issues, many minority shareholders choose to become rationally apathetic. They do not take the time to consider particular proposals and instead prefer to agree with directors without giving serious consideration to the issue.³⁴² Rational apathy is not only common for individual shareholders but also among many institutional shareholders as well. The other issue that may prevent shareholders from taking part in voting is the lack of collective action. Under the collective action theory, shareholders will not make motivated proposals or keenly stand against directors' proposals unless the potential gains are much larger than the cost of the effort. In public companies, since share ownership is dispersed among a large number of institutional and individual shareholders, the likelihood of collective action is low.³⁴³

Based on the arguments given above, at least in terms of minority shareholders, voting in public companies may not be an absolute barrier in the way of directors'

³⁴¹ David Kershaw, *Company law in context: Text and materials* (Oxford University Press 2012) 220; Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Application* (Oxford University Press 2007) 25

³⁴² Robert Goddard, 'Convergence in Shareholder Law—By Mathias Siems' (2009) 29(2) *Legal Studies* 338-341, 320

³⁴³ Brian Cheffins, 'Minority Shareholders and Corporate Governance' (2000) 21 *Company Lawyer* 238-41; Ian Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 *University of New South Wales Law Journal* 149, 153; Hans Hirt, *The Enforcement of Directors' Duties in Britain and Germany, A Comparative Study with Particular Reference to Large Companies* (Verlag Peter Lang 2004) 42; Arad Reisberg [n 341] 26

opportunistic conduct in all situations. Therefore, it should be seen how much institutional shareholders could be effective in preventing the harm to the company.

3.3.3 The UK corporate governance comply-or-explain principle and the significant role of institutional shareholders under the law

The comply-or-explain principle is a regulatory approach within UK corporate governance which provides that public listed companies should either comply with the principles of corporate governance in the UK or if they do not comply, explain publicly why they do not.³⁴⁴ This idea in corporate governance was introduced in the UK in 1992 through a report by the Committee on the Financial Aspects of Corporate Governance chaired by Sir Adrian Cadbury.³⁴⁵

The main reason behind the establishment of the Cadbury Committee was several corporate scandals which had occurred in several high profile companies during the 1980s. These scandals demonstrated the need for a higher standard of controlling companies' affairs in the UK.³⁴⁶ The outcome of the Cadbury Committee was the introduction of several recommendations in a Code which became famous as the "Cadbury Code" and which laid the ground for a series of changes in the corporate governance field.³⁴⁷

³⁴⁴ Financial Reporting Council, *What constitutes an explanation under comply-or-explain? Report of discussions between companies and investors* (February 2012) < <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/What-constitutes-an-explanation-under-comply-or-ex.pdf> (assessed 13/5/2017)

³⁴⁵ Adrian Cadbury, 'Report of the Committee on the Financial Aspects of Corporate Governance' (December 1992) < <http://www.ecgi.org/codes/documents/cadbury.pdf> (accessed 6 May 2017)

³⁴⁶ George Hadjikyprianou, 'The Principle of 'Comply-or-explain' Underpinning the UK Corporate Governance Regulation: Is There a Need for a Change?' (2015) 7 *Corporate Governance Law Journal* 4; Ruud Van Frederikslust et al. (eds), *Corporate Governance and Corporate Finance: A European Perspective* (Routledge 2008) 227

³⁴⁷ Sridhar Arcot, Valentina Bruno and Antoine Faure-Grimaud, 'Corporate Governance in the UK:

The Cadbury Committee declared that its most important outcome was that companies are permitted to not comply with the provisions listed in the Cadbury Code as long as they explain in their annual director's report the reasons for the non-compliance.³⁴⁸ The established principle is known as the comply-or-explain principle nowadays. The aim of this principle is to provide market-based solutions between companies and their shareholders without the need for judiciary intervention. The argument is that the disclosure of companies' information on their governance system provides substance for shareholders to make informed and sophisticated decisions. On the other hand, the flexibility under the principle allows the diversity of companies' boards to be taken into account.³⁴⁹ Nevertheless, despite its advantages, still there are some critiques to the implementation of the comply-or-explain principle.³⁵⁰ Overall, these critiques are based on two grounds: (1) insufficiency of shareholders engagement in controlling the companies' compliance, and (2) inadequacy of companies' explanations for their non-compliance.³⁵¹ As for the inadequacy of the explanations, there are some indications of cases in which companies either fail to provide any explanations for

Is the "Comply-or-explain" Approach Working? (2010) <
<http://www.lse.ac.uk/fmg/researchprogrammes/corporatefinance/corporategovernance/pdf/isthecomplyorexplainapproachworking.pdf> (visited 20/5/2017)

³⁴⁸ Cadbury [n 345]; also Hadjikyprianou [n 346]

³⁴⁹ Konstantinos Sergakis, 'Deconstruction and reconstruction of the "comply-or-explain" principle in EU capital markets' (2015) 5(3) Accounting, Economics and Law 240

³⁵⁰ David Seidl, Paul Sanders and John Roberts, 'Applying the comply-or-explain principle: discursive legitimacy tactics with regard to codes of corporate governance' (2013) 17(3) Journal of management & governance 791-826; Andrew Keay, 'Comply-or-explain in corporate governance codes: in need of greater regulatory oversight?' (2014) 34(2) Legal Studies 279-304

³⁵¹ Hadjikyprianou [n 346]

their non-compliance³⁵² or their explanations have been characterised as uninformative³⁵³ and vague,³⁵⁴ or perfunctory³⁵⁵ or boilerplate.³⁵⁶ The problem with the comply-or-explain principle is that there is no guidance on how directors comply with the corporate governance principles or how companies should explain the reasons for non-compliance. Hence, it is completely at the discretion of the board of directors. Giving an absolute discretion to the board to define how to explain non-compliance would bring the accountability of the board into question. In terms of shareholder control of the directors' report, the reasons for lack of such control by minority shareholders have been discussed above. Therefore, only majority shareholders, in particular when they work collectively could control directors' conduct in the company and prevent their opportunistic behaviour. That is the reason why institutional shareholders have been encouraged by the corporate governance code to consider their obligations seriously. In fact, largely the effectiveness of the comply-or-explain principle has relied on the stewardship of institutional shareholders. In July 2010, the Financial Reporting Council ratified the UK Stewardship Code with the aim of improving the quality of engagement between institutional shareholders and companies to help improve long-term

³⁵² *ibid*; also Sridhar Arcot and Valentina Bruno, 'In Letter but not in Spirit: An Analysis of Corporate Governance in the UK' (2006) <
<http://www.lse.ac.uk/fmg/research/RICAFE/pdf/RICAFE2-WP31-Arcot.pdf> (visited 26/3/2017)

³⁵³ Sridhar Arcot and Valentina Bruno *ibid*

³⁵⁴ Sridhar Arcot, Valentina Bruno and Antoine Faure-Grimaud, 'Corporate governance in the UK: Is the comply-or-explain approach working?' (2010) 30(2) *International Review of Law and Economics* 196-197

³⁵⁵ Marc Moore, 'Whispering Sweet Nothings: The Limitations of Informal Conformance in UK Corporate Governance' (2009) 9(1) *Journal of Corporate Law Studies* 125-129

³⁵⁶ *ibid*

returns to shareholders, and the efficient exercise of governance responsibility.³⁵⁷

The Stewardship Code was the successor to the good practice guidelines, which were published by the Institutional Shareholders' Committee in 2002. Under the Code, institutions have duties such as publicly disclosing their policy on how they will discharge their stewardship responsibilities and monitor their investee companies. Also, they should have a clear policy on voting and disclosure of voting activity.³⁵⁸ In addition to current responsibilities, under the new corporate governance reforms, the UK Government has put additional tasks on institutional shareholders to control the board of directors' remuneration report for the executive pay; therefore, the responsibility of institutional shareholders in monitoring and controlling the board's conduct have been increased. However, although institutional shareholders are considered to be an important corporate governance pillar for the implementation of the comply-or-explain principle, there are strong debates on whether they could provide strong protection for the company.

3.3.4 Institutional shareholders in the UK may not actively and effectively protect the company

There are several reasons for why institutional shareholders may not always play an optimal role in controlling the directors' misconduct and protecting the company. An argument is that despite UK corporate governance efforts in

³⁵⁷ Derek French, Stephen Mayson and Christopher Ryan, *Mayson, French & Ryan on company law* (Oxford University Press 2017) 435

³⁵⁸ The UK Stewardship Code (2012) principles

empowering the institutional shareholders to monitor and control the company's directors, there are some factors which could preclude them from efficiently performing the role that the Stewardship Code has considered for them. For instance, due to their large portion of shareholdings, they are normally considered to be more aware of the company's affairs and more involved in the company's management in comparison to individual shareholders. However, just like individual shareholders, institutional shareholders' passivity in voting is a common phenomenon among institutional shareholders as well. UK institutional shareholders may take the 'box-ticking approach' towards their duty to monitor the company's compliance with the corporate governance code. In this practice, they consider the company's non-compliance with the corporate governance code as an instance of breach and ignore the explanation which the company may have given for the alleged non-compliance.³⁵⁹ Such an approach might be considered an incentive to companies to comply with the corporate governance principles but in fact would bring the flexibility of comply-or-explain principles into question. The approach is in fact a sign that institutional shareholders put no real effort into being engaged or evaluating company disclosures.³⁶⁰ Institutional shareholders could also be ignoring the conduct of directors by considering the financial performance of the company as a sign that directors are complying with their duties. However, the fact is that good performance by the company is not always the sign that the

³⁵⁹ Marc Moore, 'Shareholder Primacy, Labour and the Historic Ambivalence of UK Company Law' (2016) University of Cambridge Faculty of Law Research Paper No. 40/2016 < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2835990

³⁶⁰ Aidan O'Dwyer, 'Corporate Governance after the financial crisis: The role of shareholders in monitoring the activities of the board' (2014) 5 Aberdeen Student L. Rev 112

company is protected from the directors' wrong conduct. Directors could be involved in fraudulent activities or any other opportunistic conduct yet the company may still do financially well, at least in the short term. The consequence is that the institutional shareholder may not care to effectively monitor the directors' conduct and prevent harm to the company as long as the company is doing well financially for the period that they are holding shares.³⁶¹ The problem has already been discussed in the thesis before. The main problem is that there is no guarantee that institutional shareholders prefer the company's interest to their personal interest. Shareholders will not always take the responsibility for the long-term protection of the company, which is required in the Stewardship Code. They usually have short-term, profit maximising goals which is against the notion of both long-termism or good stewardship.³⁶² Institutional shareholders' main purpose in many situations is to secure a high financial return on their investments in the short term rather than the protection of their investee company's interests. Therefore, in many situations they are reluctant to be involved in corporate governance matters and costly monitoring of their investee companies simply because "they are self-interested stewards who have no specific obligation to one particular company and even if they stay with a company for a period it is because they have planned their investment on a diverse portfolio so as to spread the risk of lower performing shares".³⁶³ Additionally, institutional shareholders might put

³⁶¹ *ibid*

³⁶² Lorraine Talbot, 'Why Shareholders Shouldn't Vote: A Marxist-progressive Critique of Shareholder Empowerment' (2013) 76(5) *The Modern Law Review* 791-816, 793

³⁶³ *ibid*

directors under pressure to behave in the interests of their shareholders. Nonetheless, such control may not necessarily protect the interests of the company as a whole. Even more arguably, it may not always protect the interest of minority shareholders because their interests and those of the majority shareholders are not always in line.³⁶⁴

In 2011, the European Union Commission Green Paper³⁶⁵ raised concerns that institutional shareholders, because of their desire for short-term high return, may even be responsible for companies' risky business tactics and short-term business objectives as management are practicing risky strategies to fulfil shareholder demands. This concern has been recently reinforced by the UK Business, Energy and Industrial Strategy (BEIS) Committee which in response to the Government Green Paper for Corporate Governance reforms has referred to the considerable concerns about the quality of shareholder engagement in the evidence received by them.³⁶⁶ Hence, few institutional shareholders may focus on monitoring a particular company even though it would be on information provided by the market. These debates over the role of shareholders, particularly institutional

³⁶⁴ The conflict of interests between majority shareholders and minority shareholders which is known as the horizontal agency problem could happen in both public and private companies. See Rene Stulz, 'Managerial control of voting rights: Financing policies and the market for corporate control' (1988) 20 *Journal of Financial Economics* 20, 25–54; Mike Burkart, Denis Gromb and Fausto Panunzi, 'Large shareholders, monitoring, and the value of the firm' (1997) 112(3) *The Quarterly Journal of Economics* 693–728; Alexander Dyck and Luigi Zingales, 'Private benefits of control: An international comparison' (2004) 59(2) *The Journal of Finance* 537–600; Sridhar Gogineni, Scott C. Linn and Pradeep K. Yadav, *Vertical and Horizontal Agency Costs: Evidence from Public and Private Firms* (September 14, 2016). Available at SSRN: <https://ssrn.com/abstract=2024597> or <http://dx.doi.org/10.2139/ssrn.2024597>

³⁶⁵ EU Commission Green Paper The EU Corporate Governance Framework COM (2011) 164 final

³⁶⁶ House of Commons Business, Energy and Industrial Strategy Committee, *Corporate governance, Third Report of Session 2016–17*, p 23, available at <https://publications.parliament.uk/pa/cm201617/cmselect/cmbeis/702/702.pdf>

shareholders in providing a long-term protection for the company, reinforce the argument that the derivative claim should be more affordable and accessible under the law. As has been mentioned several times before, the derivative claim is a mechanism for protection of the company itself. It could bring compensation to the company or deter further harm to the company. It could be used by minority shareholders or employees in situations that they cannot rely on other mechanisms to protect the company. Clearly, not all directors are wrongdoers or all shareholders ignore their role of monitoring the management of the company. Therefore, the derivative claim could still have an exceptional but vital role alongside the other mechanisms of corporate governance to provide an ultimate protection for the company.

3.3.5 Non-executive directors (NEDs)

Non-executive directors (NEDs) are another essential element of UK corporate governance for the implementation of comply-or-explain principles in public companies. The need and importance of non-executive directors for establishing good corporate governance is clear from all of the reports and recommendations, which have been made on corporate governance. From the Cadbury Report, which was the starting point for emphasising the role of non-executive directors until today, all of the reports related to corporate governance have dedicated part of their recommendations to the role and importance of non-executive directors.

Since the early attempts to reform the UK corporate governance system in the early 1990s, different committees and reports have emphasised the establishment of a mechanism that would put executive directors under tight scrutiny so that they work for the company's interests instead of seeking their own interest. Both the Cadbury Committee Report³⁶⁷ and the Greenbury Committee Report,³⁶⁸ while emphasising the significance of greater reporting to shareholders, had also considered a main role for non-executive directors of the board in monitoring the performance of the company, including that of the executive directors. The other committees which confirmed the important role of non executive directors were the Hampel Committee,³⁶⁹ Turnbull Report,³⁷⁰ Higgs Committee Report,³⁷¹ Combined Code³⁷² and Walker Report.³⁷³

The UK Corporate Governance Code clearly gives a strong role to the non-executive directors. Under the code, the non-executive directors should: constructively challenge and help in developing proposals on strategy,³⁷⁴ scrutinise management's performance in meeting agreed goals and objectives and monitor

³⁶⁷ Report of the Committee on the Financial Aspects of Corporate Governance (Gee 1992)

³⁶⁸ Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury (Gee 1995)

³⁶⁹ Hampel Committee Report (1998)

³⁷⁰ Institute of Chartered Accountants in England & Wales, *Internal control: Guidance for directors on the combined code* (1999)

³⁷¹ Derek Higgs, *Review of the Role and Effectiveness of Non-executive Directors. A Higgs Committee Report* (2003)

³⁷² Financial Reporting Council, *The Combined Code on Corporate Governance* (2003)

³⁷³ Sir David Walker, *A review of corporate governance in UK banks and other financial industry entities* (2009) < http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf (visited 15/4/2017)

³⁷⁴ Financial Reporting Council, *The UK corporate governance code. London: Financial Reporting Council, The Main Principles of the Code Section A: Leadership* (2016) < <https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx> (visited 3/5/2017)

performance reports,³⁷⁵ satisfy themselves on the integrity of financial information and that controls and risk management systems are robust and defensible, determine appropriate levels of remuneration for executive directors, appoint and remove executive directors, and carry out succession planning. The board should appoint one of the independent non-executive directors to be the senior independent director to provide a sounding board for the chairman, and to serve as an intermediary for the other directors when necessary. The senior independent director should be available to shareholders if they have concerns about contact through the normal channels of chairman, chief executive or other executive directors that has failed to resolve issues, or about which such contact is inappropriate.³⁷⁶

The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about the company, for example through direct face to face contact, analysts' or brokers' briefings and surveys of shareholder opinion.³⁷⁷ The Code requires at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent. A smaller company should have at least two independent non-executive directors.³⁷⁸ Therefore, UK non-executive directors

³⁷⁵ *ibid* para A.4: Non-executive Directors, supporting principles

³⁷⁶ *ibid* para A.4.1

³⁷⁷ *ibid* para E.1.2

³⁷⁸ *ibid* para B.1.2

may also take part in management decisions and they are not restricted to post-decision approval like the German supervisory board.³⁷⁹

The non-executive directors should meet regularly as a body, with the chairman, without the executive directors and at least once a year they should meet on their own under the leadership of the senior independent director to appraise the chairman's performance.³⁸⁰ The UK Corporate Governance Code also has made a distinction between non-executives who are independent and those who are not. In order to be qualified for the former category, the person must not only have the necessary independence of character and judgment but also be free of any connections that may lead to conflicts of interest.³⁸¹

Overall, since one of the crucial roles of the board is to monitor the executive management, this duty can be carried out best if those who monitor are independent of those who are executive. Therefore, the rationale behind having non-executive directors lays in the importance of independence in particular areas within the board where conflicts of interests are likely to happen.³⁸² In fact, the non-executive director's role is to prevent self-dealing by observing conflict-of-interest transactions.³⁸³ They also monitor the board to detect managerial fraud and also to prevent directors' mismanagement.³⁸⁴

³⁷⁹ Klaus J. Hopt and Patrick C Leyens, 'Board Models in Europe: Recent Developments of Internal Corporate Governance Structures in Germany, the United Kingdom, France, and Italy' (2004) *European Company And Financial Law Review*

³⁸⁰ The role of the board, chairman and non-executive directors – the UK corporate governance code < <https://www.out-law.com/page-8215> (visited 3/5/2017)

³⁸¹ *ibid*

³⁸² Wolf-Georg Rings, 'Independent directors: After the crisis' (2013) 14(3) *European Business Organization Law Review* 8

³⁸³ Simon Witney, 'Corporate opportunities law and the non-executive

Some scholars argue that non-executive directors serve not just the interests of the shareholders, but those of all stakeholders as well. Their role is to ensure that the company's financial information is accurate and satisfy all the stakeholders in the company.³⁸⁵ However, in the view of this thesis, despite the positive role that the non-executive directors could play in monitoring the board's conduct, there are still some limitations in their role which would prevent them to protect the company in all circumstances.

3.3.5.1 Limitations on the role of the non-executive directors in controlling directors' misconduct

In spite of the important role non-executive directors play in the UK corporate governance, there are still some practical shortcomings of their role. For instance, the UK Corporate Governance Code has failed to indicate how the roles of non-executive directors should be performed in practice. The lack of guidance on how non-executive directors should fulfil their responsibilities while they have a diversified range of duties may result in unrealistic expectations of their role.³⁸⁶ On the other hand, to define non-executive directors the UK Corporate Governance

Director' (2016) 16(1) Journal of Corporate Law Studies

³⁸⁴ Stephen M. Bainbridge, 'Corporate Directors in the United Kingdom' [2017] UCLA School of Law, Law-Econ Research Paper No. 17-04 < SSRN: <https://ssrn.com/abstract=2935388>

³⁸⁵ Prashanth Beleya et al., 'Independent directors and stakeholders protection: A case of Sime Darby' (2012) 2(4) International Journal of Academic Research in Business and Social Science 422

³⁸⁶ Jonathan Liu and Tomas Andersson, *Mind the Gap: Expectations on the Role of UK Non-Executive Directors* (2014) < <http://www.regents.ac.uk/media/975652/RWPBM1402-Liu-J-Andersson-T.pdf> (visited 23/4/2017)

Code³⁸⁷ provides a list of criteria that would normally exclude a specific director's independence, such as where the director:

- has been an employee of the company or connected entity within the past five years;
- is or has been connected with the company's auditors, advisers, directors or senior employees;
- has received additional remuneration from the company apart from director's remuneration;
- has had a material business relationship with the company; or
- represents a significant shareholder.

While it has been delegated to the board to determine whether each director is independent in character and judgment,³⁸⁸ the criteria above are just non-compulsory guidelines for the board. This means that the board is free to diverge from these criteria under the well-known comply-or-explain principle.³⁸⁹ Now, considering the criticisms of the implementation of comply-or-explain

³⁸⁷ The UK Corporate Governance Code, s B.1.1 <[http://frc.org.uk/Our-Work/Codes-Standards/Corporate governance.aspx](http://frc.org.uk/Our-Work/Codes-Standards/Corporate%20governance.aspx) (accessed 23/4/2017)

³⁸⁸ The UK Corporate Governance Code section B.1.1 provides that: 'The board should identify in the annual report each non-executive director it considers to be independent. The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including ...'

³⁸⁹ Wolf-Georg Rings [n 382] 12

principles,³⁹⁰ this approach raises some debates on whether non-executive directors would be completely independent from the board in all circumstances.³⁹¹

The other criticism of non-executive directors is that they might not be able to completely understand the complexities of the businesses, which they direct. Due to lack of expertise they might show significant deficiencies in understanding the business they were supposed to control, or might remain ineffective in solving structural problems.³⁹² Therefore, they may not always be able to fulfil the duties which have been delegated to them in improving the company's performance. Another concern is that non-executive directors are expected to perform a wide range of duties such as taking an active role in monitoring executive directors, watching for self-dealing by examining conflict-of-interest transactions, preventing fraud and directors' mismanagement, guaranteeing the quality and reliability of corporate information disclosures, keeping executives focused on the generation of shareholder value via the design and implementation of appropriate employment and remuneration schemes, and the disciplining of company executive directors who are not performing their duties well. Nonetheless, non-executive directors may lack enough incentives to effectively perform all tasks that have been assigned to them, unless they are provided with strong financial incentives, which

³⁹⁰ Shortcomings in implementation of the comply-or-explain principle was discussed in the previous section 3.3.4.1.

³⁹¹ Sanjai Bhagat and Bernard Black, 'The Non-Correlation between Board Independence and Long-Term Firm Performance' (2002) 27(2) *The Journal of Corporation Law* 231; Pass [n 58]; Samuel O. Idowu and Céline Louche (eds), *Theory and Practice of Corporate Social Responsibility* (Springer 2011) 39, 51

³⁹² Samuel O. Idowu and Céline Louche *ibid* 51; Christopher Pass, 'Non-executive directors and the UK's new combined code on corporate governance' (2008) 9(6) *Business Strategy Series* 291-296; Reisberg [n 341]

might not be the case in all companies.³⁹³ The last concern is that non-executive directors may increase the costs of companies. Some scholars have raised this concern over the non-executive directors' lack of familiarity with the business,³⁹⁴ and in addition to that concern is the cost of human resources which are expected to be used in the appointment and training process.³⁹⁵

To conclude, non-executive directors are potentially playing a significant role in monitoring directors' conduct and controlling the management, still there might be some practical shortcomings in implementation of their duties. Therefore, there might still be some situations of directors' misconduct that harm the company that the non-executive directors fail to monitor and detect. The derivative claim could be used in these circumstances to compensate for that harm.

3.3.6 The market for corporate control

As was mentioned before, the aim of this chapter is to explore different corporate governance mechanisms in public companies, and evaluate whether they could provide sufficient protection for the company to the extent that they would cover the role of the derivative claim. One of these corporate governance mechanisms in the UK is the market for corporate control. The market for corporate control has been viewed as an essential tool to restrict the misconduct of

³⁹³ Andrew Kakabadse et al., 'Role and Contribution of Non-Executive Directors' (2001) 1(1) *Corporate Governance: The international journal of business in society* 4-8; Wolf-Georg Ringe, 'Independent directors: After the crisis' (2013) 14(3) *European Business Organization Law Review*

³⁹⁴ Daniel R Fische, 'The Corporate Governance Movement' (1935) 35 *Vand. L. rev* 1259; Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Application* (Oxford University Press 2009) 34

³⁹⁵ Arad Reisberg *ibid*; Brenda Hannigan, *Company Law* (Butterworths 2003) 155

directors. It is believed that it could reduce the agency costs between shareholders and directors by reducing directors' opportunistic behaviour.³⁹⁶ However, the question is what role does the market for corporate control play in increasing the accountability of the board toward the company and not just shareholders? Would market-based solutions prevent managers from engaging in wrongdoing to such a degree as to render derivative claim intervention redundant?

The initial philosophy behind the market for corporate control is that the opportunistic behaviour of directors may cause the company's share value to fall and this would provoke a corporate takeover threat. If the takeover bid goes ahead and results in acquisition of the company, the incumbent opportunistic directors will be removed. Hence, because of the fear of losing their positions, directors would put their best effort into increasing company profits and act in the best interests of the company as a whole, rather than in pursuing their self-interests which could harm the company. In fact, the market for corporate control is based on the theory that the market for the company's share is always effective enough to the extent that it would react to the executives' wrongful conduct by dropping the value of the company's shares. Consequently, the bidder would take over the company and incumbent wrongdoing directors would be sacked from the board.

The regulations governing the UK market for corporate control have been established under Chapter 1 of Part 28 of the Companies Act 2006, with its

³⁹⁶ Frank H. Eastbrook and Daniel R. Fischel, *The economic structure of corporate law* (Harvard University Press 1996)

supervisory powers pursuant to the EC Directive on Takeover Bids.³⁹⁷ Takeovers in the United Kingdom are controlled through a market-based arrangement in which institutional shareholders have the leading roles.³⁹⁸ The City Code of Conduct on Takeovers and Mergers, which was established in 1968, is executed by the Panel on Takeovers and Mergers which is comprised of institutional shareholders such as insurers, investment companies, pensions and banks.³⁹⁹

Although the Panel was given a statutory right by the Companies Act 2006, in order to comply with the EC directive which requires the establishment of a public authority to supervise takeover bids,⁴⁰⁰ the Panel nonetheless remains completely rooted in the private sector, both in composition and in practice.⁴⁰¹

The Code of Conduct itself encompasses a series of principles, which make it completely clear that shareholders control the fate of takeover bids. The general principles require that all the targeted company's shareholders be treated equally, and provides that the targeted company board "must not deny the holders of securities the opportunity to decide on the merits of the bid."⁴⁰² The City Code

³⁹⁷ European Commission Directive number 2004/2S/EC; also Panel on Takeovers and Mergers, *The Takeover Code General Principles*, at Principle AI

³⁹⁸ Christopher Bruner [n 328] 32

³⁹⁹ The Takeover Panel: About the Panel, <http://www.thetakeoverpanel.org.uk/structure/about-the-panel>; The Takeover Panel: Panel Membership, <http://www.thetakeoverpanel.org.uk/structure/panel-membership>; The Takeover Panel: The Panel on Takeovers and Mergers, <http://www.thetakeoverpanel.org.uk/index.php?pageid=45>

⁴⁰⁰ Companies Act 2006 sections 942-943

⁴⁰¹ John Armour and David A. Skeel, 'Who writes the rules for hostile takeovers, and why-the peculiar divergence of US and UK takeover regulation' (2006) 95 *Georgetown Law Journal* 1727

⁴⁰² Panel on Takeovers and Mergers, *The Takeover Code General Principles* 1, 3, at B1 (10th edn 2011)

effectively rejects all defensive actions when a takeover bid is pending or when the target has ‘reason to believe that a bona fide offer might be imminent’.⁴⁰³

In fact, like the other mechanisms of corporate governance, the UK takeover regulations have only put shareholders in the driver’s seat and is strongly favouring their interests by giving the target company’s shareholders an almost autonomous discretion to accept or reject a hostile bid.⁴⁰⁴

The market-based solution to corporate misconduct is the replacing of directors, mostly through the hostile takeover. Hence, since the takeover regulations favouring shareholders and directors have no defensive power, it has been suggested that it could reduce the agency costs by the threat or reality of a hostile takeover bid, which would result in the incumbent wrongdoer being dismissed from the board of the company. Moreover, due to the UK’s permissive regulation of takeover bids, it is accepted that the UK’s corporate governance system, compared with that of the US, has been much friendlier to hostile takeovers.⁴⁰⁵ As a result, the wrongdoing directors in the UK are more endangered by takeover bids. Nevertheless, such an allegation could not always be true for the reasons stated in the following section.

⁴⁰³ *ibid* Principle CI (6)

⁴⁰⁴ Christopher Bruner [n 328]

⁴⁰⁵ *ibid*; as it will be discussed in the next chapter, there are two main differences between takeovers in the UK and the United States. First, that in the US, directors are able to use defensive actions such as Poison Pill and Classified Board to beat the takeover bids. In addition to that, under the Delaware jurisprudence and also the Constituency statutes in some states, directors are required to consider the interests of other stakeholders in the context of takeovers.

3.3.6.1 The market for corporate control is not a sufficient alternative to the derivative claim

In assessing the efficiency of the market for corporate control, several factors should be considered. One important concern in the market for corporate control solution lies in its weakness in preventing the managerial misconduct, particularly in situations known as the ‘one shot’ breaches of fiduciary duty⁴⁰⁶ which are in fact a frequent subject of derivative claims. The takeover is generally considered more effective in displacing wrongdoing directors from the targeted company’s board without necessarily forcing them to compensate the company. The argument is that wrongdoing directors who are benefiting from so-called ‘one shot wrongs’ might not care about being dismissed from the company’s board after committing such a wrong.⁴⁰⁷ Moreover, corporate takeovers are extremely expensive; therefore, the scale of a manager’s wrongdoing must be enormously high in order to affect the company’s share price or attract a bid for control. The agency cost-related issues might not be big enough to trigger a takeover bid even if they result in a notable reduction in a company’s share value.⁴⁰⁸ The other point is that even if the takeover happens, with such high transaction costs the market for corporate control will not effectively control all management misconduct.⁴⁰⁹ The importance of the

⁴⁰⁶ An example of a ‘one shot wrong’ by directors would be embezzlement or self-dealing, and is in contrast with the directors committing a series of wrongful actions such as misusing the company’s resources through a continued systematic payment of a wasteful amount of money to the CEO of the company, for example.

