

**THE UK STATUTORY DERIVATIVE ACTION: AN  
OPPORTUNITY TO BRING JUSTICE TO  
MINORITY SHAREHOLDERS**

Lida Pitsillidou

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Law School

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## **Abstract**

In recent years, the law on derivative actions has caused much academic and judicial debate as to what role the UK Parliament sees the new statutory derivative action under the Companies Act 2006 is (or should be) performing. While the purpose of introducing the new statutory derivative action was to make it easier for minority shareholders to bring a derivative claim, the evidence so far suggest that this is not the case. Indeed, although various new cases have considered in varying depths the new statutory derivative procedure, they are still uncertainties as to the application and interpretation of the statutory derivative procedure. It is therefore the intention of the thesis to clarify the actual role and purpose of the statutory derivative action and examine whether it achieves the objectives at which it aims. The thesis, targeting a gap in the literature, approaches the issue of derivative actions from a different angle. Specifically, the aim of the thesis is to investigate whether the new statutory derivative action provides ‘commercial justice’ to minority shareholders. The thesis argues that, due to Parliament’s failure to clarify the actual role and purpose of derivative actions as well as to provide clear guidelines for the courts to follow when determining whether to continue with a derivative claim, it is essential for the courts to embrace a more flexible concept which would be capable of adapting to the changes in the society which the courts aim to serve. The thesis argues that ‘commercial justice’ is such a concept. However, as no such concept has been used in the context of derivative actions, the purpose of the thesis is to embark upon an enquiry to develop a theoretical framework for ‘commercial justice’ in chapter two, as this will help the thesis to answer one of the most important research questions: Does the new statutory derivative action achieve ‘commercial justice’ to minority shareholders?



## **Dedication**

To the lovely memory of my grandfather, Michali Pitsillide, who inspired me to advance my legal knowledge on a subject that I am passionate about.



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## List of Abbreviations

|                |   |
|----------------|---|
| African LJ     | African Law Journal                             |
| CLJ            | Cambridge Law Journal                           |
| Co LN          | Company Law Newsletter                          |
| CUP            | Cambridge University Press                      |
| Hous L R       | Houston Law Review                              |
| ICCLR          | International Company and Commercial Law Review |
| Iowa J Corp L  | University of Iowa Journal of Corporation Law   |
| JBL            | Journal of Business Law                         |
| LMCLQ          | Lloyd's Maritime and Commercial Law Quarterly   |
| LQR            | Law Quarterly Review                            |
| MLR            | Modern Law Review                               |
| Monash U L Rev | Monash University Law Review                    |
| NLJ            | New Law Journal                                 |
| Nw UL Rev      | Northwestern University Law Review              |
| OUP            | Oxford University Press                         |
| U Chi L Rev    | University of Chicago Law Review                |
| U Pitt L Rev   | University of Pittsburgh Law Review             |
| Va L Rev       | Virginia Law Review                             |
| Vill L Rev     | Villanova Law Review                            |



# Chapter 1. Introduction

## 1.1. Background

In recent years, the law on derivative actions has caused much controversy and academic debate as to what purpose and role the UK Parliament sees the new statutory derivative action under the Companies Act 2006 is (or should be) performing.<sup>1</sup> This is due to the fact that, as compared to the unfair prejudice remedy, the derivative action has been placed on a statutory footing for the very first time.<sup>2</sup> It is therefore an opportune time to analyse in this thesis the effectiveness of the new statutory derivative action and examine whether it achieves the objectives at which it aims. As is well known, the derivative action is a mechanism by which a member of a company, usually a minority shareholder, is able to commence proceedings on behalf of the company against those who have caused wrong to the company.<sup>3</sup>

Traditionally, the derivative action in the UK was governed and regulated by the famous *Foss v Harbottle*<sup>4</sup> rule ('*Foss* rule'), where minority shareholders often found it difficult to bring derivative actions on behalf of the company, as its main effect was to actually ban minority shareholders from taking such actions. Indeed, the policy behind the *Foss* rule was to avoid the courts from interfering with the internal management of companies as it was believed that the best suitable body to take litigation decisions regarding the internal affairs of the company was the majority of shareholders at the general meeting (the so-called 'majority rule').<sup>5</sup>

It is therefore not surprising that such an approach was found to be unjust and unfair for minority shareholders. One of the main concerns of the *Foss* rule was that, in private companies (in which the main focus of the thesis is), usually those who are in control of the company, namely the board of directors and the majority of shareholders in the general meeting, are also those who have caused wrong to the company, namely the wrongdoers. In those circumstances, it was difficult for minority shareholders to bring an action against the wrongdoers, as it was unlikely for the wrongdoers to permit a derivative action to proceed

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<sup>1</sup> Andrew Keay and Joan Loughrey, 'Derivative proceedings in a brave new world for company management and shareholders' (2010) 3 JBL151, 153; See also Arad Reisberg, *Derivative Actions and Corporate Governance* (OUP 2007).

<sup>2</sup> Companies Act 2006, ss 260-264.

<sup>3</sup> Reisberg (n 1) 1.

<sup>4</sup> *Foss v Harbottle* (1843) 2 Hare 461.

<sup>5</sup> KW Wedderburn, 'Shareholders' Rights and the Rule in *Foss v Harbottle*' (1957) 15 CLJ 194, 197-198; See also Ataollah Rahmani, 'A comparative study of justifications for majority rule in corporations: the case of England and Iran' (2007) 18 ICCLR 279, 279.

against themselves.<sup>6</sup> It was only under the ‘fraud on the minority’<sup>7</sup> exception where minority shareholders were able to bring such an action, in which it was required to prove that the wrong caused to the company amounted to a ‘fraud’ and that those who have caused wrong to the company were actually in ‘control’ of the company. However, this exception was not left without its criticisms, as no clear explanations as to the meaning of ‘fraud’ and ‘control’ have been provided, and hence this made it difficult for minority shareholders to obtain justice through the use of derivative actions. The failure of the *Foss* rule to provide an effective remedy for minority shareholders thus became apparent.

Due to the complexities and inadequacies of the *Foss* rule, this boosted the UK Parliament to re-examine the shareholder derivative procedure and to propose statutory reforms for more modern, flexible and accessible criteria in determining whether a member of a company may continue a derivative claim.<sup>8</sup> As a result, a new statutory derivative procedure was introduced under Part 11 of the Companies Act 2006, which provided a wider range of circumstances for members of a company to bring a derivative claim, as compared with the common law rules.<sup>9</sup> One of the most significant developments of the new statutory derivative action is that the court has now been given the discretion to grant or refuse permission to continue with a derivative claim, which is to be exercised by taking into account various statutory criteria found under sections 261-263 of the Companies Act 2006.<sup>10</sup>

However, although it was expected that with the introduction of Part 11 of the Companies Act 2006 this would have made it easier for minority shareholders to bring a derivative claim, the evidence so far suggests that this is not the case. Indeed, although several cases have considered Part 11 of the CA 2006 in varying depths,<sup>11</sup> no clear explanation has been provided as to the interpretation and application of the new statutory derivative procedure.<sup>12</sup> This is due to Parliament’s failure to clarify the actual purpose and role of the new statutory derivative action. In addition, although the court has now been given the discretion to decide whether to allow a minority shareholder to continue with a derivative claim, it is not entirely clear as to what approach the court should follow when considering the criteria set out in

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<sup>6</sup> Reisberg (n 1) 78.

<sup>7</sup> See *Edwards v Halliwell* [1950] 2 All ER 1064.

<sup>8</sup> Law Commission, *Shareholder Remedies* (Law Com No 246, 1997) para 6.15.

<sup>9</sup> Companies Act 2006, s 260.

<sup>10</sup> Andrew Keay and Joan Loughrey, ‘Something old, something new, something borrowed: an analysis of the new derivative action under the Companies Act 2006’ (2008) 124 LQR 469, 469.

<sup>11</sup> See *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch), [2008] BCC 885 (Ch D); *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch), [2011] 1 BCLC 498; *Kiani v Cooper* [2010] EWHC 577 (Ch), [2010] BCC 463 (Ch D); *Mission Capital Plc v Sinclair* [2008] EWHC 1339 (Ch), [2008] BCC 866 (Ch D); See also Keay and Loughrey (n 1) 153.

<sup>12</sup> Keay and Loughrey (n 1) 153.

sections 261-263 of the Companies Act 2006. In these problems, the thesis has its genesis and the aims and objectives of the research become apparent.

## **1.2. The primary aims and objectives of this thesis**

In the absence of clear explanations as to how the UK statutory derivative action operates, one of the most important aims of the thesis is therefore to clarify the actual purpose and role of the statutory derivative action and examine whether this action can, or is likely to, achieve the objectives at which it aims. Therefore, two of the most important research questions that this thesis seeks to answer are: What is the role and purpose of derivative actions? Do derivative actions achieve the objectives at which they aim? In answering these questions, the thesis aims to examine the approach of the courts in recent cases as well as to discover future developments of the new statutory derivative action, particularly in terms of the courts' future approach, to develop clearer and more flexible principles when determining whether to allow a derivative action to continue or not.

Due to Parliament's failure to clarify the function and role of the courts when determining whether to allow a derivative claim to continue, it is the intention of this thesis to argue that the role of the courts should be to provide commercial justice to minority shareholders through the use of derivative actions and by doing so, it is essential for the courts to embrace a more flexible concept which would be capable of adapting to the changes in the society which the courts aim to serve. The thesis argues that 'commercial justice' is such a concept. However, as no such concept has been used in the context of derivative actions, the purpose of the thesis is to embark upon an enquiry to develop a theoretical framework for 'commercial justice' in chapter two, as this will help the thesis to identify whether the new statutory derivative action can achieve 'commercial justice' to minority shareholders, as compared with the common law rules. The thesis, targeting a gap in the literature on the law of derivative actions, approaches the subject from a different angle. Therefore, one of most fundamental questions that this thesis seeks to answer, and which has received inadequate attention in the literature, is: Does the new statutory derivative action achieve 'commercial justice' to minority shareholders?

In answering this question, it is of immense importance in chapter two, to start by examining the concept of justice in the general context. For the purposes of this thesis, particular focus is given to the theories of justice developed by Rawls and Nozick, considering the concept of justice from a different perspective. Rawls's theory of justice, for example, focuses on the just and equal distribution of society's primary goods, such as liberty and opportunity, income and

wealth, arguing that unequal distribution of such goods is only justified if it benefits everyone involved within the society, particularly those who are the least advantaged members of the society.<sup>13</sup> Rawls's focus is therefore on 'distributive justice'. On the other hand, Nozick's theory of justice, focuses on the idea that justice is based on rights and that a just society exists where individuals respect each others rights and that if someone violates one's rights then the vulnerable party has every right to be compensated because of the violation of his rights.<sup>14</sup> Nozick's focus is therefore on 'corrective justice'. By considering both theories of justice, this will help the thesis to argue that it is essential for the courts, when considering the issue of derivative actions, to look at both distributive and corrective justice and decide on a case by case basis which path is the most suitable to follow (whether distributive, corrective or both) in order to achieve 'commercial justice' to minority shareholders.

While examining those issues, the thesis embarks upon an enquiry to examine various justifications for protecting minority shareholders and by doing so, it aims to look at the issue of insider dealing as an illustration to help the thesis to find strong justifications as to why minority shareholders should be protected. The thesis argues that when vulnerability exists, then it is essential for the law to provide effective mechanisms to protect minority shareholders from the abuse of those who are in a more advantaged position in the company, namely the controlling shareholders. Due to the fact that controlling shareholders have significant powers to control and manage the affairs of the company, the thesis sees as of immense importance to also examine whether any effective constraints have been imposed on controlling shareholders' voting powers that could protect minority shareholders from the abuse of the controlling shareholders. The thesis argues that, although there are some constraints on controlling shareholders' voting powers, these cannot provide effective protection to minority shareholders. The thesis therefore aims to examine the extent to which fiduciary duties should be recognised on the part of controlling shareholders in the UK, as this will help the thesis to identify whether there are any gaps that may be filled in through the use of the new statutory derivative action. Building upon the analysis of chapter two, the thesis then aims to examine in chapter three the uncertainties surrounding the enforceability of the statutory contract contained in the articles of association as well as the problem in providing a clear distinction between personal rights and corporate rights. This will help the thesis to identify the weak and ineffective aspects of the articles of association in protecting minority shareholders. By analysing those issues, this will help the thesis to identify the gaps of the

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<sup>13</sup> John Rawls, *A Theory of Justice* (Harvard University Press 1971); See John Rawls, 'Justice as Fairness' (1957) 54 *The Journal of Philosophy* 653.

<sup>14</sup> Robert Nozick, *Anarchy, State, and Utopia* (Basic Books 1974).

statutory contract that justify the use of derivative actions in providing more effective protection for minority shareholders.

By doing so, the thesis then aims to examine the effectiveness of the UK statutory derivative action in protecting minority shareholders by looking at the new changes that have been made under the introduction of the Companies Act 2006. By analysing the effectiveness of the new statutory derivative action, this thesis aims to answer the following research questions: Does the new UK statutory derivative action provide more modern flexible and accessible criteria for determining whether a minority shareholder can pursue an action as compared with the common law rules? What significant changes have been made so far in the new statutory procedure and what further reforms are needed? In answering these questions, the thesis aims to examine various recent cases that have considered Part 11 of the CA 2006 in varying depths, as this will help the thesis to evaluate the effectiveness of the statutory derivative action in achieving commercial justice to minority shareholders. By doing so, the thesis aims to answer the following research questions: What are the significant impacts provided through the examination of recent cases that lead to further developments of the operation of the new statutory derivative action? Will the courts take a more liberal approach in the future, or will the strict line taken in recent cases for refusal of the continuation of the claim, continue? In examining those issues, this will help the thesis to identify the weak and inefficient aspects of the new statutory derivative action by demonstrating the failure of Parliament to provide clear explanations as to how derivative actions operate. By doing this, a discussion for further reforms of the UK system will inevitably include comparative references to other jurisdictions' experiences, particularly the US system, and see whether any lessons can be learnt that could help the UK to re-examine its statutory derivative procedure. Therefore, the final research question that this thesis seeks to answer is: Does the US model provide any alternative solutions from which the UK could learn? The US model is interesting in the context of this debate, as derivative actions were seen to be more popular in the United States than in the United Kingdom.<sup>15</sup> Another reason why it is important to examine the American system is because, although both the US and the UK are common law jurisdictions, derivative actions in the US are quite different from those of the UK.<sup>16</sup> The comparison between the American system and the English system on derivative actions can prove to be illuminating for the purposes of this thesis.

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<sup>15</sup> Xiaoning Li, *A comparative study of shareholders' derivative actions: England, the United States, Germany and China* (Kluwer 2007) 89.

<sup>16</sup> *ibid*; See AJ Boyle, 'The Minority Shareholder in the Nineteenth Century: A Study in Anglo-American Legal History' (1965) 28 MLR 317, 317.

To summarise, the purpose of this thesis is to answer the following research questions: What is the role and purpose of derivative actions? Do derivative actions achieve the objectives at which they aim? Does the new statutory derivative action achieve ‘commercial justice’ to minority shareholders? Does the new UK statutory derivative action provide more modern flexible and accessible criteria for determining whether a minority shareholder can pursue an action as compared with the common law rules? What significant changes have been made so far in the new statutory procedure and what further reforms are needed? What are the significant impacts provided through the examination of recent cases that lead to further developments of the operation of the new statutory derivative action? Will the courts take a more liberal approach in the future, or will the strict line taken in recent cases for refusal of the continuation of the claim, continue? Does the US model provide any alternative solutions from which the UK could learn?

### **1.3. Methodology: a library-based approach**

Advancing the state of knowledge of the law on derivative actions in the UK, it was essential to use a methodology that is complementary to both its aims and objectives as well as to the theoretical framework developed in chapter two for ‘Commercial Justice’. As the primary preoccupation of this research was to examine the effectiveness of the law on derivative actions with the perspective of ‘Commercial Justice’, it was relevant to use a methodology that focuses on both primary and secondary sources relevant for the purposes of this research. Therefore, the methodology that has been used to undertake this research was the library-based research study that mostly involves study of primary sources as well as secondary sources of this area of law. All primary and secondary sources are fully referenced in the Bibliography and are detailed and commented upon throughout the text as appropriate.

#### *1.3.1. Primary sources*

The primary sources used for the purposes of this research were mostly based on both UK and US legislation and case law. With regard to the UK legislation, particular focus has been given to the Companies Act 2006 as well as to the Insolvency Act 1986. With regard to the US legislation, particular focus has been given to the Delaware Code.

A number of important cases have also been considered for the purposes of this research. These include the old common law case of *Foss v Harbottle*<sup>17</sup> as well as the recent cases decided after the introduction of the Companies Act 2006 such as *Franbar Holdings Ltd v*

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<sup>17</sup> *Foss* (n 4).

Patel,<sup>18</sup> *Mission Capital Plc v Sinclair*,<sup>19</sup> *Iesini v Westrip Holdings Ltd*,<sup>20</sup> and *Stimpson v Southern Landlords Association*<sup>21</sup>. The recent case of *Universal Project Management Services Ltd v Fort Gilkicker Ltd & Ors*<sup>22</sup> was also important to be examined in this research as it is the first reasoned decision of an English court which allowed multiple derivative actions. With regard to the US case law, references have been made to the leading case of *Hawes v Oakland*<sup>23</sup> as well as to *Aronson v Lewis*,<sup>24</sup> *Auerbach v Bennett*<sup>25</sup> and *Zapata Corp. v Maldonado*<sup>26</sup>.

### 1.3.2. Secondary sources

A range of secondary sources have also been examined and analysed for the purposes of this research. These include leading books such as Arad Reisberg's *Derivative Actions and Corporate Governance*,<sup>27</sup> Boyle's *Minority Shareholder's Remedies*<sup>28</sup>, Paul Davies and Sarah Worthington's *Gower & Davies Principles of Modern Company Law*<sup>29</sup>, David Kershaw's *Company Law in Context: Text and Materials*<sup>30</sup>, Boyle & Birds's *Company Law*<sup>31</sup> and Finn's *Fiduciary Obligations*.<sup>32</sup> Due to the fact that a preliminary but nonetheless important aim of this research is to develop a theoretical framework for 'Commercial Justice', particular focus has also been given to the major works of John Rawls's book, *A Theory of Justice*,<sup>33</sup> and Robert Nozick's book, *Anarchy, State, and Utopia*<sup>34</sup>.

Advancing the state of knowledge of this area of law, has also required the use of leading academic journal articles. Therefore, major works were included such as those by Boyle, Brenda Hannigan, Andrew Keay, Joanne Loughrey, Jennifer Payne, Arad Reisber, Christopher Riley, and Wedderburn.<sup>35</sup> In addition, Parliamentary debates such as Hansard and

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<sup>18</sup> *Franbar* (n 11).

<sup>19</sup> *Mission* (n 11).

<sup>20</sup> *Iesini* (n 11).

<sup>21</sup> *Stimpson v Southern Landlords Association* [2010] BCC 387.

<sup>22</sup> *Universal Project Management Services Ltd v Fort Gilkicker Ltd & Ors* [2013] EWHC 348 (Ch); [2013] 3 WLR 164.

<sup>23</sup> *Hawes v Oakland* 104 US (14 Otto) 450; 26 L Ed 827 (1881).

<sup>24</sup> *Aronson v Lewis* 473 A. 2d 805 (Del 1984).

<sup>25</sup> *Auerbach v Bennett* 419 NYS 2d 920.

<sup>26</sup> *Zapata Corp. v Maldonado* 430 A 2d 779 (Del 1981).

<sup>27</sup> Reisberg (n 1).

<sup>28</sup> A J Boyle, *Minority Shareholders' Remedies* (CUP, 2002).

<sup>29</sup> Paul L Davies and Sarah Worthington, *Gower & Davies Principles of Modern Company Law* (9th edn, Sweet & Maxwell 2012).

<sup>30</sup> David Kershaw, *Company Law in Context: Text and Materials* (2<sup>nd</sup> edn, OUP 2012).

<sup>31</sup> John Birds et al, *Boyle & Birds' Company Law* (9<sup>th</sup> edn, Jordan Publishing 2014).

<sup>32</sup> Paul D Finn, *Fiduciary Obligations* (The Law Book Company Limited 1977).

<sup>33</sup> Rawls (n 13).

<sup>34</sup> Nozick (n 14).

<sup>35</sup> KW Wedderburn, 'Derivative actions and Foss v Harbottle' (1981) 44 MLR 202; Jennifer Payne, 'A Re-Examination of Ratification' (1999) 58 CLJ 604; Brenda Hannigan, 'Limitations on a shareholder's right to vote – effective ratification revisited' (2000) JBL 493; Keay and Loughrey (n 10); A Reisberg, 'Derivative claims, the

Parliamentary Reports as well as Law Commission reports were also essential to investigate for the purposes of this research. Finally, Internet sources have been used and consulted, as it was essential to find up-to-date electronic journals to examine the recent developments of the law on derivative actions.

#### **1.4. Summary of the structure of the thesis**

To achieve the objectives that this research aims, it was of immense importance to divide the chapters in the following way. Chapter two begins the exploration of the theoretical framework for ‘commercial justice’, as one of the main objectives of this research is to use this framework in order to evaluate whether derivative actions can achieve ‘commercial justice’ to minority shareholders. In developing such a theoretical framework, it is relevant to start the analysis by examining the concept of justice in general context, with particular focus on Rawls and Nozick’s theories of justice. The purpose for analysing Rawls and Nozick’s theories of justice is not to provide a critical analysis of those theories but instead, to take their most essential elements into account, as this will help the research to develop its own theoretical framework for ‘commercial justice’. Both theories will also help the research to identify strong justifications as to why minority shareholders should be protected, as well as why derivative actions are important to achieve commercial justice to minority shareholders. When exploring the existence of justifications for minority shareholders, it is also essential to examine the legal nature of shares as a personal property of shareholders as well as their property rights that derive from their ownership of shares. This will help the research to identify whether shareholders’ ownership of shares can be regarded as a strong justification for minority shareholders. For the purposes of this research, the practice of insider dealing will be used as an illustration to find possible justifications as to why the law should protect minority shareholders. After analysing the insider dealing illustration, the research will then go on to examine the possibility of imposing fiduciary duties on controlling shareholders. The aim for doing so is not to provide a definite answer as to whether fiduciary duties should be imposed on controlling shareholders, but to see whether the gaps left by not imposing such duties, might be possibly filled in with the use of derivative actions.

Building upon the discussion in the second chapter, the aim of Chapter three is to critically analyse shareholders’ personal rights provided in the corporate constitution and see whether those rights can be effectively protected through the mechanism of articles of association or

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UK Companies Act 2006 and Corporate Governance: A roadmap to nowhere?’ (2008) 9 *International Finance Review* 337; Keay and Loughrey (n 1); Christopher A Riley, ‘Derivative claims and ratification: time to ditch some baggage’ (2013) *Legal Studies* 1.

any other alternative mechanism, such as shareholders' agreements. This will help the thesis to clarify and conclude whether derivative actions have any significant role to play in protecting minority shareholders by filling the gaps of the corporate constitution to enforce shareholders' personal rights. Although the focus of this thesis is based on the law of derivative actions, brief discussion will also be provided regarding the 'unfair prejudice' remedy.

Chapter four is concerned with a fundamental question that has received inadequate attention in the literature of the law on derivative actions: Does the new statutory derivative action achieve 'commercial justice' for minority shareholders? The purpose of this chapter is to examine the effectiveness of the new statutory derivative action, introduced by the Companies Act 2006, and see whether those actions can in fact, achieve 'commercial justice' to minority shareholders. In order to examine the effectiveness of the new statutory derivative action, it is also relevant to analyse the complexities and inadequacies of the common law derivative action under the *Foss v Harbottle* rule as well as the reasons why the common law derivative action failed to achieve justice for minority shareholders.

Chapter five's main concern is to examine the American experience of derivative actions and see whether the UK can learn any lessons from the American experience. It is quite interesting to examine and analyse the American experience in this context, as derivative actions are more popular in the United States in contrast to the UK. It is also interesting because the American system on derivative actions is quite different from the UK system, although both of them are common law jurisdictions. Therefore, a comparison between the American model and the UK model on derivative actions can prove to be essential for the purposes of this research.

Finally, chapter six (the concluding chapter) aims not only to provide the concluding remarks and final findings of this research but also to provide suggestions for further improvement of the law on derivative actions. It therefore aims to provide suggestions for further reforms as well as to answer to the main research questions. The opportunity is taken in this concluding chapter to further analyse and explain the importance of the concept of 'commercial justice' and its future implications on the law of derivative actions.

## Chapter 2. Theoretical framework for ‘commercial justice’

### 2.1. Introduction: What is ‘justice’?

‘...though we’ve been talking and hearing about it for a long time, I think we didn’t understand what we were saying or that, in a way, we were talking about justice’.<sup>1</sup>

‘What is justice?’ asked Socrates in Plato’s *Republic*, and since then, this has become one of the most vital questions of legal and political philosophy.<sup>2</sup> Indeed, as Kelsen argued, this can be regarded as ‘the eternal question of mankind’<sup>3</sup>. According to Kelsen,

‘No other question has been discussed so passionately; no other question has caused so much precious blood and so many bitter tears to be shed; no other question has been the object of so much intensive thinking by the most illustrious thinkers from Plato to Kant; and yet, this question is today as unanswered as it ever was. It seems that it is one of those questions to which the resigned wisdom applies that man cannot find a definite answer, but can only try to improve the question’.<sup>4</sup>

It is therefore without doubt that defining and analysing the concept of justice has been a thorny and vexed issue for philosophical debates since ancient times, constituting particularly the central question for Plato’s *Republic*, Aristotle’s *Ethics*, and other classical philosophical works.<sup>5</sup> Philosophers, such as Plato and Aristotle, define justice, in its most general sense, as a virtue, the virtue most essential for the ‘social animals’ that human beings are, living together in polis – or state – of which other virtues were aspects.<sup>6</sup> But even what Plato and Aristotle said about the concept of justice, the answer to the question ‘what is justice?’ is at best controversial and provides no clear criteria for making the choices, just or unjust, that every person would choose for his everyday life.<sup>7</sup> So, what is justice? An attempt will be made in this chapter to analyse various concepts of justice in its general context with the ambition that this will help the thesis to develop its own theoretical framework for ‘commercial justice’. The purpose for developing a theoretical framework for ‘commercial

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<sup>1</sup> Plato, ‘Republic’ in Peter J Steinberger (ed), *Readings in Classical Political Thought* (Hackett Publishing Company, 2000) 221.

<sup>2</sup> Robert C Solomon and Mark C Murphy, *What is Justice?: Classic and Contemporary Readings* (2<sup>nd</sup> edn, OUP 2000) 3.

<sup>3</sup> Hans Kelsen, *What is Justice?: Justice, Law, and Politics in the Mirror of Science* (The Lawbook Exchange 2000) 1.

<sup>4</sup> *ibid.*

<sup>5</sup> Robert Reiner, ‘Justice’ in James Penner et al (eds), *Introduction to Jurisprudence and Legal Theory: Commentary and Materials* (Butterworths 2002) 719; See also, Bernard Cullen, ‘Philosophical theories of justice’ in Klaus R Scherer (ed), *Justice: interdisciplinary perspectives* (CUP 1992) 15; Alasdair C MacIntyre, *Whose Justice? Which Rationality?* (Duckworth 1988) 13.

<sup>6</sup> Solomon and Murphy (n 2) 3.

<sup>7</sup> *ibid.*

justice' is to help the thesis ascertain what purpose and role the courts ought to see derivative actions performing. By doing so, this will help the thesis to examine and analyse the effectiveness of the new statutory derivative action under the Companies Act 2006 in achieving 'commercial justice' to minority shareholders.

The challenges for developing such a theoretical framework will be to ascertain what practices are unequal and unfair for minority shareholders. This requires the thesis to embark on an enquiry to use the practice of insider dealing as an illustration, as this will help the thesis to provide explanations as to what can be regarded as fair and unequal for the parties (in this context the minority shareholders) when dealing with others in the commercial world.<sup>8</sup>

Such examination is important as arguments about justice feature centrally in the commercial context, particularly in circumstances where majority shareholders often use their powers to advance their own personal interests at the expense of the minority shareholders. Therefore, in identifying what practices are unequal and unfair for minority shareholders, this will help the thesis to examine the effectiveness of the new statutory derivative action in protecting the interests of minority shareholders as well as in achieving 'commercial justice' to minority shareholders.

In order to test how far this is so, this chapter aims to start by examining different kinds of justice which may have a vital influence in developing a theoretical framework for 'commercial justice'. To achieve this, an examination of the classical philosophical views about justice could provide a meaningful starting point. A variety of views about justice were offered in antiquity, including versions from Plato and Aristotle. However, the most influential approach to justice for the development of modern Western philosophy has been taken by Aristotle. Therefore, for the purpose of this thesis, Aristotle's concept of justice is a convenient starting point, especially his famous distinction between 'distributive justice' and 'corrective justice'.

This also proposes to examine contemporary versions of Aristotle's concept of justice as most of the modern philosophers still follow Aristotle in labelling their concepts of justice as either 'distributive' or 'corrective' justice. Due to the discrepancies regarding the true meaning of justice, it is essential to provide, as this thesis sets out to do, a review of contemporary theories of justice and their implications in the modern philosophy. Particularly, this chapter aims to examine two of the most influential theories of justice: John's Rawls' theory of

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<sup>8</sup> See 2.5.1.

‘justice as fairness’<sup>9</sup> and Robert Nozick’s ‘entitlement theory’ of justice<sup>10</sup>. The aim of this chapter is to draw some of the essential elements related to the general idea of justice and open up issues to which the concept of justice in the commercial context must be addressed.

## **2.2. Origins of the concept of justice: Aristotle’s perspective**

Thinking about justice and what it entails has a long history. One of the most influential views about justice is provided by Aristotle in his *Nicomachean Ethics*,<sup>11</sup> particularly his distinction mentioned above between distributive and corrective justice, which has become a central topic in modern philosophy. One arguably important aim in examining Aristotelian distinction in the context of the thesis, is therefore to provide a basic understanding of the differences between distributive and corrective justice as both types of justice have been discussed and elaborated by both Rawls and Nozick in their own theories of justice. Therefore, before embarking on an enquiry to examine both Rawls and Nozick’s theories of justice, it would be interesting first to examine Aristotle’s analysis.

### *2.2.1. Distributive and Corrective Justice*

In his Book V of the *Nicomachean Ethics*, Aristotle’s analysis of justice begins with a distinction between universal (or general) justice, which is a virtue exercised in relation to other people and not for a particular individual, and particular justice, which focuses on the distribution of honour, money, and security.<sup>12</sup> However, between these two types of justice, his principal interest was on particular justice who then divided into two types of justice for which Aristotle is best known: ‘distributive justice’ and ‘corrective (or rectificatory) justice’.<sup>13</sup>

Distributive justice, on the one hand, is ‘that which is manifested in distributions of honor or money or other things that fall to be divided among those who have a share in the constitution (for in these it is possible for one man to have a share either unequal or equal to that of another)’.<sup>14</sup> In other words, distributive justice, as its name suggests, focuses on the distribution of social goods which can be divided among those who ‘have a share in the constitution’. As Garcia argues, ‘in order to evaluate a particular distribution, one need only identify the particular conception of justice, the substantive principle, which would guide such

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<sup>9</sup> John Rawls, *A Theory of Justice* (Harvard University Press 1971); John Rawls, ‘Justice as Fairness’ (1957) 54 *The Journal of Philosophy* 653.

