Through the looking glass

Dov Ohrenstein reviews the law relating to reflective losses and derivative claims

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'Pursuant to s260(1) of the Companies Act Act, only a company member can bring a derivative claim. For this purpose "member" includes trustees in bankruptcy and other persons who have been transferred shares by operation of the law.'

Where a wrong is done to a company this will adversely impact on the value of members' shares. If the company is unwilling or unable to claim for these losses then the shareholders will be prejudiced unless they can bring their own claim. However, there are substantial obstacles to such claims by shareholders, as shown in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] at para 210:

> What [a shareholder] cannot do is to recover damages merely because the company in which he is interested has suffered damage. He cannot recover a sum equal to the diminution in the market value of his shares, or equal to the likely diminution in dividend, because such a 'loss' is merely a reflection of the loss suffered by the company.

The principle is generally known as the rule in *Foss v Harbottle* [1843]. The leading case is the decision of the House of Lords in *Johnson v Gore Wood & Co* [2000].

The rule is justified by the need both to prevent double recovery and to provide protection for the company's creditors, who might be prejudiced if the shareholder's claim were to succeed. The prohibition on recovering reflective losses applies even where the facts preclude double recovery, for example where the company has compromised its claim or chosen not to pursue it, or where there is a defence to the company's claim (for example, a limitation defence or defence based on estoppel) that does not apply to the shareholder's claim.

Equally, the prohibition applies in cases where double recovery might be avoided by a suitably drafted court order, or where the claimant gives credit in his claim for any damages that the company might have recovered. This general prohibition on recovery of reflective losses has been applied in the following recent reported cases:

- In *Rushmer v Mervyn Smith* [2009] the claimant, who was a shareholder and guarantor of a company, claimed that he had relied on company accounts that had been negligently prepared by the defendant auditor. It was held that the auditor did not owe the claimant a duty in respect of guarantee. In any event any loss suffered by the claimant (including his liability under the guarantee) was reflective of the company's loss and therefore irrecoverable.

- In *Rawnsley & anor v Weatherall Green & Smith North Ltd* [2009] a company and its director/principal shareholder sued a firm of surveyors and an insolvency practitioner. The company was insolvent and it was alleged that the marketing of the company's main asset, a property, had been negligent and that it had been sold at too low a price. The shareholder's claims were struck out on the basis that they were for a purely reflective loss.

- In *Gaetano Ltd v Obertor Ltd* [2009] the respondent counterclaimed that the company directors appointed by the applicant had breached their fiduciary duties, causing the respondent financial loss. The court held that the respondent had wrongly confused the duties of directors to their company and the obligations of joint venturers to each other as set out in a shareholders' agreement. The loss claimed by the respondent was held to be an irrecoverable reflective loss. It was not separate and distinct from the loss allegedly caused to the company as the diminution in value of the respondent's shareholding and the damage in repayments of priority distribution both resulted purely from the depletion of the company's assets or a reduction in its profits.

Despite the wide scope of the principle that reflective losses are irrecoverable, the Lords in *Johnson* acknowledged that it has its limits. The key limits are:

Where the company has no cause of action

The main limit on the prohibition is where a company has no cause of action to recover its loss. Then, if the shareholder has a cause of action, he may bring proceedings to recover his loss, even though the shareholder's loss is a diminution in the value of the shareholding. Since the company has no cause of action in respect of its loss, its assets are not depleted by the recovery of damages by the shareholder.

Where the shareholder's loss is separate and distinct

Similarly, 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 it, each of them may sue to recover the loss caused to it by breach of the duty owed to it. However, neither may recover loss caused to the other by breach of the duty owed to the other. Moreover, even if it does have its own cause of action, a shareholder cannot bring proceedings for damages unless it has suffered loss that is additional to that suffered by the company.

Where the wrongdoer has disabled the company

The rule preventing claims for reflective losses was apparently relaxed in the case of *Giles v Rhind* [2002]. There the defendant director of 'SHF' acted in breach of his obligations by diverting the business of one of SHF's customers to another company owned and controlled by him. The loss of that business drove SHF into liquidation and, as a consequence, proceedings commenced by SHF against the defendant were discontinued. By this action, the claimant sought to recover the loss in value of his shares in SHF and the loss of the salary and other benefits that he would otherwise have continued to enjoy had SHF continued in business. It was held that the decision in *Johnson* did not prevent a shareholder from recovering the value of his shares and/or the loss of the salary and other benefits that he would otherwise have continued to enjoy if it was the defendant's wrongdoing that had actually disabled the company from pursuing the cause of action that it had. *Giles v Rhind* was not followed by the Hong Kong Final Court of Appeal in *Waddington v Chan Chun Hoo Thomas* [2008]. But the decision of the Court of Appeal in *Webster v Sandersons Solicitors (a firm)* [2009] confirms it is still good authority and must be followed.