⁴⁰⁷ James Cox, ‘Compensation Deterrence and the Market as Boundaries for Derivative Suit Procedures’ (1983) 52 *George Washington Law Review* 745

⁴⁰⁸ David Kershaw, *Company law in context: Text and materials* (Oxford University Press 2012)

⁴⁰⁹ Frank H. Eastbrook and Daniel R. Fischel [n 396]

market for corporate control arises from the nexus of contract theory under which hostile takeovers are appreciated because they reduce the agency costs caused by non-shareholder value pursuing, or directors' self-serving behaviour. Hence, Contractarians argue that hostile takeovers ensure that directors accomplish their contractual obligations to shareholders. From an efficiency perspective, hostile takeovers create a more efficient economy by cleaning out weakly performing companies.⁴¹⁰ This thesis argues that the market for corporate control is inefficient in protecting the company as whole. The problem is that hostile takeovers might be a favourite mechanism for shareholders, who want to accept premium bids for their shares but such interests might be at the expense of harm to other stakeholders, such as innocent directors and employees who might fear losing their jobs and the creditors who might fear additional corporate debt. Let us consider takeover cases in which the targeted company has huge pension deficits at the time of takeover, and where the interests of employees in such situations are not considered. A takeover not only would help directors of the acquired company to easily walk away from their responsibility but also could cause the employees to lose their job as well. One argument is that the potential employment impacts of a takeover could be compensated by the social welfare benefits available to employees in the UK.⁴¹¹ The Labour Party in 1966 eventually became satisfied with the potential employment impacts of takeover activity based on the belief that the right mergers

⁴¹⁰ Lorraine Emma Talbot, 'The coming of shareholder stewardship: a contextual analysis of current Anglo-American perspectives on corporate governance' (2010) Warwick School of Law Research Paper No. 2010/22 < SSRN: <https://ssrn.com/abstract=1676869> (visited 5/6/2017)

⁴¹¹ Christopher Bruner, 'Power and Purpose in the Anglo-American Corporation' (2009) 500 Va. J. Int'l L. 623

would maximise employment opportunities and external protection could adequately mitigate any harm to employees.⁴¹² In fact, it was recognised that although there would be unemployment problems following mergers, these were felt to be problems of a transitional phase, and that the social costs faced by unemployed workers were also more broadly mitigated through the social care scheme and the Redundancy Act 1965 which was established under Labour.⁴¹³ To compensate the harm of losing their job, pro-employee legislation was established in the UK during the 1960s and 1970s under Labour and Conservative governments.⁴¹⁴ Also, the Industrial Relations Act 1971 introduced the concept of ‘unfair dismissal’ to the common law, requiring the employer to show a ‘fair reason’ for dismissal, which could include redundancy.⁴¹⁵ Moreover, the Redundancy Payments Act of 1965 introduced mandatory redundancy payments.⁴¹⁶ The argument is that before the introduction of the pro-employee regulations, redundancy was risky to employers as they were often met by spontaneous industrial action. However, pro-employee regulations were effective in mitigating the number of strikes over redundancy cases.⁴¹⁷ Hence, back to the question of whether the market for corporate control solution represents an alternative to derivative litigation, could we argue that the market for corporate

⁴¹² *ibid*

⁴¹³ Hannah Leslie, *The rise of the corporate economy* (Routledge 2013) 49

⁴¹⁴ Martin Gelter, ‘The dark side of shareholder influence: Managerial autonomy and stakeholder orientation in comparative corporate governance’ (2009) 50(1) *Harvard International Law Journal*

⁴¹⁵ The concept has now been established in the Employment Rights Act, 1996, § 98(1), (2)

⁴¹⁶ The provisions have been transferred to the employee regulations Act sections 135-46.

⁴¹⁷ Hugh Collins, K. D. Ewing and Aileen McColgan, *Labour Law Text And Materials* (Hart Publishing 2001) 26

control would compensate the role of the derivative claim? The answer is still no. Takeovers would not provide the deterrence and compensation role, which could theoretically be provided by the derivative claim for the company as a whole, not just the shareholders. The derivative claim would be initiated in situations that the directors are in breach of their fiduciary duties, either by negligence or by their opportunistic behaviour which harms the company. The takeover would not necessarily punish the wrongdoing directors in such circumstances. Nor would it bring compensation to the company for the harm. In addition to that, employees and other stakeholders in the company might get personal support which could compensate their harm if they get made redundant because of a takeover in some circumstances. However, the harm to their interest might not be compensated in situations that the directors intentionally harm the company by their opportunistic behaviour, and put the company on the verge of insolvency or a hostile takeover which would cause them to lose their job and benefits in the company. The argument is that the deterrence role of the derivative claim could help the employees and minority shareholders to prevent these circumstances to happen.

3.3.7 The power of public authorities

Another mechanism, which has been named by academics as a means of controlling directors' misconduct in the UK, is the power of public authorities both through investigating conflicted transactions and through the use of public suits and criminal sanctions to deter illegal self-dealing transactions.⁴¹⁸ However, enforcement by securities regulators in the UK is rare.⁴¹⁹ Although shareholders in a publicly traded UK company can potentially sue directors to recover losses caused by false or misleading disclosures, still private litigation enforcement such as shareholder class action and derivative claims are rare under the securities law. In fact, the problem with the UK procedural rules is that they obstruct claims under corporate law including the problem with the costs of the litigation, and discourages suits under securities law too.⁴²⁰ The UK securities regulations have been mainly based on the disclosure model, which relies on the principle of mandatory disclosure.⁴²¹ The regulatory bodies such as the Stock Exchange have an essential role in deterring directors' misconduct and reducing agency costs by enforcing the Stock Exchange Listing Rules. Listed companies are faced with a wide range of disclosure obligations under the EC Transparency Obligation

⁴¹⁸ Arad Reisberg [n 394] 31

⁴¹⁹ John Armour, *Enforcement Strategies in UK Company Law: A Roadmap and Empirical Assessment*, in *Rationality in Company Law: Essays in Honour of D.D. Prentice* 71 (John Armour & Jennifer Payne, eds, 2009); John Armour, Bernard S. Black, Brian R. Cheffins and Richard Nolan, 'Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US' (2009) *Journal of Empirical Legal Studies* Vol. 6 687-722; John C. Coffee, 'Law and the Market: The Impact of Enforcement' (2007) 156 *U. Pa. L. Rev.* 229-311

⁴²⁰ *ibid*

⁴²¹ Financial Services and Markets Act 2000 s 90; Listing Rule 6 (1)(b)

Directive.⁴²² UK companies fulfil these obligations through the FCA Disclosure Rules and Transparency Rules (DTR).

Companies are required to disclose on time all dealings in their securities, including non-voting securities, by ‘persons discharging managerial responsibilities’ and certain connected persons. Companies are also required to take all necessary steps to ensure that their persons discharging managerial responsibilities and persons connected with them comply with the Model Code on dealings in securities, which is annexed to the Listing Rules.⁴²³

Moreover, in addition to shareholder approval requirements under the Companies Act, Stock Exchange Rules require independent shareholder approval by ordinary resolution for related-party transactions, unless they fall within certain exceptions, for example small related-party transactions.⁴²⁴ Additionally, significant related-party transactions entered into by listed companies are subject to a strict procedure of shareholder approval proposed by the Listing Rules of the Financial Services Authority.⁴²⁵

The Listing Rules require the directors’ annual financial report to disclose, among other things, details of contracts of significance where a director is

⁴²² EC Directive 2004/109

⁴²³ DTR 3 & DTR 5; also Willem J L Calkoen (ed), ‘The Corporate Governance Review, chapter 26’ (2014) <
<https://www.algoodbody.ie/media/IrelandchapterinTheCorporateGovernanceReviewedition41.pdf>
(assessed 17/5/2017)

⁴²⁴ FCA, Listing Rules, LR 10, 11 and 11.1.7. Companies listed on AIM, however, do not have to hold shareholder votes in relation to such transactions, and need only disclose their details. See London Stock Exchange, AIM Rules for Companies ¶¶ 12–13; Amour above, p 719).

⁴²⁵ Listing Rules (LR) §11 (Related Party Transactions)

interested or between the company and a controlling shareholder.⁴²⁶ Furthermore, a listed company, which enters into a transaction with a related party, must make a notification to the stock market via a regulatory information service approved by the FCA.⁴²⁷

Despite the significant function of public bodies in monitoring and controlling directors' conduct through the mandatory disclosure rules, it is still impractical to rely exclusively on public enforcement for protecting the company. The mandatory disclosure rule may not necessarily detect all breaches of the law. One general argument with regards to the mandatory disclosure model is that it may not be always functional as minority investors may not read or understand the disclosures.⁴²⁸ Therefore, they may need a stronger consumer protection by the law. However, the issue of investors' personal protection is outside the subject of this thesis. The thesis argument is that in terms of the company protection as a separate personality from its shareholders, although like the other mentioned mechanisms of corporate governance the public bodies could provide protection for the company through shareholders, such protection might not be optimal in all circumstances. The reason goes back to the limitations on the role of shareholders in protecting the company. Therefore, it is correct that the public authorities in the UK, alongside other corporate governance mechanisms could provide an environment in listed companies in which the derivative claim is less needed. Still

⁴²⁶ *ibid* rule 9.8.4

⁴²⁷ *ibid* rule 11.1.7(1)

⁴²⁸ Morrissey, *University of Richmond Law Review* (2010) 44 684

they would not completely cover the role that the derivative claim could play in protection of the company as whole.

3.4 Conclusion

This chapter debated the general belief that availability of the other mechanisms of accountability for directors, especially in public companies substitutes the role of the derivative claim in holding controlling shareholders and directors accountable toward their responsibilities. Such arguments are based on the traditional shareholder value principal,⁴²⁹ which mainly considers the protection of the company as the protection of the shareholders' interest rather than of the company as a whole. Hence, in order to find that how much the company as a whole could be protected through these mechanisms, this chapter explored these so-called alternative mechanisms to the derivative litigation both in the context of private companies and public companies. The result confirmed that derivative claims still have a role to play in the English legal system. There is no doubt that the combination of these corporate governance tools could moderate the role of the derivative claim. Still, such protections have been mainly based on the majority shareholders role and, therefore, there could be some limitations on this reliance. The argument of this thesis is that the derivative claim is a mechanism for protecting the company as a separate entity from its shareholders, and there is no guarantee that shareholders always care about the long-term well-being of the

⁴²⁹ UK corporate law has its roots in the shareholder value principle and this will be discussed in chapter seven, Section 7.7.

company and the interests of other stakeholders. Even in terms of protecting shareholders' interests, reviewing these so-called means of accountability revealed that each of them has its limitations, which prevent them from being optimal in detecting and monitoring directors' conduct in all circumstances. For this reason the derivative claim still has a role to play. Overall, in order to provide sufficient protection for the company (shareholders and other stakeholders together), a body of mechanisms of accountability including the derivative claim, should work together and complement each other rather than being replaced by each other. The derivative claim in this regards is the claim that both minority shareholders and employees are able to initiate it. The reason is that in some private companies there is no shareholder or any other external mechanism to monitor the directors and controlling shareholders' conducts and to prevent them from harming the company. In such circumstances the employees could take the role of protecting the company. As was mentioned in chapter one, BHS provides a good example in this regards.

Chapter Four: Mechanisms of accountability in the United States and the role of derivative suits

4.1 Introduction

Reviewing different mechanisms of accountability for directors in the United Kingdom reinforced the argument that the availability of other corporate governance mechanisms could affect the need for the derivative claim. However, each mechanism of accountability has its own limitations, especially in terms of protecting the company as a whole. Therefore, the conclusion was that the company would be better protected if mechanisms of accountability including the derivative claim work together as a body to provide a long-term protection for the company. This is providing that other stakeholders, including employees, would also have a role to play in such a protection. Like in the UK, in the United States only shareholders have the right to be involved in the management of the company or sue company wrongdoers on behalf of the company. However, despite having similarities such as dispersed ownership corporate governance systems and the unitary board models, still the United States and United Kingdom diverge in dealing with corporate affairs. The main difference between the two corporate governance systems is on the issue of mechanisms of accountability for the board. Accordingly, while UK corporate law has remained pretty much loyal to the *ex*

*ante*⁴³⁰ mechanisms of protection, the United States' corporate system has mainly relied on *ex post*⁴³¹ remedial-based corporate governance through the shareholders as the only applicants. This means that while shareholder litigation is more potent in the United States, some other mechanisms of corporate governance such as shareholder voting power are weaker. In fact, one argument is that the shareholders' weak power in monitoring and controlling the directors' wrong conduct in advance, has resulted in frequency of shareholder litigation such as derivative suits and class actions in the United States.⁴³² It has been mentioned in the previous chapter that mere reliance on *ex ante* mechanisms in the UK might not provide a potent long-term protection for the company as a whole. The same argument applies to the heavy reliance on the *ex post* mechanisms in the United States. The argument is that there should be a balance between the availability of *ex ante* mechanisms that monitor the directors' conducts and the litigation mechanisms that bring compensation to the company. The lack of such balance has resulted in an extensive amount of shareholder litigation in the United States, which might not always benefit the company. While this research criticizes the high incident of derivative suits in the United States, it argues that there are still some positive aspects in the derivative suits financial structure which could be

⁴³⁰ *Ex ante* is a phrase meaning 'before the event' and *ex ante* mechanisms of protection refers to a series of actions that protect the company through the monitoring of the board's conduct such as the corporate governance 'comply-or-explain' principle, market for corporate control and non-executive directors.

⁴³¹ *Ex post* or 'after the event' mechanisms are the methods that companies use in litigation to punish directors' misconduct and win compensation for the company.

⁴³² For example see John Armour, Bernard S. Black, Brian R. Cheffins and Richard Nolan, 'Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US' (2009) 6 *Journal of Empirical Legal Studies* 687-722; also Christopher Bruner, *Corporate governance in the common-law world: The political foundations of shareholder power* (Cambridge University Press, 2013)

inspiring for the UK. Under the financial structure of the derivative suits the company is responsible for the cost of the litigation through the availability of contingency fee agreements. Moreover, in the United States the non-monetary benefits of derivative suits are also considered under the corporate benefit doctrine. This chapter reviews the role that derivative suits play in providing protection for the company and discusses the inspiring aspects of the financial structure of US derivative suits. The chapter also explores the availability of other corporate governance mechanisms in the United States to ascertain how much they could affect the need for the derivative suits.

4.2 Corporate governance in the United States

The United States' corporate governance is known as a 'board-centric'⁴³³ model of corporate governance by many scholars.⁴³⁴ However, like in the UK, shareholders in the company have been given a primacy over other stakeholders. Therefore, in common with the UK, shareholders are the only company stakeholders which can be involved in decision-making in the company to some extent and have the right to sue directors for harm to the company.⁴³⁵

Moreover, in the United States under the internal affairs doctrine,⁴³⁶ corporate law including the rights of shareholders has traditionally been left to the states to govern.⁴³⁷ However, under the Commerce Clause of the United States Constitution, Congress also has plenty of power to federalise corporate law to the level it likes.⁴³⁸ Following some major financial crises, Congress used its power to

⁴³³ The board-centric or director primacy model is a model of corporate governance in which the board of directors has an ultimate power over the company, and shareholders theoretically have few rights to get involved in the decision-making of the company. The United States' corporate governance is typically known as 'board-centric', which is in contrast with the UK and New Zealand's 'shareholder primacy' or 'shareholder-centric' models of corporate governance. For more information on this issue see Stephen Bainbridge, 'Director versus Shareholder Primacy in New Zealand Company Law as Compared to U.S.A. Corporate Law' [2014] UCLA School of Law, Law and Economics Research Paper Series No 14-05 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=241644 (visited 27/4/2017)

⁴³⁴ Edward Rock, 'Adapting to the new shareholder-centric reality' (2013) 161(7) University of Pennsylvania Law Review 1907-1988

⁴³⁵ Henry Hansmann and Reinier Kraakman, 'The end of history for corporate law' (2000) Geo. L.J. 89 433-34

⁴³⁶ The 'internal affairs doctrine' confirms that such issues as voting rights of shareholders, distributions of dividends and corporate property, and the fiduciary duties of directors are all determined in accordance with the law of the state in which the company is incorporated.

⁴³⁷ Restatement (Second) of Conflict of Laws §§ 302(2), 304 (1971); CTS Corp. v Dynamics Corp. of Am., 481 U.S. 69, 89 (1987); Santa Fe Indus., Inc. v Green, 430 U.S. 462, 479 (1977)

⁴³⁸ U.S. Const. art. I, § 8, cl. 3; also Christopher Bruner, *Corporate governance in the common-law world: The political foundations of shareholder power* (Cambridge University Press 2013) 37;

draft some considerable federal regulations on corporate law including the federal securities regulation and the Securities and Exchange Commission (SEC), which were established following the 1929 stock market crashes. In addition to that, following scandals such as Enron and the financial and economic crisis in recent years, some major amendments have been made to those statutes.⁴³⁹ Alongside these, the Delaware jurisprudence also plays a crucial role in forming the legal mechanisms for regulating company affairs. Despite the fact that among different stakeholder groups, only shareholders have the right to hold directors accountable toward their duties in the United States, still American shareholders do not have significant power over the board. It means that in the United States the board of directors has the ultimate power to manage the company.⁴⁴⁰ For instance, Delaware General Corporation Law provides that the ‘business and affairs of every corporation organised under this chapter shall be managed by or under the direction of the board of directors’.⁴⁴¹

The Model Business Corporation Act also provides that ‘all corporate powers shall be exercised by or under the authority of the board of directors of the

Leo Strine, ‘Breaking the Corporate Governance Logjam in Washington Some Constructive Thoughts on a Responsible Path Forward’ (2008) 63(4) *The Business Lawyer* 1107

⁴³⁹ Christopher Bruner, ‘Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate’ (2011) 36 *Del. J. Corp. L.* 1, 26–29

⁴⁴⁰ Margaret Blair, ‘Shareholder value, corporate governance, and corporate performance’ in Peter K. Cornelius and Bruce Kogut (eds), *Corporate governance and capital flows in a global economy* (Oxford University Press 2003) 64–65

⁴⁴¹ Delaware General Corporation Law, § 141

corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors'.⁴⁴²

Because of the directors' ultimate power under US corporate governance, shareholders are theoretically allowed to vote on fewer issues in comparison to their British counterparts, such as on the sales of substantially all of the listed corporation's assets, voluntary dissolution and approval of charter or bylaw amendments.⁴⁴³ Even for the bylaw amendments, although the power to amend the corporation's constitutional documents has initially been assigned to the shareholder body, the Delaware law provides that the directors have simultaneous power to amend or revoke the bylaws.⁴⁴⁴ Moreover, apart from hostile takeovers which target the company, shareholders must vote on a merger with another company,⁴⁴⁵ whereas the board alone can approve almost all other transactions. Even in some instances when there was a potential takeover bid, some quoted companies have diverged from the principle that shareholders should vote and have recategorised the shares by placing major voting power in only one of the classes of shares - mainly those owned by the directors - thus retaining their position by preventing the bid.⁴⁴⁶ Additionally, in terms of removing wrongdoing directors from the board, it is more difficult for US shareholders to remove

⁴⁴² Model Bus. Corp. Act Ann §. 8.01. This power is subject to any limitations in the articles of association.

⁴⁴³ Blair [n 442]; Bruner [n 439]

⁴⁴⁴ Delaware General Corporation Law § 109

⁴⁴⁵ Delaware General Corporation Law § 251

⁴⁴⁶ Arthur Pinto and Gustavo Visentini, *The legal basis of corporate governance in publicly held corporations: a comparative approach* (Kluwer Law International 1998) 259; Fahad Mohammed Almajid, 'A Conceptual Framework for Reforming the Corporate Governance of Saudi Publicly Held Companies: a Comparative and Analytical Study from a Legal Perspective' (Doctoral research, The University of Manchester 2008)

directors from the board in comparison to their British counterparts. In fact, the American shareholders have a default power to remove directors with or without cause by vote of a simple majority of shares,⁴⁴⁷ but in practice if the corporation has a classified board⁴⁴⁸ then directors can only be removed ‘for cause’.⁴⁴⁹ Even if the certificate of incorporation can be amended by shareholders to provide that directors should be removed ‘without cause’, in a substantial number of large corporations with classified boards can directors still only be removed ‘for cause’.⁴⁵⁰ Because of the above-mentioned restrictions on shareholder voting rights, scholars like Bruner argue that the restrictions on US shareholders has made them ‘spectators’ in the company, who have very few powers in comparison to their counterparts in the UK or other common law jurisdictions.⁴⁵¹ Although shareholders in the United States have weaker power to interfere in the management of the company, still like in the UK, their interests are preferred to those of other stakeholders.⁴⁵² Shareholder primacy principles still govern US

⁴⁴⁷ Delaware General Corporation Law § 141(k)

⁴⁴⁸ The classified board is a prominent practice in US corporate law in which a portion of the directors serve for different term lengths, depending on their particular classification.

Under a classified system, directors serve terms usually lasting between one and eight years; longer terms are often awarded to more senior board positions.

⁴⁴⁹ Daniel Attenborough, ‘The Vacuous Concept of Shareholder Voting Rights’ (2013) 14(2) European Business Organization Law Review 166

⁴⁵⁰ *ibid*

⁴⁵¹ Christopher Bruner, ‘Corporate governance reform in a time of crisis’ (2010) 36(2) Journal of Corporation Law 329–39

⁴⁵² Kevin Turner, ‘Settling the Debate: A Response to Professor Bebchuk’s Proposed Reform of Hostile Takeover Defences’ (2006) Ala. L. Rev. 57 928

corporate governance because the board of directors only provides the shareholders with an annual report about the affairs of the company.⁴⁵³

The question is that to what extent shareholders in the United States could hold directors accountable to their fiduciary duties for protecting the company?

⁴⁵³ John Colley et al., *What Is Corporate Governance?* (McGraw-Hill Executive MBA Series 2005) 33

4.3 Institutional shareholders

In order to bring the board conduct more under control, institutional shareholder activism has become an increasingly common phenomenon among US public corporations in recent years. The substantial amount of capital that flows into activist funds, especially hedge funds, provides them with a greater financial power to stand up against opportunistic managers.⁴⁵⁴ Institutional shareholder activists have been successful in persuading corporate directors through proxy contests and other interventions.⁴⁵⁵ Nowadays, several institutional shareholders hold vast amounts of shares in the US stock markets and they monitor directors by putting them under tight scrutiny. Institutional shareholders normally pursue their interests through the constructive dialogues they have with corporate directors, preferably out of the spotlight. However, many of the institutional shareholders in large corporations also take advantage of the federal mandate rule to include the institutional investors' governance proposals in the management's proxy statement, and then to submit them to a vote in the company's general meetings.⁴⁵⁶ This mandate empowers institutional shareholders to prevent the board from abusing its position. For instance, through the mandate, institutional shareholders are able to

⁴⁵⁴ Stephen Bainbridge, 'Director versus Shareholder Primacy in New Zealand Company Law as Compared to U.S.A. Corporate Law' [2014] UCLA School of Law, Law and Economics Research Paper Series No 14-05 < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=241644 (visited 27/4/2017) p14; also Stephen Arcano, 'Activist Shareholders in the U.S.: A Changing Landscape' (2013) The Harvard Law School Forum On Corporate Governance And Financial Regulation < <https://corpgov.law.harvard.edu/2013/06/28/activist-shareholders-in-the-us-a-changing-landscape> (visited 16/4/2017)

⁴⁵⁵ Bainbridge *ibid*

⁴⁵⁶ Joseph McCahery and Luc Renneboog, 'Recent Developments in Corporate Governance' in Joseph A. McCahery, Piet Moerland, Theo Raaijmakers and Luc Renneboog (eds), *Corporate Governance Regimes: Convergence and Diversity* (Oxford University Press 2002) 15; Fahad Mohammed [n 446] 83

submit proposals to remove defensive tactics often designed by managers to deter hostile takeovers or to adopt proxy voting or to limit executive directors' compensation.⁴⁵⁷ Nonetheless, despite their efforts in influencing the companies' management, their role has had little impact in preventing directors' opportunistic behaviour in US corporate governance. Bainbridge argues that despite these successes, the board's power still remains powerful and the shareholders' ability to control corporate decision-making is still restricted; therefore, significant protection for minority shareholders in the United States comes from other legal devices, such as derivative suits.⁴⁵⁸

⁴⁵⁷ *ibid*

⁴⁵⁸ Bainbridge [n 454]

4.4 The US market for corporate control and the approach in consideration of the other stakeholders' interest

The market for corporate control in the United States has been seen as a device, which could put pressure on directors who run the company poorly or prefer their own interests instead of the company's interest.⁴⁵⁹ Nonetheless, in comparison to the United Kingdom, American shareholders have less power to accept or reject hostile takeover bids for the company. In fact, in the United States, shareholders' ability to accept hostile bids is effectively weak because of the Delaware courts' significant role, as well as the existence of regulations⁴⁶⁰ which permit the board of directors to take defensive strategies to protect current company commercial plans from the threats of hostile takeovers. Indeed, the US boards have a clear freedom to consider the interests of other stakeholders, such as employees and creditors, in deciding how to respond to a hostile bid.⁴⁶¹ One of the most defensive methods which has been used by directors to defeat a takeover bid in the United States is the 'poison pill' or shareholders' right plan. The important usage of the 'poison pill' is that it deters a potential bidder from buying the shares of the targeted company by making a takeover unprofitable. There are two types of 'poison pill':

⁴⁵⁹ Maria Maher and Thomas Andersson, 'Corporate Governance: Effects on Firm Performance and Economic Growth' in Joseph A. McCahery, Piet Moerland, Theo Raaijmakers and Luc Renneboog (eds), *Corporate Governance Regimes: Convergence and Diversity* (Oxford University Press 2002)

⁴⁶⁰ Williams Act 1968; also several important Delaware courts decisions confirming board discretion to take takeover defences include *Unocal Corp. v Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Moran v Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985); *Revlon, Inc. v MacAndrews & Forbes Holding, Inc.*, 506 A.2d 173 (Del. 1986); *Paramount Commc'ns v Time Inc.*, 571 A.2d 1140 (Del. 1990); *Paramount Commc'ns v QVC Network Inc.*, 637 A.2d 34 (Del. 994); *Unitrin, Inc. v Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995).

⁴⁶¹ Christopher Bruner [n 451] 325

the ‘flip-in’ and the ‘flip-over’. The ‘flip-in’ allows shareholders, except the acquirer, to buy additional shares at a discount. This would make the takeover more expensive. The ‘flip-over’ lets shareholders buy the acquirer’s shares after the merger at a discounted rate.⁴⁶² The other most frequently used tactic is what is known as a ‘staggered’ or ‘classified’ board in which the term of each board member is three years and only a third of the board is elected each year. This mechanism of appointing directors can provide a potent takeover defence particularly when combined with ‘poison pills’. This is because they require a bidder to wait through at least two election cycles to replace enough members of the board to gain control.⁴⁶³ Bruner argues that in the context of hostile takeovers, Delaware’s courts have left the issue of corporate objective largely unclear by stating that directors owe duties of care and loyalty to the corporation and its stockholders simultaneously. It means that the Delaware courts’ general approach to takeover bids reveals that shareholder interests are not the same with corporate interests in United States in the way that it is in the United Kingdom.⁴⁶⁴ Considering this thesis’ argument that the interest of the company as a whole should be preferred to the mere interest of shareholders, such an approach is not necessarily a wrong approach. For instance, in *Unocal*,⁴⁶⁵ the court ruled that a

⁴⁶² Jordan Barry and John William Hatfield, ‘Pills and Partisans: Understanding Takeover Defences’ (2011) 160 *University of Pennsylvania Law Review* 642

⁴⁶³ *ibid* 645; Margaret Blair, ‘Shareholder Value, Corporate Governance and Corporate Performance: A Post- Enron Reassessment of the Conventional Wisdom’ in Peter Cornelius and Bruce Kogut (eds), *Corporate Governance and Capital Flows in Global Economy* (Oxford University Press 2003) 63-64

⁴⁶⁴ Bruner [n 451]

⁴⁶⁵ *Unocal Corp. v Mesa Petroleum Co.*, 493 A.2d 946 954 (Del.1985)

targeted company's board, in evaluating how to respond to the hostile takeover bid, could consider 'its effect on the corporate enterprise' generally, including impacts on 'creditors, customers, employees, and perhaps even the community generally'. In *Time*,⁴⁶⁶ the court ruled that in evaluating the takeover offer, a target board might consider 'the impact on "constituencies" other than shareholders'.

In addition to Delaware's approach, Bruner also refers to some other states which in their so-called 'constituency statutes' indicate that the interest of other stakeholders in addition to shareholders should be considered in the context of hostile takeover bids.⁴⁶⁷

Despite the previous discussion that the market for corporate control is not an optimal device for preventing directors' opportunistic conduct in all circumstances, the US approach, particularly the Delaware judicial approach in considering the other stakeholders' interests in the context of takeovers, is still potentially a positive approach. Of course, such consideration is only acceptable as long as it would not give the wrongdoing directors the opportunity to misuse such considerations for their personal benefit. Considering the role of the court, the scale of abuse could not be great.

⁴⁶⁶ *Time* 571A.2 dat115

⁴⁶⁷ For instance, both Indiana and Connecticut's states constituency statutes provision refer to the consideration of other stakeholders' interests in taking commercial decisions.

4.5 Power of public regulator in protecting the company

Some scholars argue that in light of the weaknesses of states' company law, securities regulation is arguably a significant part of protection for the company. The possibility of civil enforcement permits injured shareholders to seek compensation for disclosure failings or market abuse such as insider dealing.

A significant amount of protection available to companies through shareholders in the US is provided through private securities litigation and in the form of securities class action suits.⁴⁶⁸ In fact, with the development of the fraud-on-the-market theory which was established under *Basic v Levinson*,⁴⁶⁹ the class action suits became the popular types of shareholder litigation against the corporate wrongdoers. The reason for the popularity of these types of litigations roots in the availability of the contingency fee agreements which shift the costs of the litigation from the claimant to the company. In addition to shareholder private securities litigation, the Securities Exchange Commission (SEC) which was created in 1934 as part of the New Deal under the Securities Exchange Act 1934, provides a variety of disclosure requirements for companies that are public. The establishment of the Securities Exchange Commission was the response to a serious need for investor protection in securities markets.⁴⁷⁰ The SEC has been based on reliance on

⁴⁶⁸ Roger Barker and Iris H-Y Chiu, 'Protecting minority shareholders in blockholder-controlled companies: evaluating the UK's enhanced listing regime in comparison with investor protection regimes in New York and Hong Kong' (2014) 10(1) Capital Markets Law Journal 98-132; also Steven A Ramirez, 'The Virtues of Private Securities Litigation: An Historic and Macroeconomic Perspective' (2014) 5 Loyola University of Chicago Law Journal 669

⁴⁶⁹ *Basic v Levinson* [1988] 485 U.S. 224

⁴⁷⁰ Barker and H-Y Chiu [n 468]; Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (Aspen Publishers 1982)

disclosure, and enforcement by an independent regulatory body and it can either sue for an injunction in court or issue orders on its own to prevent violations of the law.⁴⁷¹ The discretion which has been given to the SEC is a priority for its enforcement in comparison to other jurisdictions, particularly as the market regulators it often has more information and can react quicker to the violation of law.