<sup>10</sup> Robert Nozick, *Anarchy, State, and Utopia* (Basic Books 1974).

<sup>11</sup> Aristotle, *Nicomachean Ethics* (Terence Irwin tr, 2<sup>nd</sup> edn, Hackett Publishing Company 1999).

<sup>12</sup> Aristotle, *Nicomachean Ethics* (Rodger Crisp ed, CUP 2000) 81-85.

<sup>13</sup> *ibid* 84-85; See also Frank J Garcia, *Trade, Inequality, and Justice: Toward a Liberal Theory of Just Trade* (Transnational Publishers 2003) 48.

<sup>14</sup> Aristotle, *The Nicomachean Ethics* (David Ross and Lesley Brown trs, OUP 2009) 84.

allocative decisions towards a just result'.<sup>15</sup> Aristotle's distributive justice 'is not an egalitarian principle of fairness' because he did not 'conceive of a society of equality, but one of proper shares, in which ability, economic status, and character should result in what we would consider an unequal distribution of goods; it could be called proportionate equality or proportionate fairness'.<sup>16</sup>

Corrective justice, on the other hand, is 'that which plays a rectifying part in transactions between man and man'.<sup>17</sup> It is therefore a type of justice that puts into balance something that has been imbalanced and therefore created injustice.<sup>18</sup> According to Aristotle, this type of justice can be found in what he termed as 'voluntary and involuntary' transactions.<sup>19</sup> In the case where a party involved in voluntary or involuntary transactions with another party, ends up having either more or less than what 'is properly its share of the subject of the transaction', Aristotle would argue that this is unjust and in order to provide justice to both parties the solution would be to 'restore to each party the balance between loss and gain and that was theirs before the transaction'.<sup>20</sup> Corrective justice therefore guarantees fair dealing between parties when entering into commercial transactions as it prevents individuals from enjoying a great gain or suffering a great loss.<sup>21</sup>

The purpose of Aristotle's distributive and corrective justice is to show that injustice occurs when people try to benefit themselves to the detriment of other individuals or the community. Justice is therefore concerned with people's relationships and as to whether those people's acts are just or unjust to other people. When someone uses his power to benefit himself to the detriment of others, this creates injustice. Injustice therefore occurs in situations when an individual or group of individuals wrongly obtains either less or more than other individuals. It could be argued that this applies to relations between minority and majority shareholders. The weaker party in that case is the minority shareholder who may be vulnerable to abuse on the part of the stronger party (majority shareholder) in authority if the power of the latter is not restricted.

Consequently, it is reasonable to argue that 'justice sometimes involves settling disputes arising from the merits or demerits of individual actions and sometimes involves considering

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<sup>15</sup> Garcia (n 13) 48.

<sup>16</sup> *ibid* 49.

<sup>17</sup> Aristotle (n 14) 84.

<sup>18</sup> Garcia (n 13) 49.

<sup>19</sup> Aristotle (n 12) 87.

<sup>20</sup> Garcia (n 13) 49.

<sup>21</sup> Ian Ward, *Introduction to Critical Legal Theory* (Cavendish Publishing Limited 2004) 8.

wider questions about the general situations of individuals and groups'.<sup>22</sup> This is where Aristotle's distributive and corrective justice lays, as on one hand, distributive justice focuses on the general distribution of goods to the community in the public sphere, while corrective justice focuses to restore imbalances between individuals.<sup>23</sup> The distinction offered by Aristotle between individual actions and group actions provides a starting point that could be proved significant for defining justice for the purposes of this thesis. This is justified on the fact that contemporary philosophers, since Aristotle, deals with the issues of distributive justice, such as the allocation of social goods, and issues of corrective justice such as the propriety of gain.<sup>24</sup>

This is the case between Rawls's 'justice as fairness' theory and Nozick's 'entitlement theory'. Rawls, on the one hand, treats questions involving the distribution of goods that are to be shared among a community, whereas Nozick's idea of justice is specifically based on individual (natural) rights such as the enjoyment of life, liberty and possessions without interference from others. Both theories will be further examined in the following sections of this chapter.

### **2.3. Modern views about justice**

#### *2.3.1. 'Justice as fairness' – John Rawls*

One of the most interesting contemporary attempts to define justice is found in John Rawls' book, *A Theory of Justice*, which is probably the most influential book written in the twentieth century.<sup>25</sup> Indeed, one cannot think about justice, as Putnam states, without taking John Rawls' position.<sup>26</sup> In keeping with the philosophical tradition going back to Aristotle, Rawls defines justice as 'the first virtue of social institutions'<sup>27</sup> and, in doing so, he places justice above all other virtues.<sup>28</sup> This is because Rawls believes that justice is that which prevails in a just society and, therefore, as his main consideration of his book is 'social justice', he supports that the primary subject of justice is 'the basic structure of society'.<sup>29</sup> This is justified for the reason that, according to Rawls, the theory of justice of the basic structure is the most important one for gaining a great understanding of the concept of justice, 'for particular

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<sup>22</sup> Tom Campbell, *Justice: Issues in Political Theory* (MacMillan 1988) 18.

<sup>23</sup> See Ward (n 21) 8.

<sup>24</sup> See Gracia (n 13) 48.

<sup>25</sup> Brian Bix, *Jurisprudence: Theory and Context* (5<sup>th</sup> edn, Sweet & Maxwell 2009) 109.

<sup>26</sup> RA Putnam, 'Why Not a Feminist Theory of Justice?' in MC Nussbaum and J Glover (eds), *Women, Culture, and Development: A study of Human Capabilities* (Clarendon Press 1995) 298, 303.

<sup>27</sup> Rawls, *A Theory of Justice* (n 9) 3.

<sup>28</sup> *ibid.*

<sup>29</sup> *ibid* 7.

institutions can be completely just only when they operate within a basic structure that is itself broadly just'.<sup>30</sup>

According to Rawls, the 'basic structure of a society' is the basic foundation of social institutions that allocates the benefits and burdens of social life and by doing so it forms the prospects of people's lives.<sup>31</sup> He, thus, sees justice as the basic rules of society, within which individuals who, have different interests and life goals can live together and to some extent, compete with each other.<sup>32</sup> Indeed, justice is significant where a group of individuals with different and even sometimes opposing interests exists with various perceptions on how the basic goods of society should be distributed.

The aim of Rawls's theory of justice in this context is, therefore, to establish terms of social co-operation that all individuals within the society perceive them as fair and as consistent with their own personal interests, and to which they would not have any consents to agree with.<sup>33</sup> In order to achieve this, Rawls proposes that the fundamental rights and duties and the distribution of the benefits and burdens of social cooperation are to be assigned in accordance with what he terms 'the principles of justice'.<sup>34</sup> As Rawls argues, the main idea of his theory is the claim that the principles of justice are those

'that free and rational persons concerned to further their own interests would accept in an initial position of equality as defining the fundamental terms of their association. These principles are to regulate all further agreements; they specify the kinds of social cooperation that can be entered into the forms of government that can be established. This way of regarding the principles of justice I shall call justice as fairness'.<sup>35</sup>

In developing his theory to achieve justice, Rawls uses a device that termed as 'original position', in which individuals who are to choose Rawls's principles of justice will be placed behind a 'veil of ignorance'.<sup>36</sup> For Rawls, the original position is merely a hypothesis used to achieve the answer to the question as to what justice is. To achieve this, he states that there is a need to imagine people in the original position and then consider what principles of justice they would decide to govern their civilisation. This is justified for the reason that Rawls believes that justice is the body of principles that an individual would select in the original

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<sup>30</sup> NE Simmonds, *Central Issues in Jurisprudence: justice, law and rights* (3<sup>rd</sup> edn, Sweet & Maxwell 2008) 58.

<sup>31</sup> Rawls, *A Theory of Justice* (n 9) 7.

<sup>32</sup> *ibid* 4-6.

<sup>33</sup> *ibid*.

<sup>34</sup> *ibid* 4-5.

<sup>35</sup> *ibid* 11.

<sup>36</sup> *ibid* 12.

position, since the individual making the selection will ensure that the selected principles will be fair.<sup>37</sup>

Rawls's intention was to show a 'hypothetical' situation of equal liberty, in which rational individuals will select together the binding principles which are to govern their civilisation.<sup>38</sup> He, therefore, asks us to envisage a group of rational individuals who would choose a set of principles and rules that will regulate the basic structure of their society;<sup>39</sup> a just society into which 'these disembodied souls would agree to be born'.<sup>40</sup> These principles are expected to be chosen on the basis of rational self-interest and that those principles will bind them to the best of their knowledge. Their choice, however, is limited on the fact that under the 'veil of ignorance' they are deprived from certain types of knowledge regarding their own interests.<sup>41</sup> The term of what Rawls called 'veil of ignorance' is described by him in the following way:

'No one knows his place in society, his class position or social status, nor does anyone know his fortune in the distribution of natural assets and abilities, his intelligence, strength, and the like. I shall even assume that the parties do not know their conceptions of the good or their special psychological propensities. The principles of justice are chosen behind a veil of ignorance'.<sup>42</sup>

In other words, under the 'veil of ignorance', people who are to choose the principles of justice that will govern their own society, will be hypothetically unaware of their position they will occupy in the society as well as be ignorant as to what their particular interests and inclinations will be. As Pinker argues, individuals in this position are 'ghosts ignorant of the machines they will haunt'.<sup>43</sup> Thus Rawls, argues that such principles would only arrive in situations where everyone will be treated as free and equal, and not permitting anyone to have greater bargaining powers than others.<sup>44</sup> This guarantees that whatever principles individuals will choose, they will be equally applied to everyone, without favouring or disadvantaging anyone. Therefore, both Rawls's original position and veil of ignorance are assumed to achieve a 'level playing field' where all individuals will have an equal chance to win. As Rawls states, 'it is this notion of the possibility of mutual acknowledgment which makes the concept of fairness fundamental to justice'.<sup>45</sup>

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<sup>37</sup> JG Riddall, *Jurisprudence* (2<sup>nd</sup> edn, OUP 2005) 209.

<sup>38</sup> Rawls, *A Theory of Justice* (n 9) 11.

<sup>39</sup> *ibid* 11.

<sup>40</sup> Steven Pinker, *The Blank State: The Modern Denial of Human Nature* (Penguin Putnam 2002) 59.

<sup>41</sup> Rawls, *A Theory of Justice* (n 9) 12.

<sup>42</sup> *ibid* 12.

<sup>43</sup> Pinker (n 40) 59.

<sup>44</sup> Rawls, *A Theory of Justice* (n 9) 12.

<sup>45</sup> Rawls, 'Justice as Fairness' (n 9) 658.

Although, individuals are not permitted to have knowledge of anything that could influence their decisions, there are some important things that are relevant for them to know. According to Rawls, individuals must be aware of certain ‘primary goods’ that they need to live such as rights and liberties, powers and opportunities, income and wealth. Other primary goods that individuals must be aware of are health and vigour, intelligence, imagination and self-respect.<sup>46</sup> In making the selection, people know that they would desire more rather than less primary goods.<sup>47</sup> And they look to their own interests and advantages: they are ‘mutually disinterested’<sup>48</sup> as no one is concerned with the interests of others.<sup>49</sup>

Individuals, who make the selection, are also allowed to know about political affairs such as the voting process, and human psychology. As a matter of fact there is no limitation to their knowledge of principles and theories, since they are expected to be aware of these if they are to choose the social framework, the financial system and the legal structure that will build up the society that they will choose to live in. Therefore, ‘what they do not know, what is behind the veil of ignorance, is their own circumstances within that society’.<sup>50</sup> As Riddall states, ‘their hand of cards is face down on the table’.<sup>51</sup>

Having established the role of the original position and the state of knowledge of those who are in it, the following section will consider Rawls’ account of the content of the principles of justice.

### *2.3.1.1. Rawls’s two principles of justice*

In understanding Rawls’s concept of justice as fairness one significant task is to determine which principle of justice people would choose in the original position.<sup>52</sup> Rawls believed that there were two fundamental principles of justice that people in the original position would choose: the ‘Liberty’ principle and the ‘Difference’ principle. The two principles of justice are stated as follows:

*First Principle:* ‘Each person is to have an equal right to the most extensive total system of equal basic liberties compatible with a similar system of liberty for all’.<sup>53</sup>

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<sup>46</sup> Riddall (n 37) 208.

<sup>47</sup> Rawls, *A Theory of Justice* (n 9) 93.

<sup>48</sup> *ibid* 13.

<sup>49</sup> Riddall (n 37) 208.

<sup>50</sup> Riddall (n 37) 208.

<sup>51</sup> *ibid*.

<sup>52</sup> Rawls, *A Theory of Justice* (n 9) 14.

<sup>53</sup> Rawls, *A Theory of Justice* (n 9) 302; In later works, the first principle is slightly altered: instead of speaking of each person having the ‘most extensive system of equal basic liberties compatible with a similar system of liberty for all’, the principle refers to each person having an equal claim to ‘a fully adequate scheme of equal

*Second Principle:* ‘Social and economic inequalities are to be arranged so that they are both:

- (a) to the greatest benefit of the least advantaged, consistent with the just savings principle, and
- (b) attached to offices and positions open to all under conditions of fair equality of opportunity.’<sup>54</sup>

The most vital characteristic of these principles is that the ‘Liberty’ principle enjoys ‘lexical priority’ over the ‘Difference’ principle, so that it must be fully met before the second principle can be applied at all. As Rawls argues, ‘liberty can be restricted only for the sake of liberty’. Based on this, Rawls aims to guarantee that all individuals will enjoy basic liberties that cannot be violated with the purpose to improve the welfare of the most advantaged members of the society, or the resources of the least advantaged members.<sup>55</sup> Although the ‘system of equal basic liberties’ is not defined with any precision by Rawls, he does however specify that basic liberties include, among other things, political liberty, freedom of speech and assembly, freedom of conscience, the right to hold personal property, and the right to fair treatment under the law.<sup>56</sup> By choosing Rawls’s Liberty principle of justice, individuals in the original position choose equality in these liberties.<sup>57</sup>

Moreover, individuals in the original position will prefer to give the liberty principle priority over the difference principle as this will guarantee them that such basic liberties will not be sacrificed for the sake of any gain in respect of income, wealth or power. The reason for doing so is because people in the original position, do not know, what their position in society is ‘not what things will be valued by the persons they turn out to be’.<sup>58</sup> As Rawls believes, rational self-interest would lead individuals in the original position to shape their laws in accordance to what Rawls called as ‘maximin’ criterion. In other words, individuals in the original position would desire an outcome that maximises the minimum position.<sup>59</sup>

For the same reason, individuals will wish to choose Rawls’s second principle termed as ‘difference principle’. This principle guarantees that the worst anyone could be is ‘least advantaged’ and, if they do belong to this group, they will benefit from this principle. Rawls’s difference principle focuses on issues of distribution of income and assets and the

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basic rights and liberties, which scheme is compatible with the same scheme for all’: John Rawls, *Political Liberalism* (Columbia University Press 1996) 5.

<sup>54</sup> Rawls, *A Theory of Justice* (n 9) 60.

<sup>55</sup> Simmonds (n 30) 79 – 80.

<sup>56</sup> Rawls, *A Theory of Justice* (n 9) 61.

<sup>57</sup> KR Scherer, *Justice: interdisciplinary perspectives* (CUP 2006) 21.

<sup>58</sup> *ibid.*

<sup>59</sup> Ian McLeod, *Legal Theory* (Macmillan law masters 1999) 144.

arrangement of social institutions in which differences of power and responsibility occurs. According to Rawls, inequalities will only be allowed where such inequalities benefit the least advantaged members of the society.<sup>60</sup> By selecting Rawls's difference principle means that, people who are talented may benefit themselves only if this also benefits the least advantaged members of the society. This principle is significant, as it seems to guarantee that all individuals will have an opportunity to fairly compete for jobs and promotions within public offices.

As a result, both principles can be applied on the basic structure of the society that will regulate the rights and duties that all individuals can fairly obtain through the distribution of social and economic advantages. This ensures that the principles that will govern their society will be fair and no one will be able to criticise or undermine those principles.<sup>61</sup>

### 2.3.2. Nozick's 'entitlement theory' of justice

Injustice is often related in one's mind with the violation of individuals' rights and therefore it is not surprising that some philosophers have developed theories which argued that justice is a matter of respecting an individual's personal rights. Based on this view, justice requires that such rights should be respected, because, as Ronald Dworkin stated, 'rights are trumps'.<sup>62</sup> In this subsection, one prominent rights-based theorist of justice will be considered and that is Robert Nozick.

Contrary to Rawls's view, Nozick presents an entirely different concept of justice. In his book, *Anarchy, State and Utopia*,<sup>63</sup> Nozick argues for the idea of a 'minimal state', which is based on just entitlements, and in which Rawls's distributive or social justice has no place.<sup>64</sup> For Nozick, the idea of justice is based particularly on individual's rights, as he argues that a just society exists where such rights are respected.<sup>65</sup> Moreover, as he argues, each particular individual has certain natural rights, which he can enjoy such as for example the enjoyment of life, health, liberty and possessions without being interfered by others, and the right to receive compensation by those who have caused injury to his natural rights.<sup>66</sup> For Nozick, every

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<sup>60</sup> K Mathis, *Efficiency Instead of Justice?: Searching for the Philosophical Foundations of the Economic Analysis of Law* (Shannon D tr, Springer 2009) 129.

<sup>61</sup> C Storelli, 'John Rawls's Principle of Justice' in MP Wolf and L Musselman (eds), *Voicing Ideas* (California State University) 49-57.

<sup>62</sup> Scherer (n 57) 29.

<sup>63</sup> Nozick (n 10).

<sup>64</sup> McLeod (n 59) 178.

<sup>65</sup> See AK Gavai, *Business Ethics* (Himalaya Publishing House 2010).

<sup>66</sup> Riddall (n 37) 217.

individual is free to live his or her own life without being interfered from others and when his natural rights are violated, he has every right to be compensated.<sup>67</sup>

For Nozick, ‘a state can be justified only if it is arrived at from a “state of nature” without infringing the rights of any non-consenting individuals’.<sup>68</sup> According to Nozick, the only state that could satisfy the above condition is what he termed as a minimal ‘night watchman’ state, as it is the only state, which in Nozick’s view, could offer protection against violence and theft.<sup>69</sup> This is very different from Rawls’s theory of justice, which is based on the distribution of goods to benefits everyone involved within the society. On the other hand, Nozick’s theory of justice ‘has nothing to do with the way in which the total wealth and power of society is distributed, but is exclusively concerned with the justice of people’s present holdings’,<sup>70</sup> which he termed as ‘entitlement theory’ of justice.<sup>71</sup> Nozick’s main question is therefore ‘not the pattern of comparative holdings but whether each individual is ‘justly’ entitled to his or her actual holdings’.<sup>72</sup> According to his ‘entitlement theory’, there are three principles by which property can be acquired legitimately: (a) if a property comes to the possession of an individual which was not previously owned by anyone else; or (b) if the property owners have legitimately transferred their property by way of gift, exchange or sale; or (c) if the court had transferred the property in order to rectify a previous unjust acquisition.<sup>73</sup>

The first two principles, which Nozick termed as ‘justice in acquisition’ and ‘justice in transfer’, are dealing with various forms of acquisitions of assets, while the third principle, termed as ‘justice in rectification’, operates as a corrective device where either of the first two principles has been breached. Based on the assumption that all properties were once not owned by anyone but many are now owned, the issue of ‘justice in transfer’ becomes a matter of vital significance, particularly in the market context highlighted by Nozick. Purchases, gifts and exchanges for example will be regarded as just modes of transfer but on the other hand, theft and fraud will not. Therefore, ‘Nozick’s minimal state protective power would be essential in the event of the latter’.<sup>74</sup> The respect for a person’s rights provides the basis of a free and just society as only free persons can be just.

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<sup>67</sup> See Gavai (n 65).

<sup>68</sup> Anne Baron et al, *Introduction to Jurisprudence and Legal Theory: Commentary and Materials* (Butterworths Lexis Nexis 2002) 750.

<sup>69</sup> Baron et al (n 68) 750.

<sup>70</sup> JW Harris, *Legal Philosophies* (2<sup>nd</sup> edn, Butterworths 1997) 287.

<sup>71</sup> Baron et al (n 68) 751.

<sup>72</sup> Raymond Wacks, *Understanding Jurisprudence: An introduction to Legal Theory* (2<sup>nd</sup> edn, OUP 2009) 273.

<sup>73</sup> Baron et al (n 68) 750-751.

<sup>74</sup> James E Penner, *Textbook on Jurisprudence* (4<sup>th</sup> edn, OUP 2008) 239.

### *2.3.3. Conclusion*

Having analysed both Rawls and Nozick's theories of justice, it could be argued that there are two different perspectives of the concept of justice: 'distributive (or social) justice', which focuses on the equality of everyone involved within a society, and 'corrective (or individual) justice', which focuses on the rights of individuals within the society. It is worth noting that the purpose for analysing Rawls and Nozick's theories of justice was not to provide a critical analysis of those theories but to take their most essential elements as this will help the thesis develop its own theoretical framework for 'commercial justice'. It could be argued that both perspectives of justice examined above have significant role to play in identifying strong justifications as to why the law should provide effective devices to protect minority shareholders in the following sections. The starting point in identifying strong justifications for minority shareholders is to firstly examine the legal nature of shares and see whether ownership of shares can be regarded as a strong justification for minority shareholders.

## **2.4. The legal nature of shares**

### *2.4.1. Introduction*

In order to develop a theoretical framework for 'commercial justice', it is relevant in the following sections to examine and analyse the legal nature of shares as a personal property of shareholders and the property rights that derived from the shares through the use of jurisprudential analysis. In doing so, this will help the thesis identify justifications as to why the law should provide effective mechanisms to protect minority shareholders against the abuse of majority shareholders.

### *2.4.2. Shares as a personal property*

The current legal view of shares is that a share is a personal property of shareholders.<sup>75</sup> However, this does not give shareholders 'any interests in the company's assets or ownership of the company as a thing, and nor does it give shareholders more than residual power to control the company'.<sup>76</sup> Historically, shareholders were regarded as the owners of the company's assets and therefore ownership was the strongest justification for them to have a dominant role in the company's affairs.<sup>77</sup> It was therefore essential for the law to provide effective mechanisms to protect their property rights. However, due to the fundamental

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<sup>75</sup> See Companies Act 2006, s 541: 'The shares or other interest of a member in a company are personal property (or in Scotland, movable property) and are not in the nature of real estate (or heritage)'.

<sup>76</sup> Sarah Worthington, 'Shares and shareholders: property, power and entitlement: Part 1' (2001) 22 *Company Lawyer* 258, 259.

<sup>77</sup> Ross B Grantham, 'The doctrinal basis of the rights of company shareholders' (1998) 57 *CLJ* 554, 554.

change of the company as a separate legal entity from its members,<sup>78</sup> ownership is no longer the strongest justification for shareholders to be protected under the law. As a result, the aim of the following sections will be to identify strong justifications as to why the law should protect minority shareholders. In order to do so, it is firstly important to start with an examination of the historical developments of company law and the principle of separate legal personality.

#### 2.4.2.1. *Historical developments: The shift from partnership law to company law*

Historically, what is now called ‘company’ began life in the early nineteenth century as ‘joint-stock company’.<sup>79</sup> The joint-stock company, whether incorporated or not, was recognised by the law as a large partnership which, although it had shares that were freely transferable, did not have a separate legal personality from its members. The rules that regulated this hybrid form were therefore derived from the principles of partnership law. The members, as partners, were regarded as the owners of the assets of the joint-stock company who they also had the benefit of enjoying all the rights and authorities which are conferred to them because of their ownership of shares.<sup>80</sup> The shareholders were regarded as ‘the company’ and the directors were simply the agents of the company and subject to the control of the shareholders in general meeting.<sup>81</sup> Their entitlement to control the company was therefore derived from their legal ownership of the joint-stock company’s assets.<sup>82</sup> Indeed,

‘as long as the company was viewed through a partnership lens, the position and rights of shareholders were fully explicable and justified as a natural consequence of the shareholders’ status as the ultimate proprietor of the undertaking. Ownership conferred upon the shareholders the rights, *inter alia*, to determine how their property should be used, to the exclusive benefit of the property, and to freedom from expropriation’.<sup>83</sup>

As owners of the joint-stock company’s assets, it was thus entirely proper that shareholders should have the right to control and manage the affairs of the company as well as to have the company run exclusively for their own benefits and interests.<sup>84</sup>

The application of partnership principles to joint-stock companies, however, had a number of significant problems. The principles of partnership law were based upon a genuine

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<sup>78</sup> See, *Salomon v Salomon & Co. Ltd* [1897] AC 22; *Macaura v Northern Assurance Co Ltd* (HL 1925) [1925] AC 619.

<sup>79</sup> See Paddy Ireland, ‘Company Law and the Myth of Shareholder Ownership’ (1999) 62 MLR 33; Paddy Ireland, ‘Defending the *Rentier*: Corporate Theory and the Reprivatization of the Public Company’ in John Parkinson et al (eds), *The Political Economy of the Company* (Hart Publishing 2000).

<sup>80</sup> Grantham (n77) 557-558.

<sup>81</sup> Ireland, ‘Company Law and the Myth of Shareholder Ownership’ (n 78) 39; See Worthington (n 75) 260.

<sup>82</sup> Grantham (n 77) 558.

<sup>83</sup> *ibid* 559.

<sup>84</sup> *ibid* 559-560.

relationship between the partners that presupposed mutual trust and confidence among the partners.<sup>85</sup> In a typical joint-stock enterprise, which had hundreds if not thousands of members, however, the application of partnership principles had posed real difficulties as it was impossible to achieve mutual trust and confidence among the members where the number of members in the enterprise was unduly large.<sup>86</sup>

Another problem encountered in applying the partnership principles to joint-stock companies was the integration of this form into the general private law. There is a general principle of partnership law that every partner in a firm is jointly liable with other partners for all debts and obligations incurred in the course of the partnership business.<sup>87</sup> Therefore, if a partnership was to be sued it was necessary to make all the partners party to the suit.<sup>88</sup> However, as Grantham stated, ‘while in a partnership of five or six this presented no difficulty, discovering the identity of all the members of a joint stock company, where the shares were freely transferable, posed an insuperable obstacle’.<sup>89</sup> Indeed, this had caused significant problems as it was difficult to identify all the members, especially where the joint-stock enterprise had an unduly large number of members.

Due to these problems and because of the major changes occurring in the economic nature of the joint stock companies in the early-to-mid nineteenth century, a decisive transition from partnership law to company law took place.<sup>90</sup> Particularly, what has played a significant role to the growth in both the number and size of joint-stock companies was the dramatic development of the railway system, which took place early-to-mid nineteenth century.<sup>91</sup> Indeed, as Ireland stated, ‘investment in railway companies was not only on a much larger scale than anything previously seen, it embraced groups hitherto uninvolved in investment and took a radically depersonalized rentier form’.<sup>92</sup> As a result, in the period after 1830 there emerged for the first time a developed market in joint stock company shares which transformed them into money capital – readily marketable commodities, liquid assets easily converted into money.<sup>93</sup>

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<sup>85</sup> See LCB Gower, ‘Some Contrasts Between British and American Corporation Law’ (1956) 69 *Harvard Law Review* 1369, 1372; Grantham (n 77) 558.

<sup>86</sup> Grantham (n 77) 558.

<sup>87</sup> Partnership Act 1890, s 9.

<sup>88</sup> Grantham (n 77) 558.

<sup>89</sup> *ibid.*

<sup>90</sup> Ireland, ‘Company Law and the Myth of Shareholder Ownership’ (n 79) 41-43; Worthington (n 76) 260.

<sup>91</sup> Ireland, ‘Company Law and the Myth of Shareholder Ownership’ (n 79) 41.

<sup>92</sup> *ibid.*

<sup>93</sup> *ibid.*

Transforming the financial nature of a share into money capital, this led to its legal reconceptualisation. In the crucial case of *Bligh v Brent*<sup>94</sup>, for example, it was decided that shareholders had no direct interest, legal or equitable, in the assets of the company, but only an interest in the profits of the company. The legal nature of shares has therefore begun to change into a form of property separate from the corporate assets,<sup>95</sup> as the assets of the company were no longer owned by the shareholders but only by the company itself.<sup>96</sup> The only property that was owned by the shareholders was the intangible share capital of the company.<sup>97</sup> As a result, a division has emerged between the company as the owner of its assets and shareholders as the owners of shares.<sup>98</sup>

The changes that have occurred in both the economic and legal nature of shares had a significant impact on the development of the law of joint-stock companies. Particularly, there was a shift of power and control from shareholders in general meeting to the board of directors.<sup>99</sup> Due to these changes, the shareholders in general meeting were no longer in a position to direct and control the board of directors and therefore they were not able to intervene in the day-to-day running of the company. The management of the company became the sole responsibility of the board of directors and not the responsibility of shareholders in general meeting.<sup>100</sup>

These changes gave significant impact to the emergence of the modern doctrine of separate legal personality,<sup>101</sup> whose dominant feature is that the company is a separate legal entity from its members. The company as an artificial person with its own legal personality was thus able to enjoy rights and be subject to duties and obligations different from those enjoyed by its members.<sup>102</sup> The leading case that laid the foundations for the emergence of the doctrine of separate legal personality is *Salomon v Salomon & Co Ltd*<sup>103</sup>. It is therefore essential to briefly discuss the facts of this case.

In this case, Salomon was a sole trader carrying on a business as a leather merchant. He later decided to convert his sole trading business into a limited company named as Salomon & Co

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<sup>94</sup> *Bligh v Brent* (1837) 2 Y&C Ex 268.

<sup>95</sup> See, Paddy Ireland, 'Capitalism Without the Capitalist: The Joint Stock Company Share and the Emergence of the Modern Doctrine of Separate Corporate Personality' (1996) 17 *Journal of Legal History* 40.

<sup>96</sup> Ireland, 'Company Law and the Myth of Shareholder Ownership' (n 79) 41.

<sup>97</sup> *ibid.*

<sup>98</sup> *ibid.*

<sup>99</sup> This shift can be seen in the different approaches adopted in *Isle of Wight Railway Co v Tahourdin* (1883) 25 ChD 320 and *Automatic Self-Cleaning Filter Syndicate Co Ltd v Cunninghame* [1906] 2 Ch 34.

<sup>100</sup> Ireland, 'Company Law and the Myth of Shareholder Ownership' (n 79) 42-43.

<sup>101</sup> *ibid.* 43.

<sup>102</sup> Paul L Davies and Sarah Worthington, *Gower & Davies Principles of Modern Company Law* (9<sup>th</sup> edn, Sweet & Maxwell 2012) 35.

<sup>103</sup> *Salomon* (n 78).

Ltd with Salomon acting as the managing director. Salomon, his wife and five children were the only members of the company with Salomon holding the majority of shares. He then decided to sell his sole trading business to the limited company for £39,000. The limited company paid £39,000 to Salomon for the sole trading business issuing him with 20,000 shares at £1 each, £10,000 in debentures (loans from Salomon) secured by a floating charge on the company's assets, and the remaining balance in cash. The floating charge on the company's assets made Salomon a secured creditor, which meant that in the event of the company failing he would get paid before an unsecured creditor. In less than a year, the company ran into financial difficulties and because of that a liquidator was appointed. As a secured creditor, Salomon was able to recover what he was owed in full, but nothing was left for the unsecured creditors. As a result, the unsecured creditors claimed that the company was a sham used by Salomon as a front for his own business activities, and because of that they argued that Salomon was personally obligated to pay off the unsecured creditors.