Common law derivative claim

In the light of the general prohibition on claims for reflective losses, the common law allowed shareholders under certain circumstances to bring claims on behalf of their companies.

The two basic requirements at common law for a derivative action were:

- that the alleged wrong or breach of duty was by a director and was incapable of being ratified by a simple majority of the members (eg a fraudulent breach by a director, the deliberate misappropriation of company assets etc, but not a *bona fide* misuse of powers or an incidental profit making); and

- that the alleged wrongdoers are in control of the company, so that the company, which is the 'proper claimant' cannot claim by itself.

Statutory derivative claims

Since October 2007 the provisions in ss260-264 of the Companies Act 2006 for a statutory derivative action have been in force. The conventional view (albeit not universally held) is that derivative actions that fall outside the statutory definition of 'derivative claim' can no longer be brought. Although the two basic common law requirements (set out above) will continue to be relevant to statutory derivative actions, and will play a part in the later stages of any litigation, the absence of one or other is no longer necessarily a bar to the commencement of proceedings.

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 it, each of them may sue to recover the loss.

Who can bring a statutory derivative claim?

Pursuant to s260(1) of the 2006 Act, only a company member can bring a derivative claim. For this purpose 'member' includes trustees in bankruptcy and other persons who have been transferred shares by operation of the law. No minimum shareholding is required. In fact, no shareholding at all is required (eg in cases of claims by members of companies limited by guarantee). Nevertheless, a minuscule holding acquired after the conduct complained of occurred, and with a view to commencing a derivative claim, may raise concerns about the claimant's good faith (see *Harley Street Capital Ltd v Tchigirinsky & ors* [2005] where a claimant acquired 200 £1 shares out of a capital of £230m).

It is not a requirement that the claimant be a minority shareholder. However, where (as is usually the case) a majority shareholder is in control of the company it will neither be necessary nor appropriate for the majority shareholder to pursue a derivative claim. In *Cinematic Finance Ltd v Ryder & ors* [2010] a majority shareholder maintained that there were exceptional circumstances that made its derivative claim appropriate where it was likely that the companies were or would become insolvent. Roth J held that a controlling shareholder should not seek to circumvent the insolvency regime by commencing a derivative claim.

When can a shareholder's conduct disqualify him from bringing a claim?

Where the shareholder is a wrongdoer

In a case concerning a derivative claim under the common law, the Court of Appeal in *Nurcombe v Nurcombe* [1985] held that:

> the conduct of a shareholder may be regarded by a court of equity as disqualifying him from appearing as plaintiff on the company's behalf. This will be the case, for example, if he participated in the wrong of which he complains.

Where the shareholder is acting for an ulterior purpose

In *Barrett v Duckett* [1995] one of the reasons that led the court to refuse to allow a derivative action to proceed was that it was being pursued as part of a family feud, rather than for the financial benefit of the claimant.

Who can the claim be brought against?

Third parties

The cause of action may be against the director or against another person or both. Any claim against a third party requires a cause of action connected with a director's conduct such as the third party dishonestly assisting a director's breach of fiduciary duty.

Former directors

The inclusion of former directors is significant because a former director remains subject to the duty (in s175) to avoid conflicts of interests as regards the exploitation of any property, information or opportunity of which he became aware at the time he was a director.

Shadow directors

It would be possible to base a claim against a shadow director on the grounds of 'default', for example for non-compliance with Part 10, Chapter 4 CA 2006, (transactions with directors requiring approval of members) where many of the provisions expressly apply to shadow directors; and also on the basis of being 'another person' for the purpose of s260(3) CA 2006.

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What causes of action can be pursued in a derivative claim?

Range of claims

Part 11 of the Act therefore gives shareholders, for the first time, a statutory right to sue directors in a derivative action on behalf of the company for negligence, default (including breaches of statutory obligations), breach of duty or breach of trust, subject to the court allowing the action to proceed. This covers a broader range of conduct than existed under the common law, which was based on the concept of a 'fraud on the minority'.

Negligence

It is no longer necessary to establish any negligence even if it is of the self-serving variety seen in *Daniels v Daniels* [1978] where the board sold an asset at a gross undervalue to one of the directors.