The SEC's power is limited by the so-called 'internal affairs doctrine' which favours state corporate law when authorising corporate governance matters.⁴⁷² However, to support the SEC, the Sarbanes-Oxley Act 2002⁴⁷³ provides that the Stock Exchange establishes mandatory listing rules and requires all listed companies to have an audit committee comprising only of independent directors to be responsible for hiring auditors,⁴⁷⁴ and that financial statements should be signed off by the Chief Executive and Financial Officers.⁴⁷⁵ In addition to that, the Dodd-Frank Act 2010 rules that shareholder rights in an advisory vote on executive compensation and golden parachute⁴⁷⁶ should be increased.⁴⁷⁷ In addition, the stock market should establish mandatory listing rules to check the strategies regarding executive compensation.⁴⁷⁸ On the other hand, the New York Stock Exchange listing rules combat the agency problems arising from abuse of power

⁴⁷¹ § 2.2

⁴⁷² Barker and H-Y Chiu [n 468]

⁴⁷³ Rule 14a-11

⁴⁷⁴ Section 301

⁴⁷⁵ Section 302

⁴⁷⁶ A golden parachute is a substantial benefit given to top executives if the company is taken over by another company and the executives are terminated as a result of the merger or takeover.

⁴⁷⁷ Section 951

⁴⁷⁸ Section 954

by directors, and rely fundamentally upon mandating a significant oversight and monitoring role to independent board members.⁴⁷⁹

Despite the existence of mandatory disclosure requirements under the Sarbanes-Oxley Act, the majority of protection for shareholders still arises from the *ex post* remedial litigation, either through the security class action claims or shareholder derivative suits.⁴⁸⁰ Good evidence to prove this argument is the World Bank Doing Business Report, which shows that the strength of the United States' corporate governance has been based on the shareholders litigations.

4.6 US corporate governance from the Doing Business Report point of view

To review the strength of the corporate governance mechanisms of protection in public companies, it would be useful to look at the indicator of protecting minority investors in the World Bank Doing Business Report.

The Doing Business Report methodology has not been based on statistics but instead on the so-called 'law in the book'. The information for each jurisdiction comes from the securities regulations, company laws, civil procedure codes and court rules of evidence. The Protecting Minority Investors index measures the protection of shareholders

⁴⁷⁹ Usha Rodrigues, 'The Fetishization of Independence' (2008) 33 Journal of Corporation Law 447

⁴⁸⁰ 'Director versus Shareholder Primacy in New Zealand Company Law as Compared to U.S.A. Corporate Law' [2014] UCLA School of Law, Law and Economics Research Paper Series No 14-05 < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=241644 (visited 27/4/2017); John Armour et al., 'Private enforcement of corporate law: an empirical comparison of the United Kingdom and the United States' (2009) 6(4) Journal of Empirical Legal Studies 687-722

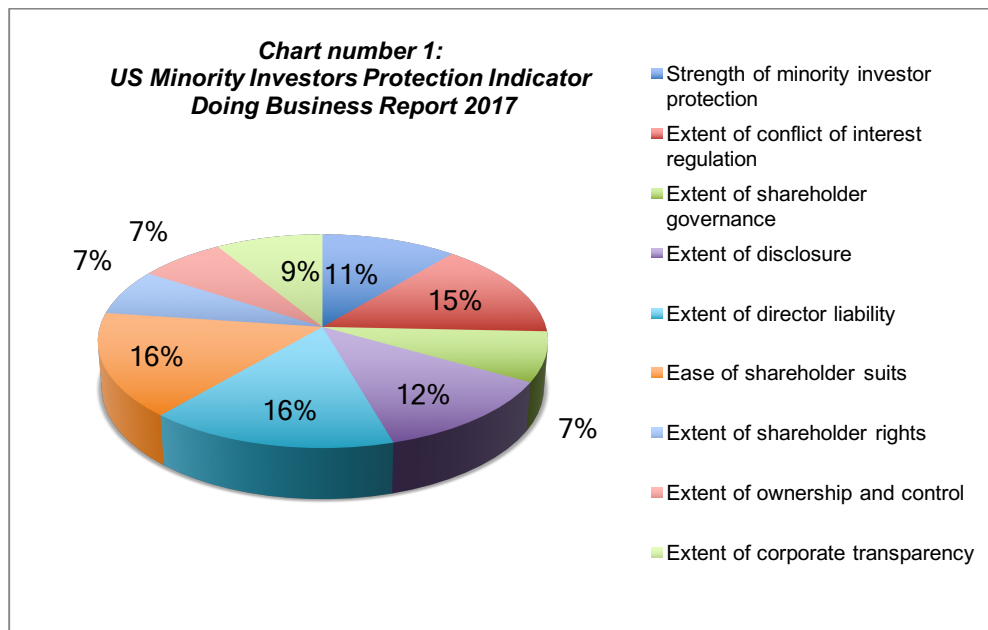
against directors' misuse of corporate assets for personal gain, by distinguishing three dimensions of regulation that address conflicts of interest: transparency of related-party transactions (extent of disclosure index), shareholders' ability to sue and hold directors liable for self-dealing (extent of director liability index), and access to evidence and allocation of legal expenses in shareholder litigation (ease of shareholder suits index).⁴⁸¹ This thesis refers to these reports for two reasons. First, the Doing Business Report methodology is in line with this thesis' argument that regardless of how much the corporate governance devices would be needed in practice, the availability of these mechanisms under the law is important. Second that the information they use comes from reliable sources of regulations and case law in each jurisdiction and this information is in line with the academic literature on each country's corporate governance to a great extent.

In order to define the strength of each country's corporate governance in protecting shareholders, the Doing Business 'protecting minority investors' indicator has been divided into nine indices. Each index is assumed to display one aspect of protection for shareholders.

To summarise the information provided by the report, the information is displayed on several charts.

⁴⁸¹ Protecting Minority Investors Methodology, available at <http://www.doingbusiness.org/Methodology/Protecting-Minority-Investors>

Chart number 1⁴⁸² shows the distribution of shareholders' protection among the different mechanisms of corporate governance in the US, mainly in public companies.



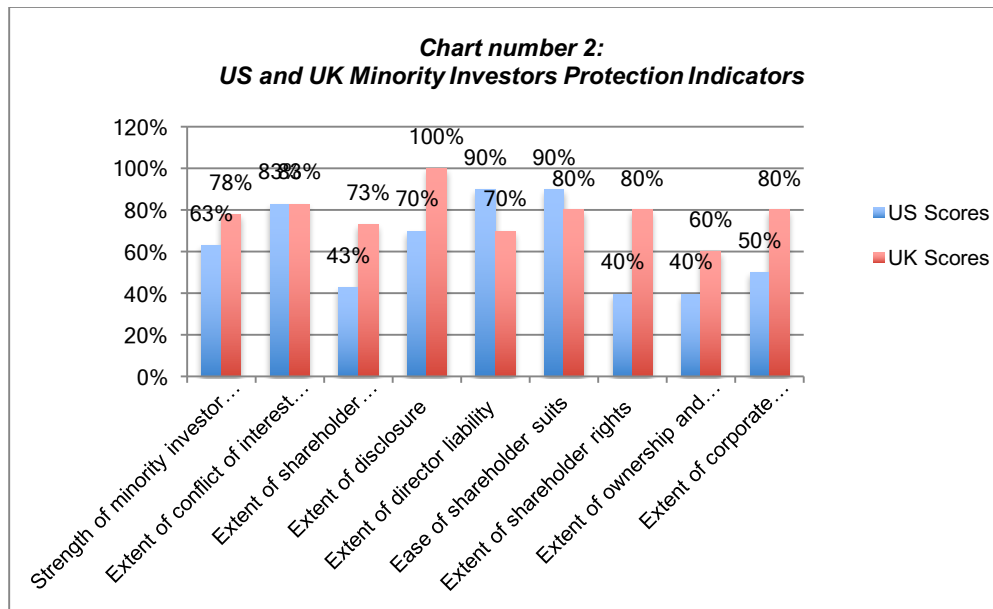
As is clear from the chart, the report shows that protecting shareholders' interests in the US arises from aspects such as shareholders' litigation suits, regulations on directors' liability, conflict of interest regulations and extent of disclosure.

Likewise, the chart shows US corporate governance weakness in areas such as shareholders' voting rights and the extent of ownership and control.

To get a better understanding of how US corporate governance differs from that in the UK, I have compared the US and the UK scores on another chart. Chart

⁴⁸² The chart has been based on the scores that the United States has obtained under the various indices of the 'protecting minority investors' indicator available on the Doing Business website: <http://www.doingbusiness.org/data/exploreeconomies/united-states#protecting-minority-investors>

number 2⁴⁸³ shows the weakness and strength of shareholder protection under US corporate governance in comparison to the UK.



The chart reveals that in areas such as shareholders' governance, shareholders' voting power, extent of disclosure and extent of corporate transparency, the UK is stronger than the US. Nonetheless, with regards to areas such as directors' liability and ease of shareholders' litigation suits, the US shows more strength. Overall, according to the Doing Business Report, the United Kingdom provides stronger protection for shareholders in comparison to the US and has obtained a better ranking under the report. The report confirms the academics' arguments on the

⁴⁸³ Like the previous chart, the comparison in this chart has also been formed on the scores that the United States and the United Kingdom have obtained under the various indices of the 'protecting minority investors' indicator available on the Doing Business website: <http://www.doingbusiness.org/data/exploreeconomies/united-states#protecting-minority-investors> and here: <http://www.doingbusiness.org/data/exploreeconomies/unitedkingdom#protecting-minority-investors>

power of shareholders' rights in the United Kingdom and the strength of shareholder litigation in the United States.

4.7 The role of derivative suits in the United States

From the academic literature and the Doing Business Report, we discovered that the derivative suits, along with class action suits are the dominant sources of protection for shareholders in the United States. Now it needs to be found how much this frequency helps with the protection of the company itself and what other factors are effective in the popularity of the American derivative suits. To find the answers I explore the role of the derivative suits both in the context of public and private companies.

The derivative suit has been in use in the United States for quite a long time. In *Cohen v Beneficial Industrial Loan Corp.*, the United States Supreme Court states that the derivative suit has long been 'the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders interests'.⁴⁸⁴ In performing their responsibilities, directors in the United States are charged with fiduciary duties of loyalty, due care and acting in good faith to the corporation and to the corporations' shareholders.⁴⁸⁵ If

⁴⁸⁴ 337 US 541,548 (1949)

⁴⁸⁵ See William Lafferty, Lisa A. Schmidt and Donald J. Wolfe, 'A Brief Introduction to the Fiduciary Duties of Directors Under Delaware Law' (2011) 116 Penn St. L. Rev 837; *Guth v Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939); In certain situations, such as when the corporation is insolvent,

shareholders believe that directors and officers are in violation of their duty of care or loyalty toward the corporation and its shareholders, they can initiate a derivative suit.

However, since in a derivative suit shareholders sue to compensate the harm to the company rather than injuries to themselves, the applicants must satisfy a number of strict standing requirements to bring the suit.⁴⁸⁶

As will be explained in the next section, the provisions under the Delaware Corporate Law, MBCA and federal rules impose restrictions, such as the demand on board requirement, the contemporaneous ownership rule and the continuous ownership rule, which stand in the way of shareholders' derivative suits.⁴⁸⁷

directors of a Delaware corporation also owe fiduciary duties to the creditors of the corporation. *Adlerstein v Wertheimer*, No. 19101, 2002 WL 205684 at 11 (Del. Ch. Jan. 25, 2002)

⁴⁸⁶ See *Pogostin v Rice*, 480 A.2d 619, 624 (Del. 1984) in which the court held that 'because the derivative action impinges on the managerial freedom of directors, the law imposes certain prerequisites to the exercise of this remedy'.

⁴⁸⁷ See Del. Code Com. S327, Fed. R.Civ.p.23.1, RMBCA § 7.41; ALI Principles of Corporate Governance § 7.02

4.8 Procedural requirements

The standing requirements for bringing derivative suits are established both by statute and by court rules.⁴⁸⁸ The important point is that despite the regularity of derivative suits in the United States, the procedural requirements are tough to prevent the misusing of this mechanism. In order to have a proper standing to initiate a derivative suit in the United States, the Federal Rules of Civil Procedure, and also most states' courts, impose the following requirements.

4.8.1 Prerequisites

This rule applies when shareholders or members of a corporation bring a derivative suit to enforce a right of a corporation.

The derivative suit may not be continued if it appears that the plaintiff shareholder does not fairly and adequately represent the interests of shareholders or the corporation.⁴⁸⁹

⁴⁸⁸ Del. Code Com. S327, Fed. R.Civ.p.23.1, RMBCA s 7.41; ALI Principles of Corporate Governance s 7.02

⁴⁸⁹ FED. R. Civ. P. 23.1; also see John D. Hughes, Gregory D. Pendleton and Jonathan Toren, 'Shareholder Derivative Litigation: A Primer for Insurance Coverage Counsel and Other Lawyers' [2012] < http://media.lockelord.com/files/uploads/documents/17908572_1.pdf (visited 7/5/2017)

4.8.2 The contemporaneous ownership rule

The major purpose of the rule is to prevent unjust enrichment by deterring the purchase of derivative suits.

In *Rosenthal v. Burry Biscuit Corp.*,⁴⁹⁰ the court held that the purpose of the contemporaneous ownership rule is ‘to prevent what has been considered an evil, namely, the purchasing of shares in order to maintain a derivative action designed to attack a transaction which occurred prior to the purchase of stock’.

Nonetheless, the rule has been the subject of critiques from some academics. For instance, Hamilton argues that the real reason for the contemporaneous ownership rule is a repugnant attitude towards derivative suits rather than the purpose of deterrence of unjust enrichment or prevention of purchase of suits.⁴⁹¹ He argues that if preventing of abuse of litigation through share purchase is the real concern, then the law should allow the shareholder who has already bought the company shares but has just discovered the wrong conduct, to bring a derivative suit even if he was not a shareholder at the time that the wrongdoing happened.⁴⁹² Li also suggests that to prevent unjust enrichment, it would be better if the rule were to require that the plaintiff must have bought the shares before the misconduct was publicly known, rather than the current approach.⁴⁹³

⁴⁹⁰ *Rosenthal v Burry Biscuit Corp.* 60 A.2D 106 at 111 (DEL.Ch.1948)

⁴⁹¹ Robert Hamilton and Richard Freer, *The Law of Corporations in a Nutshell* (West Academic 2010)

⁴⁹² *ibid*

⁴⁹³ Xiaoning Li, *A comparative study of shareholders' derivative actions. England, the United States, Germany and China* (Kluwer Law International 2007) 157

These arguments are correct. The reason is that the derivative claim is a law suit for the protection of the company and any probable compensation goes back to the company and not shareholders personally; therefore, a shareholder should be able to bring a claim on behalf of the company even if they were not shareholders at the time of the alleged wrongful conduct of directors.

In addition to the academic critiques to the contemporaneous ownership rule, The American Law Institute (ALI) Principles of Corporate Governance also depart from the rule and suggest that instead of the current requirement, the shareholder should prove he acquired the shares before the material facts relating to the breach were publicly disclosed.⁴⁹⁴ Unlike in the United States, the statutory derivative claim provisions under the Companies Act 2006 allow a shareholder to bring a derivative action for a wrongdoing that happened before he purchased his shares.⁴⁹⁵

⁴⁹⁴ ALI Principles of Corporate Governance, s 7.02(a) <<https://www.ali.org/publications/show/corporate-governance-analysis-and-recommendations/>>; also Douglas M Branson, 'The American Law Institute Principles Of Corporate Governance And The Derivative Action: A View From The Other Side' (1986) 43(2) Washington and Lee Law Review

⁴⁹⁵ Companies Act 2006 s 260(4)

4.8.3 The continuous ownership rule

According to the US continuous ownership requirement, the rule requires that the plaintiff must continue to hold shares in the corporation so as long as the suit continues. In this way, the plaintiff will share in the corporation's financial gains or losses during the litigation.

In *Lewis v Anderson*,⁴⁹⁶ the Delaware court stated that 'A plaintiff who ceases to be a shareholder, whether by reason of a merger or for any other reason, loses standing to sue derivatively'. Also, in *Strategic Asset Mgmt., Inc. v Nicholson*, the court rejected the argument that a shareholder need not preserve his or her status as a shareholder in situations where a settlement agreement has been reached, and held that 'a settlement agreement without a final judgment by the court does not terminate the litigation'.⁴⁹⁷ Furthermore, under the continuous ownership rule, in situations in which a merger occurs and the shareholder is merged out of the corporation or a corporation buys back the plaintiff's shares, the plaintiff loses standing.⁴⁹⁸ There are some exceptions with regards to mergers. For instance, Delaware allows a shareholder to preserve a derivative suit if the merger is the subject of a fraud claim and the fraud was committed merely to deprive shareholders of standing.⁴⁹⁹ In *Arnett v Gerber Scientific*, for example, shareholders had standing to sue after a merger because '(1) the plaintiff's

⁴⁹⁶ *Lewis v Anderson*, 477 A.2d 1040,1049 (Del.1984)

⁴⁹⁷ *Strategic Asset Mgmt., Inc. v Nicholson*, 2004 WL 2847875, at*3(Del.Ch.Nov.30, 2004)

⁴⁹⁸ *Quinn v Anvil Corp.*, 620 F. 3d 1005 (9th Cir. 2010)

⁴⁹⁹ *Kramer v Western Pac.Indus.*, 546 A.2d 348,354 (Del.1988)

disposition of the stock was involuntary, (2) the disposition was related to the allegedly illegal acts of defendants and (3) the remedy sought [rescission of the merger] would result in plaintiffs regaining shareholder status'.⁵⁰⁰

Additionally, the plaintiff has the right to bring a derivative suit if the merger is simply a reorganisation that does not affect the plaintiff's ownership in the business enterprise. In *Schreiber v Carney* the court held that because the 'structure of the old and new companies was virtually identical' and thus the reorganisation 'had no meaningful effect on the plaintiff ownership of the business enterprise,' the plaintiff did not lose standing to maintain a derivative action.⁵⁰¹ Based on the argument of this research that the derivative claim is a claim for protection of the company and the company does not belong to its shareholders, there is therefore a big critique to the Continuous Ownership Rule. The outcome of the derivative suits is supposed to benefit the company, hence the claimant shareholder decision for getting out of the company or a merger should not make a ground for the court to withdraw a derivative litigation.

⁵⁰⁰ *Arnett v Gerber Scientific, Inc.*, 566 F.Supp.1270,1273 (1983)

⁵⁰¹ *Schreiber*, 447 A.2d 17

4.8.4 The demand on the board requirement

A shareholder who wishes to initiate derivative litigation must secure the corporate action through making a demand to the board of directors. The demand requirement is considered as one of the most substantial barriers under the American law to shareholders' derivative suits.⁵⁰² Federal courts and most state courts permit a shareholder to initiate a derivative suit only after making a demand on the board to rectify the challenged transaction.⁵⁰³ The rationale behind the demand requirement is that it gives the board the opportunity to consider the dispute before the issue goes to court. Additionally, since generally the board of directors is granted the power to execute business matters including the decision to bring a lawsuit on behalf of the company and derivative suit is a lawsuit on behalf of the corporation, so the plaintiff shareholder in the first instance should request the board of directors to pursue the alleged misconduct.⁵⁰⁴ Moreover, courts are generally reluctant to interfere in companies' business matters so the demand requirement is considered a way of encouraging intra-corporate dispute resolution and preventing unnecessary lawsuits.⁵⁰⁵

⁵⁰² William Meade Fletcher et al., 'Fletcher Cyclopedia of the Law of Corporations' (2011) 2011 perm. ed., rev., section 1.06

⁵⁰³ The demand requirement was first codified in Federal Equity Rule 94, then in Federal Rules of Civil Procedure 23(b), which was incorporated into Federal Rule 23.1 in 1966. Also, all states now require demand on the corporate board prior to initiation of a derivative suit.

⁵⁰⁴ Xiaoning Li [n 493] 160

⁵⁰⁵ *Pogostin v Rice*, 480 A.2d 619, 624 (Del. 1984) ("The demand requirement ... exists at the threshold ... to promote inter corporate dispute resolution.")

The demand requirement must simply ‘fairly and adequately apprise the directors of the potential cause of action so that they, in first instance, can discharge their duty of authorising actions that in their considered opinion are in the best interest of the corporation’.⁵⁰⁶

In general, the demand requirement must: (1) identify the alleged wrongdoers; (2) describe the factual basis for the allegations; (3) describe the harm caused to the corporation and (4) describe the request for relief.⁵⁰⁷ However, in practice by using a procedure known as the ‘futility test’, plaintiff shareholders are usually attempting to bypass the demand requirement by asking a court to ‘excuse’ the requirement to make the demand because it would be futile. The ‘futility test’ first was established in *Aronson v Lewis* in which the court held that: ‘Under the particularised facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment’.⁵⁰⁸

⁵⁰⁶ *ibid*

⁵⁰⁷ *Lewis ex rel. Nat'l Semiconductor Corp v Sporck*, 646 F.Supp.574,578 (N.Y.Cal.1986)

⁵⁰⁸ *Aronson v Lewis*, 473 A.2d 805,14 (Del. 1984)

4.8.5 Is the demand on the board a proper requirement for derivative suits?

On the one hand, the demand requirement is rational as it works as a filter for preventing unnecessary litigation against the company, and it encourages the use of intra-corporate solutions rather than court intervention. Nevertheless, on the other hand, it might be unreasonable to use the board as a filter for derivative suits because the whole reason for the derivative suit is that the board has failed to prevent the alleged misconduct.

Hence, accepting the shareholders derivative suit request would be admitting the board's own failure and it is unlikely that the wrongdoing directors would admit such a thing. Therefore, it is not surprising that in most situations the board rejects the demand request. As such, it is unlikely that the board will be able to judge objectively whether a derivative action is meritorious.

In contrast to the United States' 'demand requirement', the UK has made the courts the primary filter for unmeritorious derivative claims. Under the statutory derivative claim, shareholders are required to obtain permission from the court before they can initiate a derivative claim. They are required to demonstrate that pursuing the derivative action would be in the best interests of the company and that the action is being brought in good faith. However, overall, the UK approach in referring the claim to the third party independent body (i.e. the court) to decide is a better approach than the US. Although, as was explained in chapter two, the UK approach has its own deficiencies, which need to be amended.

4.8.6 The special litigation committee

One independent body which could decide on the merit of the derivative suits in the United States is the special litigation committee. In fact, when a plaintiff makes a demand on the board of directors, the corporation's board has two choices: take over the litigation or oppose it. The board's decision to take over the claim ends the shareholder's control of the derivative suit, but if the board decides to take over the action, it may delegate control to an independent and disinterested special litigation committee.⁵⁰⁹ The special litigation committee is responsible for investigating the merits of the plaintiff's claim and defining whether or not litigation is in the corporation's best interest.⁵¹⁰ Nevertheless, the special litigation committee rarely happens in practice in Delaware. The reasons are that establishing a special litigation committee could be every expensive, the independency of the committee's members could be a challenging issue for the board of directors and, lastly, there is no guarantee that the court will approve the committee's opinion.

⁵⁰⁹ William Meade Fletcher et al. [n 505] § 6019.50

⁵¹⁰ *Zapata Corp v Maldonado*, 430 A 2d 779, 786 (Del.1981)

4.8.7 The role of the business judgment rule

Another difficulty in the way of shareholders derivative suits in the United States is the role of the business judgment rule which is a widely adopted principle in that jurisdiction.

Under the business judgment rule, in evaluating directors' decisions, the court should mainly examine the procedure by which the decision was made, instead of examining the merits or the substantive aspects of the decisions.⁵¹¹

The rule protects directors from liability for their business decisions if they fulfil the requirement of the rule. The requirement is that they have acted on an informed basis, in good faith and in honest belief that the action taken was in the best interest of the company. Therefore, under the business judgment rule, a rational decision made with due process will be valid and binding on the corporation even if it turns out badly later.⁵¹²

There are some rationales for the business judgment rule. The first argument is that directors rather than shareholders should have discretion in running the corporation and if their discretion has been rationally exercised then it should not be subject of judicial review.⁵¹³ Secondly, the rule acknowledges that there are inherent risks in making business decisions due to reasons such as inadequate information or unpredicted changes in events. Therefore, the evaluation of

⁵¹¹ Robert Hamilton and Richard Freer, *The Law of Corporations in a Nutshell* (West Academic Publishing 2011) 455

⁵¹² *ibid* 453

⁵¹³ *ibid* 454

business decisions should be based on the process of decision-making rather than on the merits. In this way, directors are encouraged to take business risks which may bring substantial profit for the corporation.⁵¹⁴ The last justification for the business judgment rule is that the courts should not second guess business decisions because they are not business experts and are less qualified than directors to cope with business issues.⁵¹⁵

However, the business judgment rule does not apply when the director is self-interested in a transaction, so if the plaintiff shareholder is able to prove that it is a conflicted interest transaction the business judgment rule will be rebutted. Yet again, the director may be exempt from liability if he is able to prove that the transaction is entirely fair to the corporation,⁵¹⁶ or it has been authorised by disinterested directors or a vote of disinterested shareholders after a full disclosure.⁵¹⁷

⁵¹⁴ Norman Veasey and Christine Di Guglielmo, 'What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments' (2005) 153(5) *University of Pennsylvania Law Review* 1399-1512

⁵¹⁶ DGCL s 144(a); Xiaoning Li [n 493] 150

⁵¹⁷ Stephen Bainbridge, *Corporation law and economics* (Foundation Press 2002)

4.9 The distinct role of derivative suits in private and public companies

4.9.1 The role of the derivative suit in private companies

Unlike in the UK, where the derivative claim is generally known as a remedy for shareholders in private companies, in the United States there are two different opinions on this issue. Some scholars argue that the derivative suit is not a suitable mechanism for closely-held corporations for several reasons.⁵¹⁸ First that due to the nature of derivative suits, even if the litigation is successful, all the probable compensation goes back to the corporation and since it is hard to dismiss the wrongdoing directors from the board or to remove their controlling power, they would still indirectly benefit from the recovery, based on the shares they owned. Therefore, considering the procedural impediments in the way of shareholders, derivative suits might not be as effective in closely-held corporations.⁵¹⁹ In the view of this thesis, such argument does not seem to be rational. The argument indicates that because majority shareholders might indirectly get some of the recovery back through the increase in value of the company, derivative claim is not effective in protecting minority shareholders. It is true that controlling shareholders in closely-held corporations might also benefit indirectly. On the other hand, having the derivative suit is better than not using it at all, particularly as it is still the main way of compensating the harm to the company as whole and not merely the shareholders. In contrast to the previous argument, some other scholars - for

⁵¹⁸ Xiaoning Li [n 493]

⁵¹⁹ *ibid*

instance Kenneth⁵²⁰ - argue that for private corporations with inter-shareholder conflicts and transactions involving controlling shareholders, the derivative suit still remains a critical mechanism because these companies are usually too small to be the subject of securities markets, media scrutiny and public enforcement. Therefore, the derivative suit is often the main way for minority shareholders in these companies to be protected against exploitation by the majority shareholders. This view is in line with this thesis argument. Nevertheless, I still argue that in addition to minority shareholders, the employees (especially in private companies) should also have the right to protect the company.

⁵²⁰ Kenneth Davis, 'The forgotten derivative suit' (2008) 61 Vand. Law Review 61 387

4.9.2 The role of the derivative suit in US public companies

In the United States, recourse for public companies depends on the nature of the rights being violated. There are generally two types of litigation: class action suits and derivative suits.

When the injury is personalised to a shareholder or a substantial number of shareholders and arises from violation of personal rights, the shareholders may bring a direct or a class action suit. On the other hand, where the harm is to the corporation and only affects the shareholders indirectly, the action must be brought as a derivative suit.⁵²¹

However, in some situations the classification of suits is not as clear as it first appears, especially if the same misconduct gives rise to both direct and derivative claims. As an example, the claim for compelling dividends is generally considered as a direct claim because the right to dividends arises from the share ownership, but on the other hand, a derivative suit may also be allowed to hold directors responsible for their duties to the corporation. In such situations, in addition to a direct suit or class action claim for shareholders' personal rights, a derivative suit may also be initiated to protect the rights which belong to the corporation.⁵²²

⁵²¹ *Dowling v Narragansett Capital Corp*, 735 F Supp.1105,1113 (D.R.I.1990)

⁵²² James Cox and Thomas Lee Hazen, *Cox & Hazen on Corporations* (Aspen Law & Business 2002) 421

Such an interaction between the class action suits and derivative suits is similar to the interaction between derivative claims and unfair prejudice claims in UK private companies.

Although the class action and the derivative suit differ in concept and to some extent in procedure, they share important similarities. Both require plaintiffs to give notice to the absent interested parties; both permit other parties to petition to join the suit; both provide for settlement and release only after notice, opportunity to be heard and judicial determination of fairness of the settlement; and finally under the common fund and corporate benefit doctrines, in both actions successful plaintiffs are customarily compensated from the fund that their efforts produce.⁵²³

Overall, unlike the scarcity of derivative claims in UK public companies, it seems that the United States' derivative suits play the same important role in public companies as in closely-held corporations. As I discussed at the beginning of this chapter, the reason could have root in weakness of other corporate governance legal devices. Particularly that like in the UK, the focus of derivative suits is on the protection of shareholders rather than the company as whole. Nevertheless, there are some controversial debates over the effectiveness of derivative suits in public companies. During the 1980s, some scholars argued that the cost of derivative litigation usually exceeds its compensatory value.⁵²⁴ This argument, however, was

⁵²³ Compare Fed.R.Civ.P.23 (Class action) and Fed.R.Civ.p.23.1 (derivative suits); William Allen, Reiner Raakman and Guhan Subramanian, *Commentaries and Cases on The Law of Business Organizations* (Wolters Kluwer 2003)

⁵²⁴ Thomas Jones, 'An empirical examination of the incidence of shareholder derivative and class action lawsuits' (1980) 60 Boston University Law Review 60, 2 306–30; Daniel Fischel and Michael

questioned by the ALI Principles of Corporate Governance which claim that the overall rate of plaintiff success, in derivative suit cases where some compensation was granted, was about forty-four per cent which is considered positive in comparison with the rate of plaintiff success in similar forms of civil litigation.⁵²⁵

In another argument, Romano examined all shareholder suits filed from the late 1960s through to 1987 against a random sample of 535 public corporations. She found that of the 139 total lawsuits filed against these corporations, only 12 ended with a monetary settlement in a derivative suit. Romano argues that nearly 65% of derivative suits resulted in settlement. Cash payments were made to shareholders in 21% of derivative suits and the total cash recoveries obtained were on average 0.5% of the value of the corporation's total assets. In only 25% of settlements were some changes in the composition of the board of directors or in the transaction approval procedures of the corporation obtained. However, both plaintiff and defendant's lawyers were paid rewarding fees in 90% of the shareholders' suits.⁵²⁶ Romano also examined the stock price reactions to announcements of initiation and termination of shareholder litigation in both class action and derivative suits, and drew the conclusion that the change in stock price does not provide convincing

Bradley, 'The role of liability rules and the derivative suit in corporate law: a theoretical and empirical analysis' (1986) 71 Cornell Law Review 261-97

⁵²⁵ ALI Principles of Corporate Governance (II), 2007 Part VII, Chapter 1, Introductory Note, Reporter's Note, p 9; also Xiaoning Li [n 493] 124

⁵²⁶ Roberta Romano, 'The shareholder suit: litigation without foundation?' (1991) 7(1) Journal of Law, Economics, & Organization 55-87

support for the proposal that shareholders experience significant wealth effects from litigation.⁵²⁷

Nevertheless, again the ALI Principles questioned Romano's research conclusion. ALI reasons that these studies wrongfully assumed that the stock market would sensibly react to the relatively small recoveries from derivative suits. Moreover, there is no evidence that the expected reaction from the market was unfulfilled by the termination of any derivative suits. Hence, the difference between two market prices should not necessarily result in the conclusion that the derivative suits were ineffective. The indifference could be because of concern over collusive or cosmetic settlements, which leave nothing to the corporation. Lastly, the deterrent effect of the derivative suit will not be reflected in the price of stocks in one single corporation.⁵²⁸ In addition to Romano's research, Thompson and Thomas in their studies in 2004 found that during the two-year period of 1999 to 2000, relatively few derivative suits had been established in the Delaware Chancery Court by shareholders in either public or private corporations.⁵²⁹ According to their study there were 137 derivative suits, among which eighty per cent (108) suits were filed against public companies and the remaining twenty per cent (26) suits were against private companies.⁵³⁰ Among the suits against closely-held companies, only one third were granted relief and almost half were

⁵²⁷ *ibid* 65-66

⁵²⁸ ALI Principles of Corporate Governance (II), 2007 Part VII, Chapter 1, Introductory Note, Reporter's Note, p 12

⁵²⁹ Robert Thompson and Randall Thomas, 'The public and private faces of derivative lawsuits' (2004) 57 Vand. L. Rev 1747

⁵³⁰ *ibid* 1762

dismissed.⁵³¹ They argue that, based on their study, the derivative suits have little role to play in Delaware private companies.⁵³² However, they concluded that they found little evidence of strike suits and in most derivative actions resulting in monetary recovery, the amount recovered by the corporation appreciably exceeded the plaintiff attorney's fee.