The Court of Appeal ruled against Salomon on the grounds that the whole transaction was contrary to the true intent of the Companies Act and therefore the incorporation of the limited company was a mere sham. As a result, the Court of Appeal decided that Salomon was liable to pay off the unsecured creditors. However, the House of Lords unanimously reversed the Court of Appeal decision. It was decided by the House of Lords that the company had been validly incorporated in accordance with the Companies Act and because of that, the company should be regarded as a separate legal entity from Salomon, who was merely acting as the company's agent. The business therefore belonged to the company and not to Salomon. As Lord Macnaghten argued,

‘The company is at law a different person altogether from the subscriber...; and, though it may be that after incorporation the business is precisely the same as it was before, the same persons as managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers, as members, liable in any shape or form, except to the extent and in the manner provided by the Act’.<sup>104</sup>

It is therefore clear that since the *Salomon* case, the doctrine of separate legal personality, which recognises the company as a distinct legal entity from its members, has never been doubted. The decision of the House of Lords was therefore fundamental in reformulating the corporate concept as ‘it moved the law’s paradigm from that of an association of individuals, governed by partnership principles, to something that more closely resembled the old

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<sup>104</sup> *Salomon* (n 78) 51.

chartered corporation'.<sup>105</sup> It could therefore be argued that the decision of the House of Lords in *Salomon* case represents a fundamental 'paradigm shift'.<sup>106</sup>

Due to the emergence of the doctrine of separate legal personality, it was also entirely proper that a separation between wrongs done to the company and wrongs done to the shareholders would occur.<sup>107</sup> So, for example, where a wrong has been done to the company, the only 'proper plaintiff' is the company itself not its shareholders.<sup>108</sup> This is due to the fact that the recovery belongs only to the company and not to its shareholders. However, although shareholders are not able to recover personally for wrongs done to the company,<sup>109</sup> they are allowed under section 260 of the Companies Act 2006 to bring an action against the wrongdoers on behalf of the company. This is the so-called 'derivative action' which is defined in section 260(1) to mean proceedings brought 'by a member of a company – (a) in respect of a cause of action vested in the company, and (b) seeking relief on behalf of the company'. Derivative actions are "“derivative” in the sense that the right to sue belongs not to the party actually bringing the action, but is “derived” from that of the company'.<sup>110</sup> The purpose of this remedy is therefore to provide relief to the company, rather than to the company's shareholders personally.<sup>111</sup>

It could therefore be argued that in pre-*Salomon* cases the justification of ownership was strong for shareholders to be protected as they were the owners of the company's assets. Nozick, in that case, would argue that due to their ownership of company's property, shareholders had property rights in the company. Therefore, according to Nozick, if someone violated their property rights, shareholders would have been able to use ownership as the principal justification to receive compensation because of that violation.<sup>112</sup> On this line of reasoning, Nozick would say that minority shareholders had a strong justification to protect their property rights.

However, as shareholders are no longer the owners of the company's assets, ownership alone now does not constitute a very strong justification for the law to provide protection for minority shareholders. As a result, the purpose of the following section will be to analyse the

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<sup>105</sup> Grantham (n 77) 561.

<sup>106</sup> *ibid* 561.

<sup>107</sup> See, *Foss v Harbottle* (1843) 2 Hare 461; *MacDougall v Gardiner* (1875) 1 Ch D 13; cf *Pender v Lushington* (1877) 6 Ch D 70.

<sup>108</sup> *Foss* (n 107).

<sup>109</sup> They can only recover for wrongs done to them personally either through using section 33 or section 994 of the Companies Act 2006.

<sup>110</sup> Matthew Berkahn, 'The Derivative Action in Australia and New Zealand: Will the Statutory Provision Improve Shareholders' Enforcement Rights?' (1998) 10 Bond Law Review 74, 74.

<sup>111</sup> *ibid*.

<sup>112</sup> Nozick (n 10).

contemporary legal nature of shares as this will help the thesis to identify alternative justifications as to why minority shareholders should be protected.

#### 2.4.2.2. *The current legal nature of shares*

What is the current legal nature of shares? As Davies and Worthington argue, ‘at the present day this is a question more easily asked than answered’.<sup>113</sup> Historically, as noted above, holding a share in a company was regarded as holding a share in the common property of the business. Thus, those who were holding shares in a company – the shareholders – were treated as having an equitable interest in the corporate assets.<sup>114</sup> However, with the emergence of the doctrine of separate legal personality, the courts began to treat shareholders as having no equitable interest in the corporate assets: ‘shareholders are not, in the eyes of the law, part owners of the undertaking’.<sup>115</sup> Indeed, in various cases, the courts have made it clear that shareholders have no legal or equitable interest in the company’s assets as the only beneficial owner of the company’s assets is the company itself and not its shareholders.<sup>116</sup>

Due to this fact, ‘the word “share” has become something of a misnomer, for shareholders no longer share any property in common; at the most they share certain rights in respect of dividends, return of capital on a winding up, voting and the like’.<sup>117</sup> Described by Pennington, a ‘share’ is simply the bundle of contractual and statutory rights conferred on the shareholder by both the articles of association and the Companies Act 2006, section 33.<sup>118</sup> By doing so, he approvingly quoting in support the definition provided by Farwell J in *Borland’s Trustee v Steel Bros & Co Ltd*:<sup>119</sup>

‘A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se in accordance with s 16 of the Companies Act 1862 [now s 33 of the Companies Act 2006]. The contract contained in the articles of association is one of the original incidents of the share. A share is not a sum of money... but is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount’.<sup>120</sup>

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<sup>113</sup> Davies and Worthington (n 102) 859.

<sup>114</sup> Grantham (n 77) 562.

<sup>115</sup> *Short v Treasury Commissioners* [1948] 1 KB 122, CA per Evershed LJ.

<sup>116</sup> *Salomon* (n 78); *Macaura* (n 78); See also, Robert R Pennington, ‘Can shares in companies be defined?’ (1989) 10 *Company Lawyer* 140, 142.

<sup>117</sup> Davies and Worthington (102) 860.

<sup>118</sup> Robert R Pennington, *Company Law* (8<sup>th</sup> edn, Butterworths 2001) 65-66.

<sup>119</sup> *Borland’s Trustee v Steel Bros & Co Ltd* [1901] 1 Ch 279.

<sup>120</sup> *ibid* 288; This was approved by the *IRC v Crossman* [1937] AC 26, 66: ‘A share in a limited company is a property the nature of which has been accurately expounded by Farewell J in *Borland’s Trustee v Steel Brothers and Co Ltd*. It is the interest of a person in the company, that interest being composed of right and obligations which are defined by the Companies Act and by the memorandum and articles of association of the company.’

The concept of a share in Farwell J's decision, Pennington argues, is clear. The 'statutory contract'<sup>121</sup> contained in the company's articles of association 'gives rise to contractual obligations of each member as regards the company and every other member. The aggregate of these rights and obligations of a member is his shareholding, and when divided between the shares he holds, they constitute his shares'.<sup>122</sup> However, Pennington describes the conclusion regarding the legal nature of shares as 'disappointing'.<sup>123</sup> 'The most that may be said', Pennington argues, is that 'shares in a registered company... are a species of intangible movable property which comprise a collection of rights and obligations relating to an interest in a company of an economic and proprietary character, but not constituting a debt'.<sup>124</sup>

In defining a share as 'an interest of a shareholder in the company', Farwell J appeared to suggest that while a shareholder held no equitable interests in the corporate assets, he nonetheless possessed a company's share.<sup>125</sup> This is due to the fact that, 'the company itself is treated not merely as a person, the subject of rights and duties, but also as a *res*, the object of rights and duties'.<sup>126</sup> As Davies and Worthington argue,

'...though it lays considerable and perhaps disproportionate stress on the contractual nature of the shareholder's rights, [it] also emphasises the fact that the holder has an interest *in* the company. The theory seems to be that the contract constituted by the articles of association defines the nature of the rights, which, however, are not purely personal rights but instead confer some sort of proprietary interest in the company though not in its property'.<sup>127</sup>

However, in the following cases, the courts have shifted the emphasis placed by Farwell J on a share as 'an interest in the company', measured by the specific rights which made up the share, to the rights themselves. The courts, when describing the shares avoided defining it as an interest in the company but they preferred to describe it solely in terms of rights to receive dividends, to a return of capital when the company becomes insolvent and to the right of vote.<sup>128</sup> Thus, instead of recognising the company itself as the *res*<sup>129</sup>, the courts started identifying the rights conferred by the share itself.<sup>130</sup> *Short v Treasury Commissioners*<sup>131</sup> is a

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<sup>121</sup> Companies Act 2006, s 33.

<sup>122</sup> Pennington (n 116) 144.

<sup>123</sup> *ibid.*

<sup>124</sup> *ibid.*

<sup>125</sup> Grantham (n 77) 562.

<sup>126</sup> Davies and Worthington (n 102) 861.

<sup>127</sup> *ibid.*

<sup>128</sup> Thus in *Peter's American Delicacy Co Ltd v Health* (1939) 61 CLR 457, 503-504, Dixon J said 'primarily a share in a company is a piece of property conferring rights in relation to distributions of income and capital', while in the New Zealand case of *Coleman v Myers* [1977] 2 NZLR 225, 295, Mahon J held that the share 'only vests in the holder that collection of rights provided by the memorandum and articles of association'.

<sup>129</sup> The 'thing' that is at the heart of the share and which justifies its categorisation as property: See Grantham (n 77) 563.

<sup>130</sup> These rights can be categorized into two groups. The right to a dividend and the right to a return of capital on winding up can be classified as economic rights whereas the right to vote can be classified as a control right,

leading case on this point, where the Crown was obligatorily acquiring the company's share capital in its entirety. When evaluating the payable compensation, it was opposed that since all the shares would be obtained, the members of the company were allowed to the whole value of the company, which was larger than the overall value of the shares. However, this argument was not approved by the Court of Appeal. The members of the company were not allowed to receive compensation for the company's value, but only for the shares that were taken from them.<sup>132</sup>

As Grantham argues, whilst it is true that shareholders' ownership of shares provides them with rights against the company as well as in the company itself, 'the rights in the company are no longer seen as a consequence of the shareholders' status as proprietor'.<sup>133</sup> Indeed, 'the rights in the company arise as a consequence of ownership of the share and are limited to those rights'.<sup>134</sup> Grantham then went on to argue that,

'once these rights are satisfied, there is no residual claim to the company itself because, as Short illustrates, the shareholders' entitlement is then exhausted. Shareholders have thus been transformed from owners of the assets and undertaking to owners merely of certain rights in and against the company'.<sup>135</sup>

Therefore, it could be argued that ownership is not the central justification to protect minority shareholders. The aim of the following sections will be to provide alternative justifications as to why the law should protect minority shareholders. In doing so, the following section aims to examine the practice of insider dealing as an illustration by looking at the justifications for and against that practice. This will help the thesis to identify strong justifications for minority shareholders. For the purpose of the thesis, the following section aims to examine two possible justifications: (1) fairness and (2) property rights.

## **2.5. Insider Dealing**

Insider dealing is a practice which has been regarded by many people as 'unfair'.<sup>136</sup>

Therefore, in order to justify whether this practice is in fact unfair, some good justifications must be provided. One possible justification is therefore 'fairness'. Of course, this needs further examination as what appear to many people as unfair is in fact fair. The aim of this

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both of which make up the property rights called a share: See, F Odith, 'Takeovers, share exchanges and the meaning of loss' (1996) 112 LQR 424.

<sup>131</sup> Short (n 115).

<sup>132</sup> Grantham (n 77) 563.

<sup>133</sup> *ibid* 564.

<sup>134</sup> *ibid*.

<sup>135</sup> *ibid*.

<sup>136</sup> Roy A Schotland, 'Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market' (1967) 53 Va L Rev 1425, 1439; Saul Levmore, 'Securities and Secrets: Insider Trading and the Law of Contracts' (1982) 68 Virginia Law Review 117, 122.

section will therefore be to clarify in which circumstances the practice of insider dealing can be regarded as unfair. Another possible justification is ‘property rights’ as violation of property rights renders the practice of insider dealing as illegal. An examination of these two possible justifications will therefore be provided in the following sections.

### 2.5.1. ‘Fairness’ as a justification against insider dealing

‘Fairness’ as a concept has frequently been used as a justification for regulating insider dealing practice.<sup>137</sup> It is often argued that insider dealing is ‘unfair’ because of the disparities in information which occur when people are dealing with others in the marketplace.<sup>138</sup> This is based on the assumption that trading should take place on a ‘level playing field’ because all individuals in the market should receive equal information.<sup>139</sup>

For Levmore, fairness in the marketplace can be achieved ‘...when insiders and outsiders are in equal positions. That is, a system is fair if we would not expect one group to envy the position of the other’.<sup>140</sup> This is based on the ‘market egalitarianism’ argument which suggests that every individual who is dealing with others in the marketplace should be treated equally, as far as possible.<sup>141</sup> It could therefore be argued that a ‘level playing field’ cannot be achieved when some parties in the marketplace enjoy informational advantages over others.<sup>142</sup>

This is the situation with insider dealing. As McVea argues, ‘anyone making a trade based on superior information is deemed to be “stealing” from other market participants by acting before the information is made available to all traders’.<sup>143</sup> Insider dealing therefore is regarded to be unfair because some individuals in the marketplace take advantage of superior information that others do not possess.<sup>144</sup> According to Hetherington,

‘what causes injury or loss to outsiders is not what the insider knew or did, rather it is what they themselves [the outsiders] did not know. It is their own lack of knowledge which exposes them to risk of loss or denies them an opportunity to make a profit’.<sup>145</sup>

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<sup>137</sup> Abdulsalam Albelooshi, ‘The Regulation of Insider Dealing: An Applied and Comparative Legal Study towards Reform in the UAE’ (PhD thesis, University of Exeter 2008) 23.

<sup>138</sup> Jennifer Moore, ‘What is Really Unethical About Insider Trading?’ (1990) 9 *Journal of Business Ethics* 171, 172.

<sup>139</sup> *ibid.*

<sup>140</sup> Levmore (n 136) 122.

<sup>141</sup> Harry McVea, ‘What’s wrong with insider dealing?’ (1995) 15 *Legal Studies* 390, 410.

<sup>142</sup> Peter J Engelen and Luc V Liedekerke, ‘Insider Trading’ in John R Boatright (ed), *Finance Ethics: Critical Issues in Theory and Practice* (John Wiley & Sons 2010) 208.

<sup>143</sup> McVea (n 141) 410.

<sup>144</sup> Engelen and Liedekerke (n 142) 208.

<sup>145</sup> John AC Hetherington, ‘Corporate Social Responsibility, Stockholders, and the Law’ (1973) *Journal of Contemporary Business* 45, 51.

In this sense, it could be argued that one of the possibly viable justifications against the practice of insider dealing is ‘equality of information’, which is based on the notion that all individuals in the marketplace should receive equal information.<sup>146</sup> As the practice of insider dealing seems to conflict with the ‘equality of information’ idea, it could therefore be argued that insider dealing offends the idea of fairness.<sup>147</sup>

However, this argument seems problematical in the sense that it is impossible to have a level playing field when parties are dealing in the marketplace. In challenging fairness as a ground for regulating the practice of insider dealing, it was argued by Manne that since information is often unequal in the world of commerce, it is thus unlikely to achieve equality in bargaining positions between parties in the marketplace.<sup>148</sup> Therefore, it is impossible to ensure equality of bargaining positions between individuals in the marketplace, as ‘one party to the transaction will always of necessity have more knowledge about the factors that will affect the share price than another’.<sup>149</sup> Manne, who is an advocate of this view, argues that ‘the different amounts of profit and different individuals will reflect their different degrees of sophistication and the reliability of their information. The stock market is, par excellence, the arbiter of the value of the information’.<sup>150</sup> According to this view, everyone assumes the risk that others will have better information or make better use of it,<sup>151</sup> and neither the company nor any other body should be an insurer against a loss that would result from this unevenness of ‘strength’.<sup>152</sup>

Indeed, as McGee argues, ‘one party to the transaction often knows more about the value of the item being sold than does the other party’.<sup>153</sup> In justifying his view, he mentioned as an example the position of an antique dealer who usually knows more about the value of certain goods than the owner of the goods.<sup>154</sup> This is due to the fact that some market participants are better at some things than others as they have the opportunity to develop better skills than others.<sup>155</sup> Therefore, according to McGee,

‘Penalizing those who are better at something or subsidizing those who are worse at something results in inefficient outcomes and is unfair to some groups... Not allowing

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<sup>146</sup> Albelooshi (n 137) 23.

<sup>147</sup> *ibid* 23.

<sup>148</sup> Henry Manne, *Insider Trading on the Stock Market* (Free Press 1966) 47.

<sup>149</sup> Leigh H Ffrench and Barry AK Rider, ‘Should Insider Trading Be Regulated? Some initial considerations’ (1978) 95 S African LJ 79, 84.

<sup>150</sup> Manne (n 148) 47.

<sup>151</sup> Ffrench and Rider (n 149) 84.

<sup>152</sup> *ibid*.

<sup>153</sup> Robert W McGee, ‘Analyzing Insider Trading from the Perspectives of Utilitarian Ethics and Rights Theory’ (2010) 91 Journal of Business Ethics 65, 73.

<sup>154</sup> *ibid*.

<sup>155</sup> *ibid*.

individuals to use their special talents harms the entire community and the individuals who are being held back by some government law or regulation. Forcing a level playing field on people is always harmful because it reduces efficiency and violates rights'.<sup>156</sup>

It could therefore be argued that using the 'level playing field' as an argument to justify the prohibition of insider dealing is problematic. Therefore, if the practice of insider dealing is to be prohibited then some other better justifications should be found and analysed.<sup>157</sup>

It is where people, who are in stronger positions than others, are using their special talents at the expense of others that make the use of insider dealing illegal. As Moore points out, when people in a transaction are selling or buying products, they have legal obligations not to misrepresent or lie about the product to the other parties in the transaction.<sup>158</sup> For Cameron,

'Truthfulness is required in commercial transactions, and indeed in all human interactions, because we communicate with each other. We exchange information, and then act, at least in part, on the basis of that information. Lying to the other party, in the hopes of gaining a commercial advantage, would generally be defined as unethical conduct'.<sup>159</sup>

However, although they are legally obligated not to misrepresent or lie about a product, they are not legally obligated to disclose all information to the other party in the transaction. There will always be individuals in the marketplace who possess greater information than others, as their skills, experience and knowledge are more superior to others.<sup>160</sup> Therefore, it could be argued that the asymmetrical distribution of knowledge between individuals in the marketplace cannot be seen as a strong justification to regulate insider dealing.<sup>161</sup> However, as Moore points out, there is one situation where individuals are legally obligated to provide full disclosure of information to others. As Moore argues, this obligation arises when a fiduciary duty exists.<sup>162</sup> It could therefore be argued that only in such cases is the notion of 'fairness' obligatory.

In the context of company law, for example, it has long been recognised that directors owe fiduciary duties to the company who, as agents of the company, are holding a position of trust to the company. This position requires them to act solely for the benefits of the company and

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<sup>156</sup> *ibid.*

<sup>157</sup> *ibid.*

<sup>158</sup> Moore (n 138) 172.

<sup>159</sup> George D Cameron, 'Ethics and Equity: Enforcing Ethical Standards in Commercial Relationships' (2000) 23 *Journal of Business Ethics* 161, 161.

<sup>160</sup> Philip A O'Hara, 'Insider trading in financial markets: legality, ethics, efficiency' (2001) 28 *International Journal of Social Economics* 1046, 1053.

<sup>161</sup> *ibid.*

<sup>162</sup> Moore (n 138) 172-173.

not for their own benefits. As Lord Cranworth in *Aberdeen Rail Co. v Blaikie Brothers*<sup>163</sup> stated,

‘The directors are a body to whom is delegated the duty of managing the general affairs of the company. A corporate body can only act by agents, and it is, of course, the duty of those agents so to act as best to promote the interests of the corporation whose affairs they are conducting. Such an agent has duties to discharge of a fiduciary character towards his principal, and it is a rule of universal application that no one having such duties to discharge shall be allowed to enter into engagements in which he has or can have a personal interest conflicting or which possibly may conflict with the interests of those whom he is bound to protect’.<sup>164</sup>

Since the directors have the power to control and manage the company and its assets, it is without doubt that they are in a more advantaged position than others in the company (such as the minority shareholders), as they are more likely to have much more information at their disposal about the company than others.<sup>165</sup> However, if a director decides to use this information to benefit his own personal interests instead of his company’s interests, such information will be regarded as wrongful and illegal and therefore a breach of fiduciary duty will arise. This is due to the fact that directors, as fiduciaries, are under an equitable obligation to only serve and protect the interests of the company and therefore such use of inside information will break the bond of trust and confidence to his company.

This, of course, raises the question as to who can bring legal actions against the directors who breached their fiduciary duties. The answer to this question is clear: the company itself. In such a situation, ‘the company’ as an artificial legal person might be represented by the majority of the board of directors, the shareholders in general meeting or an individual shareholder. However, as it will be seen in chapter three, the issue of who can be regarded as the most suitable person to act on behalf of the company to enforce its rights has caused significant debate and controversy ever since the emergence of the doctrine of separate legal personality.<sup>166</sup> This is due to the fact that those who are in a more advantaged position, such as directors and majority shareholders, often use their powers to advantage themselves at the expense of those who are in a least advantaged position, such as the minority shareholders. As minority shareholders are in a least advantaged position in the company than directors and majority shareholders, it would be unfair for them if the directors or the majority shareholders try to gain a commercial advantage position in an unethical way. In such circumstances, if the power to bring legal actions on behalf of the company is left only in the hands of those who

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<sup>163</sup> *Aberdeen Rail Co v Blaikie Brothers* [1843-1860] All ER Rep 249.

<sup>164</sup> *ibid* 252.

<sup>165</sup> Davies and Worthington (n 102) 508.

<sup>166</sup> Davies and Worthington (n 102) 506.

are in a more advantaged position, this will produce significant injustices and unfairness to those who are in the least advantaged position. Therefore, it is relevant for the law to provide a remedy that balances those conflicting interests. Before embarking on an enquiry to analyse the ‘property rights’ argument as a justification for insider dealing, it is firstly important to examine in the following section what Rawls would say regarding this matter.

#### *2.5.1.1. Rawls’s theory of justice in the context of insider dealing*

In the context of insider dealing, the starting point for Rawls would be to ask: if a director or a majority shareholder is arbitrarily gifted with talent, why should he be permitted to enjoy the fruits of his talent through the practice of insider dealing? Rawls would argue that the distribution of natural talents of both directors and majority shareholders should best be considered as ‘common assets’ that need to be shared across the company as a whole. In taking into account the ‘difference principle’, examined above, Rawls argues that, ‘the difference principle represents, in effect, an agreement to regard the distribution of natural talents as a common asset and to share in the benefits of this distribution whatever it turns out to be’.<sup>167</sup> The ideal Rawlsian society is therefore one that encourages the distribution of natural talents to everyone involved in the society, including the least advantaged members.

The ‘better off’ in society make transfers to the ‘worst off’ in order to gain and maintain their cooperation. In other words, for Rawls, justice concerns the allocation of the benefits derived in ‘cooperative enterprise’ as people relate to each other under common institutions, ‘for justice, which requires our institutions be arranged so as to maximize the expectations of the worst-off group in our society’.<sup>168</sup>

To Rawls, a sound regime with a sound structure of rules should be put in place to determine the allocation of the benefits which the talented are to gain from the fruits of their creation. In applying the principle that ‘an inequality of opportunity must enhance the opportunities of those with the lesser opportunity’, the inequality of opportunity is permitted if it gives the least advantaged members – ‘those with the lesser opportunity’ – more opportunities to create.<sup>169</sup> As Daniels highlighted, Rawls believes that ‘the benefits people gain from exercising their talents are determined by a structure of rules that makes that distribution of talents work to everyone’s advantage, with priority given to those who are worst off’.<sup>170</sup>

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<sup>167</sup> Rawls, *A Theory of Justice* (n 9) 101.

<sup>168</sup> *ibid.*

<sup>169</sup> *ibid.*

<sup>170</sup> N Daniels, *Just Health: Meeting Health Needs Fairly* (CUP 2008) 54.

Rawls's approach is therefore to ask what principles of justice rational individuals would select to govern their civilisation. He believes that justice and fairness can be achieved as long as 'the original position' guarantees that each individual can negotiate from a point of equal power. Although in the original position individuals select on the basis of self-interest, they are imagined to be behind a 'veil of ignorance', not knowing their race, sex, personal talents and characteristics, or whether they are rich or poor. Rawls argues that individuals in the original position would not insist on absolute equality.<sup>171</sup> Rather, they would embrace the 'difference principle', which permits social and economic inequalities but only if they are to the greatest expected benefit of the least advantaged.<sup>172</sup> Inequalities are therefore justified only if they consider the least advantaged members of the society. Choosing the difference principle therefore, means that individuals (in that case, the directors and the majority shareholders) who have natural talents may benefit themselves only if, during the process, they also benefit the least advantaged members (in that case, minority shareholders). Supporting Rawls' theory of justice, Trevino and Nelson also argues that 'rational people who use the veil of ignorance principle will be more likely to develop ethical rules that do not advantage or disadvantage any particular group'.<sup>173</sup> This is because under the veil of ignorance no one knows whether he or she is going to be the most advantaged or the least advantaged member of the society.

By looking at the justification of fairness in Rawls's terms, it can be argued that, under the difference principle, any law should be designed to have in mind the maximum use of talents to the benefit of the least advantaged; hence, the law should be not much concerned with the reward or desert of the talented person but it must be concerned with the achievement of justice for all. For Rawls, justice and fairness are therefore promoted if someone puts his talents into full use to benefit the least talented.

### 2.5.2. 'Property rights' as a justification for insider dealing

It has been recognised by Engelen and Liedekerke that 'privileged corporate information can be seen as a valuable, intangible property right'.<sup>174</sup> Therefore, since material non-public information can also be regarded as 'some kind of property', it could be argued that the practice of insider dealing is wrong because it violates property rights.<sup>175</sup> This was referred to

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<sup>171</sup> Rawls, *A Theory of Justice* (n 9) 12.

<sup>172</sup> Rawls, *A Theory of Justice* (n 9) 302.

<sup>173</sup> LK Trevino & KA Nelson, *Managing Business Ethics: Straight talk about how to do it right* (John Wiley & Sons 2011) 45.

<sup>174</sup> Peter J Engelen and Luc V Liedekerke, 'The Ethics of Insider Trading Revisited' (2007) 74 *Journal of Business Ethics* 497, 503.

<sup>175</sup> *ibid.*

by Irvine as the ‘theft theory’.<sup>176</sup> This theory states that an insider can be regarded as a thief who steals confidential information for his own benefits.<sup>177</sup>

However, in contrast to this view, it is argued that property owners have every right to use their property in whatever way they see fit, irrespective of what other people believe.<sup>178</sup> As McGee says, ‘it is an uphill battle to argue against the right of individuals to use their own property as they see fit, especially if no one’s rights are being violated’.<sup>179</sup> Of course, this begs the question as to whether property owners should be left with entire freedom to use their own property as they wish. If Nozick was asked to answer this question, he would probably say that property owners have the right to use their property in whatever way they see fit and that no one should be allowed to interfere with their property rights.<sup>180</sup> Nozick would therefore argue that the ‘property rights’ argument could be regarded as a strong justification for allowing the practice of insider dealing.

The idea behind the entire freedom of property owners to use their property as they see fit derives from the political philosophy that says that individuals have natural rights to have ‘a definite sphere of unfettered activity’, to obtain property, to trade this property, to hire or sell labour power, to obtain great wealth and become rich or to stay in poverty and become poor.<sup>181</sup> The freedom to acquire property is therefore a natural right which should not be interfered by the state unless this directly affects others.<sup>182</sup> As Brown argues, violation of property owners’ natural rights is wrong and unjust ‘which cannot be justified even if it prevents greater wrong or promotes great good’.<sup>183</sup> This is very similar to Nozick’s ‘entitlement theory’<sup>184</sup> of justice which focuses on the idea of ‘natural freedom’, where individuals possess certain ‘negative’ rights, which are ‘rights against others interfering coercively in [their] affairs and the right to property’.<sup>185</sup> It could therefore be argued that where the owner of material non-public information uses that information to benefit his own personal interests, this should not be regarded as wrong or unjust, unless there is a fraud or coercion.

However, on the other hand, if such information is used by an insider to benefit his own personal interests without taking the permission of the owner of that information, any benefits

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<sup>176</sup> William B Irvine, ‘Insider Trading: An Ethical Appraisal’ (1987) 6 *Business & Professional Ethics Journal* 3.

<sup>177</sup> *ibid.*

<sup>178</sup> McGee (n 153) 70.

<sup>179</sup> *ibid.*

<sup>180</sup> Nozick (n 10).

<sup>181</sup> Alan Brown, *Modern Political Philosophy: Theories of the Just Society* (Penguin Books 1986) 87-88.

<sup>182</sup> *ibid* 88-89.

<sup>183</sup> *ibid* 89.

<sup>184</sup> Nozick (n 10).

<sup>185</sup> Brown (n 181) 92.

that might arise from using that information belong only to the owner and not to the insider.<sup>186</sup> For Nozick, justice exists when there is an absence of coercion, ‘which means that there is justice when there is no restriction on freedom’.<sup>187</sup> As McGee argues, ‘acts between consenting adults are just. Individuals or governments that prevent such acts are acting unjustly, and individuals who commit acts that aggress against others, except in self-defence, are acting unjustly’.<sup>188</sup> He then went on to say that,

‘...the proper scope of government is to protect life, liberty and property, and any act by government that goes beyond this scope results in injustice because it must necessarily use coercion to take from some to give to others... If injustice results when one individual takes the property of another without that person’s consent, and the proper scope of government includes prevention of such acts, the government should attempt to prevent coercive (or fraudulent) takings and should refrain from interfering in nonfraudulent transactions that are between consenting adults’.<sup>189</sup>

It could therefore be argued that it is only when someone’s rights are violated that the practice of insider dealing should be regarded as wrong and unjust. In answering the question whether an individual’s property rights have been violated, Macey proposes a two-step procedure that needs to be considered. As Macey argues, it is firstly relevant ‘to determine who has legitimate ownership rights over the relevant information’.<sup>190</sup> If the insider trader is also the owner of the material non-public information then insider dealing should not be regarded as wrong and unjust. Secondly, it is also relevant to determine the relationship between the insider trader and the rightful owner of the material non-public information. If the insider trader is not the rightful owner, then it is essential to determine whether the insider trader has been given ‘actual or implied authority’ from the owner to use such material non-public information.<sup>191</sup> If the insider trader has not been given actual or implied authority from the owner to use such information then there will be a violation of owner’s property rights and therefore the practice of insider dealing will be regarded as wrong and unjust.<sup>192</sup>

Therefore, the main question that needs to be determined in order to examine whether insider dealing is wrong and unjust, is to find out who holds the property rights over the material non-public information. According to Moore, the property rights of material non-public

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<sup>186</sup> Robert W McGee, ‘Ethical Issues in Insider Trading: Case Studies’ (Global Conference on Business Economics, Association for Business and Economics Research, Amsterdam, July 2004) <<http://ssrn.com/abstract=538682>> accessed 24 June 2015.

<sup>187</sup> Gerald A Gohen, *Self-Ownership Freedom and Equality* (CUP 1995) 61.

<sup>188</sup> McGee (n 186) 2.

<sup>189</sup> *ibid* 2-3.