Breaches of the company's constitution

The existence now of a specific statutory duty on directors to act in accordance with the constitution (s171) does not confer on members a right to enforce every provision of the constitution. The preservation of the common law on authorisation by s180(4)(a) means that the distinction drawn in the case law between matters of internal management and rights conferred by the constitution *qua* member (and not within the control of the majority) remains.

What are the requirements for permission?

First hurdle: when must permission be refused?

Section 263(2) sets out three situations in which permission for a derivative claim (not being brought as part of an unfair prejudice petition under s994) must be refused:

> (2) Permission (or leave) must be refused if the court is satisfied –
>
> (a) that a person acting in accordance with s172 (duty to promote the success of the company) would not seek to continue the claim, or
>
> (b) where the cause of action arises from an act or omission that is yet to occur, that the act or omission has been authorised by the company, or
>
> (c) where the cause of action arises from an act or omission that has already occurred, that the act or omission –
>
> (i) was authorised by the company before it occurred, or
>
> (ii) has been ratified by the company since it occurred.

Second hurdle: discretionary factors

If an application overcomes the hurdles in s263(2) the court will then take into account the discretionary factors set out in s263(3) being:

> (a) whether the member is acting in good faith in seeking to continue the claim;
>
> (b) the importance that a person acting in accordance with s172 (duty to promote the success of the company) would attach to continuing it;
>
> (c) where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be –
>
> (i) authorised by the company before it occurs, or

(ii) ratified by the company after it occurs;

(d) 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;

(e) whether the company has decided not to pursue the claim;

(f) whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.

Issues concerning authorisation and ratification

At common law, a relevant question was whether or not the act or omission in question was capable of being ratified, not whether or not it had been. By contrast the first hurdle in the statutory regime prevents any derivative claim proceeding where there has been ratification or authorisation, and the second hurdle considers whether the conduct could be and is likely to be ratified.

Authorisation

The 2006 Act allows disinterested directors to authorise a director to exploit property, information or opportunity, though there is a conflict between the director's interests and the interests of the company (s175). In practice, it may be difficult for a potential claimant to determine whether or not authorisation has been given, particularly where there is reliance on an informal unanimous assent given before he became a member. In the absence of general meetings in private companies, a member will need to exercise his inspection rights under s358 to determine whether authorisation (or ratification, where ratification is possible) has occurred. Crucially, there is no requirement for board authorisation of conflicts of interest under s175 to be disclosed to the shareholders.

Ratification

As regards ratification, the change made by the 2006 Act is that, on any resolution to ratify a breach of duty, the votes of the interested director (if a member of the company) and any member connected with him (as defined in CA 2006, ss252–255) must be disregarded (see CA 2006, s239(3), (4)). Determining whose votes must be disregarded will not be straightforward, given the breadth of the definition of a connected person, and the issue of whether or not there has been effective ratification may quickly evolve into an expensive preliminary issue.

Even if a director cannot muster sufficient votes for ratification, it does not necessarily follow that a derivative claim can be brought. Effective ratification is an absolute bar to a claim, but its absence merely means that the court has a discretion as to whether the claim can proceed, which it must exercise in the light of the factors set out in s263(3).

The first hurdle in the statutory regime prevents any derivative claim proceeding where there has been ratification or authorisation, and the second hurdle considers whether the conduct could be and is likely to be ratified.

Views of a hypothetical independent director

Subsection 263(2)(b) reflects the decision in *Airey v Cordell & ors* [2006] where it was held that the appropriate test for permission to bring a derivative claim was the view of a hypothetical and independent board of directors. The court made clear in that case that its task was not to assert its own view, but merely to be satisfied that such a board could take the decision that the minority shareholder applying for permission to proceed would like it to take.

Practically, so long as a hypothetical independent director might be willing to pursue the claim, then s232(2)(b) will not bar a claim. Nevertheless, even if a claim is not barred under s232(2)(b), the views of hypothetical independent directors need to be considered as a discretionary factor under s232(3)(b), ie: the importance that a person acting in accordance with s172 (duty to promote the success of the company) would attach to continuing it.

Views of any independent shareholders

In addition, the views of any actual independent shareholders (which may match the views of hypothetical directors) need to be taken account of under s263(4), which states:

(4) 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.

Points to note include:

- The views that matter under s263(4) are of independent members. This provision reflects the attitude of the courts in relation to common law claims (eg see *Smith v Croft (No 2)* [1988]).
- Particular regard is to be had to those views; they are not merely a factor to be 'taken into account'. This emphasis may have some marginal consequence if all other factors are finely balanced.
- The decision of a company to embark on litigation is usually a matter for the directors not for the shareholders, yet it should be noted that the reference in s263(4) is to the views of members without a personal interest rather than of independent directors. This was an issue that was apparently the subject of debate within the Law Commission when the statute was being drafted.