Therefore, they argue that derivative litigation is more effective as a compensatory mechanism than other forms of representative litigation such as class actions.⁵³³ Likewise, Erickson based her research findings on shareholder derivative suits in the United States federal courts and showed that shareholders file more derivative suits than securities class actions. However, Erickson confirms that remarkably few of the derivative suits in the United States result in monetary compensation for the company. Instead, as the non-monetary function, most of the suits frequently ended with corporations agreeing to reform their own corporate governance practices, either in the form of increasing the number of independent directors on their boards or changing the methods by which they compensate their top executives. However, she argues that improving the other corporate governance mechanisms in the United States is a better approach than mere reliance on non-pecuniary outcome of derivative suits. The reason for her

⁵³¹ *ibid* 1766-1767

⁵³² *ibid* 1767

⁵³³ *ibid*

argument is that some of these corporate governance reforms achieved through settlements are unlikely to benefit the corporation itself.⁵³⁴

So what is the role of derivative suits in the United States finally? One argument is that since the early 1980s the derivative suit has started to play a less important role in the US than in earlier days.⁵³⁵ Several reasons have been suggested by academics for this decline. Some believe that the economic growth by the 1970s had resulted in a reevaluation of the balance between the corporation's efficiency and protection of minority shareholders. As a result, the shareholders' right to derivative suits was restricted.⁵³⁶

Some others bring the development of other mechanisms of corporate governance as a reason for the decline of derivative suits. Thompson and Thomas argue that until the early 1980s, derivative suits were the main method for disciplining corporate management and there were few efficient alternative corporate governance mechanisms to the derivative suits in existence.⁵³⁷

However, after the 1980s, the development of the market for corporate control and also the requirement by American stock exchanges for more independent directors for large public corporations' boards, along with the development of large institutional investors, provided effective alternatives to litigation.⁵³⁸ Davis

⁵³⁴ Jessica Erickson, 'Corporate Governance in the Courtroom: An Empirical Analysis' (2010) 51(5) William & Mary Law Review

⁵³⁵ Xiaoning [n 493] 98

⁵³⁶ James Cox, 'Social Meaning of Shareholder Suits' (1999) 65 The Brook Law Review 3-4

⁵³⁷ Thompson and Thomas [n 531]; Dan Puchniak, Harald Baum and Michael Ewing-Chow (eds), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge University Press 2012)

⁵³⁸ Thompson and Thomas [n 529]

Kenneth argues that derivative suits are not as effective a mechanism of protection as they used to be in the past. He argues that in public corporations derivative suits are almost forgotten and over the last three decades, they have not played a central role in controlling director's fiduciary duties and this role has now shifted to other mechanisms, mainly the independent members of a corporation's board of directors. He believes that in terms of controlling the corporate affairs in public companies, the role of derivative suits has been substituted with efficient securities markets, media scrutiny and public enforcement which together provide shareholders the protection that was traditionally provided by derivative suits, without the cost and distraction associated with litigation. Nonetheless, he still argues that in spite of the decline of derivative suits in public corporations, for closely-held corporations with inter-shareholder conflicts and transactions involving controlling shareholders the derivative suit remains a critical mechanism because these companies are usually too small to be the subject of serious scrutiny by financial analysts. Therefore, the derivative suit is often the only means for minority shareholders to be protected against the exploitation by the majority shareholders in smaller publicly traded companies.⁵³⁹

Unlike Kenneth, Mark Lebovitch⁵⁴⁰ believes that derivative suits still play an important role in protecting companies from corporate executives' misconduct. He argued that a meritorious derivative litigation not only can compensate aggrieved

⁵³⁹ Davis [n 520]

⁵⁴⁰ Mark Lebovitch and Jeroen van Kwawegen, 'Of Babies and Bathwater: Deterring Frivolous Stockholder Suits Without Closing the Courthouse Doors to Legitimate Claims' (2015) 40 Delaware Journal of Corporate Law (DJCL)

shareholders with a significant monetary recovery but can achieve a deterrent to corporate managers who want to avoid the shaming effect of adverse judicial rulings.

Lebovitch mentioned numerous instances of shareholder litigation including derivative lawsuits that have achieved meaningful economic and non-monetary governance-based benefits to companies.⁵⁴¹

These contradictory views on the role of the derivative suits in the United States result in the following conclusions. First, in spite of the fact that derivative suits are lawsuits on behalf of the company, still like in the UK the dominant view sees the derivative claim as a mechanism of protection for shareholders. Based on this view, since the emergence of the other mechanisms of corporate governance, derivative suits are less in use in the United States. The fact that many derivative suits in the United States result in changes to corporate governance through a settlement confirms the view that in comparison to their British counterparts, American shareholders have weaker corporate governance power. Therefore, American shareholders rely on the derivative suit as a tool to correct the corporate governance of the company and curb corporate managers' misconduct. Nevertheless, the scholarly opinions show that even in the United States in which non-monetary settlements are common, the dominant attitude regards the

⁵⁴¹ As for examples, Lebovitch mentions: *re S. Peru Copper Corp.* shareholder derivative litigation, 52 A.3d 761 (Del. Ch. 2011); also *re News Corp.* shareholder derivative litigation, 2013 WL 3231515 (Del. Ch. June 26, 2013, approving \$139 million settlement of stockholders claims that the company's mergers turned a blind eye to illegal conducts at the company); *re Freeport-McMoRan Copper & Gold Inc derivative litigation*, C.A. No.8145-VCN (Del.Ch.2015 a \$137.5 pending settlement that would be paid to shareholders via a proposed special dividend have been submitted for approval).

derivative suit as a mechanism for bringing financial compensation. As a reason, some academics do not consider it as an efficient device in situations that derivative suits result in non-monetary settlements.

Corporate governance settlements in the context of derivative suits is a worthwhile point to note. At least in terms of the deterrence function of derivative suits, some of these settlements still play an effective role. Derivative suits are intended to control corporate management and improve corporate governance generally. Therefore, by correcting the internal corporate governance of a corporation through a settlement, the danger of potential misconduct in the future will be curtailed.

As I argued in chapter one, the deterrence function of derivative claims has been widely ignored in the English legal system. Although derivative claims might be less needed in the UK in comparison to the United States, because of the role of other corporate governance devices, still this aspect of the derivative claim is beneficial in improving the corporate governance of companies by minority shareholders and employees in situations that they are not able to rely on other mechanisms to discipline directors in the company.

4.10 The role of financial incentives in pursuing the derivative suit

As was mentioned at the beginning of this chapter, one main reason for comparing the American derivative suits with the UK is the financial structure of

this mechanism in the United States. According to the academic literature, the financial structure of derivative suits plays a significant role in the frequency of derivative suits in the United States; therefore, it provides a convincing reason for the relatively high rate of derivative litigation in the United States.⁵⁴² The aim of this research is not to increase the quantity number of derivative claims in the UK by promoting the US approach. The purpose is to help with the removal of unnecessary financial obstacles in the way of meritorious derivative claims. I explore the details of the US approach to the derivative litigation costs and explain what the inspiring aspects are.

Unlike the English principle of loser party rule in which the plaintiff shareholder pays their expenses of litigation as well as the legal expenses of the defendant if the action is unsuccessful, the general American rule is that each party bears his own litigation costs.⁵⁴³ The winning party costs will not be shifted to the losing party. Additionally, a plaintiff shareholder in US derivative litigation, even if the litigation fails, may not even be burdened with litigation costs for himself because of contingency fee agreements which have been available in the United States for over a hundred years and which are widely applied in derivative suits.⁵⁴⁴ Under contingency fee agreements, the shareholder and attorney agree that the attorney will undertake the financial cost of pursuing the derivative litigation and

⁵⁴² Dan Puchniak, Harald Baum and Michael Ewing-Chow [n 38]; Arad Reisberg, 'Funding derivative actions: a re-examination of costs and fees as incentives to commence litigation' (2004) 4(2) *Journal of Corporate Law Studies* 345-383

⁵⁴³ Deborah DeMott, *Shareholders derivative actions: Law and practice* (Callaghan 2010) § 3.1 p 3-3

⁵⁴⁴ *ibid*

will be compensated only on a fixed percentage of the amount recovered if the derivative suit is successfully litigated or settled.⁵⁴⁵ Such agreements shift the financial risk of initiating a derivative suit from the plaintiff shareholder to the attorney, thereby making it worthwhile for a shareholder to proceed, even if there is only a small chance of being compensated. The contingency fee agreement is supported by two unique common law doctrines that have been established by US courts, the common fund doctrine and the corporate benefit doctrine.⁵⁴⁶

4.10.1 The common fund doctrine

According to the common fund doctrine, if attorneys' efforts generate a fund or tangible monetary benefit for other shareholders in addition to the plaintiff shareholder, the court is authorised to award the attorney's fees from that fund.⁵⁴⁷

The common fund doctrine has been accepted as a valid principle by the courts of most states. The literature on the common fund doctrine is vast⁵⁴⁸ but the general idea is that this doctrine, by making the other shareholders share the cost of

⁵⁴⁵ Herbert Kritzer, *Risk, Reputations, and Rewards: Contingency Fee Legal Practice in the United States* (Stanford University Press 2004)

⁵⁴⁶ Harvard Law Review, 'Attorneys' Fees. Substantial Benefit Doctrine. Delaware Supreme Court Grants Fees to Plaintiff Suing As an Individual Shareholder. *Tandycrafts, Inc. v. Initio Partners*, 562 A.2d 1162 (Del. 1989)' (1990) 103(5) Harvard Law Review 1187-1192

⁵⁴⁷ Curtis Milhaupt, 'Non-profit organizations as investor protection: economic theory and evidence from east Asia' (2004) 29(1) Yale Journal of International Law 169-207

⁵⁴⁸ The American Law Institute Principles of Corporate Governance: Analysis and Recommendations (Proposed Final Draft) s7.17; Carol Hamme, 'Attorneys' fees in shareholder derivative suits: the substantial benefit rule re examined' (1972) 60(1) California Law Review

the litigation with the plaintiff, prevents unjust enrichment at the expense of the litigating party.⁵⁴⁹

If the litigation generates a common fund or tangible monetary recovery for the company, the court applies the ‘percentage scale’ method. This method has existed in the United States for almost a century. It was first used in the 1880s with the start of the common fund doctrine.⁵⁵⁰ Under this method the attorney will be paid in the range of 20 to 30 percent of the common fund, depending on the prior agreement between the shareholder and his attorney.⁵⁵¹

4.10.2 The corporate benefit doctrine

The corporate benefit doctrine was first explored in *Chrysler v Dann*.⁵⁵² This doctrine allows for the award of fees to a shareholder who successfully litigates against a corporation in a way that creates a benefit for the corporation but not in the form of a monetary relief.⁵⁵³

The corporate benefit doctrine significantly increases the economic incentive for plaintiff attorneys to pursue derivative actions by allowing them to receive a contingency fee even when the company does not receive tangible monetary

⁵⁴⁹ *Boeing Co.* (1980) 444 U.S. at 478; *Sprague v Ticonic Nat’l Bank* (1939) 307 U.S. 161, 167; and *Trustees v Greenough* (1882) 105 U.S. 527

⁵⁵⁰ See *Central R.R. & Banking v Pettus*, 113 U.S. 116, 128 (1885)

⁵⁵¹ Hamme [n 548]

⁵⁵² 223 A.2d 384 (Del. 1966)

⁵⁵³ Sean Griffith, ‘Correcting Corporate Benefit: How to Fix Shareholder Litigation by Shifting the Doctrine on Fees’ (2015) 56(1) Boston College Law Review

recovery, but nevertheless is thought to benefit from the litigation through corporate governance reform. This reform may include the nullification of an election of directors, the termination of a detrimental transaction or making some procedural changes.⁵⁵⁴

Courts will apply the ‘lodestar’ method to calculate the attorney’s fees under the corporate benefit doctrine.⁵⁵⁵ The ‘lodestar’ method is applicable if the derivative suit results in a non-monetary recovery to the corporation, whether by judgment or settlement. The US Supreme Court in *Mills v Electric Auto-Lite Co* formally recognised the ‘lodestar’ method.⁵⁵⁶ In that case, the court held that this method is simply one for calculating attorneys’ fees based on the number of hours reasonably spent on the work, multiplied by the reasonable market hourly rate. The ‘lodestar’ method may be used regardless of whether a common fund is generated, and the final figure can then be adjusted upward or downward for certain factors known as multipliers, such as complexity of the case, quality of representation, risk and the like.⁵⁵⁷

The corporate benefit doctrine is a great advantage for attorneys in derivative lawsuits. Much academic evidence shows that non-monetary relief in the form of corporate governance change is the common result of US derivative litigation and attorneys still receive profitable fees in these cases.

⁵⁵⁴ James Cox and Thomas Lee Hazen, *Corporations* (2nd edn, Aspen Publishing 2003)

⁵⁵⁵ Mark Loewenstein, ‘Shareholder derivative litigation and corporate governance’ (1999) 24(1) Delaware Journal of Corporate Law

⁵⁵⁶ *Mills v Electric Auto-Lite Co* 396 US 375, 392 (1970)

⁵⁵⁷ *Friedrich v Fidelity Nat. Bank*, 545 SE 2d 107 - Ga: Court of Appeals 2001

Nonetheless, over time, despite its advantages, the corporate benefit doctrine has given rise to excessive amount of attorney-driven derivative suits, which has created many criticisms among academics.

4.10.3 The role of attorneys in American derivative suits

In the US there is an entrepreneurial class of attorneys that specialise in class action and derivative litigation. This has formed a strong financial incentive for attorneys to boost derivative suits not only to protect shareholders against the wrongdoing directors, but also to increase their own financial rewards through a contingency fee agreement.⁵⁵⁸

A plaintiff shareholder in a derivative suit, no matter whether he wins or not, bears no risk for the litigation costs, yet he still benefits indirectly from a derivative suit via the increase of a nominal value of his shares.

The attorney, however, directly benefits from any successful trial or settlement under the common fund and corporate benefit doctrines.⁵⁵⁹

Some argue that the US political environment under which lawyers are the proponents of derivative suits and also the main financial winners of these suits is the main reason for the high incidence of derivative litigation in the United States. This provides a contrast to the UK where no such rights and common fund and corporate benefit doctrines exist.

The unitary system of one bar in the UK weakens and lessens the impact of negotiations and discussions with authorities for settling the suits.⁵⁶⁰ It is not a bad thing in fact, because while attorneys' role in US derivative suits has the

⁵⁵⁸ James Kirkbride, Steve Letza and Clive Smallman, 'Minority shareholders and corporate governance: Reflections on the derivative action in the UK, the USA and in China' (2009) 51(4) *International Journal of Law and Management* 51.4 206-219

⁵⁵⁹ Xiaoning Li [n 493] 179

⁵⁶⁰ *ibid* 104

advantages of encouraging shareholders' meritorious litigation and disciplining corporate managements, nevertheless the attorneys' interests are not always consistent with the interests of the corporation and its shareholders.

For instance, attorneys generally prefer the assured rewards which result from derivative suits settlements than the uncertain result of a trial.⁵⁶¹ That is why most American derivative suits are settled.

The Federal Rules of Civil Procedure restrict derivative suit settlements by requiring that the proposed settlement and dismissal of derivative suits should be approved by the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.⁵⁶² However, some of these settlements are strike suits, which fail to bring significant benefit to the company.

⁵⁶¹ Deborah DeMott, *Shareholders derivative actions: Law and practice* (Callaghan 2010) section 6:3 pp 6-7

⁵⁶² The Federal Rules of Civil Procedure s 23.1

4.10.4 Rethinking the corporate benefit doctrine

The growing concerns over the increasing amount of shareholder litigation (both class actions and derivative suits) in the United States, also the concerns about the American attorneys' misuse of the corporate benefit doctrine have caused some academics to challenge the doctrine's current role. For instance, Griffith argues that the problem is too many suits by shareholders and not enough achievement at settlements. He argues that in terms of filings, class action suits challenge almost every merger transaction and derivative suits happen often alongside prosecutorial or regulatory interventions during many corporate crises. Yet, Griffith believes that the vast majority of these claims settle for non-monetary relief and the plaintiff counsel is nevertheless entitled to receive fees from the defendant under the corporate benefit doctrine.⁵⁶³

In addition to the growing academic debate, a decision by the Delaware Supreme Court in 2014, further challenged the current role of the corporate benefit doctrine in the context of shareholder litigation. The Delaware Supreme Court in an opinion in *ATP Tour Inc v Deutscher Tennis Bund*⁵⁶⁴ held that fee-shifting provisions in a Delaware non-stock corporation's bylaws are not per se invalid.⁵⁶⁵ What were the fee shifting bylaws? *ATP Tour Inc*, a Delaware membership corporation, runs a worldwide professional men's tennis tour. Two entities,

⁵⁶³ Griffith [n 553]

⁵⁶⁴ 91 A.3d 554,560 (Del.2014)

⁵⁶⁵ *ibid* 560

Deutscher Tennis Bund (the German Tennis Federation) and Qatar Tennis Federation, joined ATP in the early 1990s and agreed to be obliged by its bylaws, as amended from time to time. In 2006, ATP's board of directors revised ATP's bylaws to add a provision stating that if a current or former member brings litigation against ATP and "does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought", the member bringing litigation will be obliged to reimburse ATP for any fees, costs and expenses spent by ATP in connection with such litigation.

In 2007, the two tennis federations challenged a decision made by ATP and sued it in federal court alleging several federal antitrust and Delaware corporate law claims.⁵⁶⁶ However, the plaintiffs lost their claims on the merits and ATP invoked its fee-shifting bylaw to recover its fees, costs and expenses. The district court brought four questions regarding the validity and enforceability of fee-shifting bylaws to the Delaware Supreme Court.⁵⁶⁷

The Delaware Supreme Court ruled that fee-shifting bylaws are facially valid. Although Delaware generally follows the American Rule on civil procedure on legal fees,⁵⁶⁸ Delaware law permits parties to modify that rule by contract.⁵⁶⁹ Because the bylaws amount to a contract between the corporation and its shareholders, a bylaw could validly create an exception to the American Rule.⁵⁷⁰

⁵⁶⁶ *ATP Tour, Inc. v Deutscher Tennis Bund*, 91 A.3d 554, 556 (Del. 2014) (quoting ATP Bylaw Article 23.2(a))

⁵⁶⁷ *ibid* 557

⁵⁶⁸ *ibid* 558

⁵⁶⁹ *ibid*

⁵⁷⁰ *ibid*

Finally, the court held that such a bylaw was binding even on persons who became members of the corporation before the bylaw was adopted.⁵⁷¹

The court acknowledged that an otherwise valid fee-shifting bylaw would be unenforceable if adopted for an improper purpose.⁵⁷² Although the court did not explain clearly what would create an improper purpose, it held that seeking to deter shareholder litigation was ‘not invariably an improper purpose’.⁵⁷³

The Delaware Supreme Court held that fee-shifting bylaws are consistent with Delaware law, stating that contracting parties may agree to amend the so-called ‘American Rule’ which generally requires parties to pay their own costs and fees, regardless of the outcome of a litigation and instead require the losing party to pay the winner's attorneys' fees.⁵⁷⁴

The *ATP Tour* decision soon became a controversial issue among academics and practitioners.

Soon after the court decision, over fifty Delaware corporations adopted similar fee-shifting bylaws⁵⁷⁵ and the *ATP Tour* court ruling received both critique and support from academics and practitioners.

Some proponents argued that an increase in fee-shifting bylaws would result in the non-filing of many, if not most, derivative suits and it would deter ever-

⁵⁷¹ *ATP*, 91 A.3d 560

⁵⁷² *ibid*

⁵⁷³ *ibid*; Stephen Bainbridge, ‘Fee Shifting: Delaware's Self-Inflicted Wound’ (2015) 15(10) UCLA School of Law, Law-Econ Research Paper No. 15-10

⁵⁷⁴ Bainbridge *ibid*

⁵⁷⁵ Rudy, *Hostile Takeover of Shareholder Litigation* (TRIAL 2015) 28, 30

increasing shareholders' litigation.⁵⁷⁶ Some suggested that it would be an instant check for plaintiffs' attorneys to ask themselves for the first time how good their cases actually are.⁵⁷⁷ On the other hand, many scholars and practitioners criticised the *ATP Tour* ruling. For instance, Griffith argued that the court's ruling on allowing the fee-shifting bylaws, which is similar to the so-called English losing party rule, cannot solve the problem of excessive litigation by shareholders but will discourage potentially valuable shareholder claims. Therefore, as an alternative to fee-shifting bylaws, which in his view penalised plaintiffs in desirable and undesirable lawsuits alike, Griffith provides three recommendations. First, that the corporate benefit doctrine no longer be accepted in non-derivative suits; such as class action suits. Second, that the burden for proving the merit in certain corporate governance settlements be shifted to plaintiffs. And lastly, that the scope of defendant release in corporate governance settlements should be appropriate to the benefit received by the company.⁵⁷⁸

Like Griffith, Lebovitch in opposing fee-shifting bylaws suggested that in order to curtail the problem of frivolous lawsuits that achieve no substantial benefits for corporations and shareholders, the plaintiff should be required to show that a corporate governance settlement provides material benefits to the corporation or

⁵⁷⁶ Claudia Allen, 'Bylaws Mandating Arbitration of Stockholder Disputes?' (2015) 39 Delaware Journal of Corporate Law 751, 818; Pamela Park, 'More Delaware Companies Adopt Fee-Shifting Bylaws to Deter Shareholder Litigation' (2014) Westlaw Corporate Governance Daily Briefing

⁵⁷⁷ Liz Hoffman, 'Shareholder Suits May Prove Costly' (2014) <<https://www.wsj.com/articles/why-shareholder-suits-may-prove-costly-1400447173>> (visited 3/3/2015)

⁵⁷⁸ Sean Griffith [n 553]

the class; also the defendants release be appropriate to the benefit of the company obtained during the settlement.⁵⁷⁹

Finally, in order to fix the court ruling in *ATP Tour*, in March 2015 the Delaware bar proposed legislation that would limit the availability of fee-shifting bylaws to non-profit corporations.⁵⁸⁰ The proposal was introduced as Senate Bill 75,⁵⁸¹ and finally the Delaware legislature accepted alterations to the Delaware General Corporation Law (S.B. 75) that effectively bans such bylaws.⁵⁸²

By the Delaware ruling, the attempts to give a role to the loser party rule in order to reduce the excessive amount of shareholder litigation failed. However, in line with the opinions of the opponents of the fee-shifting bylaws, this thesis agrees that the loser party rule is not a proper solution for controlling frivolous lawsuits either in the United States or in the UK. The reason is that the rule, by putting the responsibility of the whole litigations' costs on the applicant, could discourage potentially valuable shareholder claims as well. The alternative proposed solutions such as proving the material benefits in derivative suit settlements or limiting the corporate benefit doctrine to derivative litigation only (omitting corporate benefit from class actions), would be more effective.

⁵⁷⁹ Mark Lebovitch and Jeroen van Kwawegen, 'Of Babies and Bathwater: Deterring Frivolous Stockholder Suits Without Closing the Courthouse Doors to Legitimate Claims' (2015) 40 Delaware Journal of Corporate Law

⁵⁸⁰ Hazel Bradford, 'Delaware Bar Association Law Council Recommends Fee-Shifting Limits' [2015] Pensions & Investments

⁵⁸¹ S.B. 75, 148th Gen Assemb. (Del. 2015)

⁵⁸² Bainbridge [n 573]

4.11 The corporate benefit doctrine remains potentially advantageous

The potential advantages of considering the non-pecuniary aspect of derivative claims was explained earlier above. Hence, as was mentioned, this thesis argues that the losing party rule and shifting the burden of derivative claims costs to the applicants is not a proper solution for controlling frivolous lawsuits. Thus, some safeguards could be put in place to prevent abuse of the corporate benefit doctrine. For example, putting burden of proof of material benefits in the derivative claims' non-monetary outcome on the derivative claim applicant. Also, the extent of defendants' release from the responsibility should match the benefit the company obtains from the non-pecuniary result or corporate governance settlement.

The general opinion of this thesis is that many aspects of the American derivative suits, including the frequency of this mechanism, which is against the nature of the derivative claim, could not be applicable in the English legal system. However, there are still some valuable lessons to be learnt from the United States for the UK. The American approach potentially encourages shareholders' legitimate claims by imposing the liability of derivative suits costs on the company as the substantial beneficiary of the claim. This non-pecuniary but still substantial benefits happening in the form of corporate governance changes in the companies could be a true motivating factor for a derivative applicant. It could help the minority shareholders and the employees particularly in private companies to change the corporate governance of the company and prevent further harm to the company with the help of a court order. Such an approach would make

wrongdoing directors more cautious because they can be sued for any failure in their duties toward the company. Therefore, the recommendation is that with putting the above safeguard in place, this aspect should be promoted in the UK.

4.12 Conclusion

The chapter revealed that the weakness of other corporate governance mechanisms, combined with the availability of contingency fee agreements and the corporate benefit doctrine has caused shareholder litigation including derivative suits to be more frequently used in the United States than in the UK. The high incidence of derivative suits in the United States is not necessarily a sign of their efficacy in preventing harm to the company in all circumstances. Some of these claims are non-meritorious claims, which mainly benefit the plaintiff's lawyers through settlements with defendants. Studying derivative suits in the United States confirms this thesis' argument that the efficiency of the derivative claim is not necessarily associated with the high number of the derivative claim cases. The availability of the other mechanisms of accountability for directors could provide an environment in which the derivative claim is less needed. Therefore, the thesis argument is that the derivative claim should not be used excessively. Nor it should be forgotten in practice. Either of these approaches could undermine the potential benefits of the derivative claim in protecting the company. This chapter also explored the financial structure of the derivative suits in the United States. This financial structure has the positive aspects of encouraging legitimate derivative claims. Particularly, the consideration of the non-monetary benefits of the derivative claim could be inspiring for the English legal system in terms of enhancing the deterrence aspect of the derivative claim. In chapter six, I will discuss the derivative litigation cost problems in the UK in more detail and I will

propose the way for including the non-pecuniary aspects of the derivative claim in the cost order.

Chapter Five: New Zealand corporate governance: more signs of balance among different mechanisms of corporate governance

5.1 Introduction

One of this thesis' argument is that the efficiency of the derivative claim is not associated with the high number of the cases but the accessibility of the derivative claim procedure under the law. New Zealand, at least under the regulations, follows such an approach. The derivative claim is an exceptional mechanism. Only in very exceptional circumstances where the board of directors refuse to prosecute the wrongdoers because they are involved in the wrong conduct, does the derivatives claim become applicable. Therefore, by nature, the derivative claim is an exceptional remedy, which is not supposed to be frequently used; otherwise it could result in the abuse of the mechanism. A comparison between the UK and New Zealand is valuable for several reasons. The United Kingdom and New Zealand corporate governance frameworks share many similarities to each other. Like their British counterparts, shareholders in New Zealand have strong voting power over the company's affairs.⁵⁸³ In addition, among the corporate stakeholders, only shareholders have the right to sue directors for their wrongdoings to the company. Similar to the UK, the New Zealand Takeovers Code contains some disclosure provisions, which are an attempt to prevent abuse

⁵⁸³ Susan Watson, 'The Board of Directors' in John Farrar and Susan Watson (eds), *Company and Securities Law in New Zealand* (2nd edn, Brookers Ltd 2013) 298

in the area of defensive measures of directors. Moreover, in common with the UK, New Zealand corporate governance has been based on the comply-or-explain principle.

Nevertheless, in spite of these similarities, there are also some differences between the two jurisdictions. The main difference is while New Zealand provides similar *ex ante* mechanisms for controlling directors to those of the UK (significant shareholding rights, non-executive directors on the board, disclosure requirements), on the other hand, *ex post* remedial mechanisms such as the derivative action provisions and procedure are more lenient in comparison to the UK. For example, under the statutory derivative action provision, the company should first have met the whole or any reasonable costs of the derivative proceedings unless the court considers it would be unjust or inequitable for the company to bear the cost.

Regardless of how often in practice either of the corporate governance mechanisms is needed, New Zealand corporate governance has under the law kept more balance between availability of different mechanisms of accountability for directors. The argument of this chapter is that taking a less restrictive approach towards the derivative claim would not necessarily open the floodgate of litigation against the company, because availability of other corporate governance devices moderates the function of the derivative claim to some extent. The chapter explores the inspiring aspects of statutory derivative action provisions and procedural requirements in New Zealand.

5.2 Shareholder voting power in New Zealand

New Zealand is a smaller country than the UK, therefore in terms of the number and types of companies, there are differences between the UK and New Zealand. The main corporate types in New Zealand are private limited liability companies (non-listed companies) and widely-held limited liability (listed) companies that are listed by New Zealand Exchange Limited (NZX) on the New Zealand Stock Market (NZSX). However, despite these differences in practice, under company law, shareholders in both jurisdictions have similar voting power.