<sup>190</sup> Jonathan R Macey, ‘Ethics, Economics and Insider Trading: Ayn Rand Meets the Theory of the Firm’ (1988) 11 *Harvard Journal of Law & Public Policy* 785, 793.

<sup>191</sup> *ibid*.

<sup>192</sup> *ibid*.

information belong to the company.<sup>193</sup> In this case, if the insider trader has not been given actual or implied authority from the company to use that information then the practice of insider dealing will be regarded as wrong and unjust. On the other hand, if the company has given its consent to the insider to use such information then, according to Moore, the practice of insider dealing is not wrong.<sup>194</sup>

Apart from the ‘property rights’ argument, Moore also argues that insider dealing is wrong because it undermines the fiduciary relationship that managers have with their company.<sup>195</sup> As Moore stated,

‘...the fiduciary relationship is one of moral and legal obligation. Fiduciaries, that is, are bound to act in the interests of those who depend on them even if these interests do not coincide with their own... Where the interests of the two parties compete or conflict, the fiduciary relationship is threatened’.<sup>196</sup>

In this case, the practice of insider dealing will therefore be regarded as wrong and unjust because ‘the insider trader “misappropriates” as the laws put it, information that belongs to the company and uses it in a way in which it was not intended – for personal profit’.<sup>197</sup>

In the context of company law, this will be regarded as a breach of a director’s fiduciary duty to the company. As mentioned above, directors’ fiduciary duties derived from the fact that the board of directors has the exclusive power to control and manage the affairs of the company and because of that, they should act in a way that benefits only the interests of the company and not their own.<sup>198</sup> Having said that, it is worth mentioning that, in close private companies, control could also be exercised, either directly or indirectly, by the shareholders as a whole in the general meeting.<sup>199</sup> Despite the fact that that the board has been given the sole responsibility to control and manage the affairs of the company, there are a number of situations where the Companies Act 2006 requires the general meeting’s approval of the board’s decision.<sup>200</sup> Without providing an exhaustive list of such situations, some of the most

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<sup>193</sup> Moore (n 138) 175.

<sup>194</sup> *ibid.*

<sup>195</sup> *ibid* 178.

<sup>196</sup> *ibid.*

<sup>197</sup> *ibid* 175.

<sup>198</sup> The power to litigate in the name of a registered company is one of the general powers of management assigned to the directors by art 3 of the model articles for private and for public companies in SI 2008/3229: ‘Subject to the articles, the directors are responsible for the management of the company’s business, for which purpose they may exercise all the powers of the company’.

<sup>199</sup> David Kershaw, *Company Law in Context: Text and Materials* (2<sup>nd</sup> edn, OUP 2012) 646.

<sup>200</sup> Davies and Worthington (n 102) 393.

important examples are: (1) alteration of the articles of association,<sup>201</sup> (2) variation of class rights,<sup>202</sup> and (3) reduction of share capital.<sup>203</sup>

In addition, under section 168 of the Companies Act 2006, the shareholders in general meeting are given the significant power to remove directors at any time by ordinary resolution.<sup>204</sup> This is a very important provision as it gives significant power to the general meeting (albeit indirectly) to interfere with the board's decision. Indeed, it is entirely proper to say that the board will probably choose to follow the views of the shareholders in general meeting, as 'they will be aware that disobedience may trigger their removal from office'.<sup>205</sup> This of course begs the following questions: Are controller's actions in general meeting subject to any duties similar to those of the board? If not, should they be? In other words, should the controlling shareholders act in a way that benefits the interests of the company as a whole or should they be left with the voting power to pursue their own financial goals? These are the questions that will occupy the reader in the following sections.

## **2.6. Controlling shareholders and fiduciary duties**

As examined above, in close private companies, both the board of directors and the shareholders in general meeting have been vested with significant powers to control and manage the property of others; they can make decisions regarding the corporate property as well as influence the rights of the minority shareholders.<sup>206</sup> This power is derived from the democratic principle that those who hold the majority of shares in a company can bind the minority by their decisions.<sup>207</sup> However, while the directors have been subjected to fiduciary duties, UK law has shown its reluctance to also impose such duties on controlling shareholders.<sup>208</sup> This is due to the fact that there is a strong line of authorities that support the view that a shareholder's right to vote is a property right which he can exercise in a way that benefits his own personal interests, even though his interests might conflict with those of the company or other shareholders.<sup>209</sup>

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<sup>201</sup> Companies Act 2006, s 21.

<sup>202</sup> Companies Act 2006, s 630.

<sup>203</sup> Companies Act 2006, s 641.

<sup>204</sup> An ordinary resolution requires a majority of not less than 50%.

<sup>205</sup> Davies and Worthington (n 102) 411.

<sup>206</sup> Zipora Cohen, 'Fiduciary duties of controlling shareholders: A comparative view' (1991) 12 *University of Pennsylvania Journal of International Business Law* 379, 379-380.

<sup>207</sup> *ibid* 380; See also *Foss* (n 107).

<sup>208</sup> Cohen (n 206) 379.

<sup>209</sup> *North West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589, 593; *Burland v Earle* [1902] AC 83, 94; *Carruth v Imperial Chemical Industries Ltd* [1937] AC 707, 765; *Northern Counties Securities Ltd v Jackson and Steele Ltd* [1974] 1 WLR 1133, 1144; See also Peter G Xuereb, 'Voting rights: A comparative view' (1987) 8 *Company Lawyer* 16, 16.

Contrary to this principle, however, some academics have argued that as long as the controlling shareholders in general meeting are free to use their voting powers in a way that they see fit, this carries the risk of abuse or exploitation by those who hold the majority of shares to the detriment of the company's interests or the minority shareholders.<sup>210</sup> Due to this problem, it is firstly essential to analyse in the following sections whether any constraints have been imposed on the exercise of controlling shareholders' voting powers in general meeting, and if there are any, to examine how effective they are to protect the interests of the company and its minority shareholders. In doing so, the thesis will then go on to examine whether fiduciary duties should be imposed on controlling shareholders. This examination will help the thesis to identify possible gaps that could justify the use of derivative actions to provide more effective protection.

### *2.6.1. A shareholder's vote is a right of property: the basic principle*

The starting point is that the duties owed by the shareholders to the company and to each other are not fiduciary: 'the shareholder's vote is a right of property, and prima facie may be exercised by a shareholder as he thinks fit in his own interest'.<sup>211</sup> Indeed, as Dixon J stated in *Peters' American Delicacy Co Ltd v Heath*,<sup>212</sup>

'The shareholders are not trustees for one another, and unlike directors, they occupy no fiduciary position and are under no fiduciary duties. They vote in respect of their shares, which are property, and the right to vote is attached to the share itself as an incident of property to be enjoyed and exercised for the owner's personal advantage'.<sup>213</sup>

As opposed to the board, which is required to act solely for the interests of the company and not for its own, it seems that shareholders have been given the entire freedom to exercise their voting powers in a way that they can further their own self-interests. In this case, Nozick would probably argue that their ownership of shares has given them the freedom to use their property rights in whatever way they wish. Therefore, for Nozick, using their votes as a property right to further their own financial goals is not wrong or unjust, unless there is fraud or coercion.

The same principle also applies to a director of a company when using his voting power in his position as a shareholder. In this case, the director is free to use his voting rights in his capacity as a shareholder to further his own personal interests, irrespective of whether his

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<sup>210</sup> Cohen (n 206) 380; Andre Tunc, 'The Fiduciary Duties of a Dominant Shareholders' in Clive M Schmitthoff and Frank Wooldridge (eds) *Groups of Companies* (Sweet & Maxwell 1991).

<sup>211</sup> *Carruth* (n 209) 765 (Lord Maugham).

<sup>212</sup> *Peter's American Delicacy Co Ltd* (n 128).

<sup>213</sup> *ibid* 504.

interest might conflict with the interests of the company as a whole. A leading example to this position is *North West Transportation Co Ltd v Beatty*<sup>214</sup>, in which a director of a company had used his voting powers in his capacity as a shareholder in general meeting to favour a resolution that ratified his wrongdoings. The question that arises in this case was whether the resolution was valid. The court held that the resolution was valid because the director had used his voting powers in his capacity as a shareholder and by doing so, he was entirely free to use his powers as he sees fit. As Sir Richard Baggalay argues in this case,

‘...unless some provision to the contrary is to be found in the character or the instrument by which the company is incorporated, the resolution of a majority of the shareholders, duly convened, upon any question with which the company is legally competent to deal, is binding upon the minority..., and every shareholder has a perfect right to vote upon any such question, although he may have a personal interest in the subject-matter opposed to, or different from, the general or particular interests of the company’.<sup>215</sup>

The difference between the position of directors, as fiduciaries to the company, from that of shareholders, who are not fiduciaries, was further illustrated by Walton J in the significant case of *Northern Counties Securities Ltd v Jackson & Steeple Ltd*<sup>216</sup> where he stated that,

‘When a director votes as a director for or against any particular resolution in a directors’ meeting, he is voting as a person under a fiduciary duty to the company for the proposition that the company should take a certain course of action. When a shareholder is voting for or against a particular resolution, he is voting as a person owing no fiduciary duty to the company and who is exercising his own right of property, to vote as he thinks fit. The fact that the result of the voting at the meeting (or at a subsequent poll) will bind the company cannot affect the position that, in voting, he is voting simply in exercise of his own property rights’.<sup>217</sup>

Therefore, as opposed to the directors, shareholders owed no fiduciary duties to the company or to other shareholders when voting in general meeting. It is clear from the above authorities that controlling shareholders are free to use their voting powers to further their own personal interests without any legal obligation to take other interests into account.

However, despite this well-recognised principle, the courts have recognised that, in special circumstances, limitations should be placed on the power of controlling shareholders to use their votes as they see fit.<sup>218</sup> This is due to the fact that, allowing controlling shareholders the entire freedom to use their voting powers as they see fit, carries the risk of abuse or exploitation of the interests of minority shareholders. As examined above, those who are in a

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<sup>214</sup> *North West Transportation Co Ltd* (n 209).

<sup>215</sup> *ibid* 593.

<sup>216</sup> *Northern Counties Securities Ltd* (n 209).

<sup>217</sup> *ibid* 1144.

<sup>218</sup> *Cohen* (n 204) 381.

more advantaged position than others are more likely to use their powers to benefit themselves at the expense of those who are in a least advantaged position. It is therefore relevant for the law to impose limitations on controlling shareholders' voting powers where such an abuse or exploitation could occur. In the absence of such limitations, this will lead to injustice for those who are in a least advantaged position, in this context the minority shareholders. It is therefore relevant in the following sections to examine the effectiveness of such limitations to protect minority shareholders. This will also help the thesis to identify possible gaps that derivative actions could fill in.

### *2.6.2. The limitations of controlling a shareholders' voting powers*

Although it has been acknowledged above that a shareholder's vote is a right of property which the shareholder can exercise in a way that benefits his own self-interests, this does not grant controlling shareholders unlimited voting powers to abuse or expropriate the interests of the minority shareholders. To prevent an abuse of power by the controlling shareholders, the courts have recognised that shareholders in general meeting are required to vote bona fide in what they consider to be the best interest of the company.<sup>219</sup> It has also been acknowledged that shareholders should not use their voting powers for an improper purpose.<sup>220</sup> It could be argued that the limitations imposed by the courts on the controlling shareholders are very similar to the fiduciary duties imposed on the directors.<sup>221</sup> However, as examined above, shareholders do not owe fiduciary duties to the company or other shareholders. Therefore, as opposed to the directors, the limitations that have been placed on the exercise of controlling shareholders' voting powers are only for certain circumstances.<sup>222</sup> Without attempting an exhaustive list of those specific circumstances, some of the most important examples are: (1) alteration of the company's articles of association, (2) appointment of directors, (3) decisions that affects class of shares, and (4) fraud on the minority.

The purpose of the following sections will be therefore to analyse those limitations and see how effective they are in protecting both the company and the minority shareholders. The focus will therefore be given to answer the following questions: To what, if any, extent is the exercise of controlling shareholders subject to limitations? Do these limitations provide effective protection for minority shareholders? If not, will any alternative rules do better to provide justice to both the company and the minority shareholders?

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<sup>219</sup> *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656, 671.

<sup>220</sup> *Re Western Mines Ltd* (1975) 65 DLR 3(d) 307, 313.

<sup>221</sup> Companies Act 2006, s 171 (duty to act within powers) and s 172 (duty to promote the success of the company).

<sup>222</sup> Derek French, Stephen Mayson and Christopher Ryan, *Mayson, French & Ryan on Company Law* (31<sup>st</sup> edn, OUP 2014) 398.

### 2.6.2.1. Alteration of articles of association: acting *bona fide* in the interests of the company

It has long been recognised by the Companies Act that the shareholders in general meeting have the power to alter the company's articles of association by using a special resolution, which requires a 75% of the shareholders' votes.<sup>223</sup> The need to alter the articles of association can be seen from the fact that the corporation, as an ongoing institution that grows and develops from time to time, needs a constitution that is able to alter to fit the changing circumstances and developments of the business.<sup>224</sup> In the process of altering the company's articles of association, every shareholder in general meeting (regardless of the size of the investment) has a right to cast his vote to decide whether the articles of association should be altered or not. As in political elections where the majority always wins, in a corporate democracy where all the shareholders in a company have been given the right to vote, it is not surprising that the final decision is taken by those who hold the majority of shares, the majority shareholders.<sup>225</sup> Thus, the decision taken by the majority binds the minority. When voting, every individual shareholder in general meeting is free to use his vote in a manner that benefits his own self-interests, irrespective of what others believe.<sup>226</sup>

However, giving the power to alter the articles of association to controlling shareholders can create significant problems, especially when the controlling shareholders use their voting powers to benefit themselves at the expense of the minority shareholders. Due to this problem, it is not surprising that the courts have imposed limitations on the power of controlling shareholders to alter the articles of association. Indeed, the courts have long recognised that controlling shareholders may only amend the articles of association only when they exercise this power 'bona fide for the benefit of the company as a whole'.<sup>227</sup> This principle was first recognised by the well-known case of *Allen v Gold Reefs of West Africa Ltd*<sup>228</sup> in which Lord Lindley held that the power to amend the company's articles of association should be:

'...exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities enabling them to bind minorities. It must be exercised, not only in the manner required by law, but also *bona fide for the benefit of the company as a*

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<sup>223</sup> Companies Act 2006, s 21; See also Kershaw (n 199) 654.

<sup>224</sup> Kershaw (n 199) 83; Davies and Worthington (n 102) 77.

<sup>225</sup> Ataollah Rahmani, 'Majority rule and minority shareholder protection in joint stock companies in England and Iran' (PhD thesis, University of Glasgow 2007).

<sup>226</sup> *North West Transportation Co Ltd* (n 209) 593.

<sup>227</sup> *Allen* (n 219) 671.

<sup>228</sup> *ibid.*

*whole*, and it must not be exceeded. These conditions are always implied, and are seldom, if ever, expressed'.<sup>229</sup>

However, beyond the well-known judgment of Lindley MR in *Allen*, little guidance has been provided regarding the precise meaning of the 'bona fide for the benefit of the company as a whole' test.<sup>230</sup> Due to this problem, the courts in subsequent cases have sought to clarify the exact meaning of the test established in *Allen*.<sup>231</sup> In two first instance judgments,<sup>232</sup> for example, the courts took the approach that the test established in *Allen* has two distinct components, 'bona fide' and 'the benefit of the company as a whole', as it was argued that an alteration of articles of association could be regarded as invalid where, on an objective assessment, the courts determine that it is not for the benefit of the company as a whole. In deciding those cases, the courts have therefore used an objective test.

However, this approach was criticised (although not overruled) by the Court of Appeal case of *Shuttleworth v Cox Brothers & Co*<sup>233</sup> in which the court stressed that the test has just one component rather than two and that the test is subjective rather than objective. The Court of Appeal argues that it is mainly for the majority of shareholders to decide what is in the interests of the company as a whole and not for the courts to decide. As Scrutton LJ stressed:

'...when persons, honestly endeavouring to decide what will be for the benefit of the company and to act accordingly, decide upon a particular course, then, provided there are grounds on which reasonable men could come to the same decision, it does not matter whether the Court would or would not come to the same decision or a different decision. It is not the business of the Court to manage the affairs of the company. That is for the shareholders and the directors'.<sup>234</sup>

From the above passage, it shows that the corporate decision as to what is in the interests of the company as a whole lies primarily on the 'bona fide subjective determination' of the suitable organ, that is the majority shareholders and the directors, and that no court should be allowed to interfere to overrule such corporate decisions.<sup>235</sup> As Sealy said, 'this goes hand in hand with the view that business decisions are a matter for business men, and not subject to review by the courts'.<sup>236</sup> The key question therefore is whether the shareholders, when voting

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<sup>229</sup> *ibid* 671 (emphasis added).

<sup>230</sup> Brenda Hannigan, *Company Law* (3<sup>rd</sup> edn, OUP 2012) 86.

<sup>231</sup> *Dafen Tinplate Co v Llanelly Steel Co* [1920] 2 Ch 124, 137; *Sidebottom v Kershaw, Leese & Co* [1920] 1 Ch 154, 163(4), 169 (CA); *Shuttleworth v Cox Bros & Co* [1927] 2 KB 9, 18, 23, 27 (CA).

<sup>232</sup> *Brown v British Abrasive Wheel Co* [1919] 1 Ch 290; *Dafen Tinplate Co* (n 229).

<sup>233</sup> *Shuttleworth* (n 231).

<sup>234</sup> *ibid* 23.

<sup>235</sup> LS Sealy, "Bona Fides" and "Proper Purposes" in Corporate Decisions' (1989) 15 Monash U L Rev 265, 277.

<sup>236</sup> *ibid*.

at a general meeting, honestly believe that the amendment of the articles of association is for the interests of the company as a whole.<sup>237</sup>

However, even if the shareholders' honesty is unchallenged by the courts, there is 'an objective threshold of reasonableness below'<sup>238</sup> which recognises that the majority's subjective view to amend the articles of association will not be accepted 'if no reasonable men could really consider it for the benefit of the company'.<sup>239</sup> In other words, if the amendment of articles of association is such that no reasonable body of directors or shareholders could 'consider it for the benefit of the company', then such an amendment will not be allowed to stand by the courts.<sup>240</sup> However, although such an objective test exists, it was recognised by a number of cases that the courts are still reluctant to strike down an alteration on this ground.<sup>241</sup> In *Sidebottom v Kershaw, Leese & Co*<sup>242</sup>, for example, where the amendment of the company's articles was done with the purpose to provide the directors with power to compulsorily purchase the shares of any member who carried on a business in competition with the company's business, the Court of Appeal recognised that the action of the majority shareholders to amend the articles was not suspicious as no evidence has been found that the amendment was done for a malicious motive. Another example is *Shuttleworth v Cox Brothers & Co*<sup>243</sup>. In this case, where the majority wanted to amend the articles of association to include a provision that a director could be disqualified from his office if requested in writing by the other directors, the Court of Appeal recognised that no 'trace of any vindictiveness or wrong motive' has been found in amending the company's articles.<sup>244</sup> It could therefore be argued that those seeking to prevent an alteration of the company's articles might find it hard to prove that such alteration was done for a malicious motive and not for the benefit of the company.<sup>245</sup>

As a result, in *Greenhalgh v Arderne Cinemas Ltd*,<sup>246</sup> Lord Evershed MR proposed an alternative approach to test whether an amendment of a company's article of association is bona fide for the benefit of the company as a whole. According to Lord Evershed MR, an amendment of a company's articles of association 'would be liable to be impeached if the effect of it were to *discriminate between the majority shareholders and the minority*

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<sup>237</sup> Hannigan (n 230) 87.

<sup>238</sup> Sealy (n 235) 277.

<sup>239</sup> *Shuttleworth* (n 231) 18 (Banks LJ).

<sup>240</sup> See John Birds et al, *Boyle & Birds' Company Law* (9<sup>th</sup> edn, Jordan Publishing 2014) 136.

<sup>241</sup> *Sidebottom* (n 231); *Shuttleworth* (n 231).

<sup>242</sup> *ibid.*

<sup>243</sup> *Shuttleworth* (n 231).

<sup>244</sup> *ibid* 17 (Banks LJ).

<sup>245</sup> Birds et al (n 240) 135.

<sup>246</sup> *Greenhalgh v Arderne Cinemas Ltd* [1951] Ch 286.

*shareholders*, so as to give the former an advantage of which the latter were deprived'.<sup>247</sup> In this case, the company's articles, which contained a provision that existing shareholders have a pre-emption right to acquire other members' shares, were amended with the purpose to permit a majority shareholder to sell his shares directly to an outsider without having to offer his shares first to the existing members, provided the sale was approved by an ordinary resolution of shareholders in general meeting. Such an alteration of the company's articles was held to be valid. This is due to the fact that, according to Lord Evershed MR's view,

'...when a man comes into a company, he is not entitled to assume that the articles will always remain in a particular form; and that, so long as the proposed alteration does not unfairly discriminate in the way which I have indicated, it is not an objection, provided that the resolution is passed bona fide, that the right to tender for the majority holding of shares would be lost by the lifting of the restriction. I do not think that it can be said that this is such a discrimination as falls within the scope of the principle which I have stated'.<sup>248</sup>

Lord Evershed MR's reasoning in *Greenhalgh* was that when parties are entering into the statutory contract laid down in the company's articles of association, everyone expects that the articles are alterable and that some provisions inserted in the articles are subject to change by a special resolution at a general meeting. Contrary to ordinary commercial contracts in which such types of contract would be regarded as abnormal, in the context of company law, it is entirely normal to expect that the articles of association may be altered by passing a special resolution at a general meeting. However, looking at the decision in *Greenhalgh*, it could be argued that the fact that the alteration of the company's articles was held not to fall within the type of *Greenhalgh*'s discrimination test, has created uncertainty as to which type of discrimination was such that could cause a court to restrain the majority.<sup>249</sup>

It is therefore interesting to see what Rawls and Nozick would say if they were asked to take a position regarding this matter. By taking into account Rawls' difference principle, it could be argued that Rawls would probably say that inequalities between majority and minority shareholders are justified only if the majority shareholders, who are in a more advantaged position in the company, also consider the interests of the minority shareholders, who are in a least advantaged position, when altering the articles of association. It could therefore be argued that, in the context of company law, the courts should consider whether the alteration benefits not only those who are in a more advantaged position but also the least advantaged members of the company. In other words, in determining whether an alteration should be regarded as valid, the courts should consider whether it was commercially just to allow the

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<sup>247</sup> *ibid* 291 (emphasis added).

<sup>248</sup> *ibid* 292.

<sup>249</sup> See Birds et al (n 240) 137.

alteration. If the answer is ‘yes’, then the decision to alter the articles should be valid. However, if the articles were altered without taking into account the interests of the least advantaged members of the company, then this should be regarded as commercially unjust and therefore the resolution to alter the articles should be void.

On the other hand, Nozick would probably look at the contractual rights of the parties and argue that if there is a breach of those rights then there should be a mechanism to compensate the vulnerable parties. Of course, considering what Lord Evershed MR said above about the expectations of the parties that the articles are alterable, it could be argued that such an alteration would be regarded as valid as long as there is no breach of contractual rights of the parties. It is worth noting that *Greenhalgh* was decided before the Companies Act 1980 (now Companies Act 2006) in which pre-emption rights were introduced and recognised under the statute. If *Greenhalgh* involved an issue of allotment of new shares, then the decision of this case would have been different due to the fact that such alteration would have been regarded as void.<sup>250</sup> However, due to the fact that the issue of *Greenhalgh* was not concerned with the allotment of new shares but with existing shares, it could be argued that if this case was decided after the Companies Act 1980, it would not have any impact on that case.

Another significant aspect of the *Greenhalgh*'s decision is what Lord Evershed MR said about the meaning of the phrase ‘the company as a whole’. The company is of course an entity distinct and separate from its shareholders and in cases such as *Allen*, *Sidebottom* and *Shuttleworth* it may be sufficient to consider whether the alteration is capable of being in the interests of the company as a commercial entity. However, cases such as *Greenhalgh* involve alterations which affect groups of shareholders differently but which have little or no effect on the company as a commercial entity.<sup>251</sup> Indeed, amendments of articles can concern matters, such as the distribution of dividends or capital or the power to dispose of shares, in which the company as a separate person has no interest, and the benefit of the company test can be seen as irrelevant to such amendments.<sup>252</sup> In such circumstances, ‘the phrase, “the company as a whole”, does not (at any rate in such a case as the present) mean the company as a commercial entity, distinct from the corporators: it means the corporators as a general body’.<sup>253</sup>

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<sup>250</sup> See Companies Act 2006, s 561.

<sup>251</sup> *Birds et al* (n 240) 138.

<sup>252</sup> French, Mayson and Ryan (n 222) 96.

<sup>253</sup> *Greenhalgh* (n 246) 291.

### 2.6.2.2. *Appointment of directors*

The Companies Act 2006 is silent regarding the issue as to who has the power to appoint the directors of the company. As a result, one should look at the model articles of association to find the answer. The model articles of association in SI 2008/3229 seems to provide the power to appoint directors both to the board of directors and the shareholders in general meeting.<sup>254</sup> As regards the power given to the shareholders in general meeting, it has long been recognised that this power should ‘be exercised for the benefit of the company as a whole and not to secure some ulterior advantage’.<sup>255</sup> In *Theseus Exploration NL v Mining and Associated Industries Ltd*,<sup>256</sup> for example, the majority of shareholders in general meeting were prevented by the courts, through an interim injunction, from appointing specific persons as directors as it was found that those persons aimed to use the assets of the company exclusively for the benefit of the majority shareholders rather than for benefit of the company as a whole.

### 2.6.2.3. *Class meetings*

As regards the issue of class meetings, it has long been recognised that the power of the majority shareholders to bind the minority should be exercised in a manner that benefits the whole class of shareholders and not for the purpose to benefit specific members. In *Re Holders Investment Trust*,<sup>257</sup> for example, a resolution at a class meeting of preference shareholders was passed with the majority favoured to reduce the capital of the company by cancelling all of its preference shares and by issuing an unsecured loan stock to the holders in exchange for their preference shares. However, a crucial point in this case was the fact that the majority of preference shareholders, who were in favour of the resolution to reduce the company’s capital, were also owners of the ordinary shares. In this case, it was found that the resolution passed to reduce the company’s capital was for the benefit of the majority’s position as ordinary shareholders, and not of their position as preference shareholders. For that reason, the court held that the majority’s approval for the reduction of capital was invalid. This is due to the fact that a shareholder, when voting at a class meeting, is required to act for the benefit of the class as a whole and not for any other class. The resolution passed was therefore to the detriment of those holding the minority of preference shares.

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<sup>254</sup> Model articles for private companies, art 17(1); Model articles for public companies, art 20.

<sup>255</sup> *Re H R Harmer Ltd* [1959] 1 WLR 62, 82.

<sup>256</sup> *Theseus Exploration NL v Mining and Associated Industries Ltd* [1973] QdR 81.

<sup>257</sup> *Re Holders Investment Trust* [1971] 1 WLR 583.

If Rawls was asked to take a position regarding this matter, he would probably say that, due to the fact that the majority of preference shareholders were also ordinary shareholders, they were in a more advantaged position to benefit themselves than those holding the minority of preference shares. The fact that the majority of preference shareholders tried to improve their position as ordinary shareholders to the detriment of those holding the minority of preference shares, should be regarded as unjust and unfair and therefore the decision of *Re Holders Investment Trust* was correctly decided. As Rawls argues, inequalities in the distribution of goods are only justified when those who are in a more advantaged position consider also those who are in a least advantaged position. The fact that the majority of preference shareholders did not consider the interests of the whole class of preference shareholders when voting at class meeting, it is entirely proper to say that if the court in *Re Holders Investment Trust* had decided otherwise, the outcome of the case would have been regarded as unjust because justice would not have been done to those who were in a least advantaged position (the preference shareholders). Notwithstanding the well-known judgment in *North West Transportation Co Ltd v Beatty* mentioned above, the power of the majority of preference shareholders to vote at a class meeting must be exercised only in the 'collective interests' of the preference shareholders and not for their interests as holders of another class of shares.<sup>258</sup>

#### 2.6.2.4 *Fraud on the minority*

Another important limitation on the majority's voting powers is when 'fraud on the minority' arises. Indeed, it has long been recognised that majority shareholders are not allowed to use their voting powers to expropriate the property of the company, as this will obviously be regarded as fraudulent conduct. In *Cook v Deeks*,<sup>259</sup> for example, three out of four directors in a railway company diverted business that belonged to the company to themselves, and by doing so, they acquired profits which otherwise would have gone to their company. As holders of three-quarters of shares, they used their votes to pass a resolution at a shareholders' general meeting asserting that the company had no interest in the business diverted to them. It was claimed by a minority shareholder of the railway company that the business belonged in equity to the company itself and not to the directors and because of that, the resolution passed by the directors in their capacity as shareholders in general meeting to ratify their actions should be regarded as invalid. The Privy Council held that the resolution passed by the majority of shareholders to ratify directors' actions was indeed invalid. This is due to the fact that the wrongdoing directors used their voting powers in their capacity as shareholders to

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<sup>258</sup> KD Tuffnell, 'Restrictions on shareholders' voting rights' (1993) 14 *Company Lawyer* 90, 92.

<sup>259</sup> *Cook v Deeks* [1916] 1 AC 554.

expropriate the property of the company and because of that their conduct was regarded as ‘fraud on the minority’.

Using the insider dealing ‘property rights’ argument examined above, it could be argued that the directors in *Cooks* have used the property of the company without its permission and because of that, their conduct should be regarded as wrong and unjust. In addition, as fiduciaries, the directors of the company were under an equitable obligation to act for the benefit of their company and not for their own personal benefits. As they tried to obtain personal profits that belonged to the company, it is therefore not surprising why their conduct was regarded as ‘fraud on the minority’.

Another important case on the expropriation of the company’s property is *Menier v Hooper’s Telegraph Works*<sup>260</sup> in which the majority shareholder had contracted to supply a submarine telegraph cable for the company but later discovered that it was more beneficial to supply the cable to a third party and by doing so, he caused the company to abandon the contract. As a result, the minority shareholder of the company brought a derivative action on behalf of the company claiming that the majority shareholder used his voting powers to acquire personal profits that belonged to the company. In this case, the court held that the minority shareholder had standing to bring a derivative action on behalf of the company against the wrongdoer. In justifying the decision of the court, James LJ stated,

‘The minority of the shareholders say in effect that the majority has divided the assets of the company, more or less, between themselves, to the exclusion of the minority. I think it would be a shocking thing if that could be done, because if so the majority might divide the whole assets of the company, and pass a resolution that everything must be given to them, and that the minority should have done nothing to do with it. Assuming the case to be alleged..., then the majority have put something into their pockets at the expense of the minority. If so, it appears to me that the minority have a right to have their share of the benefits ascertained for them in the best way in which the Court can do it, and given to them’.<sup>261</sup>

Using Rawls’ theory of justice in this context, it could be argued that justice was achieved by the decision of this case because inequalities in the distribution of goods are not permitted as long as those who are in a more advantaged position take into account those who are in a least advantaged position. In the above case, it seems that the majority shareholder acted for his own personal benefit without taking into account the benefit of the company as a whole and its minority shareholder. Therefore, the inequality between those who are in a more advantaged position (the majority shareholder) with those who are in a least advantaged position (the minority shareholder) cannot be justified.

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<sup>260</sup> *Menier v Hooper’s Telegraph Works* (1873-1874) LR 6 Ch App 350.