Member's own rights of action

If a member can pursue his own right of action that could be a powerful argument as to why permission would not be granted to continue a derivative action (s263(3)(f)). This may not only include a personal action for damages (subject to problems of reflective loss) but also proceedings pursuant to CA s994 (unfair prejudice).

Statutory derivative claim procedure

In cases where a member originally brings a derivative action, permission must be sought under s261. There is also the possibility under s262 of an alternative scenario when a company has brought a claim and a member applies to the court so that the cause of action is then pursued as a derivative claim. An example of such a scenario would be if the company has failed to pursue a claim diligently, particularly if the company had only brought the claim in an attempt to stop a derivative claim being commenced. Situations when s262 will be relied upon are unlikely to arise frequently. Under both s261 and s262 the court has the same discretion. The member seeking the court's permission to bring a derivative claim must follow a two-stage process before any substantive proceedings can be commenced.

Stage 1

- The claim form must be marked 'Derivative Claim' (see CPR PD 19C) and should include any claim for a costs indemnity. It should be accompanied by a standard application notice but the company is not to be named as respondent. The member must file sufficient evidence to establish a *prima facie* entitlement to bring a derivative claim.

- Usually the company must be notified as soon as the claim and application are issued save that, where notifying the company of the permission application would be likely to frustrate some party of the remedy sought, the court may, on application by the claimant, order that the company need not be notified for such period after the issue of the claim form as the court directs.

- At this stage there will be an *ex parte* hearing at which the court needs only to consider the evidence filed on behalf of the claimant. If the court does not dismiss the application appropriate consequential directions will be ordered, eg for the company (and any necessary third parties) to be added as respondent and for the filing of the respondent's evidence.

The front-loading of costs on the claimant might deter some of the more frivolous or vexatious claims.

Stage 2

- If the Stage 1 hurdle is passed, then the merits of the application to continue the claim as a derivative claim will be reconsidered at an adjourned *inter partes* hearing.

- The member needs to persuade the court that a derivative claim is appropriate at any adjourned hearing where the evidence of both parties will be before the court.

- At the *inter partes* hearing the court does not simply have to be satisfied that there is a *prima facie* claim. Instead something more is required: the court needs to form a provisional view on the strength of the claim to properly consider the requirements of s263(2)(a) and s263(2)(b). However, the hearing should not amount to a mini trial of the action.

This process is designed to ensure that the claimant is serious about pursuing the claim and has sufficient grounds to do so. The front-loading of costs on the claimant might deter some of the more frivolous or vexatious claims. Perhaps the most useful consequence is that it will minimise the initial expense that a company need incur if a potential derivative claim obviously lacks merit.

Conclusion

Coupled with the new duty to promote the success of the company, concerns have been raised that shareholders, especially activist shareholders of traded companies, will use these provisions to bring unmeritorious claims that will take up valuable management time, as well as result in adverse publicity for the company. Historically, the courts have taken a restrictive approach to allowing derivative claims. In the words of Lord Eldon in *Carlen v Drury* [1812]:

> This court is not to be required on each occasion to take the management of every playhouse and brewhouse in the kingdom.

The courts are likely to adopt as robust an approach to statutory derivative actions as previously occurred under the common law. ■

Airey v Cordell & ors
[2006] EWHC 2728 (Ch)

Barrett v Duckett
[1995] 1 BCLC 243

Carlen v Drury
(1812) 1 Ves & B 154

Cinematic Finance Ltd v Ryder & ors
[2010] EWHC 3387 (Ch)

Daniels v Daniels
[1978] Ch 406

Foss v Harbottle
[1843] 2 Hare 461

Gaetano Ltd v Obertor Ltd
[2009] EWHC 2653 (Ch)

Giles v Rhind
[2002] EWCA Civ 1428

Harley Street Capital Ltd v Tchigirinsky & ors
[2005] EWHC 1897 (Ch)

Johnson v Gore Wood & Co
[2000] UKHL 65

Nurcombe v Nurcombe
[1985] 1 WLR 370

Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)
[1982] 1 Ch 204

Rawnsley & anor v Weatherall Green & Smith North Ltd
[2009] EWHC 2482 (Ch)

Rushmer v Smith (t/a Mervyn E Smith & Co)
[2009] EWHC 94 (QB)

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

Waddington Ltd v Chan Chun Hoo Thomas
[2008] HK CU 1381

Webster v Sandersons Solicitors (a firm)
[2009] EWCA Civ 830