New Zealand corporate law has been established under the Companies Act 1993 with supporting regulations and government institutions such as the Companies Office, Ministry of Economic Development, the Securities Commission, and the Serious Fraud Office and, for listed companies, the Stock Exchange.⁵⁸⁴ The Securities Commission has drafted Principles and Guidelines for Corporate Governance.⁵⁸⁵ The New Zealand Stock Market listing rules binds listed companies. In addition, companies can draft their own Codes of Conduct, which may be included in their constitutions.⁵⁸⁶ Like their British counterparts, the New Zealand Companies Act 1993 has empowered shareholders by both special and ordinary resolution in general meetings.

⁵⁸⁴ Susan Watson and Rebecca Hirsch, 'The link between corporate governance and corruption in New Zealand' (2010) 24(1) New Zealand Universities Law Review 42

⁵⁸⁵ 'Securities Commission Corporate Governance' in *Corporate governance in New Zealand: Principles and Guidelines* [2004] < <https://fma.govt.nz/assets/Reports/141201-FMA-Corporate-Governance-Handbook-Principles-and-Guidelines2014.pdf> (visited 8/3/2017)

⁵⁸⁶ John Farrar and Susan Watson (eds), *Company and Securities Law in New Zealand* (2nd edn, Brookers Ltd 2013)

The Companies Act 1993 provides the following powers to shareholders by special resolution: (1) the adoption of a constitution where the company does not have a constitution,⁵⁸⁷ (2) the alteration or revocation of the constitution,⁵⁸⁸ (3) approval of major transactions,⁵⁸⁹ (4) approval of amalgamation proposals in some circumstances,⁵⁹⁰ and (5) putting the company into liquidation.⁵⁹¹

In addition, through an ordinary resolution, shareholders have the power to: (1) appoint⁵⁹² or remove directors⁵⁹³ unless the constitution provides otherwise, and (2) appoint auditors.⁵⁹⁴ Moreover, section 109(1) of the Companies Act 1993 provides the shareholders with the right to question, discuss or comment on the management of the company at a shareholders' meeting. Shareholders also have power under the Companies Act to pass a resolution relating to the management of the company, but unless the constitution of the company provides otherwise, the resolution is not binding on the board.⁵⁹⁵

Similar to the UK, the shareholder voting shortcomings of shareholders' voting power, which was discussed in chapter three, would apply in New Zealand as well. The argument is that shareholders might not properly be aware of the company's

⁵⁸⁷ Companies Act 1993 section 32(1); Silvana Schenone and Igor Drinkovic, *Duties and Responsibilities of Directors and Company Secretaries in New Zealand* (Wolter Kluwer 2013)

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⁵⁸⁸ Companies Act 1993 section 32(2)

⁵⁸⁹ *ibid* section 129(1). Major transactions are those in which 'the company would acquire or dispose of, or incur liabilities, which would represent more than half of the value of the company's assets for the transaction'.

⁵⁹⁰ Section 221(5)

⁵⁹¹ Section 241(2)

⁵⁹² Section 153(2)

⁵⁹³ Section 156

⁵⁹⁴ Section 196(1) read with section 201

⁵⁹⁵ Section 109(2) and (3)

affairs so may not know about the wrongful conduct to prevent it. In order to be aware of the details of the company management and to vote logically, shareholders are required to be familiar with the company's activities, but they may be reluctant to participate in general meetings and vote. The reason for comparison between the shareholder voting power in both the UK and New Zealand is to illustrate that both jurisdictions are strong in terms of shareholders' power and, consequently, the availability of ex ante mechanisms which shareholders could use to monitor the directors' conduct and prevent the harm to the company. However, as has been discussed before, in addition to the shareholder voting power, New Zealand in terms of regulations and procedural requirements is strong in ex post litigation mechanisms such as the derivative claim too. Therefore, if shareholders fail to monitor the directors' conduct and prevent the harm to the company, they could compensate the harm through a derivative claim litigation.

5.3 The comply-or-explain principle and the disclosure requirements

In common with the UK, in New Zealand all companies must comply with certain mandatory rules contained in the Companies Act 1993 and related legislation such as the Financial Reporting Act 1993. In addition to these, there is a set of mandatory requirements imposed on listed companies by the Listing Rules, which require listed companies to ‘comply-or-explain’ the extent to which they have complied with the NZX Corporate Governance Best Practices Code.⁵⁹⁶

The New Zealand Securities Commission recommends nine principles and guidelines that are aimed to ensure a high standard of corporate governance practices in New Zealand companies. The key features of these principles and guidelines include: independence of the chair, non-executive/independent directors, audit independence, non-audit services, board committees, adoption of international accounting standards and continuous disclosure.⁵⁹⁷ Moreover, the Securities Commission principles consider it desirable for boards of larger or listed companies to have independent directors. Also, the Securities Commission considers ‘independence of mind is a basic requirement for directors’.⁵⁹⁸

⁵⁹⁶ NZSX LR 10.5.5 (h) and (i), also Mark Fox, Gordon Walker and Alma Pekmezovic, ‘Corporate governance research on New Zealand listed companies’ (2012) 29 (1) *Arizona Journal of International & Comparative Law*

⁵⁹⁷ Krishna Reddy et al., ‘Corporate governance practices of small cap companies and their financial performance: an empirical study in New Zealand’ (2008) 4(1) *International Journal of Business Governance and Ethics*

⁵⁹⁸ The Securities Commission states that ‘.... board effectiveness is not always enhanced by directors’ formal independence if this is given too much weight in contrast to the independence of mind, and the skills, knowledge, experience, and time that a director can contribute to the entity. Independent representation is an important contributor to board effectiveness, but only when considered along with the other attributes sought in a non-executive director.’

In New Zealand, private corporations are not required to publicly disclose their financial accounts at present. However, the New Zealand Ministry of Economic Development (MED) has proposed in a recent discussion document, “Review of the Financial Reporting Act 1993, Part II”, that large private corporations should have to publicly disclose their financial accounts.⁵⁹⁹ One probable reason for that is New Zealand's economy is dominated by small to medium-sized companies. Many of them are private corporations, which expressly influence New Zealand's corporate governance culture.⁶⁰⁰

A unique characteristic of the New Zealand board is that directors are required by the Companies Act 1993 to buy shares in the company before being appointed to the board of that company. Under the Companies Act 1993,⁶⁰¹ directors are required to pay or receive fair value when they buy or sell shares; for issuer companies the Securities Markets Act 1988 prohibits insiders using inside information to their advantage.⁶⁰² This latter Act also contains continuous disclosure provisions and disclosure requirements for directors. These provisions also seek to address the information asymmetry problem.⁶⁰³

⁵⁹⁹ Corporate Governance of Non-Listed Companies in Emerging Markets, OECD Publications, <https://www.oecd.org/corporate/ca/corporategovernanceprinciples/37190767.pdf> (visited 4/3/2017)

⁶⁰⁰ Oliver Krackhardt, ‘New Rules for Corporate Governance in the United States and Germany- A Model for New Zealand’ (2005) 36 Victoria U. Wellington L. Rev 327

⁶⁰¹ Companies Act 1993 sections 146-149

⁶⁰² Securities Markets Act 1988 part 1

⁶⁰³ Securities Markets Act 1988 sections 21-22

In non-listed companies, related party provisions are permitted as long as the interest is disclosed and fair value paid.⁶⁰⁴ However, the New Zealand Securities Exchange Listing Rules have restricted the ability of directors on related party transactions in listed companies.⁶⁰⁵

5.4 Institutional shareholders

Institutional shareholders play an important role in mediating any governance-performance relationship in New Zealand.⁶⁰⁶

Similar to the UK, institutional shareholders in New Zealand are expected to improve the company value in several ways, including enhancing capital market productivity and liquidity; monitoring the affairs of the company to prevent harm to the company; and taking action to stop unreasonable compensation schemes that do not reflect the company performance.⁶⁰⁷ However, like the UK, the problem of ‘shareholder passivity’ could exist in New Zealand as well.

There is some evidence that institutional shareholders do not intervene effectively in the governance of their investment companies. Considering the size of most institutional investors in New Zealand, the institutional shareholders may face a collective action problem as in order to be effective, the activism of several institutional shareholders may be needed to participate in actions against the

⁶⁰⁴ Companies Act 1993 sections 139-144

⁶⁰⁵ Rule 9 of NZSX Listing Rules

⁶⁰⁶ Fox et al. [594] 8

⁶⁰⁷ *ibid*

board.⁶⁰⁸ The other reason is the cost of such involvement. For instance, these costs include the cost of circulating lobby documents, proxy solicitation and dedicating time and effort to argue their case at shareholders' meetings. Considering that institutional investors' primary goal is profit maximisation, expending cost and time on governance issues may not be proportionate to the probable benefits received for their effort. Still the most important problem is that the institutional shareholders in many situations have only short-term profit maximisation interests and might only care about their own investing returns in the near future. Therefore, they might not care about the protection of the company in the long run.

Overall, in terms of reliance on shareholder power only for protection of the company, New Zealand bears the same shortcomings that we discussed on the UK corporate governance. Therefore, in the context of broadening the scope of the derivative claim applicants, New Zealand could not be inspiring for the UK. Nevertheless, as was mentioned at the beginning of this chapter, in addition to strong *ex ante* mechanisms of protection, the *ex post* mechanisms are fairly potent under New Zealand law. Therefore, like in the United States, some aspects of the derivative claim procedure requirements in New Zealand could be inspiring to improve the quality of the derivative procedure in the UK, regardless of who is acting as the applicant for the derivative claim.

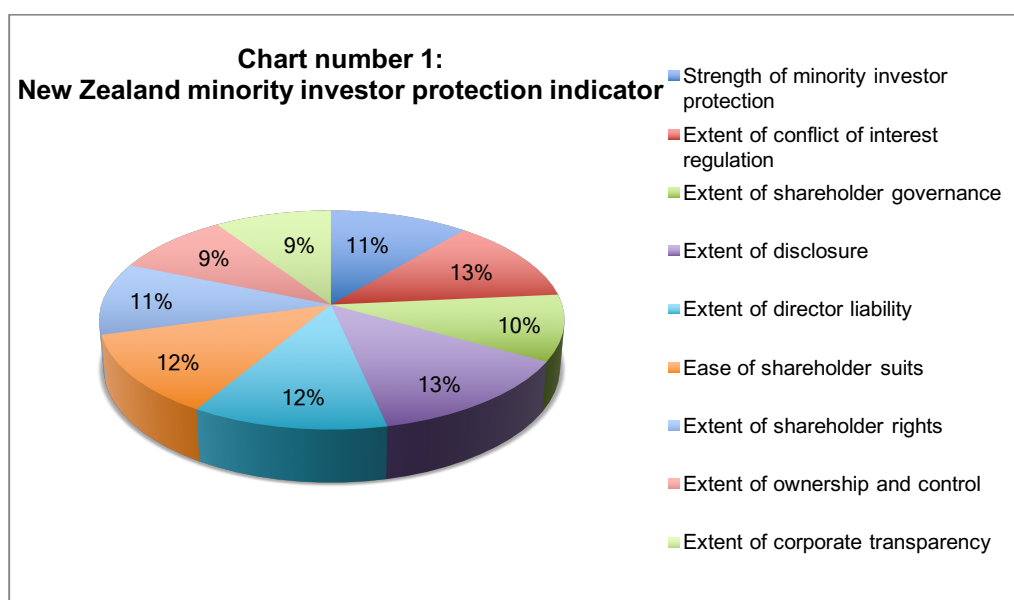
⁶⁰⁸ Aik Win Tan and Trish Keeper, 'Institutional investors and corporate governance: a New Zealand perspective' [2008] Working Paper Series Working Paper No. 65 <<http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/working-papers/WP65.pdf> (visited 10/8/2016)

In terms of having a good law on both *ex ante* and *ex post* corporate governance mechanisms in New Zealand, the World Bank Doing Business Report provides good evidence. New Zealand obtains the highest ranking among different jurisdictions on the index of minority investors' protection.

5.5 New Zealand minority shareholder protection from the World Bank Doing

Business Report point of view

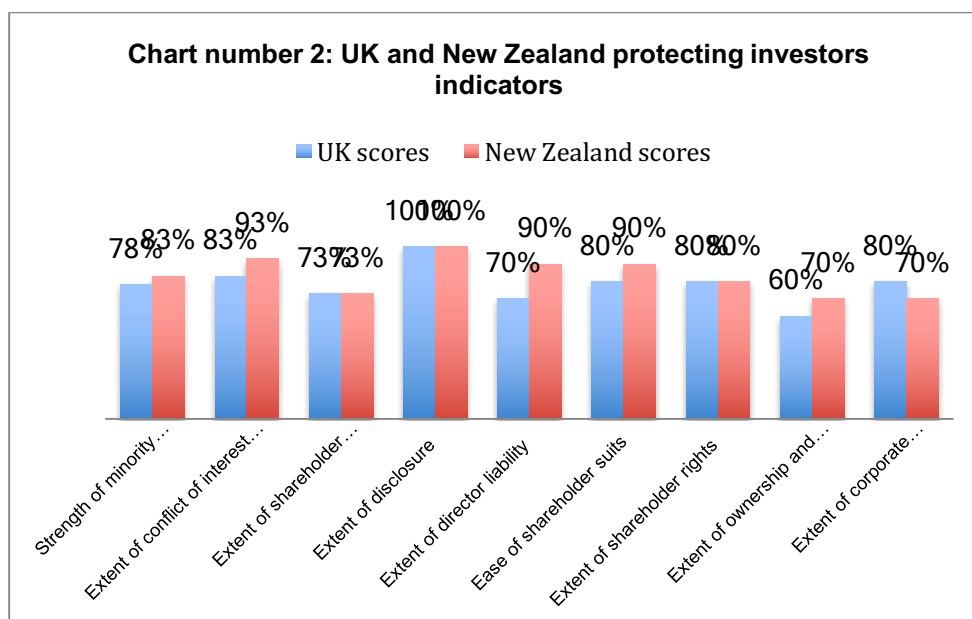
The chart below (Chart number 1)⁶⁰⁹ shows the distribution of shareholders' protection among New Zealand's different mechanisms of corporate governance, mainly in public companies.



As we observe from the chart, under the Doing Business Report, New Zealand shows strength on all the different aspects of protecting investors.

Chart number 2⁶¹⁰ shows the differences between New Zealand and the United Kingdom.

⁶⁰⁹ The chart has been based on the scores that New Zealand has obtained under the various indices of the protecting minority investors indicator available on the Doing Business website at: <http://www.doingbusiness.org/data/exploreeconomies/new-zealand#protecting-minority-investors>



The chart reveals that both countries are almost equally strong in the different aspects of protecting shareholders. However, in areas such as shareholders' litigation, directors' liability and conflict of interest regulations, New Zealand shows more strength than the UK.

To complete this comparison, Chart number 3 shows the strength of minority shareholders' protection in all the three countries of the United Kingdom, United States and New Zealand:

⁶¹⁰ The comparison in this chart has also been formed on the scores that New Zealand and the United Kingdom have obtained under the various indices of the protecting minority investors indicator available on the Doing Business website at: <http://www.doingbusiness.org/data/exploreeconomies/new-zealand#protecting-minority-investors> and <http://www.doingbusiness.org/data/exploreeconomies/unitedkingdom#protecting-minority-investors>

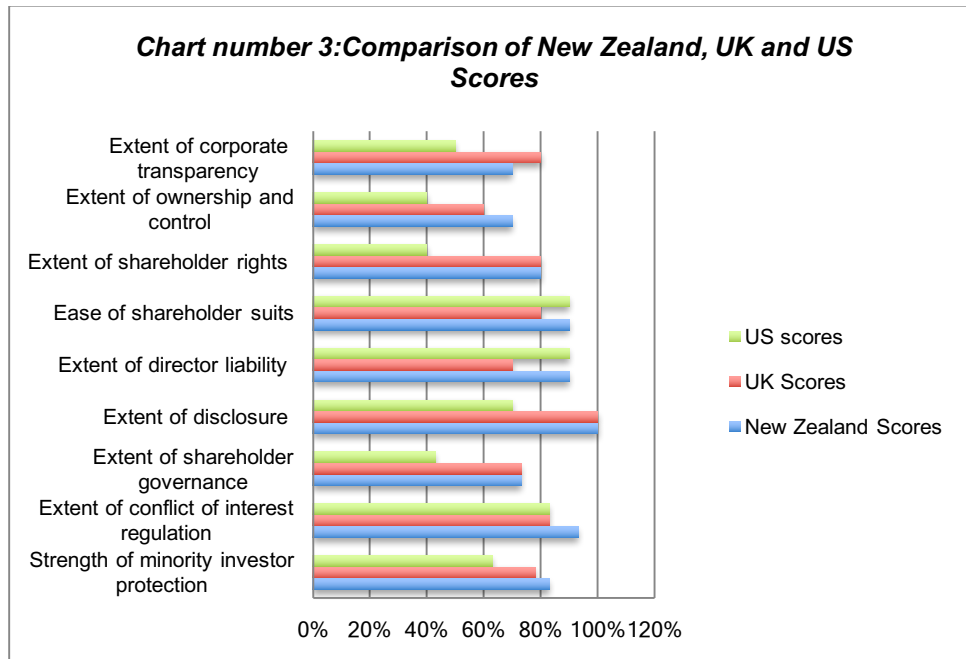


Chart number 3 confirms previous discussions on these countries' strengths and weaknesses in protecting shareholders.

Overall, the United Kingdom and New Zealand provide stronger protection for minority investors according to the Report, but in terms of directors' liability and shareholder litigations both the United States and New Zealand show more strength than the UK.

5.6 Derivative actions in New Zealand

New Zealand statutory derivative action provisions have been in use for more than twenty years. Since 1994, the common law rules governing the availability of derivative actions were replaced with rules contained in sections 164 to 168 of the Companies Act 1993.

The derivative claim provisions in both the UK and New Zealand are, in substance, very similar in many ways. In both countries, derivative claims mostly happen in closely-held companies; both countries' provisions require the permission of the court to initiate or intervene in derivative proceedings, both provide the court with the wide power to make any order it thinks fit in relation to the derivative proceeding, also both prohibit the plaintiff from discontinuing a derivative claim without the court's approval.

Nevertheless, the New Zealand statutory derivative action provisions appear to establish easier criteria for leave of the court to initiate a derivative litigation and seem to be more shareholder-friendly on the litigation costs provisions; accordingly, statutory derivative action has been used more frequently in New Zealand than in the UK.

5.6.1 Standing to bring a derivative action under the England and New Zealand provisions

Unlike in the UK, in which only shareholders have the right to initiate a derivative claim, in New Zealand, section 165(1) provides that a shareholder or director of a company can grant leave to bring proceedings in the name and on behalf of the company or any related company.

Moreover, section 165(1)(b) indicates that a shareholder or director can not only bring proceedings in the name of the company, but they can also intervene in proceedings to which the company or any related company is a party for the purpose of continuing, defending, or discontinuing the proceedings on behalf of the company or related company, as the case may be. Nevertheless, like in the UK and the United States, under the New Zealand statutory provisions other stakeholders such as employees do not have the right to initiate a derivative action.

Also, there is no specific section under the New Zealand Companies Act 1993 which clarifies the causes of action for which the derivative claim is available.

Unlike in the UK, the multiple or double derivative action has been given statutory recognition and a derivative action can now be brought in the name of a subsidiary and certain other companies. The possibility of bringing a multiple derivative action has been recognised under section 165(1) of Companies Act 1993 in the name of a 'related company'.

Moreover, the New Zealand Companies Act, except in some limited circumstances, such as when a derivative action is brought on behalf of an overseas company or a company registered under a different statute,⁶¹¹ has clearly abolished the right to bring a derivative action under the common law.⁶¹²

5.6.2 Criteria for the granting the leave in New Zealand

In New Zealand, the statutory criteria for the granting of leave are set out in section 165 of the Companies Act 1993, subsections 2 and 3.

Under section 165, the leave requirements are divided into two categories: first, the factors to which the court shall have regard⁶¹³ and second, the factors with which the court must be satisfied in order to permit a derivative action to be continued.⁶¹⁴

As with the UK, the New Zealand statutory provisions give the court a wide discretion to permit or deny leave to a derivative action. Section 165(1) indicates that the court ‘may’ grant leave having regard to the matters listed in section 165(2) and when it is satisfied with one of the criteria in section 165(3). There is no requirement that an application ‘must’ be granted leave if any or all of the required criteria are met.⁶¹⁵

⁶¹¹ *Carre v Owners Corporation*, Strata Plan 53020 (2003) 58 NSWLR 302 (NSWSC)

⁶¹² Companies Act 1993 s 165(6)

⁶¹³ Companies Act 1993 s 165(2)

⁶¹⁴ *ibid* s 165(3)

⁶¹⁵ Land Thai and Matt Berkahn, ‘Statutory derivative actions in Australia and New Zealand: What can we learn from each other?’ (2012) 25(2) New Zealand universities law review 370-401

However, the New Zealand criteria under which only one of the factors in 165(3)(a) or (b) must be satisfied by the court seems to set out an easier standard to grant leave for a derivative action than the criteria under section 263(3) in the UK, in which all of the list of requirements have to be satisfied by the court.

Section 165(2) also sets out four factors to which the court shall have regard in deciding whether to give permission to a derivative action.

The first consideration is the likelihood of the proceedings succeeding.⁶¹⁶ Some scholars⁶¹⁷ believe that the leading authority as to proper interpretation of this requirement was the judgment in *Vrij v Boyle*.⁶¹⁸ In this case, in assessing the likelihood of a claim succeeding, Fisher J made it clear that this criterion does not require a court to conduct an interim trial on the merits.⁶¹⁹ The court held that the appropriate test is that which would be exercised by a prudent business person in the conduct of his or her affairs when deciding whether to bring a claim.⁶²⁰ Also, in judging how a prudent business person would act, the court in *re Russley Hotel & Villas Ltd* held that ‘a court must assume that such a person has knowledge of his or her rights and actions of the other parties’.⁶²¹

The second consideration in section 165(2)(b) requires the court to have regard to the costs of the proceedings in relation to the relief likely to be obtained. In *Stichbury v One4All Ltd* the court described this section as requiring the court to

⁶¹⁶ Companies Act 1993 s 165(2)(a)

⁶¹⁷ Peter Watts; Neil Campbell; Christopher Hare, *Company Law in New Zealand* (LexisNexis New Zealand Ltd 2011)

⁶¹⁸ *Vrij v Boyle* [1995] 3 NZLR 763 (HC)

⁶¹⁹ *ibid* [765]

⁶²⁰ *ibid*

⁶²¹ *re Russley Hotel & Villas Ltd* [2000] 8 NZCLC 262,399 (HC) [30]

consider ‘the economics of taking a derivative action relative to any possible return’.⁶²²

Also in *Peters v Birnie*, Asher J held that the requirement in section 165(2)(b) is linked to the issue of the strength of the claim’s merits.⁶²³

The third factor to which the court shall have regard is section 165(2)(c) in which the court should consider if any action has been already taken by the company or related company to obtain relief. In many cases the courts have not considered this particular section as an important factor and not even mentioned it in their judgments.⁶²⁴ In *Cameron v Coleman*, Gendall J held that this section would only be really relevant if the company has actually taken some other additional steps to obtain relief.⁶²⁵

Finally, under section 165(2)(d) the fourth factor to which the court shall have regard is the interests of the company or related company in the proceedings being commenced, continued, defended, or discontinued, as the case may be. As the court in *Irving Baker Ltd* held, considering the best interest of the company has been a challenging issue for the courts, and the courts have struggled to find a truly separate role for the consideration in this section beyond factors that in reality relate to the costs or the likely success of the derivative proceeding in the previous subsections.⁶²⁶

⁶²² *Stichbury v One4All Ltd* [2005] 9NZCLC 263,792 (HC) [37]

⁶²³ *Peters v Birnie HC Auckland* CIV-2009-404-8119-22 April 2010 [57]–[58]

⁶²⁴ Peter Watts; Neil Campbell; Christopher Hare [n 617]

⁶²⁵ *Cameron V Coleman* HC Wellington CIV-2010-485-2151-22 June 2011 [51]

⁶²⁶ *Re Irving Baker Ltd* HC Whangarie CIV-2003-488-42-29 July 2004 [45]

In *re Russley Hotel & Villas Ltd* the court related the best interest of the company to the financial situation of the company and held that, because the company was not financially strong and required the further injection of shareholders' funds, derivative action would not be in the company's best interest as it might lead to the unwinding of the share allotments and ultimately deprive the company of much needed capital to fund the operation.⁶²⁷

Besides consideration of the factors in section 165(2), pursuant to section 165(3) in order to give permission to a derivative action the court must be satisfied that either (a) the company or the related company does not intend to bring, diligently continue or defend or discontinue the proceedings as the case may be, or (b) it is in the interest of the company that the conduct of proceedings should not be left to its directors or to the determination of the shareholders as a whole.

Lynne Taylor argues⁶²⁸ that in the great majority of derivative action cases, there has been no difficulty for the court in concluding section 165(3)(a) is met, as the company itself has not taken action on its own behalf. She also argues that the court may be satisfied of the matters set out in section 165(3)(a) and (b) where there is a deadlock between a company's directors and shareholders.⁶²⁹

⁶²⁷ *re Russley Hotel & Villas Ltd* [2000] 8 NZCLC 262,399 (HC) [41]

⁶²⁸ Lynne Taylor, *Company and Securities Law in New Zealand* (Thomson Reuters 2013) 580

⁶²⁹ *ibid*

5.6.3 Ratification

Unlike in the UK which considers the issue of ratification of directors' conduct as an important element in giving permission to a derivative claim, none of the New Zealand statutory derivative action provisions mention anything about shareholders' ratification and whether it may prevent a derivative action from being continued. However, in general, Companies Act 1993 section 177 deals with the issue of ratification of certain actions of directors.

Thai and Berkahn argue that under section 177(3)⁶³⁰ the ability of shareholders to ratify certain actions of directors does not limit the courts' power under section 165 to give permission to a derivative action. They suggest that this section has superseded the common law rule under which derivative actions could only be brought in relation to non-ratifiable actions of directors.⁶³¹

However, despite that argument, it seems that section 177(4) preserves the common law rule on ratification of directors by providing that: 'Nothing in this section limits or affects any rule of law relating to the ratification or approval by the shareholders or any other person of any act or omission of a director or the board of a company'.

Peter Watts makes the point that section 177(3) and (4) sit rather uneasily together. He argues that section 177(3) has been designed to provide that

⁶³⁰ Companies Act 1993 section 177(3) provides that: 'The ratification or approval under this section of the purported exercise of a power by a director or the board does not prevent the court from exercising a power which might, apart from the ratification or approval, be exercised in relation to the action of the director or the board'.

⁶³¹ Land Thai and Matt Berkahn [n 615]

ratification by shareholders is no longer a bar to derivative action proceedings but that it is merely a fact to be taken into account by the courts.⁶³²

In *MacFarlane v Barlow* the New Zealand High Court admitted the uncertainty in the wording of section 177 but decided that: ‘an application for leave such as this is not an appropriate forum for a considered analysis of the exceptions to the ratification rule’.⁶³³

However, it seems that in New Zealand the role of ratification in a derivative action procedure is less important than in the UK. Even if under section 177(4) the ratification is considered to be effective by the court in a derivative procedure, it would only be effective with regard to the directors’ conduct which shareholders have already ratified and therefore potential future ratification of the particular wrong is not a bar to a derivative proceeding. In contrast, in the UK under section 263(3)(d) Companies Act 2006, the court must take into account where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company.

⁶³² Peter Watts; Neil Campbell; Christopher Hare [n 617]

⁶³³ *Macfarlane v Barlow* [1997] 8 NZCLC 261,470 at 261,475

5.6.4 Costs

While in the UK the statutory derivative claim provisions under the Companies Act 2006 do not mention anything about the costs of the derivative procedure, Civil Procedure Rule 19.9E provides that in a derivative claim procedure the court may order the company, body corporate or trade union for the benefit of which a derivative claim is brought to indemnify the claimant against liability for costs incurred in the permission application or in the derivative claim or both.

Nonetheless, as will be discussed in the next chapter, in practice the operation of indemnity orders has shown severe flaws, and the court has ordered the company to indemnify the plaintiff shareholder for the costs in only a few cases since the introduction of statutory derivative claims in the UK.

In New Zealand, however, under section 166 of the Companies Act 1993, the court, on an application of shareholder or director to whom leave has been granted to bring or intervene in proceedings, shall order that the whole or any reasonable costs of the proceedings be met by the company, unless the court considers it would be unjust or inequitable for the company to bear the costs.

There are some factors that the court relied upon to justify a decision that it is unjust for the company to bear the costs.⁶³⁴ One factor is the lack of company assets to fund the derivative action. In *Re Kambrook Manufacturing Ltd*,⁶³⁵ Master Thomson ordered that no costs order should be made against the company and

⁶³⁴ Peter Watts; Neil Campbell; Christopher Hare [n 617]

⁶³⁵ *Re Kambrook Manufacturing Ltd* HC Wellington M505/95, 23 May 1996

even indicated that the absence of corporate funds might point towards the court denying leave.

Also in *Fryberg v Heaven*,⁶³⁶ Heath J relied upon the fact that the plaintiff has a substantial stake in the company to justify his conclusion that it would be unjust and inequitable for the company to bear the costs.⁶³⁷

Taylor points to an interesting aspect that while under the statutory derivative action the company should bear the costs of a derivative proceeding, some surprising cases suggests that the applicants have frequently declined to make any application that the company bear the costs of the derivative action, or even have given a positive undertaking to bear the costs themselves.⁶³⁸

Watts⁶³⁹ believes that one reason for adopting such an attitude is the fact that the applicant's ability and willingness to bear the costs of the derivative action can be an important consideration for the courts when deciding whether to give permission to a derivative action.⁶⁴⁰

⁶³⁶ *Fryberg v Heaven* [2002] 9 NZCLC 262, 966

⁶³⁷ *ibid* 45-52-54

⁶³⁸ Lynne Taylor, 'The Derivative Action in the Companies Act 1993: An Empirical Study' (2006) 22 NZULR 355 and 362

⁶³⁹ Peter Watts; Neil Campbell; Christopher Hare [n 617]

⁶⁴⁰ *Needham v EBT Worldwide Ltd* [2006] 3 NZCCLR 57 (HC) [20],[40] and [70]-[74]

5.6.5 The courts' power and supervision

In New Zealand under section 167 Companies Act 1993, the court at any time may make any order that it thinks fit in relation to derivative proceedings, including, but without limitation that the plaintiff or any other person should control the conduct of proceedings or order the directors to control the conduct of proceedings, or order the company or director to provide information or assistance in relation to the proceedings.

However, the most interesting order that the court may make is in section 167(4) which provides that the court may order that any amount ordered to be paid by a defendant in the proceedings must be paid, in whole or part, to former and present shareholders of the company or of a related company, instead of to the company or the related company itself.

This is a very interesting point as nothing similar to this order exists under the statutory derivative claim in the UK, and in fact such an order seems to be in contrast with the nature of a derivative action which is a claim on behalf of the company and any compensation naturally should go back to the company itself. Therefore, finding the ways that the courts operate such an order is the subject of further study in this research.