<sup>261</sup> *ibid* 353.

Apart from the expropriation of the company's property, expropriating minority shareholder's property can also be regarded as 'fraud on the minority'. It has been established that majority shareholders are not permitted to use their voting powers to compulsorily acquire the shares of the minority shareholders. In the case of *Brown v British Abrasive Wheel Co Ltd*,<sup>262</sup> there was a need for the company to further raise its capital. The majority of shareholders, holding 98 per cent of the shares, offered to raise the company's capital only under the condition to purchase the 2 per cent of the minority's shares. Due to the fact that the minority shareholders were not willing to sell their shares, the 98 per cent of the majority shareholders decided to alter the articles of association to include a provision that would give them the power to compulsorily purchase the 2 per cent of the minority's shares. Using their voting powers to expropriate the minority of shares was regarded by the courts as 'fraud on the minority' and therefore the alteration of the articles of association was held to be invalid.

However, although the cases mentioned above provided some examples when 'fraud on the minority' would arise, they have failed to provide clear guidance as to what fraud in this context means. It has been acknowledged by Megarry VC in *Estmanco (Kilner House) Ltd v Greater London Council*<sup>263</sup> that fraud in this context has a wider meaning than fraud at common law. According to Megarry VC,

'...the essence of the matter seems to be an abuse or misuse of power. 'Fraud' in the phrase 'fraud on the 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'.<sup>264</sup>

It seems from the above that still no clear explanations have been provided on the meaning of fraud in this context. For the purpose of this research, the complexities of the meaning of 'fraud on the minority' will be further analysed and examined in chapter four when an investigation of the complexities and uncertainties of the common law derivative action will be provided. What is now relevant to examine in the following section is the equitable principle of a 'fraud on a power' that Megarry VC mentioned above, which has a vital role to play in controlling the exercise of such powers.

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<sup>262</sup> *Brown* (n 232).

<sup>263</sup> *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2.

<sup>264</sup> *ibid* 12.

#### 2.6.2.4.1. *The equitable concept of a 'fraud on a power'*

Lord Parker provided a classic definition of fraud on a power in *Vatcher v Paull*<sup>265</sup> where he stated that:

‘The term fraud in connection with frauds on a power does not necessarily denote any conduct on the part of the appointor amounting to fraud in the common law meaning of the term or any conduct which could properly be termed dishonest or immoral. It merely means that the power has been exercised for a purpose, or with an intention, beyond the scope of or not justified by the instrument creating the power’.<sup>266</sup>

Fraud on a power functions as a significant boundary on the exercise of power and not as ‘an investigation of the presence of dishonesty or bad faith’.<sup>267</sup> In company law, occurrences of the operation of fraud on a power principle can be found in the proper purposes rule, which applies to the directors of a company.<sup>268</sup> Nonetheless, apart from its role in the proper purposes doctrine, fraud on a power can also be found in the situation where shareholders are prevented from using their powers they hold as members of a company to vote at a general meeting. Based on the limitations conferred on the power of the majority to modify the company’s articles of association, it has been established that shareholders should use their votes ‘bona fide for the benefit of the company as a whole’ and that they must not exercise their powers for an improper purposes. As Gower stated

‘[Although] members, unlike directors, are not required to act bona fide in the interests of others, they, like directors, must exercise their powers for a proper corporate purpose. The purpose is proper if it is to benefit the company or the generality of the members or class concerned. It is improper if it is primarily to injure other members, or perhaps, to benefit extraneous interests, whether of the persons voting for the resolution or of third parties’.<sup>269</sup>

This shows that the doctrine of fraud on a power has a well-recognised application in limiting shareholders powers when voting at a general meeting.<sup>270</sup> The doctrine of fraud on a power accepts two issues regarding the power held by the donee. First, the power itself ‘cannot be an original one vesting in the holder as of right’.<sup>271</sup> It is also assumed for fraud on a power that the basis on a power itself is given from another individual. As a result of the first matter, the second one comes in place. The power held by an individual, is not free from restrictions, in

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<sup>265</sup> *Vatcher v Paull* [1915] AC 372.

<sup>266</sup> *ibid* 378.

<sup>267</sup> Rachel PS Leow, *Minority protection doctrines: from company law and equity to strata title* (2011) 2 *Conveyancer and Property Lawyer* 96, 102; See also, Paul Matthews, ‘The doctrine of fraud on a power: Part 1’ (2007) 2 *Private Client Business* 131.

<sup>268</sup> Companies Act 2006 s 171 ‘A director of a company must – (b) only exercise powers for the purposes for which they are conferred.’

<sup>269</sup> L Gower, *Principles of Modern Company Law* (4<sup>th</sup> edn 1979).

<sup>270</sup> Leow (n 267) 102.

<sup>271</sup> Grantham (n 77) 575.

terms of what might be achieved by the exercise, even if the holder is not a fiduciary. Even though the position of a company's member as a donee of authorised power might be regarded as an insignificant artifice imposed by the company's official position as the main actor, the downside of using fraud on a power to make effect of limitations is that the company's members' authority to assign directors and to modify the articles of association, is not regarded as a power which they have from their rights as owners but only because the company's constitution recognises them as the donee.<sup>272</sup> Thus, as controlling shareholders are given the authority to manage the company's and the minority's property, significant limitation on those powers are important to be forced.<sup>273</sup>

### *2.6.3. Should fiduciary duties be imposed on controlling shareholders?*

The following sections aim to examine the extent to which fiduciary duties should be recognised on the part of controlling shareholders in the UK. In doing so, an examination of the rationale for and against the recognition of a fiduciary duty will be provided. By focusing on the justifications for and against the recognition of that duty, the section aims to shed some light on whether there are gaps that the derivative action can fill in to provide more effective protection to minority shareholders. So the question that needs to be asked here is: Should the controlling shareholders' duties imposed on them to act bona fide for the benefit of the company as a whole be akin to the fiduciary duty owed by the directors of a company?

In answering this question, the section will start by identifying who can be regarded as the controlling shareholder. In doing so, it will then examine who can be regarded as a fiduciary. This will help the section to identify whether controlling shareholders should be regarded as having a fiduciary relationship to the company and its members. It will then go on to examine the justifications for and against the recognition of fiduciary duties on controlling shareholders. The section argues that there are no strong justifications to impose fiduciary duties on controlling shareholders. Therefore, in the absence of a fiduciary duty of controlling shareholders, other effective mechanisms should be provided to fill in the gaps and to protect minority shareholders. In that case, derivative actions might have a significant role to play in filling those gaps.

#### *2.6.3.1. Who are the controlling shareholders?*

Prior to focusing on who can be regarded as a fiduciary, it is firstly essential in this section to give a brief definition as to who can be regarded as a 'controlling shareholder'. A member of

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<sup>272</sup> *ibid.*

<sup>273</sup> Cohen (n 206) 380.

a company can be regarded as a ‘controlling shareholder’ (or the equivalent term used in the UK – a ‘majority shareholder’) if he is the owner of more than 50 per cent of the shares in a company. By holding more than 50 per cent of the shares in a company, this gives the controlling shareholder the voting power to significantly influence and control the decision-making activities of the company when voting at a shareholders’ general meeting.<sup>274</sup> This could be done either by an ‘ordinary resolution’,<sup>275</sup> which requires a majority of shares of not less than 50 per cent, or by a ‘special resolution’,<sup>276</sup> which requires a majority of shares of not less than 75 per cent. Without giving an exhaustive list, an ordinary resolution is required on issues such as the appointment<sup>277</sup> and removal<sup>278</sup> of directors, whereas a special resolution is required on issues such as the alteration of articles of association<sup>279</sup> and reduction of share capital<sup>280</sup>. Depending on the size of the investment, a majority shareholder might be able to control the decisions of both ordinary and special resolutions. The more shares a person holds in a company, the more power he has to control and influence corporate decisions. Therefore, those who own a smaller percentage of shares in a company (the minority shareholders) are in a least advantaged position as they do not possess a significant power to impose their will at a general meeting, unless a controlling shareholder, who owns a high percentage of shares (but less than 50 per cent), and a minority shareholder can join together and formulate ‘a coalition of shareholders’.<sup>281</sup> In such a situation, although a shareholder might own less than 50 per cent of the shares he can still be regarded as de facto controlling shareholder.

Due to the controlling shareholders’ power to control and influence the corporate decisions, this gives them the power to also ‘flex their muscles to exclusively benefit themselves, without regard for the interests and rights of others, namely the minority shareholders’.<sup>282</sup> It could therefore be argued that, if the voting powers of controlling shareholders are left without limitations, this might harm the least advantaged members of the corporation (the minority shareholders) as well as the corporation itself.<sup>283</sup> As mentioned above, those who own a smaller percentage of shares in a company are unlikely to impose their will at a general meeting and because of that, they are unable to block controlling shareholders’ decisions and

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<sup>274</sup> Mahmoud Almadani, ‘The Reform of Minority Shareholder Protection in Saudi Arabia and Dubai in Private Companies (PhD thesis, University of Leeds 2011) 16.

<sup>275</sup> Companies Act 2006, s 282.

<sup>276</sup> Companies Act 2006, s 283.

<sup>277</sup> Model articles for private companies, art 17(1)(a); Model articles for public companies, art 20(a).

<sup>278</sup> Companies Act 2006, s 168.

<sup>279</sup> Companies Act 2006, s 21(1).

<sup>280</sup> Companies Act 2006, s 641(1).

<sup>281</sup> Andrew Keay, ‘Company directors have poorly: disciplinary option for shareholders’ (2007) JBL 656, 664.

<sup>282</sup> Almadani (n 274) 15.

<sup>283</sup> *ibid* 29.

actions that they do not agree with.<sup>284</sup> In such circumstances, it is essential for the law to provide effective devices that constrain the voting powers of the controlling shareholders in order to protect the interests of the company and its minority shareholders.<sup>285</sup> To overcome this problem, some academics have argued that it is necessary to also impose fiduciary duties on controlling shareholders.<sup>286</sup> It is therefore essential to further analyse those arguments (as well as their opponents') in the following sections. However, before embarking on an enquiry to examine the justifications both for and against imposing fiduciary duties on controlling shareholders, it is firstly relevant to briefly discuss as to who can be regarded as a fiduciary.

#### 2.6.3.2. *Who is a 'fiduciary'?*

Who is a fiduciary? Unfortunately, the answer to this question is still unclear.<sup>287</sup> This is because, no definition as to who a 'fiduciary' is has been provided that would be universally accepted and neither 'the criteria which distinguish fiduciary obligation from other obligations be said to be settled'.<sup>288</sup> As Frankfurter J said:

'To say that a man is a fiduciary only begins the analysis: it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?'<sup>289</sup>

The word 'fiduciary' derives from the Latin words 'fiducia', similar to a modern trust and 'fiduciarus' similar to a trustee. Thus, from the words origins, it can be said that a fiduciary relationship has to be based on trust and therefore, a fiduciary individual is someone who is expected to be trusted and be relied on.<sup>290</sup> As Stafford and Richie argued, 'this permits some degree of orientation, but it is not helpful in ascertaining those obligations which can be said to be peculiarly "trustee-like"'.<sup>291</sup>

There have been numerous attempts in trying to described and better defined the so-called fiduciary principle concept. One of those numerous attempts that more accurately described this concept comes from Finn. In his classic work *Fiduciary Obligations*, Finn argues that 'a fiduciary is not subject to fiduciary obligations because he is a fiduciary; it is because he is

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<sup>284</sup> Almadani (n 274) 16.

<sup>285</sup> *ibid* 29.

<sup>286</sup> Cohen (n 206); Tunc (n 210).

<sup>287</sup> Described by Sir Anthony Mason, the fiduciary relationship is a 'concept in search of a principle': Anthony Mason, 'Themes and Prospects' in Paul D Finn (ed), *Essays in Equity* (Law Book Company 1985) 246.

<sup>288</sup> Andrew Stafford and Stuart Richie, *Fiduciary Duties: Directors and Employees* (Jordans Publishing Limited 2013) 15.

<sup>289</sup> *Securities and Exchange Commission v Chenery Corporation* 318 US 80, 85-86 (1943).

<sup>290</sup> Peter Birks, 'The content of fiduciary obligation' (2002) 16 *Trust Law International* 34, 36; See also Peter Birks, 'Equity in the Modern Law: An Exercise in Taxonomy' (1996) 26 *Western Australian Law Review* 1, 17.

<sup>291</sup> Stafford and Richie (n 288) 15.

subject to fiduciary obligations that he is fiduciary'.<sup>292</sup> In other words, what makes a fiduciary is where an individual undertakes to act for or on behalf of another in a specific situation.<sup>293</sup> In *Bristol & West Building Society v Mothew*,<sup>294</sup> in a well-known passage that has been widely recognised and accepted by both the judiciary and academic writers, Millett LJ held that

'A fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty'.<sup>295</sup>

Millett LJ seems to believe, that being loyal can be regarded as the fundamental responsibility within a relationship that will increase the trust and confidence between the parties. Hence, it can be said that by understanding the idea of loyalty one can easily comprehend the fiduciary obligations. Millett LJ in his seminar article entitled as *Equity's place in the Law of Commerce*,<sup>296</sup> pointed out three different categories of fiduciary relationship, each one of those three having distinct characteristics and entailing distinct fiduciary responsibilities. These are: (1) trust and confidence, (2) undue influence, and (3) confidentiality. Based on Millett LJ, the most significant of these is the first one, namely the fiduciary relationship of trust and confidence. This is due to the fact that, a relationship of this type of category comes to the surface when an individual undertakes to act in the benefits of another, or even when he puts himself in a position where he is expected to act in the benefits of another.<sup>297</sup>

Hence, as Millett LJ argues in *Bristol & West Building Society* case:

'A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal. This is not intended to be an exhaustive list, but it is sufficient to indicate the nature of fiduciary obligations'.<sup>298</sup>

It can however be argued that duties of loyalty can also be found in non-fiduciary related relationships, like in the case of a relationship between the member's of a company. For example, in *Allen v Gold Reefs of West Africa Ltd*<sup>299</sup>, it was established that members when voting at a general meeting they should use their powers 'bona fide in what they consider to

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<sup>292</sup> Paul D Finn, *Fiduciary Obligations* (Law Book Company 1977) 2.

<sup>293</sup> *ibid* 201.

<sup>294</sup> *Bristol & West Building Society v Mothew* [1998] Ch 1.

<sup>295</sup> *ibid* 18.

<sup>296</sup> Peter J Millett, 'Equity's place in the law of commerce' (1998) 114 LQR 214, 219-220.

<sup>297</sup> *ibid*.

<sup>298</sup> *Bristol & West Building Society* (n 294) 18.

<sup>299</sup> *Allen* (n 219).

be the best interest of the company'.<sup>300</sup> Therefore, under the obligation of loyalty, shareholders are required to exercise the power of voting bona fide to promote the company's best interests. Due to this obligation, shareholders are not allowed to improperly use their positions in any other way, apart from the company's best interests.

However, it should also be noted that a relationship between shareholders is regarded as 'contractual' and hence individual shareholders are not obliged to act for or on behalf of the company and other members of the company. Therefore, when exercising their right to vote at a general meeting, members of the company do not hold a fiduciary position and thus, they are not under any fiduciary obligations.<sup>301</sup> This is because 'they vote in respect of their shares, which are property, and the right to vote is attached to the share itself as an incident of property to be enjoyed and exercised for the owner's personal advantage'.<sup>302</sup>

Of course, if Finn's view that, 'for a person to be a fiduciary he must first and foremost have bound himself in some way to protect and/or to advance the interests of another',<sup>303</sup> is applied, it can be argued that, in some rare occasions examined and analysed in previous sections, members of a company hold fiduciary positions and at the same time, they possess fiduciary obligations to the company and its members. Expanding the concept of an individual acting for another, Finn came up with a better description of when a fiduciary obligation arises:

'A person will be a fiduciary in his relationship with another when and insofar as that other is entitled to expect that he will act in that other's or in their joint interest to the exclusion of his own several interest'.<sup>304</sup>

This concept embraces the idea of acting for and on behalf of another, but on the same time, it is developed by expressing that the court is the one to define if the actor is to be expected to set aside his own benefits and act exclusively for the other's party benefit. Therefore, a fiduciary relationship arises when it is sensibly assumed that the person who is said to be a fiduciary will act by discharging his own self-interests.<sup>305</sup> That assumption is abnormal in contracts, as the parties that are involved in the contract are usually expected to act, aiming

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<sup>300</sup> *ibid* 671.

<sup>301</sup> Finn (n 292) 10.

<sup>302</sup> *Peter's American Delicacy Co Ltd* (n 128) 504.

<sup>303</sup> Finn (n 292) 9.

<sup>304</sup> Paul D Finn, 'The Fiduciary Principle' in Timothy G Youdan (ed), *Equity, Fiduciaries and Trust* (Carswell 1989) 1, 54; Paul D Finn, 'Fiduciary Law and the Modern Commercial World' in Ewan McKendrick (ed), *Commercial Aspects of Trust and Fiduciary Obligations* (Clarendon Press 1992) 9.

<sup>305</sup> Matthew Conaglen, *Fiduciary Loyalty: Protecting the Due Performance of Non-Fiduciary Duties* (Hart Publishing 2010) 250.

for their own benefits.<sup>306</sup> This similarly applies to the relationship between the company and its members. This then raised the following question: where is it reasonable to expect that a person will put aside his own interest and act solely in the interest of the other party?

If someone applies Finn's position, it could be argued that shareholders by entering into a contract with other members have not expressly agreed to act in the interests of other members. Shareholders are entering the contract with the expectation that they are going to use their voting powers freely as they think fit for their own advantage. In contrast with shareholders, a director of a company is expected to act in the best interest of the company as a whole. This is due to the fact that members are entering into the contract with the legitimate expectation that directors will not use their property to advantage their own positions and that they will act, under the duty of loyalty, for the best interest of the company.<sup>307</sup>

However, if one looks at the unfair prejudice remedy under section 994 of the Companies Act 2006, majority shareholders are not permitted to exercise their voting powers to defeat the 'legitimate expectations' of the other shareholders.

For example, if shareholders have joined the company thinking that along with all the other members of the company they have all put in money and will all manage the company, a 'legitimate expectation' will be expected to be held for this agreement. Even if the members that hold the minority of shares within a company were under the reasonable and legitimate impression that an expectation would be a 'legitimate expectation', this is not bound to happen.<sup>308</sup> As Dalley argues,

'Commentators generally assume that the minority holder would have demanded that the controlling shareholder agree to be subject to fiduciary duties. But would the majority holders have agreed to give up their right to prefer the interests of the business over those of the minority holder?'<sup>309</sup>

Finn's opinion regarding this issue is of highly importance as he stated that:

'The fiduciary principle... is, itself, an instrument of public policy. It has been used, and is demonstrably used, to maintain the integrity, credibility and utility of relationships perceived to be of importance in a society. And it is used to protect interests, both personal and economic, which a society is perceived to deem valuable'.<sup>310</sup>

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<sup>306</sup> *ibid.*

<sup>307</sup> Companies Act 2006, s 172.

<sup>308</sup> *O'Neil v Philips* [1999] 1 BCLC 14.

<sup>309</sup> Paula J Dalley, 'The Misguided Doctrine of Stockholder Fiduciary Duties' (2004) 33 Hofstra Law Review 175, 203.

<sup>310</sup> Finn (n 304) 26.

In other words, fiduciary obligations are appropriate in specific cases because the institutions (in this context the companies) themselves are significantly related to the society and are worthy of more protection than offered by other legal mechanisms.<sup>311</sup> It is therefore obvious that the interests between the shareholders and the company's itself need to be harmonized in a way similar to the one which John Rawls' has described and tried to establish for the political society in '*A Theory of Justice*'.<sup>312</sup>

Although fiduciary duties on controlling shareholders are not recognised in the UK, there are some academics who have argued that it is of immense importance to impose such duties on controlling shareholders. It is therefore essential to examine in the following section the justifications provided by some academics as to why fiduciary duties should be imposed on controlling shareholders as well as their opponents' arguments against imposing such duties on controlling shareholders. The purpose of this chapter is not to provide a clear answer as to whether fiduciary duties should be imposed on controlling shareholders but to see how the gaps left by not imposing such duties on controlling shareholder could be filled in with the use of derivative actions.

#### *2.6.3.3. Justifications for and against imposing fiduciary duties on controlling shareholders*

It was argued by Tunc, that English law should make an extra step towards imposing fiduciary obligations on controlling shareholders. He defended his idea by suggesting that, as described by Lindley MR in *Allen v Gold Reefs of West Africa Ltd*<sup>313</sup>, members of a company must exercise their votes bona fide for the best interest of the company, and by doing so it brings the voting right closer to a function or finally to imply a duty of the member towards the other members of the company.<sup>314</sup> As Tunc argues, 'while an ordinary shareholder may vote as he thinks fit in his own interest, a controlling one should consider himself as a member of an association, with a power which commands duties towards his fellow members'.<sup>315</sup> He further went on to argue that legislation goes in the same direction:

'When, under section 210 [now section 994], a remedy was provided against the 'oppression' of a minority shareholder, was not this remedy the recognition of the principle that a controlling shareholder should not always be allowed to exercise fully his legal rights?'<sup>316</sup>

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<sup>311</sup> Conaglen (n 305) 263.

<sup>312</sup> Tunc (n 210) 5.

<sup>313</sup> *Allen* (n 219) 671.

<sup>314</sup> Tunc (n 210) 6.

<sup>315</sup> *ibid.*

<sup>316</sup> *ibid* 8.

He therefore justifies his position by arguing that the unfair prejudice remedy must be considered as another way of expressing the fiduciary duties of controlling shareholders to its fellow members.

Similarly, Cohen<sup>317</sup> supports the argument that a general fiduciary duty should be applied to controlling shareholders by arguing that the law should impose a fiduciary duty on anyone who has the power to control the property of another person. This is due to the fact that as long as the power of control exists, it carries the risk of abuse or exploitation; it may be used in favour of the person in whom it is vested to the detriment of the other parties. Therefore, as Cohen argues, by imposing fiduciary duties the law prevents fiduciaries from misusing their powers to the detriment of others. He justified his position by stating that controlling shareholders have the power to control the property of others as they may take decisions concerning the company's property and influence the rights of the other shareholders. This power, he argues, is derived from the democratic principle on which the company's activity is based; the so-called majority rule.<sup>318</sup> The majority can direct the company's actions and may bind the minority by its decisions.<sup>319</sup> According to Cohen:

'Generally, the law imposes a fiduciary duty on anyone controlling another's property. As controlling shareholders effectively control the company's and the minority's property, such a general duty should apply to controlling shareholders'.<sup>320</sup>

There are also some authorities that seem to support that English law should impose fiduciary duties on controlling shareholders. For example, in *Daniels v Daniels*<sup>321</sup>, Templeman J seemed to have equated directors and majority shareholders as regards the 'duty' (or the breach of duty) 'which they owe to the company'. He stated that:

'The authorities which deal with simple fraud on the one hand and gross negligence on the other do not cover the situation which arises where, without fraud, the directors and majority shareholders are guilty of breach of duty which they owe to the company, and that breach of duty not only harms the company but benefits the directors. In that case it seems to me that different considerations apply. If minority shareholders can sue if there is fraud, I see no reason why they cannot sue where the action of the majority and the directors, though without fraud, confers some benefits on those directors and majority shareholders themselves'.<sup>322</sup>

In addition, according to Zhao and Lv, it is difficult to set a detailed and clear statutory contract between the company and its members and therefore the incomplete statutory

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<sup>317</sup> Cohen (n 206).

<sup>318</sup> Cohen is referring to the democratic principle of majority rule.

<sup>319</sup> Cohen (n 206).

<sup>320</sup> *ibid* 380.

<sup>321</sup> *Daniels v Daniels* [1978] Ch 406.

<sup>322</sup> *ibid* 413-414.

contract itself is a contract with loopholes. For that reason, the role of the law should be to remove those loopholes by imposing fiduciary duties to the controlling shareholders. As Zhao and Lv argue, ‘imposing fiduciary duties to controlling shareholders can achieve the ultimate goal of justice that the law always pursue’.<sup>323</sup>

In that case, Rawls<sup>324</sup> would probably argue that in order to achieve justice, majority shareholders should be subjected to fiduciary duties. This is due to the fact that Rawls’ difference principle states that social and economic inequalities will be allowed only if it could satisfy the greatest benefit of the least advantaged. The least advantaged in that case is the minority shareholder. It could therefore be argued that, to satisfy Rawls’ principles of justice, majority shareholders should be subjected to fiduciary duties with the purpose to protect the interests of minority shareholders.

However, in contrast to Rawls, Nozick<sup>325</sup> would argue that controlling shareholders should not be imposed with fiduciary duties as shareholders’ votes are property rights which they can use as they think fit as long as they do not harm others. Shareholders enter into a statutory contract with the belief that they will benefit their own positions and not others. Therefore, as long as they do not harm others’ property, shareholders have the right to use their property as they think fit. Indeed, as Pennington stated:

‘In the absence of contractual restraints, a member may vote as he wishes at a general meeting, and may consult his private interests exclusively, even though they conflict with those of the company. This is so even though the member or a group of members who act in concert can exercise or control a majority of the votes which may be cast. Unlike American law, English law has not developed the principle that a controlling shareholder owes a fiduciary duty to the company or to his fellow shareholders, and that his freedom to consult only his own interests is correspondingly limited’.<sup>326</sup>

What Pennington argues is that, as long as there is no express term in the contract which provides such an obligation on controlling shareholders, shareholders are free to use their votes as they wish for their own private interests. Similarly, Davies and Worthington argue that the statements that members must exercise their votes ‘bona fide for the benefit of the company as a whole’, although it might suggest that shareholders are subject at common law to be precisely the same basic principles as directors<sup>327</sup>, should not be regarded as imposing

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<sup>323</sup> Jinlong Zhao & Si Lv, ‘On Fiduciary Duties of Controlling Shareholders of Targeted Corporation’ (2011) 4 *Journal of Politics and Law* 85, 86.

<sup>324</sup> Rawls, *A Theory of Justice* (n 9).

<sup>325</sup> Nozick (n 10).

<sup>326</sup> Robert Pennington, *Company Law* (6<sup>th</sup> edn, 1990) 643.

<sup>327</sup> Companies Act 2006, s 172.

fiduciary duties on controlling shareholders as this would be highly misleading.<sup>328</sup> However, they went further to observe that:

‘...to deny the fiduciary character of shareholders’ voting rights and to assert their proprietary nature is not to say that the exercise of shareholders’ voting powers is, or should be, unconstrained by law. The controlling shareholders may not be required to exercise their powers in the best interests of the non-controlling shareholders, but this does not mean they may trample over the interests of the latter with impunity’.<sup>329</sup>

In other words, controlling shareholders’ voting powers should be constrained by the law if the controlling shareholders use their powers to abuse the interests of the minority shareholders. If that is the case, then the law should develop a set of criteria for the effective review of majority shareholders’ decisions.<sup>330</sup>

## **2.7. Conclusion: Justice in the commercial context**

In conclusion, the primary preoccupation of this chapter was to develop a theoretical framework for ‘commercial justice’ as this will help the thesis in the following chapters to examine and analyse whether the new statutory derivative action under the Companies Act 2006 is an effective remedy to provide ‘commercial justice’ to minority shareholders. In order to develop such a theoretical framework, it was firstly essential to start with an examination of the concept of justice in the general context. Although various political and legal philosophers have provided their own notions of justice, for the purpose of this research, particular focus has been given to Rawls’s and Nozick’s theories of justice. Both theories of justice were of immense importance in developing a theoretical framework for ‘commercial justice’. This is due to the fact they have looked at the notion of justice from two different perspectives: distributive (or social) justice and corrective (or individual) justice.

Looking at Rawls’ theory of justice, in which his main focus was to establish the principles of justice that rational people would agree to govern their own society, it could be argued that in a ‘collective’ association such as a corporation where various interests need to be balanced,<sup>331</sup> it is essential for the law to establish rules that are fair and just to all the parties involved in the corporation. Under his first principle of justice (the so-called ‘Liberty’ principle), Rawls seeks to ensure that all people within a society enjoy a set of basic liberties (such as the right to hold personal property and the right to fair treatment under the law) that cannot be infringed for the purpose to improve the welfare of the majority. He places his first principle

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<sup>328</sup> Davies and Worthington (n 102) 691.

<sup>329</sup> *ibid* 692.

<sup>330</sup> *ibid* 692.

<sup>331</sup> Arad Reisberg, ‘Shareholders’ remedies: the choice of objectives and the social meaning of derivative actions’ (2005) 6 *European Business Organisation Law Review* 227, 231.

above his second principle (the so-called 'Difference' principle), as he believes that people in the 'original position' would choose an institutional structure that will guarantee that equality in these basic liberties will not be infringed by any gain of the majorities in respect of income, wealth or power. Due to the fact that inequalities in the distribution of income, wealth and power exist between people within a society, Rawls acknowledges that such inequalities are only permissible where they improve the lot of the least advantaged members of society. This is what he calls the 'Difference' principle. In other words, individuals who have natural talents, and are therefore better than others, may increase their wealth only if they also increase the wealth of the least advantaged members of the society.

In the context of company law, the most advantaged persons in a company are the majority shareholders whereas the least advantaged persons are the minority shareholders. This is due to the fact that majority shareholders, who have in their possession higher number of shares in contrast to the minority shareholders, are able to control and influence the corporate decisions and hence they are in more advantaged position to impose their will when voting at a general meeting than the minority shareholders. If Rawls was asked to take a position regarding this matter, he would probably argue that, due to the fact that majority shareholders are in a more advantaged position than the minority shareholders, under Rawls's difference principle, majority shareholders would only be able to improve their wealth if they also increase the wealth of the minority shareholders. As was seen from the insider dealing illustration above, inequalities between individuals in the marketplace are inevitable as some individuals often have better knowledge and skills than others. The same applies to the inequalities that exist between majority and minority shareholders. Majority shareholders, due to the large size of their investment in the company, are in a more advantaged position to control and influence the affairs of the company than the minority shareholders.

However, in circumstances where majority shareholders are using their voting powers to benefit themselves at the expense of the minority shareholders, it could be argued that there is an obligation, on the basis of 'commercial justice', for the law to provide effective mechanisms to protect the minority shareholders. In order to achieve 'commercial justice', the law should allow minority shareholders to bring actions against the wrongdoers by using such mechanisms in order to protect themselves and their company. If the majority shareholders, when voting at a general meeting, choose to ignore the interests of the minority shareholders in the company to benefit their own self-interests, then 'commercial justice' should require the majority shareholders to take into account the interests of the minority shareholders as, under Rawls' difference principle, majority shareholders would only be able to improve their

wealth if they also increase the wealth of the minority shareholders. The law should therefore provide effective devices to minority shareholders that can bring 'commercial justice' for them. 'Commercial justice' exists only when the law provides effective devices that balance those conflicting interests within the company. One of the reasons why majority shareholders abuse the interests of the minority shareholders is due to the lack of effective limitations to provide 'commercial justice' to minority shareholders. The aim of 'commercial justice' is to guarantee that all members of the company are treated properly and that inequalities are permissible only if those who are in a more advantaged position also benefit those who are in the least advantaged position.

On the other hand, if Nozick was asked to take a position regarding this matter, he would probably argue that, property owners have the right to use their property as they see fit and that no one should be allowed to interfere with their property rights. As it was recognised above, a shareholder's vote is a right of property which can be used by the shareholder in whatever way he thinks fit to advantage his own self-interests, irrespective of what others think. Therefore, Nozick would probably argue that majority shareholders at a general meeting have every right to use their voting powers as they see fit without any obligation to take into account the interests of the minority shareholders. The law should therefore not interfere against the rights of majority shareholders to use their property as they think fit as this could result in injustice. It is only when someone else's property rights are violated where the law should interfere. As was seen from the insider dealing illustration above, if an individual uses someone else's property without his consent then this will be regarded as wrong and unjust. In such circumstances, the law should provide effective devices to prevent such acts from happening as well as to compensate the other party when his property rights are violated. Therefore, the purpose of the law should be to protect minority shareholders and the company from the abuse of the majority shareholders to benefit their own self-interests. The law ought to provide effective limitations that prevent majority shareholders from using their voting powers at the expense of the company and its minority shareholders.

'Commercial justice' therefore exists when they are effective devices that protect the property of the company and also its minority shareholders against the abuse and expropriation of the majority shareholders.

From the above analysis, in order to achieve 'commercial justice', the law should provide effective devices that balance the interests of all the parties involved within the company. It could be argued that the law when providing such devices should consider elements from both 'distributive or social justice' and 'corrective or individual justice' discussed above. On the

one hand, the purpose of the law is to protect all the members of a company by forcing those who are in a more advantaged position to also take into account the interests of those who are in least advantaged position. On the other hand, the law should also consider that property owners have the right to use their property as they see fit but only if no fraud or coercion exists. If someone else's property rights are violated, then the law should provide effective mechanisms to prevent the wrongdoers from expropriating someone else's property as well as to compensate the injured party. This of course begs the question: Does the new statutory derivative action achieve that balance? In other words, does the new statutory derivative action achieve 'commercial justice' to minority shareholders? This is the question that will occupy the reader in the following chapters.

Having established a theoretical framework for 'commercial justice' and before embarking on an enquiry to examine the effectiveness of the new statutory derivative action, it is firstly relevant in the following chapter to consider the distinction between the personal rights of shareholders and the rights of the company as whole.

## **Chapter 3. Shareholders' personal rights: do those rights provide justice to minority shareholders?**

### **3.1. Introduction**

Before embarking on an enquiry to examine the effectiveness of the new statutory derivative action, it is essential in this chapter to examine shareholders' rights in enforcing their personal rights contain under the statutory contract of the company's articles of association. This examination is important as it will help the thesis to identify whether there any gaps and inconsistencies in enforcing the statutory contract which may make it difficult for minority shareholders to protect their rights as well as receive justice because of a violation of their rights, and see whether those gaps could be filled in through the use of derivative actions. For the purpose of the thesis, this chapter is structured in the following way. First, it examines the significance of the corporate constitution in protecting shareholders' personal rights, by looking at the mechanism of articles of association. Secondly, it aims to analyse the contractual effect of the statutory contract as well as the problems in providing a clear distinction between personal rights and corporate rights. This will lead the thesis to examine the problem of the statutory contract in enforcing outsider rights and conclude that, due to the uncertainties and inconsistencies surrounding the statutory contract other mechanisms must be found to protect minority shareholders rights. In searching for a suitable mechanism, the thesis aims to examine an alternative method to protect those rights: the shareholders' agreement. The chapter concludes that, although such an agreement may assist in protecting minority shareholders to some extent, it does not provide a complete protection for them. Although it is not the intention of the thesis to examine the effectiveness of the unfair prejudice remedy, it is essential to provide a brief analysis of the purpose of this remedy in protecting minority shareholders. Finally, concluding remarks and thoughts will be provided.

### **3.2. The significance of the corporate constitution**

As Reisberg stated, 'a company is, of its essence, a collective association in which the interests of different shareholders have to be balanced with and subject to the common interest in accordance with its constitution'.<sup>1</sup> In order to achieve such a balance, a company needs to establish a set of constitutional rules that specify who has the power and control to act and make decisions on the company's behalf.<sup>2</sup> These rules can be found primarily in two

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<sup>1</sup> Arad Reisberg, 'Shareholders' remedies: the choice of objectives and he social meaning of derivative actions' (2005) 6 *European Business Organisation Law Review* 227, 231.

<sup>2</sup> David Kershaw, *Company Law in Context: Text and Materials* (2<sup>nd</sup> edn, OUP 2012) 79.

places: the Companies Act 2006 ('CA 2006') and the articles of association. The CA 2006 contains rules regarding the basic structure of the company, such as rules on how a company operates, how it acts and who can enforce its rights when wrong has been done to the company.<sup>3</sup> One might expect that, for a 701 pages statute, it is entirely logical that it will cover all the rules regarding the regulation and function of the company. However, it might be surprising to say that in fact this is not the case, as many rules regarding the formation and regulation of the company are not specified in the CA 2006.<sup>4</sup> For example, it says nothing about how the power and control of the company is to be distributed between the two most important organs of the company - the board of directors and the shareholders in general meeting, and how decisions regarding the affairs of the company should be taken.<sup>5</sup> Therefore, due to the fact that the CA 2006 remains silent on some issues, these can be found in what the UK company law refers to as the articles of association.<sup>6</sup> A significant feature of the UK company law is that it leaves the company itself to decide how the internal affairs and management of the company are to be regulated through rules laid down mainly in the articles of association.<sup>7</sup> An important role of the articles of association is therefore to fill in the gaps on issues that the CA 2006 had not mentioned.

The importance of having the articles of association can be seen from the fact that members of a company are free to choose their own rules that will govern their company.<sup>8</sup> Through those articles, the members are free to choose rules that set out the powers of the company and to determine how those powers are to be distributed between the different organs of the company, such as the board of directors and the shareholders in general meeting. The articles of association may also contain rules on how the different organs of the company are to act – whether individually or collectively. Given the fact that companies and their body of members work differently, it is entirely logical to give the freedom to those members to choose their own rules that will govern their company.<sup>9</sup> The articles of association can therefore be regarded as a set of rules to which the members of the company 'have implicitly agreed or consented to as the rules that they, or at least a majority of them, believe are the optimal rules' of the company.<sup>10</sup>

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<sup>3</sup> *ibid.*

<sup>4</sup> *ibid.* 80.

<sup>5</sup> Paul L Davies and Sarah Worthington, *Gower & Davies Principles of Modern Company Law* (9<sup>th</sup> edn, Sweet & Maxwell 2012) 65.

<sup>6</sup> Kershaw (n 2) 80.

<sup>7</sup> Davies and Worthington (n 5) 64.

<sup>8</sup> Kershaw (n 2) 81.

<sup>9</sup> *ibid.*

<sup>10</sup> *ibid.* 79.

As Rawls would argue, the articles of association contain the rules that people would choose to govern their collective association, namely the company. For Rawls, the purpose of the articles of association would be to establish the rules of social-cooperation that all members of the company would regard as fair and consistent with their own self-interests, and to which they would willingly give their consent to govern their company. In order to achieve the right balance between those different members in the company, Rawls would probably propose that the rights and duties of each member within the company as well as the distribution of benefits and burdens of their social cooperation are to be assigned with what he defines as ‘the principles of justice’.<sup>11</sup>

As developed in chapter two, according to Rawls, the principles of justice are those ‘that free and rational persons concerned to further their own interests would accept in an initial position of equality as defining the fundamental terms of their association’.<sup>12</sup> To achieve justice in the context of company law, Rawls would probably use the device he termed as the ‘original position’ in which members of the company when choosing their principles of justice are to be placed behind the ‘veil of ignorance’.<sup>13</sup> In the context of company law, Rawls would probably see justice, as the body of principles that the members of a company would choose in the original position to govern their company, since the members making the selection will ensure that the principles they choose are fair to everyone involved within their collective association.<sup>14</sup> This is due to the fact that behind the ‘veil of ignorance’, members of the company will not actually know what positions they will have in the company nor what their particular interests and preferences will be.<sup>15</sup>

Rawls, therefore, would argue that the principles of justice would only arrive when all the members of the company are to be treated as free and equal with no one allowed to have superior bargaining powers than others. In other words, since the rules chosen by the members of the company in the original position are based on justice, they will not allow vulnerable parties to be exploited and abused by those who are more powerful than them. Of course, as it has been acknowledged in chapter two,<sup>16</sup> it is impossible to ensure equality of bargaining positions and powers in the marketplace, as there will always be individuals who have better knowledge and skills than others. The same applies in the context of company

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<sup>11</sup> John Rawls, *A Theory of Justice* (Harvard University Press 1971) 11.

<sup>12</sup> *ibid.*

<sup>13</sup> *ibid.* 12.

<sup>14</sup> JG Riddall, *Jurisprudence* (2<sup>nd</sup> edn, OUP 2005) 209.

<sup>15</sup> Rawls (n 11) 12.

<sup>16</sup> Text to n 143 in ch 2.

law, as those who are investing more money in the company it is entirely logical that they will hold more powerful positions than those who are investing less money.

It seems that Rawls acknowledged this inequality under the umbrella of his ‘difference principle’<sup>17</sup> where he stated that inequality is only permissible where those who are in a more advantaged position also improve the lot of the least advantaged members of the society. Under Rawls’ difference principle, those who hold a more advantaged position in the company (such as the majority shareholders and the board of directors), may allow to increase their wealth only if, in the process of doing so, they also increase the wealth of the least advantaged members, in this context the minority shareholders. This guarantees that, whatever rules are selected by the members of the company they will apply to everyone without favouring or disadvantaging anyone. There may be cases in which minority shareholders may feel that either the board of directors or the majority of shareholders in the general meeting has treated them unfairly. Under Rawls ‘difference principle’, neither the board nor the majority shareholders in the general meeting will be allowed to use their powers at the expense of the minority shareholders.

It could therefore be argued that the notion of treating members equally using Rawls’ original position, envisages the articles of association being a possible mechanism for laying down fair and equal terms for all members of the company. Therefore, as Rawls would argue, one purpose of having the articles of association is to make sure that everyone in this ‘statutory contract’ will be treated fairly and equally and that no one would be allowed to use his powers to the detriment of others.

For the purpose of this thesis, it is essential to examine in the following sections the effectiveness of the ‘statutory contract’ laid down in the articles of association in protecting minority shareholders from the abuse of the majority shareholders and the board of directors. This will help the thesis to identify any possible gaps of the statutory contract and see whether those gaps may be possible to fill in through the use of derivative actions. The thesis argues that due to the great uncertainty surrounding the enforcement of the statutory contract, minority shareholders often find it difficult to protect their personal rights derived from that contract, and this usually has the consequence of denying justice to minority shareholders. It is therefore essential for the law to develop effective mechanisms that could protect the right of minority shareholders and thereby could provide justice to them.

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<sup>17</sup> Rawls (n 11).

### 3.2.1. *The legal status of the constitution: the 'statutory contract'*

Over the years, there has been an increasing debate (both academic and judicial) regarding the contractual effect of the 'statutory contract' laid down in the company's articles of association.<sup>18</sup> The uncertainty surrounding the enforcement of the 'statutory contract' derived from the fact, in a number of cases, the judiciary has provided different interpretations and also the meaning of words provided in previous Companies Acts was unclear.<sup>19</sup> As Lord Greene MR correctly stated, the contractual effect of the statutory contract 'has been the subject of considerable controversy in the past, and it may very well be that there will be considerable controversy about it in the future'.<sup>20</sup> This is due to the fact that it is not entirely clear what types of rights and duties can be enforced and who can enforce them under the statutory contract.

Due to the complexities surrounding the enforcement of the statutory contract, the aim of the following sections will be to examine whether any significant changes to resolve this problem have been made with the introduction of the CA 2006 section 33, as this will help the thesis to identify possible gaps that might justify the use of derivative actions in providing more effective protection to minority shareholders. This requires the thesis to also examine the actual scope and policy behind section 33.

#### 3.2.1.1. *The contractual effect of the statutory contract*

Prior to the introduction of section 33 of the CA 2006, section 14 of the CA 1985 provided that,

'Subject to the provisions of this Act, the memorandum and articles, when registered, bind the company and its members to the same extent as if they respectively had been signed and sealed by each member and contained covenants on the part of each member to observe all the provisions of the memorandum and of the articles'.

It can be seen from the above that, although section 14 provides that the memorandum and articles bind both the company and its members, it omitted to indicate that the company itself, as a distinct legal person, has also the legal authority to sign and seal.<sup>21</sup> Despite the omission of section 14, there is ample judicial authority that recognised the company as a party to the

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<sup>18</sup> See *Eley v Positive Life Association* (1876) 1 Ex D 88 (CA); *Hickman v Kent or Romney Marsh Sheep-Breeders' Association* [1915] 1 Ch 881; KW Wedderburn, 'Shareholders' Rights and the Rule in *Foss v Harbottle*' (1957) 15 CLJ 194; GD Goldberg, 'The enforcement of outsider-rights under section 20(1) of the Companies Act 1948' (1972) 33 MLR 362; Roger Gregory, 'The section 20 contract' (1981) 44 MLR 526; RR Drury, 'The relative nature of a shareholder's right to enforce the company contract' (1986) 45 CLJ 219.

<sup>19</sup> See Companies Act 1929, s 20; Companies Act 1948, s 20; Companies Act 1985, s 14.

<sup>20</sup> *Beattie v E and F Beattie Ltd* [1938] Ch 708, 721.

<sup>21</sup> Ian J Dawson and IS Stephenson, *The Protection of Minority Shareholders* (Tolley 1993) 11; Alan Dignam and John Lowry, *Company Law* (8<sup>th</sup> edn, OUP 2014) 160.

statutory contract. *Hickman v Kent or Romney Marsh Sheep-Breeders' Association*<sup>22</sup> is the leading case on this point. This case involves an arbitration clause laid down in the articles of association that specified that, in case of a dispute between the company and its members, they should go to arbitration, before the court. When a dispute arose, a member of the company started court proceedings against the company, rather than go to arbitration. The question for the court was whether the member was bound under the articles of association to comply with the provision contained in the articles that allowed for arbitration proceedings. It was held that the member was bound to comply with the arbitration provision as the articles constituted a binding contract between the member and the company. As Astbury J argued,

‘A company cannot in the ordinary course be bound otherwise than by statute or contract and it is in this section that its obligation must be found. As far as the members are concerned, the section does not say with whom they are to be deemed to have covenanted, but the section cannot mean that the company is not to be bound when it says it is to be bound, as if, etc., nor can the section mean that the members are to be under no obligation to the company under the articles in which their rights and duties as corporators are to be found’.<sup>23</sup>

He therefore came to the conclusion that ‘articles regulating the rights and obligations of the members generally as such do create rights and obligations between them and the company respectively’.<sup>24</sup> The company’s articles of association were therefore held to have a contractually binding effect between the company and its members. It was therefore recognised in this case that the company should be treated as a party to the statutory contract.

However, despite that *Hickman* clarified this issue, it was not until the introduction of section 33 of the CA 2006 where an opportunity was taken to remedy this omission by adding the company itself as a party to the statutory contract.<sup>25</sup> Section 33 of the Companies Act 2006 now 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 company and of each member to observe those provisions’. Contrary to its predecessors,<sup>26</sup> section 33 seems to now clarify that both the company and its members are bound by the statutory contract lay down in the articles of association and thus the articles constitute a binding contract between the members and the company.

Aside from this issue, there was also considerable debate as to whether the statutory contract binds the members *inter se*.<sup>27</sup> This is due to the fact that, while section 33 clarified that both

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<sup>22</sup> *Hickman* (n 18).

<sup>23</sup> *ibid* 897.

<sup>24</sup> *ibid* 900.

<sup>25</sup> Dignam and Lowry (n 21) 160.

<sup>26</sup> See Companies Act 1929, s 20; Companies Act 1948, s 20; Companies Act 1985, s 14.

<sup>27</sup> Dignam and Lowry (n 21) 161.

the company and its members are bound by the statutory contract, no clarification has been provided as to whether the statutory contract also binds each member with every other member of the company.<sup>28</sup> This is a significant issue for a member who may wish to enforce a specific provision contained in the articles against other members. For example, the company's articles may contain a provision that a member has a pre-emption right to buy new shares in the company and if this provision is not complied with, it may have a significant impact on the shareholding of the member.<sup>29</sup>

The uncertainty surrounding the enforceability of the statutory contract between members of the company has caused much controversy and judicial debate, as it is not clear whether a member of a company is allowed to enforce a right contained in the company's articles of association directly against another member or whether the proper claimant to enforce such an action is the company itself.<sup>30</sup> If under section 33 a member of a company is able to enforce his pre-emption right directly against other members, this makes it easier for the member to enforce his rights contained in the articles of association. On the other hand, if the proper claimant to enforce such rights is the company itself this has the consequence of making it more difficult for the member to get justice, as there is a risk that the majority shareholders will take an advantage of the statutory contract to do nothing about it.<sup>31</sup>

According to Stirling J in *Wood v Odessa Waterworks Co*,<sup>32</sup> 'the articles of association constitute a contract not merely between the shareholders and the company, but between each individual shareholder and every other'.<sup>33</sup> However, although it seems from the above that Stirling J argued that members could enforce rights contained in the articles directly against other members, the courts have long shown their unwillingness to allow a member to enforce contractual rights directly against other members.<sup>34</sup> Contrary to Stirling J's statement, Lord Herschell in *Welton v Saffery*<sup>35</sup> stated that,

'it is quite true that the articles constitute a contract between each member and the company, and that there is no contract between the individual members of the company, but the articles do not any less, in my opinion, regulate their rights inter se. Such rights can only be enforced

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<sup>28</sup> *ibid.*

<sup>29</sup> *ibid.*

<sup>30</sup> *ibid.*

<sup>31</sup> *ibid.*

<sup>32</sup> *Wood v Odessa Waterworks Co* (1889) 42 Ch D 639.

<sup>33</sup> *ibid* 642.

<sup>34</sup> In *Salmon v Quin and Axtens Ltd* [1909] 1 Ch 311, 318, for example, Farwell LJ stated that 'it may well be that the court would not enforce the covenant as between individual shareholders in most cases'.

<sup>35</sup> *Welton v Saffery* [1897] AC 299.

by or against a member *through the company*, or through the liquidator representing the company'.<sup>36</sup>

From the above statement, it seems that what Lord Hershell suggested in *Welton* was that under the statutory contract the proper claimant to enforce such rights is the company itself and that no member is allowed to enforce his statutory contract rights directly against other members.

On the other hand, as opposed to Lord Hershell's dicta, Vaisey J in *Rayfield v Hands*<sup>37</sup> held that the provision contained in the company's articles that a member of a company who wished to transfer his shares should first inform the company's director who would then purchase his shares equally at a fair value, was enforceable between the member and the directors (in their capacity as members) and that it was not needed to have the company as a party to the action. In this case it was therefore held that there was binding contract between the members inter se and that such a contract could be enforced by one member against the other. However, it is worth noting that Vaisey J acknowledged that the principles upon which his conclusion is founded 'are of more general application than might be supposed from some of the authorities on the point',<sup>38</sup> as Vaisey J's ruling was not able to apply to every company since Vaisey J's conclusion was based on the quasi-partnership nature of the company he was dealing with in the *Rayfield* case.<sup>39</sup> As Dawson and Stephenson argued,

'it would have been odd to have required the company which had not duty in the matter nor, presumably, any interest (at any rate in general) as regards the outcome of the litigation, to have been a party to the attempt to enforce the provision. But as regards obligations of a collective character created by the articles and having equal force as regards a company's entire membership, the remark of Lord Hershell as to the enforcement being feasible only through the company (or if in liquidation, through its liquidator) must be noted'.<sup>40</sup>

The idea raised by Lord Hershell that the rights contained in the statutory contract are enforceable only 'through the company' derived from the well-known 'internal management' principle that supports that the proper claimant to enforce such rights is the company itself.<sup>41</sup> This of course depends as to whether the wrong complained of has been caused to the company or to the individual shareholders personally.<sup>42</sup> If the wrongdoers have caused wrong to the company and not to the members personally, then the proper claimant to bring an action

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<sup>36</sup> *ibid* 315 (emphasis added).

<sup>37</sup> *Rayfield v Hands* [1960] Ch 1.

<sup>38</sup> *ibid* 9.

<sup>39</sup> Dawson and Stephenson (n 21) 12.

<sup>40</sup> *ibid* 13.

<sup>41</sup> See *MacDougall v Gardiner* (1875) 1 Ch D 13.

<sup>42</sup> Dignam and Lowry (n 21) 163.

against the wrongdoers is the company itself.<sup>43</sup> This derives from the well-known *Foss v Harbottle*<sup>44</sup> rule which provides that if a wrong is done to the company, then the proper claimant to enforce its right is the company itself and not the individual shareholders. A predominantly clear formulation of the rule in *Foss* was well articulated by Lord Davey in *Burland v Earle*<sup>45</sup> that the basis of the *Foss* rule lies first on the principle that the proper claimant to enforce an action against a wrong done to the company is the company itself, and secondly that the court should not interfere with the internal affairs of the company. The consequence of the *Foss* rule is that an individual shareholder often found it difficult to enforce his rights contained in the company's articles of association. The rationale behind the *Foss* rule is that the minority shareholders should follow the decisions made by the majority of shareholders in a general meeting. It was therefore established that the wishes of the majority become the wish of the company as a whole and therefore no individual shareholder should be permitted to complain about such a decision.<sup>46</sup> Mellish LJ also supported this approach in *MacDougall v Gardiner*<sup>47</sup> where he argued that:

‘if the thing complained of is a thing which in substance the majority of the company are entitled to do, or if something has been done irregularly which the majority of the company are entitled to do regularly, or if something has been done illegally which the majority of the company are entitled to do legally, there can be no use in having a litigation about it, the ultimate end of which is only that a meeting has to be called, and then ultimately the majority gets its wishes’.<sup>48</sup>

The justification of the majority rule was based on the fact that, if the internal irregularity can be resolved by the majority of shareholders in the general meeting then there is no reason to allow minority shareholders to bring an action to challenge the decision of the majority.<sup>49</sup>

On the other hand, if the wrong has been done to the shareholders personally, then the individual shareholder will be able to sue.<sup>50</sup> However, the distinction between corporate rights and personal rights is unclear, as no clear guidelines have been provided as to which rights are regarded as corporate rights and which others are regarded as personal rights.<sup>51</sup> In *MacDougall v Gardiner*,<sup>52</sup> for example, the court refused to allow a minority shareholder to enforce a right to a poll as that was held to be an internal irregularity which could be resolved

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<sup>43</sup> *Foss v Harbottle* (1843) 2 Hare 461.

<sup>44</sup> *ibid.*

<sup>45</sup> *Burland v Earle* [1902] AC 83, 93.

<sup>46</sup> *MacDougall* (n 41) 25.

<sup>47</sup> *ibid.*

<sup>48</sup> *ibid.*

<sup>49</sup> See Alastair Hudson, *Understanding Company Law* (Routledge 2012) 150.

<sup>50</sup> Dignam and Lowry (n 21) 163.

<sup>51</sup> *ibid.* 164.

<sup>52</sup> *MacDougall* (n 41).

by the majority of shareholders, rather than being a member's personal right. On the other hand, in *Pender v Lushington*<sup>53</sup> where a shareholder was refused to use his vote at a general meeting, this was recognised as a wrong done to his personal right in which the individual shareholder had a right to sue. As Davies and Worthington argued, 'there are a number of decisions of the courts over the past 150 years putting such breaches in one category or the other, but it is difficult to discern the principled basis on which the classification was carried out'.<sup>54</sup> Indeed, as Dignam and Lowry stated, 'the two cases of *MacDougall* and *Pender* are entirely at odds with one another and many of the cases that follow after them emphasise one or the other depending on the individual judge's view'.<sup>55</sup>

Although Wedderburn, in his seminal article entitled as *Shareholders' Rights and the Rule in Foss v Harbottle*,<sup>56</sup> had tried to shed some light on the issue by setting out a list of rights which the courts had in previous cases considered as personal rights,<sup>57</sup> unfortunately the distinction between corporate rights and personal rights still remains unclear.<sup>58</sup> It could therefore be concluded that, although a member may sue

'to enforce a provision in the articles which appears to confer a right on the member, he or she may nevertheless be defeated by the argument that the provision does not confer a personal right on the member but creates only an obligation on the company, breach of which constitutes 'a mere internal irregularity' on the company's part'.<sup>59</sup>

### 3.2.1.2. *Qua member? The policy behind section 33 of the Companies Act 2006*

Aside from the uncertainties discussed above, no clear explanations have also been provided as to who can enforce the statutory contract under section 33. As Gower argues, 'the standard answer to the question, at common law, of who can enforce a contract is: the parties to the contract'.<sup>60</sup> Since the statutory contract is between the company and its members, it seems that only members can enforce the contract.<sup>61</sup> However, although it has been established that the articles constitute a binding contract between the company and its members, there is ample judicial authority which established that not all provisions are enforceable under

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<sup>53</sup> *Pender v Lushington* (1877) 6 Ch D 70.

<sup>54</sup> Davies and Worthington (n 5) 74.

<sup>55</sup> Dignam and Lowry (n 21) 164.

<sup>56</sup> Wedderburn (n 18).

<sup>57</sup> According to Wedderburn's list provided in his *Foss* article, an individual shareholder has a personal right 'to transfer shares and to vote; to protect preferential rights and class interests, such as the right to have shares offered to him; to be registered and to enforce delivery of a share certificate in accordance with the articles; to enforce a declared dividend as a legal debt... to prevent an irregular forfeiture; to prevent directors holding office in breach of the articles, and other "procedural" irregularities': Wedderburn (n 18) 211.

<sup>58</sup> Dignam and Lowry (n 21) 164.

<sup>59</sup> Davies and Worthington (n 5) 74.

<sup>60</sup> *ibid* 71.

<sup>61</sup> *ibid*.

section 33 of the CA 2006 and that only those provisions which relate to the members in their capacity as members are enforceable.<sup>62</sup> In other words, those who are not members ('outsiders') in the company cannot enforce the statutory contract, 'even if they are intimately involved with the company, for example, as directors'.<sup>63</sup>

However, in circumstances where one person in the company holds several roles or has several capacities (for example, a director may also be a shareholder), this creates significant difficulties.<sup>64</sup> The question of who can enforce the statutory contract has therefore created much controversy and debate (both judicial and academic).<sup>65</sup> For that reason, it is relevant to examine this issue in further detail. *Eley v Positive Life Assurance Co Ltd*<sup>66</sup> is a classic example on this point. As is well known, in this case the company's articles of association contained a provision that Eley should be acting as a solicitor of the company and that he should not be removed from office unless there are serious reasons for misconduct. It is worth noting that Eley became a member of the company a year after the incorporation of the company. The company's directors decided to remove Eley from office as the company's solicitor and they wished to use other solicitors instead. As a result, Eley commenced an action against the company for damages, alleging that there was a breach of the statutory contract between him and the company. The court refused to allow Eley to enforce the statutory contract against the company for the reasons that Eley was not enforcing the provision in his capacity as a member of a company but as a company's solicitor (an 'outsider'). The fact that Eley had enforced the contract in his capacity as a company's solicitor, and not as a member, played a significant role for Eley not being able to enforce the statutory contract.

The fact that Eley became a member of the company after its incorporation raises the question whether the decision in *Eley* would have been different, especially if Eley's interests as a company's solicitor would have affected his rights and interests as a member of the company. In answering this question, there is a need to consider both the judicial and academic debates on this matter. An important case to consider is *Cumbrian Newspaper Group Ltd v Cumberland and Westmorland Herald Newspaper and Printing Co Ltd*<sup>67</sup> where Scott J acknowledged that, whereas in *Eley* it was easy to identify that the provision did not attach a right to Eley in his capacity as a member, if Eley had been a member of the company from its

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<sup>62</sup> See *Eley* (n 18); *Hickman* (n 18); *Beattie* (n 20).

<sup>63</sup> Davies and Worthington (n 5) 71.

<sup>64</sup> Kershaw (n 2) 87.

<sup>65</sup> See *Eley* (n 18); *Hickman* (n 18); *Wedderburn* (n 18); *Goldberg* (n 18); *Gregory* (n 18); *Drury* (n 18).

<sup>66</sup> *Eley* (n 18).

<sup>67</sup> *Cumbrian Newspaper Group Ltd v Cumberland and Westmorland Herald Newspaper and Printing Co Ltd* [1987] Ch 1.

beginning the conclusion might not have been so easy.<sup>68</sup> It is therefore worth examining the *Cumbrian* case to see whether *Eley*'s decision would have been different, if the court in *Eley* had considered what was said in the *Cumbrian* case. The question in *Cumbrian* case was whether any class rights were attached to the claimant's shares. In this case, the claimant company, Cumbrian Newspapers Ltd, held in its possession 10.67 per cent of the ordinary shares in the defendant company, Cumberland and Westmorland Herald Newspaper and Printing Co Ltd. The defendant company's articles of association were amended with the purpose to provide the claimant company with: (a) pre-emption rights over the ordinary shares; (b) rights attached to unissued shares; and (c) the right to nominate one person to be the company's director, provided it continued to hold 10 per cent of the ordinary shares. The claimant company declared that its rights contained in the defendant company's articles of association should be regarded as class rights, and that such rights can only be varied in accordance with section 630 of the CA 2006.

According to Scott J, the rights or benefits conferred by the defendant company's articles to the claimant company should be divided into three separate categories. The first category recognises rights or benefits that are annexed to specific shares, such as, for example, rights to receive dividends and rights to participate in a surplus in case of an insolvency of the company; these should be termed as class rights. As Scott J observed 'if the articles provide that particular shares carry particular rights not enjoyed by the holders of other shares, it is easy to conclude that the rights are attached to a class of shares, for the purpose of... section 630'.<sup>69</sup> Scott J's second category involves rights or benefits that are conferred on persons otherwise than in their capacity as members of the company, such as in *Eley* case where a provision of the company's articles conferred rights to Eley in his capacity as a company's solicitor. As Scott J argued, this type of category cannot be regarded as class rights. Scott J's third category concerns rights or benefits which, though they do not attach to any particular shares as such, nevertheless attach to the member in his capacity as a qua member of the company.<sup>70</sup>

On the facts of the *Cumbrian* case, the court held that the provisions contained in the company's articles, which conferred the claimant company with a pre-emptive right over the ordinary shares in the defendant company, alongside with its right to appoint a director to join its board so long as it continued to hold at least 10 per cent of the ordinary shares in the company, were class rights. Scott J, in reaching his conclusion, referred to the House of Lords

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<sup>68</sup> *ibid* 16.

<sup>69</sup> *ibid* 15.

<sup>70</sup> *ibid* 15-17.

decision in *Bushell v Faith*,<sup>71</sup> in which a provision contained in the company's articles provided a director of a company with weighted voting rights which protected him from a resolution to remove any director from office. Scott J observed that in *Bushell* the right in question was

‘conferred on the director/beneficiaries in their capacity as shareholders. The article created, in effect, two classes of shareholders – namely, shareholders who were for the time being directors, on the one hand, and shareholders who were not for the time being directors, on the other hand’.<sup>72</sup>

In *Bushell*, the provision contained in the company's articles provided the director with safeguards to protect his rights and interests as a member of the company, which indirectly protected his outsider rights against his removal as a director of the company. In this case, the interests of the director in his capacity as a director affected also his interests in his capacity as a member of the company. As Scott J argued in *Cumbrian* case, rights were conferred to the director in his capacity as a member that were neither particularly annexed to the shares nor granted to other members. Having discussed what was said in *Cumbrian* case, it is now relevant to examine whether *Eley*'s decision would have been different if the court in *Eley* had considered the decision of *Cumbrian* case. As mentioned above, if rights are conferred on persons otherwise in their capacity as members, such rights cannot be regarded as class rights. In this situation, *Eley* would not have been able to enforce the statutory contract to prevent the directors from removing him as the company's solicitor. However, if *Eley* was conferred with rights or benefits which, while they do not attach to any particular shares as such, but nevertheless attach to the member in his capacity as member, he might have been able to enforce the statutory contract but only if he sued in his capacity as a member, and not in his capacity as a company's solicitor. Therefore, if *Eley* was a member from the beginning of the company's incorporation, then the decision in *Eley* would have been different. The fact that his right to be the company's solicitor was attached to the company's articles before *Eley* became a member of the company, played significant role for *Eley* not being able to enforce the statutory contract.<sup>73</sup>

It seems that the decision in *Cumbrian* case, shed some light on the uncertainty surrounded the enforceability of the statutory contract under section 33 of the CA 2006. As noted above,

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<sup>71</sup> *Bushell v Faith* [1970] AC 1099.