5.7 Conclusion

The chapter reviewed the New Zealand approach to the derivative claim. The argument is that in different aspects of corporate governance such as corporate transparency and shareholders' rights and conflict of interest regulations both the UK and New Zealand are almost equally strong. However, while the UK has taken an overly restrictive approach to the derivative claim, the New Zealand statutory provisions show a smoother approach. Exploring the leave requirements and the costs provisions, which are the main factors in a derivative proceeding in both the UK and New Zealand, shows that there are some major differences between the two countries' statutory derivative actions.

While multiple derivative action has got statutory recognition under the New Zealand provisions, the statutory provisions on derivative claims in the UK has not mentioned it, which has caused some uncertainties and ambiguities under the court procedure.

Moreover, although ratification still plays an important role in preventing shareholders to continue a derivative action under the statutory derivative claim in the UK, it has not been mentioned as a factor which needs to be considered by the court under the New Zealand derivative action provisions. Unlike the role of shareholder ratification in the UK, it does not apparently play much role as an obstacle in the way of derivative actions in New Zealand.

Another difference is in the provisions related to the costs of the derivative litigation. In the UK the general rule is that the derivative claim applicant should bear the costs of the litigation himself. Nonetheless, under the statutory derivative action in New Zealand, it is the company which should pay the costs of a derivative application unless the courts consider it to be unjust or inequitable for the company to pay the costs. The issue of ratification and the derivative litigation costs will be further discussed in the next chapter.

To sum up, studying the corporate governance systems and the different corporate governance tools in both jurisdictions revealed that New Zealand, at least under the law, has kept more of a balance between different mechanisms of accountability for directors. The other point, which has been revealed, is that the taking of a more lenient and not overly restrictive approach has not opened the floodgates of litigation towards companies. In New Zealand despite more friendly derivative action provisions, derivative actions are not frequently used.

Chapter Six: Reforms to the UK derivative claim

6.1 Introduction

Exploring the role of the derivative claim in the three jurisdictions of the UK, United States and New Zealand revealed that although the rate of the derivative claim could be affected by the availability of other mechanisms, none of those so-called alternative methods substitutes the role of the derivative claim in terms of protecting the company itself. Therefore, in order to provide optimal long-term protection for the company for the benefit of all the stakeholders, the derivative claim framework which is subject of this thesis should be amended.

Based on this argument, this chapter gives some recommendations for reforming the derivative claim on the grounds of the shareholder ratification as a procedure requirement and the derivative litigation costs. In the context of the UK derivative claim, ratification has inherited some of the uncertainty and complexity of the common law approach and could discourage potentially valuable derivative claim applications. In addition to the problems the ratification causes in the way of minority shareholder derivative claim, this research adds another argument too. The argument is that in the case of employees' derivative claim which is the proposal of this research, shareholders ratification should not be considered as a procedural requirement. The reason is that the interest of shareholders and that of employees is not always in line in the company. Therefore, their concerns for protection of the company should be considered on separate grounds. Otherwise it would be unfair to the employees if the claim they initiate on behalf of the

company would be rejected because the directors' wrong conduct has been authorised by shareholders previously.

In addition to the issue of ratification, the cost of derivative litigation is a constant and major problem which stands in the way of derivative claim applications. This chapter proposes a blended approach which has been inspired by the financial structure of the United States and New Zealand derivative claims. The aim of the proposal is to make the derivative claim a more affordable mechanism for legitimate applicants.

6.2 The role of ratification in UK derivative claims

Despite the reforms to the derivative claim, ratification of the directors' breach of duty by shareholders plays a significant role in defining whether permission should be granted by the court to hear a derivative claim.

Section 263(2)(c) of the Companies Act 2006 provides that the court must refuse to give permission to the derivative claim if the cause of action arises from an act or omission that has been ratified by the company. At the next stage, section 263(3)(c)(ii) provides that, in its discretion to whether to give permission, the court must have regard to whether the act or omission is likely to be ratified.

The problem with the reforms to the derivative claim procedure is that neither the Law Commission nor the Government in drafting the statutory derivative claim provisions made substantial changes to the role of ratification in a derivative claim procedure.

In fact, the Law Commission did not support substantial reforms to the ratification question based on the view that any changes would need to be considered within a comprehensive review of directors' duties. Hence, it would not be appropriate to make piecemeal changes within the reform of shareholder remedies, which may have wider implications.⁶⁴¹

⁶⁴¹ Law Corn No. 246, para 6.8; Julia Tang, 'Shareholder Remedies: Demise of the Derivative Claim' (2012) 1(2) The University College of London Journal of Law and Jurisprudence 178

However, the Law Commission's decision in not reforming the substantive law on ratification resulted in allowing the uncertainties and defects of the common law to pass into the statutory derivative claim and ruined the certainty and accessibility that was the original purpose of the reforms.

The only substantial change to the issue of ratification by the corporate law reforms was in relation to shareholders' voting ability. Section 239 of the Companies Act 2006 now provides that the votes of wrongdoing directors and connected members will be omitted in ratifying such wrongful conduct.

6.2.1 Ratification under the common law

Under the common law, shareholders' ratification of directors' breach of duty was an absolute bar in the way of a derivative action.

The rationale behind this position was that if an effective ratification discharges a director from her breach of duty, then there would be no wrong to the company that entitled a shareholder to sue derivatively on the company's behalf.⁶⁴² A further rationale was based on the principle of majority rule. If the majority shareholder voted to ratify, then minority shareholders had to accept that decision and could not sue derivatively.⁶⁴³

However, not all wrongs were ratifiable under the common law. In *Edwards v Halliwell*,⁶⁴⁴ the court held that four categories of wrongful conduct were beyond

⁶⁴² *Burland v Earle* [1902] AC 83 at 93

⁶⁴³ Christopher Riley, 'Derivative claims and ratification: time to ditch some baggage' (2014) 34(4) Legal Studies 584

⁶⁴⁴ *Edwards v Halliwell* [1950] 2 All ER 1064

the power of majority to ratify.⁶⁴⁵ These categories were in fact the grounds for bringing the derivative action under the common law.

Just one of the four unratifiable wrongs was considered to be a true exception to the *Foss v Harbottle* principle and consequently was considered as an unratifiable wrong. This was ‘fraud on the minority’, where ‘wrongdoers were at the control of the company’ at the same time. Such a breach was incapable of ratification by shareholders.⁶⁴⁶

The notion of ‘fraud on the minority’ was a complicated and obscure concept, which had made it extremely difficult for minority shareholders to prove in court. Therefore, in terms of ratification, the category of ‘fraud on the minority’ was also fraught with confusion.⁶⁴⁷

In fact, the main critique to ratification under the common law was that the ratification was based on the transaction-based approach.⁶⁴⁸ This meant that the legitimacy of ratification was dependent upon whether that breach could be considered as ‘fraud’ and there was uncertainty about which breach constituted a fraudulent act.⁶⁴⁹ Nevertheless, in addition to the uncertainty on the concept of the fraud, there were some other conflicted views on the ratifiability of the fraudulent

⁶⁴⁵ These non-ratifiable acts were *ultra vires* and illegal acts, the special majority requirement, breaching personal rights of shareholders and acts that constitute a fraud on the minority. A fifth exception, which was wherever the justice of the case so requires, was also mentioned in some cases but later was rejected by the Court of Appeal in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] 1.

⁶⁴⁶ *Burland v Earle* [n 642]

⁶⁴⁷ Christopher Riley [n 643] 585

⁶⁴⁸ *ibid*; also Hans C. Hirt, ‘Ratification of breaches of directors’ duties: the implications of the reform proposal regarding The availability of derivative actions’ (2004) 25 Company Lawyer

⁶⁴⁹ Kenneth Wedderburn, ‘Shareholders’ Rights and the Rule in *Foss v. Harbottle*’ (1957) 15(2) The Cambridge Law Journal

act as well. While the dominant view was that a fraudulent act is not ratifiable, the other opinion was that such wrongs were not inherently incapable of being ratified. Rather, it is only their fraudulent character, which avoided the wrongdoers from getting released from the consequences of their conduct through the ratification.

For instance, in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*⁶⁵⁰ the court interpreted the earlier case law to conclude that fraud happens when the wrongdoer gets a personal benefit from his act.⁶⁵¹ However, that opinion was opposed to *Regal v Hastings*⁶⁵² where the court held that liability applied regardless of whether the company has in fact been damaged or the wrongdoer has benefited by his action.⁶⁵³

In *Prudential*, however, Vinelott J argued that *Regal* proved that even fraudulent wrongdoing was capable of ratification, provided that the wrongdoers ‘did not control the company’ and that the majority ‘does not have an interest which conflicts with that of the company’.⁶⁵⁴ Vinelott J also argued that the House of Lords in *Regal* had confirmed that the directors could have had their misconduct ratified.⁶⁵⁵

However, in addition to the ambiguities surrounding the definition of fraud, the other problem under the common law was that the wrongdoing director was

⁶⁵⁰ *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] 1Ch 257

⁶⁵¹ *ibid* 316

⁶⁵² *Regal v Hastings* [1967] 2 AC 134

⁶⁵³ *ibid* 144

⁶⁵⁴ *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [n 636] 307

⁶⁵⁵ Christopher Riley [n 643] 587

authorised himself to vote as a shareholder in favour of ratification of his own misconduct.⁶⁵⁶

⁶⁵⁶ *North-West Transportation v Beatty* [1887] 12 App. Cas. 589

6.2.2 Ratification under the statutory derivative claim

The English Law Commission was aware of the importance of ratification in the context of the derivative claim through confirming that ‘it is not always clear when ratification will be effective’.⁶⁵⁷

Nevertheless, it argued that ratification was outside its terms of reference, and hence refused to offer recommendations for its reform.

Rather it recommended that actual, and ‘effective’, ratification should continue to be a complete obstacle to the derivative claim.⁶⁵⁸ Nonetheless, the Law Commission raised the concern that there was a ‘danger that our desire to simplify the derivative action could be undermined by the complexities which arise where it is claimed that the relevant breach of duty has been (or may be) ratified’.⁶⁵⁹

Despite the Law Commission’s reluctance in suggesting reforms to the question of ratification, the Company Law Reform Steering Group (CLRSG) considered reforms to ratification in the context of the derivative claim. In its consultation paper,⁶⁶⁰ the CLRSG confirmed that ‘modernisation and simplification’ of the law on ratification might be appropriate. The CLRSG proposed that defining whether a derivative claim should be permitted to continue depends upon whether any

⁶⁵⁷ Law Commission Shareholders’ Remedies: A Consultation Paper (Law Commission Consultation Paper 142, 1996) para 5.2

⁶⁵⁸ *ibid* para 6.84

⁶⁵⁹ *ibid* para 6.81

⁶⁶⁰ CLRSG, *Modern Company Law for a Competitive Economy: Developing the Framework* (London: DTI, March 2000)

decision not to sue ‘has been taken by, or was dependent on, the votes of the wrongdoers or those under the influence of the wrongdoers’.⁶⁶¹

If ratification has been obtained other than in these ways, then ‘it should clearly not be valid to preclude a derivative claim’.⁶⁶² This view was largely based on the voting-based approach to ratification.⁶⁶³

In the second Consultation Paper the CLRSG confirmed that the validity of ratification ‘depends on whether the necessary majority had been reached without the need to rely upon the votes of the wrongdoers, or of those who were substantially under their influence, or who had a personal interest in the condoning of the wrong’.⁶⁶⁴ In addition to that, it depends on whether or not the wrong was a fraud.⁶⁶⁵ In its final report, the CLRSG confirmed its proposal and consequently the Government followed the CLRSG opinion and made some reforms to the ratification of directors’ breach of duty.

However, the Government’s changes to ratification had a narrow scope and were limited to the process by which ratification is to be attained, and there is still no clarity on the concept of fraud.⁶⁶⁶ Under the Companies Act 2006, wrongdoers’ votes must now be ignored on any ratification.⁶⁶⁷

⁶⁶¹ *ibid* para 4.135; also Christopher Riley [n 643] 600

⁶⁶² *ibid* para 4.136

⁶⁶³ Christopher Riley [n 643] 587

⁶⁶⁴ CLRSG, *Modern Company Law for a Competitive Economy: Completing the Structure* (London: DTI, November 2000) para 5.85

⁶⁶⁵ *ibid*, also Christopher Riley [n 643]

⁶⁶⁶ Riley *ibid* 601

⁶⁶⁷ Companies Act 2006 Section 239(3)

In *Franbar* the court confirmed that the Companies Act 2006 does not alter the common law position that certain wrongs are unratifiable.⁶⁶⁸ The court held that the 'connected person' in sections 239(3) and 239(4) impose extra requirements for effective ratification which arise from the existing equitable rules but which impose more severe demands.

Moreover, 'wrongdoer control' is still applicable to ratification in cases where the connected persons requirement in section 239(4) has not been satisfied.⁶⁶⁹

The court opinion relates to the situations where section 239(4) has not been satisfied but actual wrongdoer control exists. In this scenario, the wrongdoers should not then be able to ratify their wrongdoing by using the ambiguity in the statutory derivative claim provisions.⁶⁷⁰

Overall, the court in *Franbar* tended towards the voting-based approach to ratification. It confirmed that some of the acts complained of might be incapable of ratification, which initially suggests that it was adopting the transaction-based approach. The judge's view on what established an unratifiable wrong reflected the common law position and all the ambiguities around it.⁶⁷¹

One of the main critiques of ratification under the Act is on vote counting and identification of connected persons. The argument is that such a process might be

⁶⁶⁸ *Franbar* [2008] EWHC 1534 (Ch); [2008] BCC 885 894

⁶⁶⁹ *Franbar* [2008] EWHC 1534 (Ch); [2008] BCC 885 [44]-[45]

⁶⁷⁰ Tang [n 642] 198

⁶⁷¹ Andrew Keay and Joan Loughrey, 'An assessment of the present state of statutory derivative proceedings' in Joan Loughrey (ed), *Directors' duties and shareholder litigation in the wake of the financial crisis* (Edward Elgar 2012) 205

easy in the context of small, private companies; however, in terms of large public companies which tend to vote by proxy this issue is complicated.⁶⁷²

The issue is whether the courts have the ability to find that the shareholders who voted to ratify the directors' breach of duty were truly independent of the wrongdoers. One simple disadvantage of this could be the length and complexity of the leave application.⁶⁷³ The other problem arises from the fact that the Act makes ratification a significant battleground in derivative claims. By providing ratification as a bar to this remedy, it fails to clarify the issue of unratifiable wrongs. This position was not adopted in other jurisdictions.

The problem with ratification in the context of the derivative claim is not limited to the actual ratification, which has already occurred before the initiation of the derivative claim. Under section 263(3)(c), the Act requires the court in its discretion to consider whether the act or omission that has raised the derivative claim would be likely to be ratified or authorised by shareholders in future.

The argument is that such considerations would only add to the complexity of the derivative procedure and would also cause confusion for the courts, because in practice it would be unpredictable whether the breach of duty would be ratified or not, unless the court can sustain the procedure until the company shareholders decide on whether or not to ratify the alleged wrong. Such a lengthy procedure could be unfair to the derivative claim's applicant.

⁶⁷² *ibid* 199

⁶⁷³ *ibid* 207

Considering the uncertainties on the issue of ratification, the question is why should ratification remain as a significant battleground in the context of derivative claims in the UK? Hence, the proposal of this thesis is that instead of playing a role as a substantial requirement, ratification should be taken into account by the court as a subsidiary consideration and only with regards to the wrongs, which have already been ratified. Such approach has already been adopted in New Zealand. In the United States, also, the shareholder ratification is not a bar in the way of shareholders bringing derivative suits. Both countries do not consider ratification as a requirement for the derivative claim.

A similar approach applies in other jurisdictions in which ratification is not part of the derivative claim requirements or plays a less important role than in the UK.⁶⁷⁴ One of this thesis' proposals which will be discussed in the next chapter is to extend the standing to bring a derivative claim to the employees' representatives in the company. The argument is that in the case of an employee's derivative claim, the ratification of the directors' breach of duty by shareholders should not be a significant bar in the way of any employee's derivative claim.

Considering that the interests of shareholders are not always in line with the interests of employees in the company, such requirement would otherwise be unfair to the rights of employees.

⁶⁷⁴ Andrew Keay, 'Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006' (2012) 16(1) *Journal of Corporate Law Studies* 39-68

6.3 Problems of derivative litigation costs in the United Kingdom: Lessons from New Zealand and the United States

The cost of derivative litigation in the United Kingdom is one of the practical barriers to the commencement of derivative proceedings. The derivative claim is a claim on behalf of the company and the claimant lacks any direct personal benefit in the claim. Hence, in terms of shareholders as the applicants, they might only own a small number of shares in a company. Therefore, they would have little incentive to initiate a derivative claim because the benefit of any recovery goes to shareholders according to the size of their shareholding, not their efforts in bringing the claim. If the applicant loses the litigation, under the English 'losing party' rule, they should pay not only the costs of the litigation for themselves but for the winning party as well. The problem of the derivative litigation costs applies to the employees' derivative claim as well. As with shareholders, employees would not gain any personal benefit from the derivative claim outcome and initiating a derivative claim could entail so much risk for employees. Awareness of the problems of funding such expensive litigation could discourage claimants from pursuing meritorious claims, which could protect the company from the wrongdoers harm.

This research views this as a problematic approach because a functional derivative claim is a crucial mechanism for disciplining directors in a company. The protection that derivative claims potentially provide for a company is unique and other mechanisms ensuring accountability of directors cannot effectively fill the role of the

derivative claim in all circumstances. The reason is that those other mechanisms of accountability for directors have been essentially designed to protect the shareholders' interests in the company in the first instance, but the derivative claim protects the company itself as a separate legal entity from its shareholders. The protection of the company is important for the protection of all the stakeholders whose interests are tied to the long-term functioning and financial stability of the company. Hence, any harm to the company could put their interests in jeopardy. The risk of bearing the litigation costs for applicants' meritorious derivative claims should be reduced and in this regards the financial structure of derivative claims in the United States and New Zealand which I discussed in previous chapters, could be inspiring for the UK. In both of these other jurisdictions, the statutory presumption is in favour of the company covering the costs for the derivative claim. Therefore, by drawing on inspiring aspects of financial structure in these jurisdictions, this research suggests a new solution for English law. Before discussing the thesis' proposed solution, I review the current problems with the derivative litigation costs in more detail.

6.3.1 Costs as the hurdle to shareholder derivative litigation in the UK

6.3.1.1 Indemnity cost order

In the UK the indemnity cost order, which is covered by the Civil Procedure Rule (CPR) 19.9, provides that a court is authorised to grant an indemnity order to the claimant in respect of costs incurred in the proceeding as it thinks appropriate.⁶⁷⁵

The indemnity cost order which has been established under the well-known decision of the Court of Appeal in *Wallersteiner v Moir*,⁶⁷⁶ addresses the obstacle of funding in a derivative claim by recognising that the applicant should be reimbursed for the costs incurred during the procedure. The justification is that the company that is receiving the benefit of the derivative claim ought to bear the risk of losing the case; hence, the derivative litigation procedures should be simple and inexpensive for the claimant.⁶⁷⁷

Although the establishment of the indemnity cost order was a positive step in mitigating the risk of litigation for the derivative claim applicant, there are some difficulties and flaws in its operation. The CPR 19.9 does not lay down any specific procedure that the party or court must follow. This could cause uncertainty for the court regarding under which circumstances it should issue the costs order for the applicants. The application for an indemnity has been integrated into the application for leave on

⁶⁷⁵ Rule 19.9E provides that ‘the court may order the company, body corporate or trade union for the benefit of which a derivative claim is brought to indemnify the claimant against liability for costs incurred in the permission application or in the derivative claim or both’.

⁶⁷⁶ *Wallersteiner v Moir* (No2) [1975] 1 All ER 849

⁶⁷⁷ *ibid* 859

the first stage.⁶⁷⁸ This issue could cause uncertainty for the court, because the court does not substantially investigate the alleged claim at this stage.⁶⁷⁹ It is only at the second stage of the derivative claim procedure that the court enters into full hearing, based on the factors set out in section 263(2), (3) and (4), and is able to evaluate the merit of the claim. Moreover, consideration of the applicant's indemnity cost request at the first stage could be disadvantageous for the claimant as well, as it could be difficult for him to prove their eligibility for the indemnity order to a suspicious court with very little evidence at this stage before the claim has been heard on its merits.⁶⁸⁰ This could increase the length and cost of the litigation for the claimant, instead of compensating him for the costs⁶⁸¹ and it is against the notion of the indemnity cost order, which was intended to turn the derivative claim into a 'simple and inexpensive' procedure.⁶⁸²

The flaws in implementing the indemnity cost order have resulted in uncertainties and inconsistencies for the courts. The argument is: if the derivative claim is a claim on behalf of the company, why is the burden of the costs not imposed on the company itself in the first instance? Why do not the courts follow the approach laid out in *Wallersteiner v Moir* in granting the indemnity cost order? The main concern is that the current approach fails to overcome the discouragement of applicants to initiate a meritorious derivative claim, as they are not reassured that they will be reimbursed for the costs of the claim even if they have strong evidence for wrongdoers' misconduct. Hence,

⁶⁷⁸ CPR r 19.9(7) also Companies Act 2006, s 261(2)

⁶⁷⁹ Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Application* (Oxford University Press 2007)

⁶⁸⁰ *ibid*; also *Smith v Croft* [1986] 1 WLR 580

⁶⁸¹ Consultation paper Para 14.1; see also the judicial case management under CPR r 1.4(1).

⁶⁸² Arad Reisberg [n 679]

disappointed shareholders prefer to sell their shares and leave the harmed company rather than challenging the company's wrongdoers through potentially expensive litigation.

In private companies, the situation may be worse as there is no market for minority shareholders to sell their shares, or there may be restrictions on transferring their shares. For example, under the company's Article of Association, they might only be able to sell their shares, often at a reduced price, to controlling shareholders themselves. Therefore, in situations where controlling shareholders harm the company with opportunistic behaviour, the most plausible option for minority shareholders is to sell their shares to controlling shareholders and exit the company.

However, selling the shares is not a rational solution for dealing with the wrongdoers' opportunistic behaviour in the company. Selling the shares (assuming a buyer can be found) is not the best possible option for shareholders. Even if selling the shares personally benefits shareholders in terms of preventing further harm to their interest, it would not bring any benefit to the damaged company. It will not bring any financial recovery for the harm done to the company; it will not punish directors for misconduct, or will not prevent future harm. If every single shareholder decided to sell their shares in such a situation, then theoretically there would be no remedy for the company and this would create greater incentive for wrongdoers to continue their wrongful actions without concern about the consequences. Preserving the company's well-being is important not only for the sake of shareholders but also for the interests of other stakeholder groups such as employees and society in general.

Derivative claims are brought to compensate the company for harm inflicted by a company wrongdoer whom the board of directors has failed to sue. While a costs hurdle confronts the derivative claim applicant who seeks to vindicate the company's rights through the derivative claim, the defendant director is in a stronger position. This is because the defendant director has access to substantial corporate funds for their defence. Moreover, directors and officers are normally protected through directors' and officers' liability insurance.⁶⁸³ Therefore, in order to achieve a balance between the directors' power and the company's protection, the problem of derivative litigation costs should be solved.

⁶⁸³ Directors and officers' liability insurance, or management liability insurance, is insurance cover that offers financial protection to directors, partners or officers of a company. It is designed to cover the cost of claims against those who have responsibility in running the company.

6.3.1.2 Conditional and contingency fee agreements

In addition to the indemnity cost order, there are other sources of financial aid available for shareholder litigation in the UK in the form of conditional and contingency fee agreements. The conditional fee agreement (CFA) is an agreement between a client and their lawyer, which allows the lawyer to take a claim based on the understanding that if the litigation is lost, he will not be entitled to charge his client any fee. However, if the litigation is won, the lawyer will receive the full fee plus an enhancement calculated as a percentage uplift on the fee (of up to 100% of the lawyer's normal bill) to recompense for the risk of not being paid.⁶⁸⁴

Another type of agreement is the contingency fee agreement, which is known as a damages-based agreement (DBA) in the UK. The damages-based agreement is the same as the US contingency fee agreements. It is an agreement in which a claimant and their lawyer agree that the claimant will be responsible for the attorney's fees only if a given lawsuit is decided in the claimant's favour, either by settlement or a court decision. Otherwise, like the conditional fee agreement, the lawyer will not be entitled to any remuneration. However, the difference is that under the contingency fee agreements the lawyer's reward is usually set as a percentage of the damages awarded to the company. The difference between the English damages based agreement and the American contingency fee agreement is that the American contingency fee agreement is supported

⁶⁸⁴ See the Conditional Fee Agreements Order 1998 (SI 1998/1860); also see generally "Access to Justice with Conditional Fees", a Lord Chancellor's Department Consultation Paper (March 1998).

by both the Common Fund and Corporate Benefit doctrines. None of these doctrines exist in the English legal system. Despite the availability of the damages-based agreements, these agreements have not been used in any shareholder derivative litigation in the UK.

6.3.1.3 Reasons for the inefficiency of conditional and contingency fee agreements in reducing the costs of the derivative claim

The main problem with both conditional and contingency fee agreements in the UK is that they only offer a partial solution to the problem of derivative litigation costs. Even with these agreements, the English losing party rule still remains as a hurdle in the way of derivative claims. Therefore, although the losing claimant may not be obliged to pay the lawyer fees under these kinds of agreements, he will still remain liable for the opposite party's costs.

One solution to this problem is the use of insurance policies that cover the client's potential liability for the other side's litigation costs. However, 'after-the-event' insurance is generally only available for cases with prospects of success greater than 65 per cent and premiums tend to be about 20 to 30 per cent of the amount of cover required. Thus, the insurance premium is very expensive and relying on it would still pose a great risk for shareholders in litigation like the derivative claim. The reason is

that courts are traditionally reluctant to challenge directors' conduct in the company,⁶⁸⁵ hence a successful outcome can in no way be guaranteed in a derivative claim.

Another important problem with conditional and damages-based agreements is that these agreements are practically unworkable in the UK. These agreements can only be advantageous when lawyers have a critical mass of derivative claim cases, which enable them to diversify the risk of losing some derivative claim cases and winning others under contingency fee agreements. Otherwise, making use of these types of agreements would be a risky task for British lawyers. However, as I explained in previous chapters, the UK corporate governance system is not generally litigation-based. It has mainly been based on institutional shareholders' power, which through *ex ante* mechanisms⁶⁸⁶ monitor and control directors' conduct and hold them accountable to their fiduciary duties. Therefore, litigation mechanisms including derivative claims have never been frequent in the UK to make the damages-based agreements favourable to British lawyers. As such, while the damages-based agreements and conditional agreements have failed to address the problem of derivative claim costs in the UK, this research proposes other solutions for solving the problem of costs.

⁶⁸⁵ For example, the courts' adherence to the Majority Rule or the Business Judgment Rule.

⁶⁸⁶ *Ex ante* is a phrase meaning 'before the event' and *ex ante* mechanisms of protection refers to a series of actions that protect the company through the monitoring of the board's conduct, such as the corporate governance 'comply-or-explain' principle, market for corporate control and non-executive directors.

6.4 The thesis proposal: A blended approach to the derivative litigation costs

If the derivative claim is intended to have a practical role in the English legal system, then the current hurdle of litigation costs should be removed. The current approach has created an environment which discourages legitimate derivative claim applicants from initiating a claim on behalf of the company, even in situations in which they have strong evidence of company directors' misconduct. Based on the arguments outlined, this paper proposes a blended approach to derivative costs in the UK, inspired by the United States and New Zealand approaches.

To improve the deterrence function of the derivative claim in the UK, the American corporate benefit doctrine could be inspiring in terms of considering the non-monetary but substantial benefits that could arise from a derivative claim. Therefore, it is suggested here that in granting the costs order, the court considers not only the possible financial recovery but the likelihood of non-financial but advantageous recovery as well. As was discussed in chapters one and six, these non-financial advantages could happen in the form of changes to the management of the company, or a court injunction which terminates a detrimental transaction, or any other corporate governance reforms in the company either by a judicial order or through a settlement. Since the corporate benefit doctrine does not exist in the UK, the non-pecuniary consideration of the derivative claim could be added to the provisions, which define the criteria for granting the derivative claim leave. Also, as I will mention, it could be considered as a subsection under a cost provision which requires the court to consider the possibility of

both the monetary relief and non-financial advantages of the derivative claim in issuing the cost order.

The second proposal is inspired by the approach taken in New Zealand. Instead of the current indemnity costs order approach, upon granting permission to continue a derivative claim in which the claimant has already established a *prima facie case*, the court should order the company to meet the whole or part of the reasonable costs of the derivative claim. The exceptions would be cases in which the plaintiff is willing to pay the costs of the litigation or when the court considers it unreasonable for the company to pay the costs. One example of a situation in which it is unreasonable for the company to pay would be when, in the later stages of the proceeding, the court is presented with evidence that calls the merit of the derivative claim into question. In such circumstances, the court would have the option of recalling the costs order and instructing the applicants to compensate the company for the costs.

The reason for this proposal is that in derivative litigation, the real claimant is the company and all benefits go back to it. Therefore, it is not fair that the claimant, who has already obtained leave to continue a derivative claim and has already satisfied the court that their claim has sufficient merit for leave to be granted, should bear the costs personally and the other shareholders and stakeholders in the company receive the benefit without any cost to themselves.

The proposal remains similar to the current indemnity costs order in that the courts would still have discretion to decide when it is unreasonable for the company to pay the costs, thus preventing the abuse of the derivative claim procedure. However, it is

different in terms of that it puts more a mandatory burden on the company to pay for the costs of legitimate litigation on its behalf. This means that in meritorious derivative litigation in which the claimant has proved a *prima facie* claim, the costs of the litigation would shift from the claimant to the company unless the court considers it otherwise. Instead of putting the burden of proof on the claimant to reason why the company should bear the costs of their meritorious claim, it would be for the company to show reasons why it is not legitimate for it to pay the costs of a claim, which has been initiated on its behalf. Such a statutory order would be more reassuring for applicants in a potentially advantageous derivative claim, as these applicants would take less financial risk in initiating a claim on behalf of the company. The experience in New Zealand shows that the availability of other mechanisms of accountability for directors may limit the role of the derivative claim to some extent. Moreover, because of the difficulties with leave requirements and the court scrutiny in the two-staged procedure, which is designed specifically to filter out vexatious claims, such an approach would not open the floodgates of litigation against the company. Also, in order to prevent the chance of abuse that might remain, the court would have the ability to recall the cost order at a later stage if the claim subsequently turns out to be unmeritorious and order the plaintiff to pay back the costs to the company. There is a low possibility that shareholders or other applicants would make time-consuming and risky litigation from which they would not even obtain any personal profit, without a proper cause of action and with the mere aim of harming the directors.

The both mentioned proposals for the derivative litigation cost could be covered under a statutory provision for the costs. The suggested provision could provide as follows: “The court, on an application of shareholder or employees to whom leave has been granted to bring the derivative claim shall order that the whole or any reasonable costs of the proceedings be met by the company, unless the court considers it unreasonable for the company to bear the costs or the applicant is willing to pay the cost of the litigation himself”. Also, the consideration of the non-financial benefit of the derivative claim could come under a subsection, which provides that: “in addition to any financial relief which may arise from the derivative claim, the criteria for granting the cost order shall include the non-financial but beneficial outcome arising from the derivative claim”.