<sup>72</sup> *Cumbrian Newspaper Group Ltd* (n 67) 17.

<sup>73</sup> *Eley*'s decision was later supported in the case of *Browne v La Trinidad* (1887) 37 Ch D 1. In this case, a provision contained in the company's articles conferred a member of a company the right to be the company's director. However, the fact that the provision conferred a right to the member in his capacity as qua director and not qua member, the court refused to allow the member to enforce his right to be the company's director.

the court in *Cumbria* held that there are three categories of shareholders and one category is excluded from enforcing the statutory contract, as it was recognised that outsiders cannot enforce the statutory contract.

The view that outsiders cannot enforce the statutory contract was supported in the leading case of *Hickman v Kent or Romney Marsh Sheep-Breeders Association*,<sup>74</sup> where Astbury J stated that,

‘An outsider to whom rights purport to be given by the articles in his capacity as such outsider, whether he is or subsequently becomes a member, cannot sue on those articles, treating them as contracts between himself and the company, to enforce those rights’.<sup>75</sup>

As mentioned above, this case involved a provision contained in the company’s articles which stated that if any disputes arise between the company and any of its members, they should go to arbitration, before the court. When a member commenced proceedings to the court against the company for a dispute arose between him and the company, the question of the court was whether the company’s articles provided a contractually binding contract between the company and the member, which was found that it did. Astbury J, in reaching his conclusion, stated three principles of law that he believed governed the provision:

‘First, that no article can constitute a contract between the company and a third person, secondly, that no right merely purporting to be given by an article to a person, whether a member or not, in a capacity other than that of a member, as, for instance, as solicitor, promoter, director, can be enforced against the company; and thirdly, that articles regulating the rights and obligations of the members generally as such do create rights and obligations between them and the company respectively’.<sup>76</sup>

This seems to support the view that where a member of a company holds several roles in the company, such as a director, he will be prevented from enforcing any rights purporting to be conferred on him by the articles in his capacity as a director. In other words, rights that are conferred on persons otherwise than in their capacity as members, cannot be enforced.

Another significant case that supports *Hickman*’s principle on outsider rights is *Beattie v E and F Beattie*.<sup>77</sup> The question arose in *Beattie* case was whether or not an arbitration clause contained in the company’s articles was enforceable by a member of a company, when a dispute arose between him and the company concerning the member’s activities as a director. The fact that the arbitration clause attached a right on the member in his capacity as a director, the statutory contract was held not to be enforceable. This is due to the fact that, as Greene

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<sup>74</sup> *Hickman* (n 18).

<sup>75</sup> *ibid* 897.

<sup>76</sup> *ibid* 900.

<sup>77</sup> *Beattie* (n 20).

MR stated, ‘the contractual force given to the articles of association by the section is limited to such provisions of the articles apply to the relationship of the members in their capacity as members’.<sup>78</sup>

However, this approach to the enforceability of the statutory contract has received considerable criticism by a number of academic commentators. One of the greatest opponents of this approach was Lord Wedderburn who stated that

‘a member can compel the company not to depart from the contract with him under the articles, even if that means indirectly the enforcement of “outsider”-rights vested in third parties or himself, so long as, but only so long as, he sues qua member and not qua “outsider”’.<sup>79</sup>

It seems from the above statement that Wedderburn supports the idea that a member has a right to compel the company not to depart from the statutory contract, irrespective of what the provision, contained in the company’s articles, relates to. In other words, Wedderburn recognises that if there is a link between a member’s right in his capacity as member with his rights in his capacity as qua outsider, then a member has every right to enforce the statutory contract, irrespective of whether this indirectly protects his outsider rights. To support his view, he referred to the case of *Salmon v Quin & Axtens Ltd*<sup>80</sup> in which the House of Lords allowed Salmon, the company’s managing director, to bring an action on behalf of himself and all other shareholders, to get an injunction preventing the general meeting acting as the company from passing a resolution authorising the purchase and letting of some property without the consent of the two managing directors (who dissented with this decision) as was required under the company’s articles.<sup>81</sup> It was recognised in this case that Salmon, suing as a member, was able to enforce the articles requiring his consent as managing director to continue with the transactions. In other words, it was accepted in *Salmon* that a member has every right to have the articles enforced, although this would indirectly enforce his outsider rights.<sup>82</sup>

Wedderburn’s proposition was strongly supported by Gregory,<sup>83</sup> describing Wedderburn’s view as ‘the better one’.<sup>84</sup> According to Gregory, the judge in *Hickman* failed to take into account that cases such as *Salmon v Quin & Axtens Ltd* recognised that a member of company

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<sup>78</sup> *ibid* 721.

<sup>79</sup> Wedderburn (n 18) 212-213.

<sup>80</sup> *Salmon* (n 34).

<sup>81</sup> Wedderburn (n 18) 207-208.

<sup>82</sup> *Salmon* (n 34).

<sup>83</sup> Gregory (n 18).

<sup>84</sup> *ibid* 531.

can enforce the statutory contract to protect his outsider rights.<sup>85</sup> As Gregory argued, ‘it is respectfully submitted that the proposition that “outsider” rights in the articles are beyond the scope of section [33] is wrong, since it is flatly contrary to all those cases where such rights have actually been enforced’.<sup>86</sup> Gregory, therefore, supports that the provisions contained in the articles of association are also enforceable by outsiders and not only qua members.

On the other hand, Davies and Worthington seems to support that the statutory contract contained in the articles, is a binding contract between the company and its members and therefore only members qua members can enforce the statutory contract, and not qua outsiders.<sup>87</sup> According to Davies and Worthington, ‘on the wording of the section [33] it would be difficult to interpret it as creating a contract with anyone other than the company and the members’.<sup>88</sup> They acknowledged that, as a consequence of this interpretation, a solicitor, who becomes a member a year after the company’s incorporation, will not be able to enforce a provision that he or she will be the company’s solicitor.<sup>89</sup> More significantly, they argue, this has the consequence of preventing a member of a company who is also holding a position as a director or other officer of the company to enforce any rights conferred on him by the company’s articles.<sup>90</sup> By considering what Wedderburn have said above about the enforcement of the statutory contract, Davies and Worthington argue that if Wedderburn’s view is correct then, ‘the supposed principle, that there is a statutory contract between the company and its members only in respect of matters affecting members qua members, is effectively outflanked’.<sup>91</sup> They then went on to argue that, notwithstanding *Hickman*’s opponents’ criticisms, when the Company Law Review consulted on the question whether any further reforms are needed in this area,<sup>92</sup> ‘a positive response was not forthcoming’ as it seems that the CLR preferred to leave the law regarding the enforceability of the statutory contract as it is.<sup>93</sup>

In contrast to the above criticisms, Goldberg, on the other hand, has sought to find ‘a middle way’<sup>94</sup> to this problem by stating that:

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<sup>85</sup> *ibid.*

<sup>86</sup> *ibid* 539.

<sup>87</sup> Davies and Worthington (n 5) 71.

<sup>88</sup> *ibid* 72.

<sup>89</sup> *ibid*; See *Eley* (n 18).

<sup>90</sup> *ibid.*

<sup>91</sup> *ibid* 73.

<sup>92</sup> See Company Law Review Steering Group (CLRS), *Modern Company Law for a Competitive Economy: Company Formation and Capital Maintenance* (October 1999) paras 2.6-2.8.

<sup>93</sup> Davies and Worthington (n 5) 73-74; See Company Law Review Steering Group (CLRS), *Modern Company Law for a Competitive Economy: Completing the Structure* (London, DTI November 2000) paras 5.66-5.67.

<sup>94</sup> Goldberg (n 18) 363.

‘A member of a company has under section [33] of the Act a contractual right to have any of the affairs of the company conducted by the particular organ of the company specified in the Act or the company’s memorandum or articles, even though the enforcement of that right... may incidentally enforce also a right or power bestowed by the memorandum or articles on a person in a capacity otherwise than as a member of the company’.<sup>95</sup>

In Goldberg’s opinion, outsider rights can only be enforced if two conditions are satisfied.<sup>96</sup> For Goldberg, the first condition was identified by Wedderburn, and the other is that ‘the enjoyment of the outsider-right is incidental to the exercise by a particular organ of the company of a power vested by the Act or by the company’s memorandum or articles in that organ’.<sup>97</sup> To explain how his idea operates in practice, he used *Eley*’s case as an example. Notwithstanding that the provision contained in the articles provided Eley with the right to be appointed as the company’s solicitor, Goldberg argued that, ‘on the proper construction of the articles when read as a whole’, the power and authority to appoint Eley as the company’s solicitor was vested on the board of directors, who then decided to remove Eley from office and to appoint other solicitors. According to Goldberg, ‘the power of appointment had been exercised by the organ of the company in which by the articles it was vested’.<sup>98</sup> Therefore, since the enforcement of Eley’s outsider rights as a company’s solicitor were not incidental, but in contrast ‘to the enforcement of the members’ right... to have that part of the company’s affairs relating to the engagement of its solicitors conducted by the organ of the company entrusted’ by the company’s articles, Eley’s claim was therefore bound to be rejected.<sup>99</sup>

Finally, Drury argued that the problem of enforceability of the statutory contract could be resolved with what he termed as the ‘relational approach’.<sup>100</sup> According to Drury, the statutory contract contained in the company’s articles ‘is one which forms the basis for a long-term relationship’ between the company and its members.<sup>101</sup> Therefore, as Drury argues, the right of any shareholder in a company to enforce a provision contained in the statutory contract ‘should be considered in the light of the other shareholders in that company’,<sup>102</sup> and that any disputes arise to enforce the statutory contract should be resolved internally by the company’s ‘own dispute-resolution machinery’, namely the majority of shareholders in the general meeting.<sup>103</sup> According to Drury, if an individual shareholder had been given an unrestricted right to enforce every provision contained in the company’s articles, this would

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<sup>95</sup> *ibid.*

<sup>96</sup> *ibid* 365.

<sup>97</sup> *ibid.*

<sup>98</sup> *ibid* 366.

<sup>99</sup> *ibid.*

<sup>100</sup> Drury (n 18) 224.

<sup>101</sup> *ibid* 223.

<sup>102</sup> *ibid* 224.

<sup>103</sup> *ibid* 229.

have the consequence of giving an individual shareholder an unrestrictive freedom to bring an action to set aside the wishes of the majority shareholders at a general meeting.<sup>104</sup> As Drury argues, giving the individual shareholders an ‘unrestrictive right to litigate could thus jeopardise the long-term relationship between the members’.<sup>105</sup> As a result, he came into the conclusion that ‘the rights given to a member by this contract are not necessarily absolute ones. They cannot be seen in isolation but only in relation to the rights enjoyed by the other members’.<sup>106</sup>

However, it could be argued that the consequence of following Drury’s approach would be to leave the decision to resolve the internal disputes between members and the company exclusively in the hands of the majority of shareholders, who may exercise their voting powers to abuse the interests of the individual shareholders. This would be regarded as unjust and unfair for individual shareholders as it would have been difficult for them to sue to enforce their rights contained in the statutory contract, except if they manage to take majority shareholders by their side. If Rawls was asked to take a position regarding this matter, he would probably argue that if those who are in more advantaged position in the company (the majority shareholders) take such decisions without considering the interests of the least advantaged members of the company, then this would be regarded as unjust. The purpose of the law in such circumstances is to provide individual shareholders with an effective mechanism to protect themselves against the abuse of the majority shareholders in the general meeting. In other words, the purpose of the law should be to provide individual shareholders with an effective mechanism that could bring justice to them. Of course, in circumstances where the decision of the majority shareholders considers also the interest of the individual shareholders, then there is no reason why the wishes of the majority shareholders should not be followed, especially if their decision was taken with the purpose to promote the best interests of the company as a whole.

On the other hand, Nozick would probably argue that every shareholder has a right to bring an action if a violation of his property right occurs. Nozick would argue that the law should therefore allow individual shareholders to enforce the statutory contract in circumstances where their property rights have been violated. Of course, it could be acknowledged that this approach might have the consequence of giving an unrestrictive power to individual shareholders to commence vexatious litigation against the company, which this might end up having the consequence of harming the interests of the company as a whole. It could therefore

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<sup>104</sup> *ibid* 237.

<sup>105</sup> *ibid*.

<sup>106</sup> *ibid* 224.

be argued that, in order to achieve justice, the role of the law should be to provide effective mechanisms that protects and balances those interests where internal disputes arises between the company and its members. From the above discussion, it could be argued that Wedderburn's view on memberships rights is more flexible than others and more likely to provide 'commercial justice' to minority shareholders as it allows members to enforce indirectly 'outsider rights'; rights that are connected with shareholders interests and rights. But of course, as mentioned above, this should be done with caution, as this could have the consequence of opening the floodgates for vexatious litigation by individual shareholders.

### *3.2.1.3. Section 33: a missed opportunity to achieve justice to minority shareholders?*

To conclude, the law surrounding the operation and enforcement of the statutory contract is still less than clear. This is due to the fact that there is a great controversy between the judiciary and academic writers as to how the statutory contract under section 33 should be interpreted and operated. Due to the uncertainties surrounding the enforcement of the statutory contract, this has the consequence of making it difficult for individual shareholders to enforce their rights contained under the articles of association. It is therefore not surprising that individual shareholders often seek to protect their rights and interests by entering into personal contracts, known as 'shareholder agreements'.<sup>107</sup> As a result, it could be argued that section 33 is a missed opportunity to achieve justice for minority shareholders. This is due to the fact that individual shareholders often find it difficult to enforce their personal rights contained in the articles of association. The purpose of the law should therefore to provide effective mechanisms for minority shareholders that could protect their rights and interests and by doing so to bring justice to them.

It is therefore not surprising that other effective mechanisms have been introduced to deal with these matters, such as the unfair prejudice remedy and the statutory derivative procedure under the Companies Act 2006. The purpose of both the unfair prejudice remedy and statutory derivative procedure is to fill the gaps of the statutory contract which is basically incomplete and unable to provide effective protection for minority shareholders. Indeed, as Keay and Zhang argue, the parties in a contract 'are not able to foresee the future perfectly'.<sup>108</sup> As a result, they 'cannot make complete provisions in a contract for every eventuality', and hence such contracts are 'incomplete'.<sup>109</sup> The same applies to the statutory contract contained under the articles of association, as it is impossible to provide complete

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<sup>107</sup> Davies and Worthington (n 5) 78.

<sup>108</sup> Andrew Keay and Hao Zhang, 'Incomplete Contracts, Contingent Fiduciaries and a Director's Duty to Creditors' (2008) 32 Melbourne University Law Review 141, 154.

<sup>109</sup> *ibid.*

provisions that cover every eventuality, and hence statutory contracts are incomplete.

Although the statutory contract under section 33 of the CA 2006 may assist in protecting the rights and interests of individual shareholders to some extent, it cannot provide a complete protection for them and hence it is difficult to achieve justice for them. As Almadani argues, ‘the company statute is the appropriate provider of complete protection, and any other source has only a secondary role’.<sup>110</sup>

It could therefore be argued that there is a gap here which the Companies Act 2006 might be able to fill in through the use of either the statutory derivative action or the unfair prejudice remedy. It is perhaps not surprising that the UK Parliament has introduced the above two remedies with the aim to protect minority shareholders from the abuse of the majority shareholders. Although it is not the intention of the thesis to examine and analyse the effectiveness of the unfair prejudice remedy, it is essential to briefly discuss how this remedy operates. However, before embarking on an enquiry to briefly analyse the unfair prejudice remedy, it is firstly essential to examine the effectiveness of shareholders’ agreement in protecting minority shareholders in the following section.

### **3.3. Shareholders’ agreements as a supplement to the statutory contract**

Although members of a company have the freedom to lay down their own rules that will govern their company under the company’s articles of association, the articles ‘may not be the last word on how the rights and obligations of the members and the company are allocated’.<sup>111</sup> Indeed, there is an alternative way in which shareholders can further protect their rights and interests and this is by entering into a shareholder agreement; an agreement separate from the company’s articles and to which the corporation may or may not be a party to the agreement.<sup>112</sup> Due to the complexities and inconsistencies surrounding the enforceability of the statutory contract under section 33, shareholder agreements became ‘an increasingly common feature’ of UK company law as an alternative mechanism to protect those who enter into such an agreement.<sup>113</sup> Although shareholder agreements are not usually considered as part of the statutory contract, their effect might be quite similar to a provision contained in the

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<sup>110</sup> Mahmoud Almadani, ‘The role of Sharia law in protecting minority shareholders in private companies’ (2010) 21 ICCLR 395, 400.

<sup>111</sup> Dignam and Lowry (n 21) 167.

<sup>112</sup> Davies and Worthington (n 5) 79.

<sup>113</sup> Dignam and Lowry (n 21) 167.

company's articles.<sup>114</sup> The aim of such an agreement is to give shareholders additional rights to those conferred on them by the statutory contract.<sup>115</sup>

For example, the agreement might contain a provision that conferred on shareholders the right to appoint the company's director and that no shareholder would be able to vote in favour of a resolution to alter the articles of association, unless all the shareholders have given their consent to do so. One of the main advantages of a shareholders' agreement is that, contrary to the company's articles of association that can be altered by a special resolution at a general meeting, normal rules of contract law apply and therefore the provisions contained in the shareholders' agreement are not alterable by the majority of shareholders at a general meeting, unless the agreement provides otherwise.<sup>116</sup> Therefore, a shareholder will have every right to bring a personal claim to prevent other shareholders from altering such an agreement without his permission to do so.<sup>117</sup>

In circumstances where all the shareholders in a company are parties to a shareholder agreement, it is not unusual for the company to be also regarded as a party to that agreement. In such a case, the legal status of such an agreement becomes very similar to the statutory contract, a contract that exists between the company and its members.<sup>118</sup> As Kershaw stated, 'a vital issue that arises from the use of shareholders' agreements is therefore the interrelationship between the provisions of the shareholders' agreement and the company and the corporate constitution respectively'.<sup>119</sup> However, this raises the question which provision will prevail in case of a conflict between a provision in the shareholders' agreements and a provision in the statutory contract. The House of Lords in *Russell v Northern Bank Development Corp Ltd*<sup>120</sup> addressed this issue. In this case, there was a shareholders' agreement between all the members in a company which contained a provision that no further share capital would be created or issued without first taking a written permission by all the parties who had entered into the agreement. A resolution at an extraordinary general meeting was about to pass with the purpose to increase the company's share capital without taking first a written consent from all the parties. As a result, Mr. Russell applied for an injunction to prevent other shareholders from voting in favour of a resolution. However, both the First Instance court and the Northern Ireland Court of Appeal dismissed his application, as it was

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<sup>114</sup> Davies and Worthington (n 5) 79.

<sup>115</sup> Victor Joffe et al, *Minority Shareholders: Law, Practice and Procedure* (4<sup>th</sup> edn, OUP 2011) 114.

<sup>116</sup> Len Sealy and Sarah Worthington, *Sealy's Cases and Materials in Company Law* (9<sup>th</sup> edn, OUP 2010) 244; See Kershaw (n 2) 93-94.

<sup>117</sup> Joffe et al (n 114) 114.

<sup>118</sup> Kershaw (n 2) 93-94.

<sup>119</sup> *ibid.*

<sup>120</sup> *Russell v Northern Bank Development Corp Ltd* [1992] BCLC 1016.

argued that the provision contained in the shareholders' agreement improperly fettered the powers of the company to raise its share capital. As a result, Mr. Russell appealed to the House of Lords.

The House of Lords held that if a provision contained in the shareholders' agreement prevents the company from exercising its available rights then this provision will be regarded as unenforceable. However, it was acknowledged that as far as the shareholders' contractual relationship was concerned, as to how they exercise and use their voting powers, the contract would be regarded as enforceable. In such a case, Mr. Russell would have been able to get an injunction to restrain the shareholders from voting in favour of the resolution. However, during the proceedings, it became obvious that Mr. Russell's intention was not actually to go against the rise of the company's share capital, but to get a declaration regarding the enforceability of the shareholders' agreement. As a result, the House of Lords rejected to issue an injunction for Mr. Russell.

Another advantage of having a shareholders' agreement is that such an agreement is not subject to any constraints previously mentioned on the enforceability of the statutory contract. Contrary to the statutory contract, shareholders' agreements can be enforced by any party to the agreement whether or not such enforcement may affect the members' rights in another capacity, rather than in their capacity as members.<sup>121</sup> In such cases, it is possible for a member in a company to enforce his outsider rights, which would otherwise not be able of enforcing as a result of *Hickman's* principle that prohibits outsiders from enforcing the statutory contract. For example, if the company's articles contained a provision for payment of a director's remuneration, and such a provision is incorporated into an extrinsic contract between the company and the director, who is also a member of the company, although such a provision may not be possible of being enforced under the statutory contract, the director will still be entitled to the specified remuneration under the extrinsic contract. It is therefore relevant for a member of a company who might want to enforce his rights in his capacity other than qua member, such as a director, to enter into an extrinsic contract with the company outside the statutory contract lay down in the company's articles.<sup>122</sup> In such a case, it would have been possible for Eley to enforce his outsider rights against the directors for removing him as the company's solicitor. Aside from the advantages mentioned above, shareholder agreements also have some disadvantages. The main disadvantage of a shareholders' agreement is that it binds only the parties who have entered into the agreement

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<sup>121</sup> Kershaw (n 2) 93-94.

<sup>122</sup> Joffe et al (n 14) 114.

and not any other party who, for example, later joins the company as a new member as the privity rules of contract law therefore apply.<sup>123</sup>

To conclude, it could be argued that shareholders' agreements can be regarded, to some extent, as an effective mechanism to fill in the gaps of the statutory contract contained in the company's articles and to provide justice to minority shareholders. However, similar to the company's articles, shareholders' agreements do not provide complete protection to minority shareholders, as it is difficult to foresee every possible situation that might occur between the parties to the agreement.<sup>124</sup> As a result of this problem, the role of the law is to provide other effective mechanisms that can protect the rights and interests of the minority shareholders as well as to provide justice to them. It is not surprising that Parliament tried to provide safeguards for minority shareholders either under the umbrella of derivative actions or the unfairly prejudice remedy. Although the purpose of the thesis is to only examine the effectiveness of the new statutory derivative action in protecting minority shareholders, it is relevant in the following section to briefly discuss about the unfairly prejudice remedy.

### **3.4. Unfairly prejudicial petition: the statutory remedy**

So far in this chapter the focus has been on whether shareholders' rights, provided in the corporate constitution, can be effectively protected by the mechanism of the statutory contract under section 33 of the CA 2006. In analysing those issues, gaps have been identified that justify the use of other effective mechanisms to protect minority shareholders, such as the use of derivative actions and the unfairly prejudicial remedy. As mentioned above, although the purpose of the thesis is not to examine the effectiveness of the unfairly prejudicial remedy but the effectiveness of the statutory derivative action under CA 2006, it is important to briefly discuss about the unfairly prejudice remedy and its role in achieving justice to minority shareholders.

#### *3.4.1. The origins of section 994 of the CA 2006*

Under the unfairly prejudicial remedy, an aggrieved individual shareholder can form a petition under 994(1) of the CA 2006 against a majority shareholder, as a result of an unfairly prejudicial conduct on the part of the majority. The purpose of section 994 of the CA 2006 is to provide the court with an extensive power to remedy conduct of a company's affairs that is

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<sup>123</sup> The Contract (Rights of Third Parties) Act 1999 does not apply to the company's constitution: s 6(2) of that Act.

<sup>124</sup> See Keay and Zhang (n 108) 154.

‘unfairly prejudicial to the interests of members generally or to some part of its members’.<sup>125</sup>

Section 994(1) provides that:

‘A member of a company may apply to the court by petition for an order... on the ground (a) that the company’s affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of its members generally or of some part of its members (including at least himself), or (b) 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’.

However, before embarking on an enquiry to examine section 994, it is firstly essential to briefly consider its antecedents as well as the reasons that paved the way for a statutory reform. Until 1948, limited protection was offered to individual shareholders due to the strict application of the rule in *Foss v Harbottle*<sup>126</sup> which prevented the courts from interfering with the internal affairs of the company, and this made it difficult for individual shareholders to bring an action against the wrongdoers.<sup>127</sup> The only protection that individual shareholders had to protect themselves against the oppressive behaviour of the company’s directors and majority shareholders, was the remedy of just and equitable winding up.<sup>128</sup> As a result of the limited remedies available to protect the rights and interests of the individual shareholders, statutory reforms have been proposed that led to the introduction of section 210 of the Companies Act 1948.<sup>129</sup> As the Cohen Committee recommended,

‘the Courts should have... the power to impose upon the parties to a dispute whatever settlement the Court considers just and equitable. This discretion must be unfettered, for it is impossible to lay down a general guide to the solution of what are essentially individual cases. We do not think that the Court can be expected in every case to find and impose a solution; but our proposal will give the Court a jurisdiction which it at present lacks, and thereby at least empower it to impose a solution in those cases where one exists’.<sup>130</sup>

The purpose for this statutory reform was to provide effective protection to individual shareholders against the ‘oppression’ of those who are in control of the company, namely the board of directors and the majority shareholders in a general meeting. However, section 210 failed in practice to provide justice to minority shareholders, as only a few cases were successful under this section.<sup>131</sup> The most important reason for the failure of this section, derived from the fact that the notion of ‘oppression’ was interpreted in a very narrow sense by

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<sup>125</sup> Companies Act 2006, s 994(1).

<sup>126</sup> See *Foss* (n 43).

<sup>127</sup> Anthony O Nwafor, ‘Unfair prejudice remedy: a relief for the minority shareholders – a comparative perspective’ (2011) 22 ICCLR 285, 285.

<sup>128</sup> See Insolvency Act 1986, s 122.

<sup>129</sup> Cohen Committee, *Report of the Committee on Company Law Amendment* (Cmnd 6659, 1945).

<sup>130</sup> *ibid* para 60.

<sup>131</sup> See *Scottish Cooperative Wholesale Society Ltd v Meyer* [1959] AC 324; [1958] 3 WLR 404; [1958] SC (HL) 40; *Re HR Harmer Ltd* [1959] 1 WLR 62; See also DD Prentice, ‘Protection of Minority Shareholders – Section 210 of the Companies Act 1948’ (1972) 25 Current Legal Problems 124.

the courts. The House of Lords in *Scottish Cooperative Wholesale Society Ltd v Meyer*, for example, stated that the oppressive conduct was that which was ‘burdensome, harsh and wrongful’.<sup>132</sup> Another significant reason for the failure of section 210 to provide effective protection for minority shareholders, was the fact that only members in their capacity as members were able to petition for oppression and not in any other capacity, for example as directors.<sup>133</sup> The failure of section 210 to provide justice for minority shareholders led the Jenkins Committee<sup>134</sup> to review the operation of this remedy and by doing so, it identified a number of flaws that needed to be addressed if it was ‘to afford effective protection to minorities in circumstances such as those with which it is intended to deal’.<sup>135</sup> The Jenkins Committee believed that section 210 ‘must extend to cases in which the acts complained of fall short of actual illegality’.<sup>136</sup> The Committee therefore recommended amending section 210 to cover complaints that the company’s affairs were being conducted in a manner ‘unfairly prejudicial to the interest of the petitioner’.<sup>137</sup>

These recommendations boosted UK Parliament to introduce section 75 of the Companies Act 1980, which later on became sections 459-461 of the Companies Act 1985. As a result, after the introduction of section 75 of the Companies Act 1980, most of the restrictions of section 210 were removed. Some innovations were also later introduced by section 459 of the Companies Act 1985 that aimed to remedy the difficulties surrounding section 210. Section 459 also replaced the word ‘oppression’ with the term ‘unfair prejudicial’, and by doing so, it made it easier for members of a company to complain of any conduct on the part of the directors or the majority shareholders in the general meeting that was harmful to them.<sup>138</sup> This clearly shows that the intention of the Parliament was to give the court a more active role to interfere where such complaints occur.<sup>139</sup> It could therefore be argued that when sections 459-461 of the Companies Act 1985 were introduced, this was a ‘giant step forward for the rights of minority shareholders’.<sup>140</sup>

Although significant changes have been made with the introduction of section 459, one significant problem of this section was that it provided that a petition was allowed to be brought only where the affairs of the company had been conducted in manner which was

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<sup>132</sup> *Scottish Cooperative Wholesale Society Ltd* (n 130) 47.

<sup>133</sup> See Bryan Clark, ‘Unfairly prejudicial conduct: a pathway through the maze’ (2001) 22 *Company Lawyer* 170, 170.

<sup>134</sup> Jenkins Committee, *Report of the Company Law Committee* (Cmnd 1749, 1962).

<sup>135</sup> *ibid* para 201.

<sup>136</sup> *ibid* para 203.

<sup>137</sup> *ibid* para 204.

<sup>138</sup> Nwafor (n 127) 285.

<sup>139</sup> Davies and Worthington (n 5) 723.

<sup>140</sup> Clark (n 133) 170.

unfairly prejudicial to the interests of ‘some part’ of the members. In *Re Carrington Viyella plc*,<sup>141</sup> for example, it was held that a petition under section 459 for breach of directors’ duties was not allowed because it affected all the shareholders. As a result of this problem, the wording of the provision under section 459 was changed by the Companies Act 1989 where the words ‘of its members generally’ were inserted with the purpose to make the law on unfair prejudice remedy much more flexible for the minority shareholders. This wording has also later been included in the Companies Act 2006 when section 994 was introduced.<sup>142</sup>

### 3.4.2. *The meaning of the ‘company’s affairs’*

From the wording of section 994 of the CA 2006 mentioned above, it seems that this provision only applies where the unfairly prejudicial conduct relates to the company’s affairs. As section 994 focuses on the conduct of the company’s affairs, this section seems to be wide enough to cover the activities of those who are in control of the company, namely the board of directors and the majority of shareholders in the general meeting.<sup>143</sup> A petitioner under section 994 of the CA 2006, will complain of conduct by persons who are in *de facto* control of the company but it can only complain of their conduct of the affairs of the company, not their own affairs which happen to affect the company. For example, in *Re a Company*,<sup>144</sup> it was held that a petition under section 994 could not be supported in circumstances where a director had acquired a debt that was owed by the company without firstly informing the company itself and also where a request was made to his fellow members to move their shares to her, so she would then be able to resign as the company’s director. Likewise, in *Re Leeds United Holdings plc*<sup>145</sup> it was decided that an alleged understanding between the shareholders that those who hold the majority of shares would not sell their shares without taking the opinion of each other, could not be regarded as a conduct of the affairs of the company.