6.5 Conclusion

This chapter discussed new proposals on the issue of ratification and derivative litigation costs. The argument is that the complexities and ambiguities in the current role of ratification has resulted in confusion in the derivative claim procedure and might prevent legitimate derivative claims.

The reason is that in practice it would be unpredictable whether the breach of duty would be ratified or not, unless the court hold the procedure until the company shareholders decide whether to ratify the alleged wrong or not. However, such a lengthy procedure could be apparently unfair to the derivative claims applicant. Moreover, in the context of the employees’ derivative claim, which will

be discussed in the next chapter, dismissing an employee's derivative claim on the ground that the shareholders would ratify that misconduct would be unfair to the employee applicant, because the interest of shareholders and employees is not always in line with each other and their claim should be considered on the grounds of their own interests only.

As the solution, this thesis suggests that instead of playing a role as a substantial requirement for assessing a derivative claim, ratification should be taken into account by the court with regards to the shareholders' derivative claim as a subsidiary consideration and under the court's discretion. Such approach has already been adopted in New Zealand and the United States and some other common law jurisdictions. In terms of derivative litigation costs, this chapter revealed that, under the current situation, these costs are one of the biggest hurdles in the way of derivative claims in the UK.

This chapter showed that the current financial support, in the form of the indemnity cost orders or the conditional or the damages-based agreement, is not effective in reducing the risk of the litigation for shareholders. Hence, this thesis proposes a blended approach inspired from both the United States and New Zealand. Under the suggested solution, in granting the cost order the court would consider both pecuniary and non-pecuniary outcomes in a derivative claim.

In addition to that, upon granting permission to continue the claim, the court should order that the company must meet the whole or part of the reasonable costs

of a derivative claim unless the plaintiff is willing to pay the costs of the litigation himself, or the court considers the costs unreasonable.

Chapter 7: Employees' derivative claim

7.1 Introduction

This chapter deals with the thesis proposal on expanding the standing for initiating the derivative claim to the employees. As was discussed in the first chapter, the reason that this thesis argues for the employees' derivative claim is that among the different groups of stakeholders, employees are in a better position to be aware of the internal management of the company because they are working in the company and they could even have better access to the company's documents. On the other hand, they are in a vulnerable position when the company gets harmed because they may lose their job and the ability to earn their livelihood. The apparent evidence for this assertion is the BHS scandal, which led to the loss of many employees' jobs and significant harm to their entitlements with substantial pension deficits. Therefore, employees could have stronger motivation to protect the company from the wrongdoers harm.

Overall, the argument for the employees' derivative claim has been based on three grounds. The first is that shareholders may only have short-term profit maximisation interests and they may only care about their own investing returns in the near future. Hence, they may be reluctant to be involved in corporate governance matters and costly monitoring of their investee companies, or they may not care if their companies earn profits by breaking the law or hurting the company in the long run.⁶⁸⁷ Even in some

⁶⁸⁷ Lorraine Emma Talbot, 'Why shareholders shouldn't vote: a Marxist-progressive critique of shareholder empowerment' (2013) 76(5) *Modern Law Review* 791-816; Lynn Stout, *The Shareholder*

private companies like the former BHS, there might be no shareholder outside the wrongdoers' team to deter their harm to the company. Therefore, protection of the company as a separate legal entity should not be in the monopoly of shareholders only. Just like shareholders who have both personal rights as well as the right to make a claim on behalf of the company, employees should have similar rights to protect the company and consequently their interest in the company. The argument is that extending the derivative claim right to the employees would increase the overall protection of the company for the benefit of all the stakeholders. The employees have sufficient incentive to protect the company in the long run.

Second, although the long-term debate on the corporate objective in the UK finally resulted in partial consideration of employees' interest and promotion of business relationships with other stakeholders under section 172, still the current enlightened shareholder value principle has remained fundamentally loyal to the shareholder primacy theory and it is not effective in protecting the company as a whole in the long run. The most obvious reason for this inability, in addition to the section 172 ambiguities, is the lack of enforcement power for employees to protect the company against the directors and controlling shareholders' damages in situations that shareholders are absent or are not willing to do that.

Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public (Berrett-Koehler Publishers 2013); Aidan O'Dwyer, 'Corporate Governance after the financial crisis: The role of shareholders in monitoring the activities of the board' (2014) 5 *Aberdeen Student Law Review* 115 112; George C. Hadjikyriou, 'The Principle of 'Comply-or-explain' underpinning the UK Corporate Governance Regulation: Is There a Need for a Change?' (2015) 7 *Corporate Governance Law Journal*; Lorraine Talbot, 'Polanyi's Embeddedness and Shareholder Stewardship: A contextual analysis of current Anglo-American perspectives on corporate governance' (2011) 62 *Northern Ireland Legal Quarterly* 451

Third, in light of tragedies like BHS, the UK Government has set out some reforms to strengthen employee engagement in the company. The Government's specific plans for improving the protection of employees' interests in the company have been set in the form of a specific provision requiring premium listed companies to adopt, on a "comply-or-explain" basis, one of three employee engagement mechanisms: a designated non-executive director; a formal employee advisory council; or a director from the workforce. However, although the Government's approach toward strengthening the employees' protection is well-intentioned, this thesis argues that these measures will likely have little impact in practice. In fact, the proposed reforms merely offer tokenism rather than a much-needed call to action. Therefore, the thesis argues that in order to enhance the overall protection of the company and to safeguard the employees and other stakeholders' interest in the company, in addition to the proposed reforms, the standing for bringing derivative claims should be broadened to the employee's representative. The argument is that tragedies like BHS might have been prevented if the company employees had had the right to bring a derivative claim. While there were no other mechanisms from outside to stop the harm to the company, the derivative claim's deterrence function could have enabled the employees to sue the BHS wrongdoers on behalf of the company for their negligence and mismanagement, and might have prevented them from further misappropriation of the company's assets. In fact, the employees' derivative claim right would be a threat to potential wrongdoers like Mr. Green, who in turn might be more cautious about the consequences of their misconduct, and it would prevent them from easily enriching themselves on the back of

the company with no concern for anyone else. This chapter reviews employees' interest consideration in the UK. Also, it explores the proposed corporate governance reforms intended to strengthen the employees' voice and discusses why these proposals are not insufficient. The chapter also explains how employees' derivative claims could help prevent tragedies like BHS and discusses the implementation of an employees' derivative claim in the UK.

7.2 Attempts to diverge the UK corporate law from its shareholder-centric

orientation

Although the predominant ‘shareholder primacy’ basis of the UK’s company law framework seems to be clear and recognised, in fact such normative cohesiveness covers up a longer history of substantial uncertainty with regard to the corporate objective in the UK.⁶⁸⁸ In fact, until the enactment of the Companies Act 2006, UK corporate law had taken an uncertain approach towards the issue of for whose benefit the company should be run. This debate had taken over 40 years in the UK and as was discussed in the first chapter, resulted in establishment of the enlightened shareholder value principle under the Companies Act 2006 with still strong loyalty to the shareholder primacy principle. Although the UK corporate governance has neo-liberal political orientation, during the post-war period, some democratic public policy actions were carried out to directly incorporate employees into the UK’s corporate legal framework.⁶⁸⁹ During these years, at one stage UK company law became close to adopting employees’ board representation like some of the other European jurisdictions.⁶⁹⁰ Such an attempt failed mainly because of the opposition of labour unions in the UK who were reluctant to be engaged in management of the company.⁶⁹¹ Overall, the attempts to diverge the UK company law from shareholder primacy value could be traced in three important periods: (1) from the Bullock report in 1977 to

⁶⁸⁸ Marc Moore, ‘Shareholder Primacy, Labour and the Historic Ambivalence of UK Company Law’ (2016) University of Cambridge Faculty of Law Research Paper No. 40/2016 <
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2835990 p 2

⁶⁸⁹ *ibid* 3

⁶⁹⁰ Alan Bullock, *Report of the committee of inquiry on industrial democracy* (1997) Vol. 6706 HM Stationery Office

⁶⁹¹ Marc Moore [n 688] 3

section 309 of the Companies Act 1985; (2) from section 309 of the Companies Act 1985 to the enlightened shareholder value principle under section 172(1) of the Companies Act 2006; and finally (3) from section 172 Companies Act 2006 to corporate governance proposed reforms in 2017. However, in none of these considerations have employees been given the right to directly sue the ones who damage the company on behalf of the company and to protect the company and their reflective interests in the company through the derivative claim. Therefore, this thesis argues that none of these attempts were successful in increasing the protection of the company for the benefit of the company itself and for the overall interest of all the stakeholders. The scandals like BHS are evidence of this issue.

7.2.1 The employees' representative proposal under The Report of the Committee of Inquiry on Industrial Democracy

After the Labour Government came into power in 1974 and in light of the looming introduction of industrial democracy in the UK, the Government published the 1977 Bullock Report on Industrial Democracy which became famous as the “Bullock Report” after it was chaired by Lord Alan Bullock.⁶⁹² The report suggested that the board of large companies be comprised of shareholders and employee representatives similar to the large companies in Germany.⁶⁹³ The proposal would have required the same level of

⁶⁹² Alan Bullock Baron, *Report of the committee of inquiry on industrial democracy* (1977) Vol. 6706 HM Stationery Office

⁶⁹³ Tom Hadden, *Company Law and Capitalism* (Littlehampton Book Services Ltd 1977) 458–59; Otto Kahn-Freund, ‘Industrial democracy’ (1977) 6 *Industrial Law Journal* 65-69; Christopher Bruner, *Corporate governance in the common-law world: The political foundations of shareholder power* (Cambridge University Press 2013) 162

shareholder and employee representatives on the boards of all companies with more than 2,000 shareholders, subject to a minimum of four directors on each side.⁶⁹⁴

The rationale behind the report was that the growth of large companies had amplified the distance between the locations where decisions affecting workers were made, and where they were felt, leaving directors responsible to shareholders only, in practice.⁶⁹⁵ Moreover, social changes such as better education had led to a greater desire and ability of workers to control their working environment, and a greater power of unions and legislative changes.⁶⁹⁶ Nonetheless, the proposal encountered much opposition. For instance, Sir Otto Kahn-Freund put emphasis on the natural conflict between the respective interests of shareholders and employees. Kahn-Freund argued that it simply was not possible to express the interests of the company in such a way as to allow this concept to encapsulate the particular interests of employees in those instances (e.g. proposed plant closures or mass layoffs) when the latter constituency is most in need of the protection of company law.⁶⁹⁷ Thus, although he was not completely against the notion of employee representatives on the board, he was cautious in highlighting the need of such mechanisms being seen as an extension of the independent rights of trade unions to protect employees' interests through adversarial industrial action, as opposed to a way of integrating the specific interests of a company's workforce into the general interest of company as a whole.⁶⁹⁸

⁶⁹⁴ Moore [n 688] 21

⁶⁹⁵ Alan Bullock [n 692] 20-21

⁶⁹⁶ *ibid* 22-24

⁶⁹⁷ Otto Kahn-Freund [n 693]

⁶⁹⁸ Moore [688]

The Bullock Report visibly recognised the long foundation of shareholder primacy in the UK, noticing that ‘[t]he ultimate control of the company is seen in law as residing with its owners or shareholders,’ and that the board’s duty to act in ‘the best interests of the company’ had been ‘narrowly interpreted by the Courts to mean the best interests of the shareholders’.⁶⁹⁹ The Bullock Report was therefore unsuccessful in shifting shareholders from their key position in UK corporate law, facing resistance to the proposal from City institutions, employers, and the Thatcher Government alike.⁷⁰⁰

The Bullock Report’s failure was also attributed to the concerns that the objective of corporate decision-making would be unclear if it is diverged from its strict shareholder-centric framework.⁷⁰¹ Trade unions themselves barely supported the Bullock Report’s proposals. Many were scared that employee board representation might tend to damage efforts to secure gains through collective bargaining.⁷⁰² They also feared being drawn into management responsibilities and losing their independence from capital.⁷⁰³ In any event, due to the opposition against it, the Bullock Report could not gain approval and later Margaret Thatcher’s neo-liberal Conservative Government, known for its hostility to organised labour, further caused the dismissal of the industrial relations reform movement in the UK.

⁶⁹⁹ Alan Bullock [n 692] 59–62

⁷⁰⁰ Bruner [n 693]; Andrew Gamble and Gavin Kelly, ‘Shareholder value and the stakeholder debate in the UK. Corporate Governance’ (2001) 9(2) *An International Review* 110-112; James Moher, ‘Democracy in the Workplace – The Bullock Report’ (2010), <http://www.historyandpolicy.org/forums/union/meeting_090710.html (visited 6/8/2017)

⁷⁰¹ Otto Kahn-Freund [n 696] (arguing that “employee representatives on a board . . . [would be] exposed to a conflict of duties which is simply insoluble”)

⁷⁰² Moher [n 700]

⁷⁰³ David Marsh and Gareth Locksley, ‘Capital in Britain: Its structural power and influence over policy’ (1983) 6(2) *West European Politics* 49-50; Ben Clift, Andrew Gamble and Michael Harris, ‘The Labour Party and the company’ in John E. Parkinson, Andrew Gamble and Gavin Kelly (eds), *The political economy of the company* (Hart Publication 2000) 79-80

7.2.2 Section 309 of the Companies Act 1985: no derivative claim right for the employees

Margaret Thatcher's Conservative Government introduced section 46 of the Companies Act 1982 shortly after coming to power in 1979. The section stated 'the matters to which the directors of a company are to have regard in the performance of their functions shall include the interests of the company's employees in general as well as the interests of its members.'⁷⁰⁴ This provision seemed to be an alternative to the Bullock Report in considering the interests of employees by requiring directors to 'have regard' for the employees' interests, but in practice the provision proved to be of little consequence, not least due to the fact that employees could not force directors to comply with their fiduciary duties.⁷⁰⁵ Section 309 of the Companies Act 1985, the immediate successor of section 46 of the Companies Act 1980, inherited exactly the same features. Neither of the provisions had empowered employees with the derivative claim right on behalf of the company. Section 309 provided that the matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in general, as well as the interests of its shareholders.⁷⁰⁶ Therefore, directors were only required to consider or have regards to the interests of employees in the context of their duty to the company, which was for the interests of its members. There was also no guidance provided to directors as to how they interpreted their responsibility under this provision and how they should strike a

⁷⁰⁴ Companies Act 1980, section 46

⁷⁰⁵ D.D. Prentice, 'A Company and Its Employees: The Companies Act 1980' (1981) 10 Industrial Law Journal 1; Simon Deakin and Giles Slinger, 'Hostile takeovers, corporate law, and the theory of the firm' (1997) 24(1) Journal of Law and Society 124-151; Christopher Bruner [n 693] 164

⁷⁰⁶ Companies Act 1985, s 309(1)

balance between employees' interests and those of the shareholders.⁷⁰⁷ However, in instances such as *Re Saul D. Harrison & Sons Ltd*⁷⁰⁸ the courts refused to order directors to wind up a loss-making company whose premises were seized for the extension of a subway line. According to the High Court, in light of their duty to employees, directors were 'entitled to take into account if they were of the opinion that there was a reasonable prospect that the company's business could be saved'. While the decision also involved a majority-minority conflict, the decision is sometimes cited as an example where section 309 was used as a defence for directors.⁷⁰⁹ In *Dawson International v Coats Patons*,⁷¹⁰ the court held that directors had a fiduciary duty to the company 'to have regard to the interests of members and employees'⁷¹¹ in the course of their duty to make a good faith recommendation to shareholders about a takeover bid. Also in *Re Welfab Engineers Ltd*⁷¹² even if the court did not clearly refer to section 309, it used the provision to dismiss the liquidator's claim against the directors of an insolvent company after they had entered into a doubtful transaction to temporarily save the employees' jobs, citing 'widespread unemployment and industrial devastation' in the region. Nevertheless, despite its occasional implication in the case law, section 309 never functionally worked for the interests of employees in the context of company law. In fact, the ability of shareholders to ratify breaches of directors' duties demonstrated

⁷⁰⁷ Simon Goulding and Lilian Miles, 'Regulating the Approach of Companies towards Employees: The New Statutory Duties and Reporting Obligations of Directors within the United Kingdom' in Stephen Tully, *Research Handbook on Corporate Legal Responsibility* (Edward Elgar 2005)

⁷⁰⁸ *Re Saul D. Harrison & Sons Ltd* [1994] B.C.C. 475

⁷⁰⁹ Paul Davies, 'Shareholder value, company law, and securities markets law: a British view' in Klaus J. Hopt and Eddy Wymeersch (eds), *Capital Markets and Company Law* (Oxford University Press 2000) 267

⁷¹⁰ *Dawson International v Coats Patons* [1988] 4 B.C.C. 305

⁷¹¹ *ibid* 313

⁷¹² *Re Welfab Engineers Ltd* [1990] B.C.C. 600

that employee interests continued to be alien to the edifice of company law. Also, in the absence of a direct derivative right for employees, section 309 was a toothless mechanism against the directors' breach of duty. Hence, scholars continued to confirm that the dominant approach was still shareholder primacy.⁷¹³

7.2.3 Enlightened shareholder value principle: consideration of stakeholders' interests for the benefit of shareholders

It was explained in chapter one that the issue of company objection came to the attention of the UK Government again in 1998 when Tony Blair's Labour Government initiated the "Company Law Review".⁷¹⁴ The efforts of the Company Law Review Steering Group in defining the corporate objective resulted in establishment of the enlightened shareholder value principle, which has been based on the ambition of promoting the success of the company for the benefit of members as a whole. In achieving such a goal, however, a director must have regards to factors such as the interests of the company's employees and the need to foster the company's business relationships with suppliers, customers and others. As was argued in chapter one, section 172 has two main problems. First, under the section, directors have been given the discretion to consider a wide range of issues without a clarification of how they should consider the factors mentioned in that section. Second, the section fails to

⁷¹³ K.W Lord Wedderburn, 'Companies and employees: common law or social dimension' (1993) 109 Law Quarterly Review 220; Paul L. Davies p 270; Jonathon Richford, 'Overview and the British Approach' (2004) 1(4) European Company and Financial Law Review 406

⁷¹⁴ Department of Trade and Industry, *Modern Company Law for a Competitive Economy 1.1* (1998), at <http://www.berr.gov.uk/files/file23283.pdf> (visited May 25 2017)

empower the employees with the right to make a claim on behalf of the company in situations that the directors are in breach of their fiduciary duties toward the company.

The deficiencies of section 172 have become evident to the UK government, which has responded with a proposed package of reform. However, under the proposed reforms, shareholders are still the only company law's executive arms for holding directors accountable toward the company. This thesis argues that the lack of a derivative claim right for the employees is one of the main shortcomings of the proposed corporate governance reforms. Without a right to make a claim on behalf of the company, employees would be powerless in increasing the protection of the company and protecting their reflective interests. In the next section, I discuss why the proposed reforms are not sufficient and why employees still need a derivative claim right as a complementary mechanism.

7.3 The Government's new package of reforms: Would it enhance the protection of the company as a whole?

In light of tragedies like BHS, the UK Government has proposed a package of corporate governance reforms. The House of Commons report named the BHS scandal as “the unacceptable face of capitalism,”⁷¹⁵ and the UK Prime Minister Theresa May has promised to stamp out irresponsible corporate behaviour through the new corporate governance framework. The proposed plans have three key components: fixing executive pay; strengthening the employee, customer, supplier and wider stakeholder engagement in the company; and extending the corporate governance code to large privately-held businesses. For strengthening the employees and other stakeholders' voice, the Government's intention is to: introduce secondary legislation and require all companies of significant size (private as well as public) to explain how their directors comply with the requirements of section 172 to have regard to employee and other stakeholders' interests. Also, on a “comply-or-explain” basis, the Financial Reporting Council (FCR) requires premium-listed companies to adopt one of three employee engagement mechanisms: a designated non-executive director; a formal employee advisory council; or a director from the workforce. Furthermore, the government intends to invite the GC100 group of the largest listed companies to complete and publish new guidance on the practical interpretation of directors' duties in section 172 of the Companies Act.

⁷¹⁵ The House of Commons Report Inquiry into BHS, para 168

The Government's assumption is that these proposals will drive change in how big companies engage with their key stakeholders by putting higher expectations on companies especially on leading, premium listed companies. My argument is that to enhance the protection of the company, more mandatory mechanisms than the ones envisioned by the Government are needed, such as the derivative claim for employees. I review the current proposals to justify my argument.

7.3.1 Fixing the executive pay

The first part of the Government Corporate Governance proposals deals with the issue of executive pay and highlights the concerns over very high levels of executive remuneration at UK quoted companies. The Government argument is that the executive pay is a key factor in public dissatisfaction with large businesses, and a source of frustration to UK investors. FTSE100 CEO total pay has increased from an average of around £1m in 1998 to over £4m today, fuelling a widespread perception that boardroom remuneration is increasingly disconnected from the pay of ordinary working people. It is also questionable whether long-term company performance has consistently matched this rapid growth in pay.⁷¹⁶ However, in order to fix the problem the Government has mainly focused on the shareholder interests. In response to the shareholders' concerns on the executive remuneration the Government has invited the Financial Reporting Council to: (1) revise the UK Corporate Governance Code and make it specific about the steps that premium listed companies should take when they

⁷¹⁶ Department for Business, Energy & Industrial Strategy, *Corporate Governance Reform, The Government response to the green paper consultation*, para 1.1 p 8

encounter significant shareholder opposition to executive pay policies and awards; (2) give remuneration committees a broader responsibility for overseeing pay and incentives across their company and require them to engage with the wider workforce to explain how executive remuneration aligns with wider company pay policy (using pay ratios to help explain the approach where appropriate); and (3) extend the recommended minimum vesting and post-vesting holding period for executive share awards from 3 to 5 years to encourage companies to focus on longer-term outcomes in setting pay.⁷¹⁷ In addition to that, the Government has plan to introduce secondary legislation to require quoted companies to: (1) report annually the ratio of CEO pay to the average pay of their UK workforce, along with a narrative explaining changes to that ratio from year to year and setting the ratio in the context of pay and conditions across the wider workforce; and (2) provide a clearer explanation on remuneration policies of a range of potential outcomes from complex, share-based incentive schemes. Furthermore, the Government invites the Investment Association to implement a proposal it made in its response to the green paper to maintain a public register of listed companies encountering shareholder opposition to pay awards of 20% or more, along with a record of what these companies say they are doing to address shareholder concerns. Lastly, in addition to these proposals, the Government will take forward its manifesto commitment to commission an examination of the use of share buybacks to ensure that they cannot be used artificially to hit performance targets and inflate executive pay. The review will also consider concerns that share buybacks may be crowding out the

⁷¹⁷ *ibid* 3

allocation of surplus capital to productive investment. The Government will announce more details shortly.⁷¹⁸

In the view of this thesis, the Government proposal for executive pay may result in a modest fall in levels of remuneration to some extent and the requirement concerning pay ratio reporting may generate adverse publicity for some companies. However, it is unlikely that the proposed reforms make a radical change in the context of directors' pay and prevent any misuse. There are some reasons for that. First, that the proposed reforms target only large quoted companies in the UK. Other large companies, which are not quoted, especially large private companies are beyond the scope of the Government proposals and will be exempt. The other main problem, however, is that the Government concerns about the shareholders' interests only and trusts that shareholders would consider the overall interest of the company and even broader interests of society to their own interests. Therefore, only shareholders would have the right to get the report on the executives' pay. However, as it has already been discussed in this thesis, the shareholder primacy model of corporate governance cannot address the problems with poor management of the company nor it is able to curb the directors and controlling shareholders' opportunistic behaviour or remunerations which exceed the company profits. Shareholders usually do not have long-term commitment to the company. They are mainly interested in short-term returns. Even institutional shareholders, who are expected to have a longer commitment to their investees' companies and play an important role as the companies' stewards, may not share the

⁷¹⁸ *ibid*

general public's concerns about high pay as long as the so-called directors guarantee their profit maximisations. Hence, relying on shareholders only may not be enough for improving the corporate governance. As the evidence for this argument, the House of Commons Business, Energy and Industrial Strategy Committee launched its own inquiry into corporate governance, and published a report in April 2017. The report was specifically concerned that companies appear to be under pressure to focus on the short-term profit maximisation for the shareholders rather than the long-term protection of the company, and that current share ownership patterns have resulted in shareholders not being in a position to exercise their supervisory function properly.⁷¹⁹

7.3.2 The non-executive director

Under the new corporate governance reforms, one way of engaging the employees in the management of the company is through assigning an existing non-executive director who represents the interests of employees and other stakeholders in the company.⁷²⁰ However, it is neither clear at this stage how the designated non-executive director is supposed to increase the protection of employees and other stakeholders at the board level, nor whether the designated non-executive director will act for different stakeholder groups or only for the employees in the company.

⁷¹⁹ House of Commons Business, Energy and Industrial Strategy Committee, *Corporate governance, Third Report of Session 2016–17* p 23, available at <https://publications.parliament.uk/pa/cm201617/cmselect/cmbeis/702/702.pd>

⁷²⁰ Department for Business, Energy & Industrial Strategy, *Corporate Governance Reform, The Government response to the green paper consultation*, Action 7 p 34

Some respondents to the Government Green paper have suggested that there should be more than one non-executive director acting as a point of liaison for different stakeholders.⁷²¹ Other respondents have suggested that non-executive director(s) should be able to meet management, the workforce and unions to discuss matters of concern; should have access to employee engagement survey results and other statistics; should be able to consult with key suppliers; and should be able to review customer feedback, including complaints. Regardless of the extent to which the Government would apply the proposed recommendations in defining the role of the non-executive directors for employees, it is unlikely that this option would be effective. In fact, it is difficult to analyse the possible impacts of designating a non-executive director to protect the interests of stakeholders without knowing how the mechanism will be implemented. Respondents to the Green Paper have raised the concern that, if the non-executive director is expected to promote rather than channel the interests of particular groups, the role could potentially conflict with the joint duties of directors and compromise their independence. There are also concerns that designated non-executive directors could find themselves isolated on the board, unable to provide an effective challenge.⁷²² Another concern is the difficulty of reconciling diverging stakeholder interests. This thesis adds some more general concerns about the role of non-executive directors and their efficiency in protection of the company as a whole. These concerns have already been discussed in chapter three.⁷²³ The fact is that although the non-executive directors

⁷²¹ *ibid* para 2.10 p 25

⁷²² *ibid* para 2.11 p 26

⁷²³ I have discussed the shortcomings of non-executive directors in protection of the company as a whole in chapter three under section 3.3.5.1.

have broad duties to monitor the executive directors' conduct, there is lack of clarity on how they should perform their duties and what fiduciary duties they have toward the company.⁷²⁴ In addition, they may not always completely understand the complexities of the businesses they direct.⁷²⁵ Moreover, they may lack incentives to effectively perform the tasks that have been assigned to them,⁷²⁶ unless they are provided with strong financial incentives that likely align their interests with those of shareholders only. Further, they may be under the influence of the executive directors who have proposed them.⁷²⁷ Based on these reasons, the non-executive directors might not protect the company and the interests of other stakeholders in the company in all circumstances.

7.3.3 Formal employee advisory council

The second option under the Government reform for engaging the employees in the corporate governance of the company is through a formal employees' advisory council. As for the previous option, it is not clear how this body is expected to strengthen the employees' voice. Also, it is not clear how the council members would be chosen and

⁷²⁴ Arad Reisberg, *Derivative Actions and Corporate Governance: Theory and Application* (Oxford University Press 2007); James Kirkbride and Steve Letza, 'Can the Non-executive Director be an Effective Gatekeeper? The Possible Development of a Legal Framework of Accountability' (2005) 13(4) *Corporate Governance An International Review* 542-550; Wolf-Georg Ringe, 'Independent directors: After the crisis' (2013) 14(3) *European Business Organization Law Review*; Jonathan Liu and Tomas Andersson, *Mind the Gap: Expectations on the Role of UK Non- Executive Directors* (2014), < <http://www.regents.ac.uk/media/975652/RWPBM1402-Liu-J- Andersson-T.pdf> (visited 23/4/2017) ; Simon Witney, 'Corporate opportunities law and the non-executive director' (2016) 16(1) *Journal of Corporate Law Studies* 145-186

⁷²⁵ Christopher Pass, 'Non-executive directors and the UK's new combined code on corporate governance' (2008) 9(6) *Business Strategy Series* 291-296; Reisberg *ibid* 34

⁷²⁶ Andrew Kakabadse et al., 'Role and Contribution of Non-Executive Directors' (2001) 1(1) *Corporate Governance: The international journal of business in society* 4-8; Ringe [n 724] 418

⁷²⁷ Sanjai Bhagat and Bernard Black, 'The Non-Correlation between Board Independence and Long-Term Firm Performance' (2002) 27(2) *The Journal of Corporation Law* 231; Pass [n725]; Samuel O. Idowu and Céline Louche (eds), *Theory and Practice of Corporate Social Responsibility* (Springer 2011) 39, 51

what kind of task they would have. If works councils in Germany and other Continental European jurisdictions serve as the model, would employees elect the council members themselves, or would the task be given to the directors or shareholders?

What impact would the council have on the board's decisions? Would the panel have enough power to challenge the board? Would they participate in decisions about company strategy and its execution? Would they similarly to the work councils in Germany have an impressive set of information, consultation and co-decision rights?⁷²⁸ Still there is no clear answer to these questions. The respondents to the Green Paper have suggested, among other things, that the panel should be able to issue an annual public statement (potentially as part of the annual report) and commission independent investigations, in order to maintain its independent voice. The panel should ensure that the board and management are clear about key risks and amplify perspectives that may be absent or weak at board level. Moreover, the panel could have a formal consultative role with the remuneration committee in reviewing executive pay policies and performance. While it is unclear whether the Government will implement any of these suggestions, it is evident that the employee advisory council as an optional mechanism would not have a sufficient mandatory nature to oblige directors to consider the employees' interests in their decision-making, nor would it have strong power to prevent the directors' opportunistic behaviour.

⁷²⁸ Paul Davies, 'Efficiency Arguments for the Collective Representation of Workers: A Sketch' in C Costello, Bogg, Paul Davies and J Prassl (eds), *The Autonomy of Labour Law* (Hart Publishing, Oxford 2014) 367, 382-386

7.3.4 Appointment of an employees' representative to boards

The third proposed employee's engagement mechanism is appointing a director from the workforce, which was actually one of the UK Prime Minister's campaign pledges. However, she eventually stepped back from her initial promise by substituting mandatory employees' representative on board with an optional workforce representation for public listed companies.

As a general concept, providing employees with the right to have a representative on the board could provide some advantages both to the company and to the employees themselves. The economic rationale for employee representation is that employees may be more motivated to invest in the company-specific skills if they are less exposed to threats of opportunistic wage negotiations or termination of pension plans.⁷²⁹ Also, the employees' representative could introduce different perspectives on the operation of the company. The employees' representative could potentially raise concern on the board decisions, which is likely to harm the stability of the company in the long run. On the other hand, however, there are some potential problems. The first important point is that an employees' representative in the UK as a voluntary option based on the "comply-and-explain" principle might not be effective in protection of the company. Listed companies might not see this as an opportunity to engage with employees. Even if companies choose this option, some factors might undercut its potential benefits. It is not clear how the proposed employee's director would be elected. Company employees

⁷²⁹ Martin Gelter and Genevieve Helleringer, 'Constituency Directors and Corporate Fiduciary Duties' in Andrew Gold and Paul Miller (eds), *Philosophical Foundations of Fiduciary Law* (Oxford University Press 2016) 302-320; Eger [n 13] 384-385; see also Martin Gelter, 'The Pension System and the Rise of Shareholder Primacy' (2013) 43 Seton Hall Law Review 909, 937-941

might either hold an official election, or they might only be permitted to nominate a candidate for subsequent appointment by directors or election by shareholders.⁷³⁰ In the latter case (which is currently practiced in the few British companies having employee representatives)⁷³¹ the powers of employees would remain notional. The purpose of employees' representatives is not merely to serve as figureheads, but to preserve the stability of the company and protect the employees' interest in the company. The employees' representative who has been selected by the board and voted into office by shareholders will likely not be able to achieve the mentioned goals. Moreover, the Government has not clarified the prospective role of employees' directors. If the purpose is to represent the interests of employees and to contribute their concerns to board deliberations, this role could be potentially in conflict with general duties of directors. The UK Companies Act 2006 clearly indicates that the company is the only beneficiary of directors' fiduciary duties.⁷³² Therefore, all the fiduciary duties described in sections 171 to 177 of the Companies Act 2006, including the duty to avoid conflict of interest⁷³³ must be discharged in a similar way by employee directors and others.⁷³⁴

It is far from clear how the proposed employees' representative will be positioned to promote the interests of employees and protect the company without creating the conflict of interest. Also, information sharing between the employees' director and the group he is representing is a two-edged sword. Employees' directors may struggle in

⁷³⁰ Edo Groenewald, 'Corporate Governance in the Netherlands: From the Verdam Report of 1964 to the Tabaksblat Code of 2003' (2005) 5 European Business Organization Law Review 291, 299

⁷³¹ This is currently the practical approach in the First Group PLC which is apparently one of the few UK public companies who has an employee representative on the board; <http://www.firstgroupplc.com>.

⁷³² Companies Act 2006 s. 170

⁷³³ Companies Act 2006 s 175

⁷³⁴ Gelter and Helleringer [n 729] 309

keeping their duty of confidentiality on the one hand, while reducing the asymmetry of information between employees and the board by providing the employees with reliable information, on the other. The UK Government needs to clarify the mentioned ambiguities on the role of the employees' representative. Even if her duty would be to provide perspective rather than representing particular interests, the scope of her role should be clear. The other serious concern is that a single employees' representative will be isolated on the board and will not have an impactful voice there. For the Government proposal to work in practice, a critical mass of two or three directors would have to be appointed. Considering the traditional board structure of UK companies, few firms will likely choose this option.

7.3.5 Mandatory report on compliance with section 172

The Government's fourth option is strengthening the reporting requirements on how directors comply with the requirements of section 172 to have regard to the employees' interests. Again, the details of the proposal could hardly be less clear. Under the current plan, companies will be required to explain how they have identified and sought the views of key stakeholders, why the mechanisms adopted were appropriate, and how they influenced boardroom decision-making. In addition to the annual report, the government may require disclosures on the company website.⁷³⁵ The new reporting requirement is expected to encourage directors to give more thought to how they engage with employees and other stakeholders.⁷³⁶ However, the requirement does not provide

⁷³⁵ Department for Business, Energy & industrial Strategy, *Corporate Governance Reform, The Government response to the green paper consultation*, para 2.36

⁷³⁶ *ibid* para 2.39

any guidance on how directors can ensure effective engagement.⁷³⁷ Nonetheless, it is not clear how the new reporting requirement will be different from the contents of section 414C of Strategic Report and Directors' Report Regulations 2013. Section 414C of the Companies Act 2006 requires directors to report to members of the company on how they have performed their duty under section 172.⁷³⁸ The problem with the current and the proposed report is that directors are required to report their compliance to the company shareholders only. Unless directors are required to report to the employees or employees' representatives or other stakeholders' representative directly, the consideration of employee or other stakeholders' interests will not be a priority, because shareholders will likely only consider the information relevant to the extent that it serves shareholder interests. As mentioned above, directors may sacrifice long-term stability of a company in order to enhance short-term profit maximisation.⁷³⁹ This could be damaging for the long-term development of the company, and might ultimately harm society as a whole.⁷⁴⁰ One reason is that in such situations, institutional shareholders would be indifferent to other stakeholder interest or corporate social responsibility.⁷⁴¹ As a result, strengthening the directors' report on compliance with section 172 may not be an adequate solution to control corporate misconduct in all circumstances. The

⁷³⁷ *ibid*

⁷³⁸ Companies Act 2006 section 414C(4)(b)

⁷³⁹ Iris H-V Chiu, 'Operationalizing a stakeholder conception in company law' (2016) 10(4) *Law and Financial Markets Review* 173-192; Caitlyn Helms, Mark Fox and Robert Kenagy, 'Corporate Short-Termism: Causes and Remedies' (2012) 23 *International and Comparative Company Law Review* 45

⁷⁴⁰ Chiu *ibid*

⁷⁴¹ Chiu *ibid*; also Emeka Duruigbo, 'Tackling Shareholder Short-Termism and Managerial Myopia' (2011-12) 100 *Kentucky Law Journal* 531; David Millon, 'Shareholder Social Responsibility' (2012) 36 *Seattle University Law Review* 911; Marc Moore and Edward Walker-Arnott, 'A Fresh Look at Stock Market Short Termism' (2014) 41 *Journal of Law and Society* 416; BIS, *The Kay Review of UK Equity Markets and Long-Term Decision Making (Final Report, 23 July 2012)*, http://www.ecgi.org/conferences/eu_actionplan2013/documents/kay_review_final_report.pdf

question is why the Government if it feels that stakeholders' interests are being ignored, would not turn the directors' duty under section 172 into a pluralist duty, in which stakeholders' interests rank equally with shareholders' interests? In that case they would have equality with the shareholder right to sue directors on behalf of the company.

While the Government has announced that it has no plans to amend the wording of section 172, it has considered publishing a new guidance on the practical boardroom interpretation of directors' duties, for which it has invited the GC100 group of largest listed companies to prepare and publish a draft. Considering the ambiguous wording of section 172, such guidance on the performance of directors' duties is a step in the right direction. However, without knowing any details at this point, it is impossible to predict effects.

7.3.6 Strengthening the corporate governance framework in the UK's largest privately held companies

In addition to the proposed reforms for increasing the employees and other stakeholders' voice, the Government aims to enhance the protection of large private companies by providing a set of corporate governance principles. Nevertheless, adopting these principles will be voluntary, given that companies will be permitted to retain industry-level codes and guidance. At least, in order to increase transparency in private companies, large private companies with over 2,000 employees will be required

to disclose their corporate governance arrangements in their Directors' Report and on their websites.⁷⁴²

Critics argue that these measures will not impose any meaningful obligations on wrongdoing controlling shareholders and directors to refrain from detrimental opportunistic behaviour. Even if large private companies in the UK adopted the corporate governance principles and reporting requirements, they would not serve to shield companies from harm in all circumstances. For instance, in cases such as BHS, there would be no shareholders outside the wrongdoers' team to discipline directors.

7.4 The Government's proposed mechanisms are not sufficient

The UK Government has claimed that the proposed reforms "will improve corporate governance and give workers and the other stakeholders stronger power to engage in the management of the company".⁷⁴³ The UK Prime Minister has also pledged to introduce tough new laws for pension schemes to prevent a repeat of the BHS pension scandal. She has promised the Pensions Regulator will have the power to block business takeovers that could be used to raid pension funds.⁷⁴⁴ As we have seen, the Government reforms, although are promising in rhetoric, will be unlikely to have a practical impact.

All of this reveals the key problem: in proposing these reforms, the Government still assumes that shareholders are the only important group of stakeholders. Only shareholders will receive a report on executive pay, and only shareholders will have a

⁷⁴² Department for Business, Energy & Industrial Strategy, *Corporate Governance Reform, The Government response to the green paper consultation*, Action 11 p 42

⁷⁴³ *ibid* Introduction from the Prime Minister

⁷⁴⁴ Josephine Cumbo, 'UK Pension Scheme Protections not expected before 2020' (October 19 2017) Financial Times, at <https://www.ft.com/content/9aec9d16-b4d6-11e7-aa26-bb002965bce8>

binding vote on it. Even in terms of strengthening the employees and other stakeholders' voice, shareholders would still have more rights themselves than those groups. Directors will still report exclusively to shareholders on how they discharge their duty to consider employee and other stakeholders' interests. Also, it is very plausible that shareholders will play a greater role in forming the proposed advisory council and choosing the employees' director than the employees. As previously discussed, shareholders may not always have a long-term orientation, and they may not object to extraordinary rewards for executives as long as they receive substantial short-term returns on their investments. They may not care when directors harm the company assets with opportunistic behaviour putting employees' jobs in jeopardy.

There is no chance that the Government's proposals for large private companies will prevent scandals comparable to BHS, which was a family-run business in which controlling shareholders and directors stripped the employees' pension fund. There are many other private companies where there are no control mechanisms outside of the board of directors. Due to the lack of scrutiny by markets and regulators, the wrongdoers' abuses remain unchecked, and the transparency provided by the proposed corporate governance code would likely not affect internal management.

Employees, however, are the arm and brawn of the company, and the Government has clearly identified the need for strengthening their protection. Nevertheless, the Government has failed to adequately adopt practical solutions that preserve company stability in the long term for the sake of the employees and other stakeholders' interest. Therefore, in addition to the current proposals, which are theoretically constructive, the

right to initiate a derivative claim, which is currently restricted to shareholders, should be broadened to employees. The employees' derivative claim right would increase the accountability of directors and controlling shareholders toward the company. The need for broadening the derivative claim right to other stakeholders, including the employees, has also been mentioned by respondents to the Government Green Paper.⁷⁴⁵ The argument is that empowering the employees with the derivative claim right would benefit other stakeholders as well because they could benefit from the stability of the company in the long run.

The thesis argues that instead of only empowering the pension regulator to prevent scandals such as BHS in the future, it would be better if such an enforcement right were granted to employees themselves. Employees have stronger incentives than the pension regulator to protect their own interests in the company either in the form of protecting their pension schemes or protecting the company from any other negligent or opportunistic behaviour, which could harm the company and damage their interests.

7.5 Establishing an employees' derivative claim

How can a derivative claim be a useful mechanism in cases like BHS? As we previously discussed, protecting the interests of employees very much depends on the stability of the company in the first instance. The derivative claim is the only direct protection available to the company, as a separate legal entity, to maintain its

⁷⁴⁵ *ibid* para 4.7 p 44

sustainability. If a violation of the law harms the company and puts the employees' interests in danger, but benefits shareholders in the short run, shareholders will not necessarily have incentives to bring a suit; or even in cases like BHS, there might not be a minority shareholder to protect the company. Consequently, broadening the derivative right to employees in such situations would benefit the company as a whole in general.

The BHS tragedy might have been prevented, and the company could have been saved, if the company's employees had been equipped with the right to initiate a claim on behalf of the company against Sir Philipp Green and all those other company wrongdoers for their negligence, mismanagement, and for the misappropriation of the company's assets through dividends and a variety of intragroup transactions. Under the current statutory provisions, the derivative claim could be initiated against a wrongdoing director or another person, or both⁷⁴⁶ but only by shareholders. Nevertheless, in cases like BHS – which was a private company – there is no shareholder from outside the wrongdoers' team to act as a watchdog and control and stop the wrongdoers' misconduct. If BHS employees had been equipped with the right to initiate a claim on behalf of the company, they could have challenged the directors or controlling shareholders' opportunistic behaviour such as excessive dividends, extraction of cash from the company or depleting of the pension funds. Through a derivative claim the employees could bring compensation to the company and prevent further harm to it. The deterrence role would increase the likelihood of a derivative lawsuit by the employees and could have a deterrent effect in preventing losses to the

⁷⁴⁶ Companies Act 2006 section 260(3)

company. The employees would be able to prevent the misappropriation of the company assets or stop a self-dealing transaction, which harms the company through a court order. The employees derivative claim right would be a threat to managers or majority shareholders like Sir Green, who under the current situation feel free to do whatever they want with the company's assets while disregarding the interests of others. Although employees do not formally have the right to investigate the company's documents or get direct information on the board's conduct, they are still in a better position to obtain information about the directors' wrongful conduct in the company and challenge them by initiating a derivative claim.

7.6 The proposal is not in conflict with other employee rights

It needs to be clear that the thesis proposal is neither a substitute for other proposed reforms, such as the right to have a representative on the board, nor does It claim that having the derivative right only, would provide ironclad protection for the company either through employees or shareholders in all circumstances. Like any other mechanism, the derivative claim has its limitations. However, the thesis argues that the derivative claim right could work as a complement to other mechanisms.

The argument is that just like shareholders who have both personal rights as well as the right to make a claim on behalf of the company, employees who are often more deeply invested in a company with their human capital, and are dependent on the company for their livelihoods and their pension benefits, should have similar rights to protect their reflective interests. As Paul Davies argues, employee governance rights which operate only at sub-board or only at board level (including the advisory panel and

having a representative on the board) are unlikely to provide sufficient support for a fully effective cooperation arrangement, but each is arguably a necessary ingredient in a complete structure.⁷⁴⁷ Employees' governance rights such as having a representative on the board and a work council can have beneficial effects, provided that the role and function of these mechanisms have been defined clearly. The employees' derivative claim right could be the building block to complete this edifice. It is less likely that mechanisms providing representation for workers work effectively in preventing harm to the company without an enforcement mechanism to support them. What would be the advantage of employees being aware of directors' opportunistic behaviour that harms the company when they would not have the enforcement power to stop them?

One might possibly argue that employees could use other platforms such as media discussions or whistleblowing to bring wrongful conduct to the attention of the public. However, while either of these mechanisms could be helpful, they both fall short of holding directors accountable for breaching their fiduciary duties compared to legal action. Many companies, especially private companies, are not large or sufficiently well-known to invoke the media attention or become the subject of financial analysts. The derivative claim could theoretically play an outsize role in protecting smaller publicly traded or private companies against the exploitation by majority shareholders.

Another argument could be that employees should be given stock in the company, or buy it in order to have a greater governance role. This would permit them to sue wrongdoing directors in their capacity as the shareholder. Again, this solution does not

⁷⁴⁷ Davies [n 728] 381

apply to all companies. Whether employees hold shares depends on the company's capital structure, public trading status, and remuneration policies. It might not apply to all the companies. For instance, as a large privately held firm, BHS is an example where employees could not have availed themselves of a shareholder derivative claim.

7.7 Extending the derivative claim right to the employees' representative

Based on the arguments given, statutory provisions under the Companies Act 2006 should be broadened to include employees as the claimant for the derivative claim. In this regard, in addition to the shareholders, the proposed derivative claim would be initiated by, a registered trade union that represents employees of the company, or another representative of employees of the company.

The proposal resembles section 165(2)(c) of the South African Companies Act 2008,⁷⁴⁸ which clearly permits a registered trade union that represents employees of the company or another representative of employees of the company to initiate a derivative action.

In the view of this thesis, limiting the derivative claim right to the employees' representative would reduce the amount of litigation and undercut concerns about abusive lawsuits.

One argument could be that the employees' representative, especially a trade union, might pursue its own agenda rather than serve the employees' interests. The situation is similar as in collective bargaining, where the union representative could take advantage of the situation when dealing with the company's directors. However, the situation discussed here differs crucially in that a derivative claim is brought on behalf of the company and only the company would receive any possible benefit or remedy that arises from the derivative claim. Considering the factors such as the role of the court, the derivative claim's tough procedural requirements and the costs of the litigation, it is

⁷⁴⁸ South African Companies Act 2008 section 165(2)

unlikely that the derivative claim would create many opportunities for misuse. It seems doubtful that employees or their representative would take the risk of initiating a time-consuming and costly litigation, which would not even benefit them personally, with the aim of abusing the directors. If we are too concerned about the risk of an employees' representative abusing the situation of a claim on behalf of the company, then we could find employees' representatives on the board, which has already been proposed by the UK Government, equally troubling. In the end, it is a larger question as to what extent unions are accountable to their constituents, and to what extent the relationship between unions and workers entails an agency problem. If such a concern would affect all union activities, unions that are properly accountable to workers should be largely immune from this criticism.

Another objection might be that the proposed reform would cause an excessive amount of litigation against company directors and would reduce directors' business risk-taking, and consequently affect the profit growth because broadening liability risks would make directors more risk-averse. Other jurisdictions have already expanded the derivative claim right to other corporate stakeholders, including corporate employees, without such an effect. The experience in these jurisdictions reveals that because of the derivative claim's procedural requirements expanding the derivative claim right to other stakeholders would not open the floodgates to litigation against the company.

For instance, the Canada Business Corporations Act 1985 section 238 provides that in addition to the members, some specific types of creditors, and directors, the derivative action can also be initiated by "any other person who, in the discretion of a

court, is a proper person to make an application”. Singapore has also taken the same approach to Canada.⁷⁴⁹ As was mentioned above, more in line with the thesis argument, section 165(2) of the South African Companies Act 2008 provides that in addition to the members of the company, a registered trade union that represents employees of the company, or another representative of employees of the company can also initiate the derivative action.⁷⁵⁰ In *Lewis Group Limited v Woollam and Others*⁷⁵¹ The High Court of South Africa held that:” One of the most obviously reformatory aspects of s165 of the 2008 Companies Act is that standing to bring derivative actions is afforded more widely than it appears to have been under the common law. Standing is afforded under s 165 also to directors, employee representatives and any other person who might obtain the court’s leave to proceed derivatively”. The court further reasoned that:” Whilst the majority of shareholders might be prepared to condone loss occasioned to a company due to the negligent conduct of its directors, employees faced with resultant redundancy or wage cuts might have a different view and be able to persuade a court that objectively it would be in the company’s best interests to seek redress against the negligent directors.”⁷⁵².

This thesis agrees with the court ruling that the derivative right for employees would pose a greater deterrent to wrongdoers in the company. This is true especially in private

⁷⁴⁹ Singaporean Companies Act section 216A(1)(c); also see Andrew Keay, ‘Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006’ (2016) 16(1) Journal of Corporate Law Studies 39-68

⁷⁵⁰ In addition to the right to initiate a derivative action, an employees representative under the South African Companies Act 2008 has also the right to institute a class action proceeding, initiate a complaint, restrain a company from acting in conflict with the Companies Act and apply to the court to declare a director delinquent or be put on probation; see Maleka Femida Cassim, *The New Derivative Action Under the Companies Act : Guidelines for Judicial Discretion*, (Juta Company Ltd, 2016)

⁷⁵¹ *Lewis Group Limited v Woollam and Others* (9900/2016) [2016] ZAWCHC 130

⁷⁵² *ibid* para 33

companies whose directors may otherwise feel sufficiently secure to interfere as they please with the company's assets, or to run the company in a way that benefits them personally without having to consider any consequences of their conduct for others. The derivative right to employees would make directors and managers more cautious in their conduct. Even if they had shareholders supporting them or ignoring harm being done to the company, employees would be theoretically in the position to prevent harmful actions. Hence, the benefit of broadening the derivative claim provisions to include employees would outweigh its possible disadvantages.

As was explained above, the risk of abusing the litigation is not high. The derivative claim is a lawsuit on behalf of the company predicated on shareholders and employees' ability to show that the company's interest is harmed or is in jeopardy. Therefore, due to the claim's limited grounds, which only apply when the company has sustained harm, the two-staged judicial procedure for the admission of derivative suits, and the difficulty of surmounting the leave requirements, mean that the risk of abusive claims cannot be high.

7.8 The structure of the current statutory provision should change

Based on the above arguments, this thesis proposes that the scope of the derivative claim's applicants under section 260 of the Companies Act 2006 should be broadened to the employees' representative. The current statutory derivative claim scheme has been established on the shareholder primacy principle. Under the statutory provisions, only shareholders have the right to initiate the claim. Consequently, the procedural requirements have been based on the shareholder derivative right only. To implement

this employees derivative claim proposal, the wording of the current provisions as well as some of the procedural requirements should be amended. In the first step the scope of the derivative claim applicants under section 260 of the Companies Act 2006 should be changed and the section should provide that the statutory derivative claim would be initiated by a member of the company, a registered trade union that represents employees of the company, or another representative of employees of the company. In addition to that, the current derivative claim procedural requirements should be reformed and these requirements should be defined by considering both shareholders and employees as the applicants. For instance, the current role of the shareholder ratification in the context of the derivative claim under section 263(3)(c) should be changed. I have already discussed this issue in chapter six. My argument is that the ratification of directors' conduct by shareholders should not prevent employees to bring a claim on behalf of the company. The interest of shareholders and employees is not always in line with each other and the employees' derivative claim should be considered on the grounds of their own interests only. Furthermore this research's proposal for the derivative claim costs applies to the employees as the applicants as well and they should have the equal right as shareholders to apply for an indemnity costs order.

7.9 Conclusion

In light of the BHS scandal and some other companies' failure in protecting the employees' interests, the UK Government has set out some plans to strengthen the employees and other stakeholders' voice.

The Government's specific plans for improving employee protection in the company have been set in the form of a mandatory report on how directors comply with the section 172 requirements in considering the employees interest, adopting either: a designated non-executive director; a formal employees advisory council; or a director from the workforce on a "comply-or-explain" basis. Moreover, the Government requires the GC 100 group of the largest listed companies to prepare guidance on the practical interpretation of the directors' duty under section 172 of the Companies Act 2006. In addition, the Government has unveiled some other corporate governance reforms such as standardizing the executive pay and establishing a voluntary set of corporate governance code for large private companies. The Government proposed reforms, provided that the role and function of these mechanisms will be defined clearly, may have beneficial effects.

However, thesis' argument is that these proposed reforms would be insufficient to enhance the company's protection. A derivative claim right for employees would help to further protect their reflective interest in the company and preserve the company from the wrongdoers' harm. In the current situation, only shareholders have the right to bring a claim on behalf of the company when directors fail to comply with their fiduciary duties. Nevertheless, they may not care when directors harm the company assets with

their opportunistic behaviours and put the employees' jobs in jeopardy as long as they are benefiting from short-term developments in the company. Employees often have better incentives than shareholders to protect the company in the long run. Therefore, empowering them with the derivative claim right would enhance the protection of the company and would benefit the other stakeholders and even in a greater scale society as well.

In this regard, the paper proposed the broadening of the derivative claim provisions to a registered trade union that represents employees of the company, or another representative of employees of the company. Providing a derivative right to employees at least in theory would pose a threat to wrongdoers, especially in private companies where there is no external control on directors and controlling shareholders. If directors and other wrongdoers are aware that their misconduct can be challenged by a larger group of applicants, they will be more strongly deterred from acting without care and disloyally, and they would be less likely to run the company in a way conducive to their personal benefit, while harming the company itself and its other stakeholders.

Chapter Eight: Conclusion

8.1 Summary of the research objective and arguments

After much consideration and many years of consultation, the statutory derivative claim was finally established in the UK under the Companies Act 2006. The enactment was the result of the difficulties with common law derivative action. The English Law Commission, which at the time was in charge of reforming the derivative actions, described the law governing derivative action as obscure and outmoded. The aim of the reforms was to set a more modern, flexible and accessible criteria for derivative actions.

In the view of this thesis, however, there are some major critiques to the statutory derivative claim structure in the UK. Despite the reforms to the common law derivative actions, the approach to the derivative claim is still overly restricted. The shortcomings of the statutory derivative claim were reviewed in chapter two. It was revealed that the problem with derivative claims costs along with the ambiguities in the derivative claim procedure requirements, discouraged applicants to initiate a meritorious claim on behalf of the company. In addition to that, the scope of the derivative claim applicants is limited to shareholders and the statutory derivative claim provisions are likely to have been established to protect the interest of the shareholders rather than the company as separate legal personality. Nevertheless, this thesis argued that the company is a separate legal personality, which should be protected for the interest of all the stakeholders in the long run.

Therefore, the role of the derivative claim as the only mechanism of protection for the company itself should be reconsidered. In chapter three, the thesis reviewed the different mechanisms of accountability for directors in both private and public companies and argued that the other mechanisms of accountability for directors protect the company to the extent that shareholders care. However, shareholders might not care about the protection of the company as a whole as long as their personal rights are preserved or they can receive profits for their investment in the short term. Therefore, although the combination of these mechanisms could provide an environment in which the derivative claim is less needed, they might not protect the company in all circumstances. To enhance the protection of the company, the derivative claim should be available as a complementary mechanism for the situations that it is needed.

The thesis also argued that the efficiency of the derivative claim stands from not the high number of the derivative claim cases but the quality of the law that rules the derivative claim procedure. The derivative claim is an exceptional remedy and which is not supposed to be frequently used by shareholders or employees, otherwise it could result in the abuse of the mechanism. The evidence for this situation is the United States. It was discussed in chapter four that although the derivative suits are frequently in use in the United States, they are not resulting in benefit to the company in all circumstances. Therefore, the thesis argued that the derivative claim could be an affordable and accessible mechanism under the law without the necessity to be implemented too much. To support this argument,

chapter five explored the derivative action in New Zealand and although the statutory derivative action has a set of smother procedural requirements in comparison to the UK, derivative claims are still not frequently used in this country. One apparent reason is that under the law the mechanisms of accountability are also sufficiently available to protect the company.

8.2 The thesis proposals

In order to improve the quality of the statutory derivative claim in the UK, this research proposed some reforms. The main proposal of this research is that the scope of the derivative claim should be broadened to employees. The thesis discussed the limitations of the shareholder primacy theory and the shortcomings of reliance on shareholders to protect the company. It was argued that in addition to shareholders, employees should have the right to make the derivative claim. Among the different stakeholder groups, employees are in a better position to protect the company through the derivative claim. They invest in the company with their skill and their economic fortune is tied to the company's well-being. Therefore, they have strong incentive to protect the company from the wrongdoers' harm. The thesis also discussed the UK Government proposed ways of engaging employees in the management of the company in chapter seven. The thesis reviewed these proposals to illustrate why they are not sufficient in increasing the protection of the company as a whole in the long term, and why the employees' derivative claim is still needed as a complementary mechanism to these proposals. Based on the arguments, the thesis proposed the extension of the

derivative claim right to the employees' representative in the company and subsequently suggested some reforms to the structure of the statutory derivative claim. The proposal for extending the derivative claim right to the employees' representative has been inspired by section 165(2) South African Companies Act 2008.

The other research proposals were a set of reforms to the derivative claim procedure requirements. With regards to the role of ratification in the context of the derivative claim, this thesis argues that the current approach has added to the complexities and ambiguities of the statutory derivative claim. In chapter six, the research reviewed the current problems with the role of shareholder ratification and suggests that instead of playing a role as a substantial requirement to derivative claims, the directors' conduct which has been ratified by shareholders should be taken into account by the court only in the context of the shareholders' derivative claim. It was argued that the employees' derivative claim should be considered on separate grounds because the interest of employees and shareholders are not always in line.

In terms of reform to derivative litigation costs, inspired from the derivative claim financial structure in New Zealand, the thesis proposes that upon granting permission to continue the claim, the court orders that the whole or part of the reasonable costs of a derivative claim must be met by the company unless the plaintiff is willing to pay the costs of the litigation himself, or the court considers the costs to be unreasonable. Moreover, the research suggests that similar to the

corporate benefit doctrine in the United States, in granting the cost order the court considers the likelihood of any non-financial but advantageous recovery as well. The consideration of non-pecuniary benefit of the derivative claim includes any probable court order that would stop the directors to continue a detrimental transaction which harms the company. It could also happen in the form of any corporate governance reform in the management of the company, for example the nullification of a wrongdoing director. The non-monetary outcome of the derivative claim could give minority shareholders or the employees the power that they do not have in ordinary situations.

8.3 Final remarks

If derivative claims are supposed to have a practical role in the English legal system, and if all the efforts in reforming the mechanisms are to be effective, then some further reforms are needed. The reforms suggested in this thesis would ensure that the derivative claim could play a more practical role in protecting the company in situations in which the other mechanisms of accountability fail to monitor or detect the directors' misconduct. On the other hand, it guarantees that the proposals would not open a floodgate of unmeritorious litigation against the company.

Overall, in the view of this research, the risk of abuse of the derivative claim is over-estimated. Because the derivative claim is a claim on behalf of the company and all the probable benefit goes back to the company, it is unlikely that the shareholder or employee applicant would make a time-consuming and risky litigation from which they would not in any event obtain any personal profit, without a proper cause of action and only with the aim of abusing the directors.

Additionally, there would still be sufficient safeguards in the derivative claim's procedure and under the court's scrutiny to prevent any probable vexatious claim.

Lastly, directors are usually protected by liability insurance for their business decisions. The company takes out the insurance to cover the costs of any probable litigation against them. It would be unfair if shareholders and employees who are

exposed to the opportunistic behaviour of company directors did not have a fairly accessible and affordable remedy to compensate the harm to them.

8.4 Beyond this thesis: future direction

Although this research attempts to improve the function of the statutory derivative claim in the UK, it cannot explore all aspects in this area. In fact, I hope that the theoretical inquiry developed in this thesis provides new insight for the future study of derivative claims in the UK.

One of the further avenues of research relevant to the subject of this thesis is the question of whether derivative claims could be extended to the creditors in a company.

Creditors are an important group of stakeholders in a company and which could have their interests harmed by directors' opportunistic behaviour and wrongful conduct. Like the employees, the creditors could have strong incentive to save the company from the wrongdoers' harm. Although section 172(3) of the Companies Act 2006 requires directors to consider the interest of creditors in situations where the company is close to insolvency, the Act fails to empower the creditors with a statutory right to pursue a derivative claim in situations where directors harm the company.

Another problem is that it is not clear when the company is "close to insolvency" and when directors must consider the interests of creditors under section 172 (3). Reviewing the case law reveals that the judicial view is that where a company is insolvent, directors must consider the interests of creditors. However, the courts have

also failed to be consistent and precise in defining when the duty of directors toward the creditors arises.

Creditors are said to be able to protect themselves by the terms of the contracts that they make with the company. They are said to have fixed claims in an insolvent company and therefore they take the least risk among different stakeholders in a company. However, despite the mentioned rights, still the contractual protections are not sufficient to protect creditors in all circumstances. One apparent reason is that no contract is complete enough to encompass all the proper safeguards against the probable harm to the interest of creditors in the future. Therefore, the argument could be that like employees and shareholders, creditors should also be empowered with a statutory right for the derivative claim. Granting the derivative claim right would empower them to bring a claim on behalf of the company in situations that the harm to the company affects their reflective interests in the company.

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