In *Re Legal Costs Negotiations Ltd*,<sup>146</sup> the term of ‘conduct of the company’s affairs’ was further analysed. This case involves a company who was formed by four individuals, owning equal shares in the company who they were also at the same time the company’s employees and directors. However, their relationship was broken down and because of that one of the four individuals was released as the company’s employee, who was also resigned from the board of directors just before the other three decide to remove him. However, he still owned shares in the company who he denied to sell to the remaining directors. The remaining three

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<sup>141</sup> *Re Carrington Viyella plc* (1983) 1 BCC 98.

<sup>142</sup> Dignam and Lowry (n 21) 226.

<sup>143</sup> Davies and Worthington (n 5) 720.

<sup>144</sup> *Re a Company (No 0001761 of 1986)* [1987] BCLC 141.

<sup>145</sup> *Re Leeds United Holdings plc* [1996] 2 BCLC 545.

<sup>146</sup> *Re Legal Costs Negotiators Ltd* [1999] 2 BCLC 171.

directors then tried to bring a petition under section 459 (now section 994), with the purpose to force the shareholder to sell his shares to them. Their petition was denied by the Court of Appeal on the ground that, as the remaining three directors were holding the majority of shares, they were able to prohibit any prejudice being caused by the shareholder. It was therefore recognised that, by remaining as a shareholder of the company this could not be regarded as a conduct relating to the affairs of the company. The Court of Appeal emphasised that it is relevant that the conduct complained of by the petitioners should: relate to the company's affairs, relate to acts that has been caused by the company, for example, by those who have the authority to act as the company's organs, and finally, it must not be referable to the individual shareholder's conduct acting in his personal capacity.

Additionally, the case of *Oak Investment Partners XII, Limited Partnership v Boughtwood*<sup>147</sup> provides some remarkable understandings regarding the meaning of the 'company's affairs'. This case involves an allegation that the respondent, B, had tried to use his managerial powers in relation to a subsidiary company, which went beyond what was initially agreed in the shareholders' agreement, and by doing so, he had disrupted those who were involved in the management team of the company as well as distracted them from the proper conduct of the company's business and this led to a severe detriment of the corporate group. A question however arises as to whether such conduct, which did not implicate B using any of the company's organs, could be regarded as an unfairly prejudicial conduct that could be brought under section 994. It was decided by Sales J that where a significant member in a company such as B (who due to his ownership of shares he had been given a managerial role in the company) then involves in a course of conduct in his managerial role engaging inappropriate assertion of rights of control, over the practical management of the company's affairs, such a conduct will be able of being regarded as a conduct of the company's affairs in an unfairly prejudicial manner and hence be able to be brought under section 994. Sales J also continued his argument by holding that:

'there is no sound reason to exclude the possibility that what someone does in exercising or purporting to exercise managerial powers as a director or senior employee should not in principle qualify as conduct of the affairs of a company for the purposes of that provision'.<sup>148</sup>

It seems that section 994 of the CA 2006 could also be applied to the conduct of corporate groups. Contrary to the statutory derivative action (until recently),<sup>149</sup> in unfair prejudice

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<sup>147</sup> *Oak Investment Partners XII, Limited Partnership v Boughtwood* [2009] 1 BCLC 453.

<sup>148</sup> *ibid* 460.

<sup>149</sup> The recent decision in *Universal Project Management Services Ltd v Fort Gikicker Ltd & Ors* [2013] EWHC 348 (Ch) is an important and interesting as the trial judge held that the Companies Act 2006 did not abolish the multiple derivative actions. The issue of multiple derivative actions will be dealt in the next chapter.

remedy under section 994, the courts seem to have adopted a more flexible approach towards corporate groups.<sup>150</sup> Even though a shareholder's conduct (whether or not a majority shareholder) of its own affairs is precluded from section 994 of the CA 2006, nonetheless, where a holding company is in control of its subsidiary's affairs and handles the financial affairs of both companies as a single enterprise, then any actions taken by the holding company in its own self interest might be regarded as actions done in the conduct of the subsidiary's affairs and in some circumstances, vice versa. The minority shareholders in the subsidiary company will then be able to use section 994 to safeguard themselves from being exploited by the majority-shareholding holding company.<sup>151</sup>

The view that the holding company's affairs are capable of being amounted to the conduct of its subsidiary company's affairs was accepted by *Nicholas v Soundcraft Electronics Ltd*.<sup>152</sup> This case involves a holding company owning 75% of the subsidiary company's shares, with the petitioner owning half of the remaining shares. It was alleged by the petitioner that the holding company withheld a large amount of money which the holding company owed to its subsidiary company. At first instance,<sup>153</sup> it was decided that the money withheld by the holding company was amounted to the conduct of the affairs of the holding company, not the conduct of the affairs of the subsidiary company.

It was agreed by the Court of Appeal that if the only facts were that the holding company withheld money owed to its subsidiary company, then it could be argued that the holding company was not acting in any way other than conducting its own affairs. However, it was found that the holding company had used significant financial control over the affairs of the subsidiary, resulting in treating both companies' financial affairs as a single enterprise to which the holding company had the power to control. As the holding company used a thorough control over the subsidiary company's affairs, when the holding company withheld payments from the subsidiary, it did so as part of its control over the subsidiary's financial affairs. Therefore, the fact that the holding company did not pay the money that were due to the subsidiary company, this was amounted to conduct of the affairs of the subsidiary.

Likewise, in appropriate cases, the subsidiary's affairs might also amount to the holding company's affairs for the purposes of section 994 of the CA 2006, particularly in circumstances where the holding company's directors are also the subsidiary's directors.<sup>154</sup>

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<sup>150</sup> Jennifer Payne, 'Section 459-461 Companies Act 1985 in flux: the future of shareholder protection' (2005) 64 CLJ 647, 661.

<sup>151</sup> Davies and Worthington (n 5) 720.

<sup>152</sup> *Nicholas v Soundcraft Electronics Ltd* [1993] BCLC 360.

<sup>153</sup> *Re a Company* (No 002470 of 1988), ex p *Nicholas* [1991] BCLC 480.

<sup>154</sup> *Gross v Rackind* [2005] 1 WLR 3505.

While there is a fundamental principle of UK company law that companies in a group are treated as separate legal entities,<sup>155</sup> ‘in disposing of a petition under [s 994 CA 2006] a parent company is likely to account for the unfairly prejudicial conduct of the affairs of its subsidiary company’.<sup>156</sup> Judge Weeks in *Gross v Racking*,<sup>157</sup> for example, when referred to the case of *Nicholas v Soundcraft Electronics Ltd*,<sup>158</sup> accepted that ‘in the right circumstances acts in the conduct of a subsidiary’s affairs can also be acts in the conduct of the holding company’s affairs’.<sup>159</sup> As he argued, there is ‘no logical reason for protecting shareholders of a trading company by [s 994] but not shareholders in a holding company’.<sup>160</sup> In Sir Martin Nourse’s opinion, the decision in *Nicholas v Soundcraft Electronics Ltd* establishes that conduct of a company’s affairs can be regarded as conduct of another company’s affairs. Certainly, ‘the pragmatic approach adopted by the Court of Appeal to the issue of determining whether particular conduct of a parent company relates to the affairs of its subsidiary for the purpose of satisfying the requirements of [section 994]’<sup>161</sup> can be equally applied to both the *Gross* and *Nicholas* cases.<sup>162</sup> As a result, it was accepted in *Gross* that not only the subsidiary company’s members could be unfairly prejudiced by the conduct of those who are in control of the holding company, but also the members of the holding company could rely on the unfair prejudice petition for the purposes of section 994 ‘in the right circumstances’.<sup>163</sup> As Mukwiri argued, ‘although stretching the application of [s 994] in those circumstances would potentially abrogate the corporate entity doctrine in *Salomon v Salomon*’,<sup>164</sup> it seems ‘that the decision in *Gross v Rackind* demonstrates that the courts have got the balance right’.<sup>165</sup>

It could nevertheless be argued that the application of the unfair prejudice remedy under section 994 of the CA 2006 might only be successful in the event of a quasi-partnership where the subsidiary company’s directors are also the holding company’s directors and they can actively control the affairs of the company.<sup>166</sup> However, it was acknowledged in *Re Astec (BSR) Plc*<sup>167</sup> that an unfair prejudice petition under section 994 of the CA 2006 would be unlikely to succeed in public companies. This is due to the fact that it is very rare for a

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<sup>155</sup> Jonathan Mukwiri, ‘Section 459 on Parent and Subsidiary Companies’ (2005) 26 *Company Lawyer* 75, 75.

<sup>156</sup> *ibid.*

<sup>157</sup> *Gross* (n 154).

<sup>158</sup> *Nicholas* (n 152).

<sup>159</sup> *Gross* (n 154) 14.

<sup>160</sup> *ibid.*

<sup>161</sup> John P Lowry, ‘The scope of ‘unfairly prejudicial conduct’’ (1994) *JBL* 160, 165.

<sup>162</sup> Mukwiri (n 155) 76.

<sup>163</sup> *Gross* (n 154) 14.

<sup>164</sup> Mukwiri (n 155) 75.

<sup>165</sup> *ibid.*

<sup>166</sup> *ibid.* 78.

<sup>167</sup> *Re Astec (BSR) Plc* [1998] 2 *BCLC* 556.

dissatisfied member of a company to keep his shares in a public company, ‘given the ready market for the public shares that exist’.<sup>168</sup> However, such a petition is not impossible.

### 3.4.3. *The meaning of ‘members’ interests’: qua members?*

Contrary to section 210 of the Companies Act 1948, in which a member of a company was only allowed to petition under this remedy if he has suffered ‘oppression’ in his capacity as a qua member and not qua outsider, in later decisions, the phrase ‘interests of members generally or of some part of its members (including at least himself)’<sup>169</sup> was interpreted in a more flexible manner in order to remove the difficulties surrounding section 210.<sup>170</sup> In *Re a Company (No 00477 of 1986)*,<sup>171</sup> for example, it was recognised that ‘the interests of a member are not necessarily limited to his strict legal rights under the constitution’.<sup>172</sup> Similarly, in *O’Neill v Philips*<sup>173</sup> it has been accepted that the requirement of unfairly prejudice to be suffered by a member of a company must not be ‘too narrowly or technically construed’.<sup>174</sup> This is due to the fact that ‘the use of the word “interests” instead of “rights” in the provision is a clear indication that the law creates a room to accommodate wider complaints by the shareholders than that based on strict legal rights’.<sup>175</sup> In accordance with section 994 of the CA 2006, such interests, for example, were held to include: the appointment of the company’s director,<sup>176</sup> the involvement in the management of the company’s affairs,<sup>177</sup> and the right of consultation regarding the company’s policy decisions.<sup>178</sup>

It could therefore be argued that the unfairly prejudice remedy could easily fill in the gaps of the articles of association which restricts the enforcement of the statutory contract only to members of the company in their capacity as qua members. It seems that the unfair prejudice remedy supports Wedderburn view mentioned above<sup>179</sup> that a member of a company have a general right to compel the company to enforce the statutory contract, notwithstanding that this may indirectly enforce his outsider rights.<sup>180</sup> As a result, the unfairly prejudice remedy under section 994 of the CA 2006 provides an opportunity for minority shareholders to claim

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<sup>168</sup> Mukwiri (n 155) 78.

<sup>169</sup> Companies Act 2006, s 994(1)(a).

<sup>170</sup> John Birds et al, *Boyle & Birds’ Company Law* (Jordans 2009) 677.

<sup>171</sup> *Re a Company (No 00477 of 1986)* [1986] BCLC 376.

<sup>172</sup> *ibid* 378.

<sup>173</sup> *O’Neill v Philips* [1999] 1 WLR 1092.

<sup>174</sup> *ibid* 1105.

<sup>175</sup> Nwafor (n 127) 290.

<sup>176</sup> See *Re a Company* (n 171).

<sup>177</sup> See *Re a Company* (n 171); *Re a Company (No 003260 of 1986)* [1986] BCLC 391.

<sup>178</sup> See *Re Elgindata Ltd* [1991] BCLC 959.

<sup>179</sup> See text to n 79.

<sup>180</sup> See Wedderburn (n 18) 212-213.

in a capacity other than as members and this gives members the flexibility to protect their interests both as qua members and qua outsiders. However, it is worth noting that it was recognised that a petition for unfairly prejudice remedy would only be allowed if a connection is found between the members' interests as qua member with his interests as qua outsider.<sup>181</sup>

A leading case on this point is *Gamlestaden Fastigheter AB v Baltic Partners Ltd*<sup>182</sup>. In this case, the question of the court was whether the petition brought by a member of a company should be rejected in a situation where the company became insolvent and the relief sought would not provide any financial benefit on the member in his capacity as qua member. It was argued by the company's directors that the application should be rejected as the alleged misconduct did not confer on the member any economic loss in his capacity as qua member but as qua creditor, and hence he should not be able to petition under section 994. It was therefore argued that a member of a company has a locus standi to bring a petition under section 994 only if the relief would benefit his interests in his capacity as qua member and not as qua outsider. The Privy Council rejected this view by stating that it is,

‘someone artificial to insist that the qualifying loss for Art 141 (now section 994) purposes, must be loss which has reduced the value of the investor's equity capital and that it is not sufficient to show that it has reduced the recoverability of the investor's loan capital’.<sup>183</sup>

The Privy Council then went on to argue that:

‘in a case where an investor in a joint venture company had, in pursuance of the joint venture agreement, invested not only in subscribing for shares but also in advancing loan capital, the investor ought not, in their Lordship's opinion, [to] be precluded from the grant of relief under Art 143(1) (now section 996) on the ground that the relief would benefit the investor only as loan creditor and not as a member’.<sup>184</sup>

It could be argued that the Privy Council has rightly rejected the arguments that petition under section 994 should only be given to a member of a company if the relief sought benefits the member in his capacity as qua member and not as qua outsider. As Singla argued, the decision in *Gamlestaden* is important because of the fact that, ‘in holding that *Gamlestaden* was entitled to use Art 141 to protect its interests as a creditor, the Privy Council carved a broad exception out of the traditional rule that unfair prejudice must be suffered by a petitioner in

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<sup>181</sup> *Gamlestaden Fastigheter AB v Baltic Partners Ltd* [2007] BCC 272.

<sup>182</sup> *ibid*; cf *In Re JE Cade & Son Ltd* [1991] BCC 360 a petition under the unfairly prejudice remedy of section 994 was rejected on the ground that there was no connection between the member's interests as qua freeholder with his interests as qua member.

<sup>183</sup> *ibid* 274.

<sup>184</sup> *ibid*.

his capacity as a member'.<sup>185</sup> Hoffman J in *Re a Company (No 00477 of 1986)*<sup>186</sup> recognised that

'A member's interests as a member who had ventured his capital in a company's business might include a legitimate expectation that he would continue to be employed as a director, and his dismissal from office and exclusion from the company's management might be unfairly prejudicial to his interests as a member'.<sup>187</sup>

Peter Gibson J in *Re Sam Weller & Sons Ltd*<sup>188</sup> has also confirmed this where he stated that 'the word "interests" is wider than a term such as "rights", and its presence as part of the test... to my mind suggests that Parliament recognised that members may have different interests, even if their rights as members are the same'.<sup>189</sup>

### 3.5. Conclusion

In conclusion, it could be argued that the uncertainties surrounding the enforceability of the statutory contract pose significant problems for the minority shareholders to safeguard their rights and interests as they often find it difficult to enforce the statutory contract against the wrongdoers. The fact that the distinction between personal rights and corporate rights still remains unclear also makes it more difficult for minority shareholders to protect their rights contained in the statutory contract, due to the uncertainties and difficulties as to whether the right person to enforce such a contract is the member individually or the company itself. This is due to the fact that if a wrong is done to the company then it was recognised that the proper claimant is the company itself and not the individual shareholder. But how can it be defined whether the wrong was actually caused to the company and not to the members personally? This is a question that does not have a definite answer. Aside from this problem, is also the fact that members are not able under the statutory contract to enforce their rights in their capacity otherwise than qua members. Contrary to this problem, it seems that the unfair prejudice remedy provides a more flexible approach in this matter in protecting minority shareholders. This leads the thesis to conclude that the purpose of the law is to provide alternative effective mechanisms for minority shareholders to prevent wrongs remaining unredressed. As the purpose of the thesis is to analyse and examining the effectiveness of the new statutory derivative action under the CA 2006, this raises the question as to whether the

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<sup>185</sup> Tony Singla, 'Unfair prejudice in the Privy Council' (2007) 123 LQR 542, 543.

<sup>186</sup> *Re a Company (No 00477 of 1986)* (1986) 2 BCC 99171.

<sup>187</sup> *ibid* 99174.

<sup>188</sup> *Re Sam Weller & Sons Ltd* [1990] Ch 682.

<sup>189</sup> *ibid* 683.

gaps and inconsistencies identified in this chapter as to the enforceability of the statutory contract could be filled in through the use of the new statutory derivative action. In other words, whether the new statutory derivative can provide justice for minority shareholders. This is the question that will occupy the reader in the following chapter.

## Chapter 4. Derivative actions under the UK Companies Act 2006

### 4.1. Introduction

As already mentioned in chapter one, the uncertainty surrounding the actual purpose and role of the new statutory derivative action under the Companies Act 2006 in protecting minority shareholders has caused much controversy and academic debate.<sup>1</sup> Although it was expected that with the introduction of Part 11 of the CA 2006 more modern, flexible and accessible criteria would be provided to determine whether a member of a company might continue a derivative claim,<sup>2</sup> the evidence so far suggests that this is not the case. Indeed, although several new cases have considered Part 11 of the CA 2006 in varying depths,<sup>3</sup> there are still some concerns regarding the interpretation and application of the new statutory derivative action.<sup>4</sup>

In the absence of clear explanations as to how the new statutory derivative action operates, this chapter aims to clarify the actual purpose and role of derivative actions and see whether those actions can, or are likely to, achieve the objectives at which they aim. By doing so, one of the most fundamental questions that this chapter seeks to answer, and which has received inadequate attention in the literature, is: Does the new statutory derivative action achieve ‘commercial justice’ for minority shareholders? In answering this question, the chapter will pay attention to the theoretical and practical justifications behind the necessity to protect the minority shareholders by critically analysing the effectiveness of the UK statutory derivative action in protecting the minority shareholders.

However, before embarking on an enquiry to critically analyse the purpose and role of the new statutory derivative action, it is firstly relevant to examine its origins under the *Foss v Harbottle*<sup>5</sup> rule (‘*Foss* rule’) as well as the complexities and deficiencies of the common law that led to its reform. Traditionally, derivative actions in the UK have been regulated by the famous *Foss* rule which has been of great importance in governing whether minority shareholders are able to take action on behalf of the company.<sup>6</sup> The policy behind the *Foss*

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<sup>1</sup> Andrew Keay and Joan Loughrey, ‘Derivative proceedings in a brave new world for company management and shareholders’ (2010) 3 JBL 151, 153.

<sup>2</sup> Law Commission, *Shareholder Remedies* (Law Com No 246, 1997) para 6.15.

<sup>3</sup> *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch), [2008] BCC 885 (Ch D); *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch), [2011] 1 BCLC 498; *Kiani v Cooper* [2010] EWHC 577 (Ch), [2010] BCC 463 (Ch D); *Mission Capital Plc v Sinclair* [2008] EWHC 1339 (Ch), [2008] BCC 866 (Ch D).

<sup>4</sup> Keay and Loughrey (n 1) 153.

<sup>5</sup> *Foss v Harbottle* (1843) 2 Hare 461.

<sup>6</sup> Nicholas Bourne, *Bourne on Company Law* (6<sup>th</sup> edn, Routledge 2013) 227.

rule was to avoid the courts interfering with the internal management of companies. However, this approach suffered from difficulties as individual shareholders were generally not able to bring an action on behalf of the company for wrongs done to the company, only subject to some ‘exceptions’.<sup>7</sup> It is therefore these difficulties which the chapter aims to further examine in the following sections.

To achieve its aims, the chapter will be divided in the following way. Firstly, it aims to critically analyse the difficulties and complexities of the *Foss* rule and provide reasons why the common law derivative action failed to provide justice to minority shareholders. In doing so, it will then examine the effectiveness of the new statutory derivative action under the CA 2006 by comparing it with the common law derivative action. One of the most significant aims of this chapter is to significantly contribute to the literature by applying the theoretical framework for ‘commercial justice’ developed in chapter two to derivative actions and see whether those actions can, in fact, achieve justice to minority shareholders. This will help the thesis to identify the weak and ineffective aspects of the new statutory derivative action by demonstrating the failure of UK Parliament to provide clear explanations as to its interpretation and application. Finally, suggestions for further reforms will be provided.

#### **4.2. The failure of the common law derivative action to provide justice to minority shareholders**

The purpose of this section is to explore and analyse the historical origins of the *Foss* rule and its exceptions, whose main effect was to bar individual shareholders from taking derivative actions, as this will help the thesis to identify the complexities and deficiencies of the common law to provide justice to minority shareholders. Particular focus will be given to the failure of the common law to provide clear explanations as to the meaning of the ‘fraud on the minority’ and ‘wrongdoer control’. It is therefore essential in the following sections to examine the reasons that lie behind the statutory reform and this can be achieved through an analysis of the old case law and the UK parliamentary debates.

##### *4.2.1. The origins of the Foss v Harbottle rule and its principles*

In *Burland v Earle*,<sup>8</sup> Lord Davey stated the following:

‘It is an elementary principle of the law relating to joint stock companies that the court will not interfere with the internal management of companies acting within their powers, and in fact has no jurisdiction to do so. Again, it is clear law that in order to redress a wrong done to

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<sup>7</sup> *Edwards v Halliwell* [1950] 2 All ER 1064, 1067.

<sup>8</sup> *Burland v Earle* [1902] AC 83.

the company, or to recover money or damages alleged to be due to the company, the action should prima facie be brought by the company itself'.<sup>9</sup>

From the above statement, two important principles have been derived – the ‘internal management’ and the ‘proper plaintiff’ principles – which are usually referred to as the *Foss v Harbottle* rule.<sup>10</sup> Both principles are based on two different rules – ‘partnership rule’ and ‘corporate rule’.<sup>11</sup> This is due to the fact that the genesis of *Foss* rule was derived from the principles of partnership law which, due to the major changes which occurred in the economic and legal nature of the joint-stock companies in the early-to-mid nineteenth century,<sup>12</sup> were changed to adopt to the needs of joint-stock companies.<sup>13</sup> As Jordan CJ acknowledged in the Australian case of *Australian Coal & Shale Employers’ Federation v Smith*,<sup>14</sup> a registered company ‘is a hybrid growth... a partnership which has been invested with the character of incorporation’; ‘it is not, therefore, surprising,’ as Wedderburn argues,<sup>15</sup> that the ‘rules which are applicable are partly referable to both characters’.<sup>16</sup> Therefore, it is not surprising that the *Foss* rule has its origins in both partnership and corporate principles. As a result, it is of immense importance to start the analysis of the *Foss* rule by examining these two principles.

#### 4.2.1.1. The ‘internal management’ principle – ‘partnership rule’

As mentioned above, the genesis of the famous *Foss* rule derived from partnership law principles<sup>17</sup> where it has long been recognised that the courts have no right jurisdiction to interfere with the internal disputes arising between partners in a partnership, except only in circumstances where dissolution of a partnership arises.<sup>18</sup> This is due to the fact that, in the early nineteenth century, the relationship that partners had with each other in a partnership was grounded on principles of good faith and mutual trust, and therefore such a relationship would not have been possible if the courts were allowed to interfere.<sup>19</sup>

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<sup>9</sup> *ibid* 93.

<sup>10</sup> KW Wedderburn, ‘Shareholders’ Rights and the Rule in *Foss v Harbottle*’ (1957) 15 CLJ 194, 195.

<sup>11</sup> Khurram Raja, ‘Majority shareholders’ control of minority shareholders’ use and abuse of power: a judicial treatment’ (2014) 25 ICCLR 162, 165; See also Wedderburn (n 10) 196; AJ Boyle, *Minority Shareholders’ Remedies* (CUP 2002) 5.

<sup>12</sup> See Text to n 77 in ch 2.

<sup>13</sup> Boyle (n 11) 5; See also Wedderburn (n 10) 195.

<sup>14</sup> *Australian Coal & Shale Employers’ Federation v Smith* (1983) 38 SR (NWS) 48.

<sup>15</sup> Wedderburn (n 10) 195.

<sup>16</sup> *Australian Coal & Shale Employers’ Federation* (n 14) 53.

<sup>17</sup> Wedderburn (n 10) 196; Boyle (n 11) 2; See also Raja (n 11) 166.

<sup>18</sup> Wedderburn (n 10) 196; AJ Boyle, ‘The Minority Shareholder in the Nineteenth Century: A Study in Anglo-American Legal History’ (1965) 28 MLR 317, 318; Boyle (n 11) 2.

<sup>19</sup> Raja (n 11) 166.

The reluctance of the courts to interfere with the internal affairs of a partnership was evidenced in one of the earliest cases, *Carlen v Drury*,<sup>20</sup> where the Chancellor, Lord Eldon, declined to interfere because of the already existing effective internal remedy to deal with partnership disputes; the articles of a partnership.<sup>21</sup> Where such an effective internal remedy for mismanagement exists, as Lord Eldon acknowledged, it is inappropriate for the courts to interfere.<sup>22</sup> As Lord Eldon argued, ‘this Court is not to be required on every occasion to take the management of every Playhouse and Brewhouse in the Kingdom’.<sup>23</sup> It is only where, ‘the means of redress, provided by the parties themselves in the articles, are not effectual, this court will interfere’.<sup>24</sup>

The general partnership rule of non-intervention applied by Lord Eldon was later applied and used by Sir James Wigram V-C in *Foss v Harbottle*<sup>25</sup> where he established that the internal affairs of an incorporated company were for the majority of the shareholders to decide and not for the courts.<sup>26</sup> This is the so-called majority rule which allows those who hold the majority of shares to control and manage the internal affairs of the corporation without the intervention of the courts.<sup>27</sup> The decision in *Foss* is therefore of great significance as it marked the transformation of old partnership principles into one of the fundamental principles of modern company law – the majority rule.<sup>28</sup> For the purposes of this research, the majority rule will be further examined in section 4.2.2 of this chapter.

#### 4.2.1.2. The ‘proper plaintiff’ principle – ‘corporate rule’

The second principle of the *Foss* rule – the ‘proper plaintiff’ principle – springs naturally from the notion that the company is a separate legal ‘person’ from its members.<sup>29</sup> As a result, if a wrong is done to the company then, under the ‘proper plaintiff’ principle, the person suitable to claim is prima facie the company itself and not its members.<sup>30</sup> The notion that the company has a separate legal personality from its members was well recognised by Lord Halsbury LC in the seminal case of *Salomon v Salomon & Co Ltd*<sup>31</sup> where he stated that ‘once

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<sup>20</sup> *Carlen v Drury* (1812) V&B 154.

<sup>21</sup> Boyle (n 18) 318.

<sup>22</sup> *Carlen* (n 20) 159; See also Raja (n 11) 166.

<sup>23</sup> *ibid* 158.

<sup>24</sup> *ibid* 157 (Lord Eldon).

<sup>25</sup> *Foss* (n 5).

<sup>26</sup> Wedderburn (n 10) 197-198.

<sup>27</sup> *ibid* 198.

<sup>28</sup> Boyle (n 11) 3.

<sup>29</sup> *Salomon v Salomon & Co Ltd* [1897] AC 22 (HL); See also Wedderburn (n 10) 196.

<sup>30</sup> *Edwards* (n 7) 1066.

<sup>31</sup> *Salomon* (n 29).

the company is legally incorporated it must be treated like any other independent person with its rights and liabilities appropriate to itself'.<sup>32</sup>

The 'proper plaintiff' principle seems to be 'one of the most important consequences of the property right, whereby only the owner of a piece of property has right to initiate action in respect of that property'.<sup>33</sup> It could therefore be argued that Nozick's 'entitlement theory' of justice can justify the 'proper plaintiff' principle as, if Nozick was asked to take a position regarding this matter, he would probably argue that only the owner (the company) can use his property as he thinks fit and therefore it is only the owner who has the right to initiate action in respect of a wrong done to his property.<sup>34</sup> For Nozick, 'property rights' could be seen as a plausible argument that justifies the 'proper plaintiff' principle.

However, although the 'proper plaintiff' principle is quite persuasive as far as it goes, it suffers from difficulties. This is due to the fact that the corporation, as an artificial legal person, needs human agents to act on its behalf, usually the board of directors or the shareholders in general meeting.<sup>35</sup> One difficulty with this approach is that it is not entirely clear as to who should be given the legal power to initiate an action on behalf of the company, particularly if issues such as conflict of interests arise.<sup>36</sup> The complexities of the 'proper plaintiff' principle need to be further analysed in the following section, alongside the inadequacies of the *Foss* rule to provide justice to minority shareholders. Further examination of the two principles already mentioned will be provided.

#### 4.2.2. *The rule in Foss v Harbottle*

In his seminal article, *Shareholders' Rights and the Rule in Foss v Harbottle*,<sup>37</sup> Wedderburn posed the following question: 'If an irregularity has been committed in the course of a company's affairs, or some wrong has been done to the company, can the individual shareholder bring a complainant before the court?'<sup>38</sup> According to Wedderburn, the rule in *Foss* provides a 'negative answer to this question, subject to certain "exceptions"'.<sup>39</sup> As mentioned above, the courts have for long shown their unwillingness to interfere with the internal management of corporations and this is because 'they have usually abdicated their

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<sup>32</sup> *ibid* 30.

<sup>33</sup> Ataollah Rahmani, 'A comparative study of justifications for majority rule in corporations: the case of England and Iran' (2007) 18 ICCLR 279, 287.

<sup>34</sup> See Robert Nozick, *Anarchy, State, and Utopia* (Basic Books 1974).

<sup>35</sup> Hans C Hirt, *The Enforcement of Directors' Duties in Britain and Germany: A Comparative Study with Particular Reference to Large Companies* (Peter Lang 2004) 76.

<sup>36</sup> *ibid* 76.

<sup>37</sup> Wedderburn (n 10).

<sup>38</sup> *ibid* 194.

<sup>39</sup> *ibid* 194.

jurisdiction in favour of the obvious alternative remedy – the majority of the members’.<sup>40</sup> This is the so-called ‘majority rule’.

The ‘majority rule’ has long been recognised as a vital principle of the UK company law as it is a device that allows members in a company, who hold the majority of shares, to control and manage the decision-making of the affairs of the company.<sup>41</sup> It is a device that ‘integrates the whole body of shareholders and provides a mechanism for the settlement of any internal disagreements among the shareholders’.<sup>42</sup> The majority rule derives from the view that ‘membership of any kind of association involves an obligation to settle disputes within the association and to abide by majority decisions’.<sup>43</sup> As Lord Wilberforce stated in *Re Kong Thai Sawmill (Miri) Sdn Bhd*:<sup>44</sup> ‘Those who take interests in companies limited by shares have to accept majority rule’.<sup>45</sup>

As the majority of shareholders have been given the power to control and manage the affairs of the company, it is entirely proper to say they also have the power to decide whether or not the company should take an action in order to remedy a wrong done to its property by the wrongdoing directors.<sup>46</sup> It has long been recognised that the majority of shareholders in the general meeting can exercise their voting powers to ratify wrongs done to the company by the directors and by doing so, they can relieve the wrongdoing directors from their personal liability to the company arising from a breach of their duties.<sup>47</sup> If the majority of shareholders in the general meeting decides that proceedings should not be taken by the company against the wrongdoing directors, this will be the end of the matter and therefore neither the company nor an individual shareholder (through derivative action) will be able to bring an action against the wrongdoer.<sup>48</sup> This principle of majority rule is the basis of the *Foss*<sup>49</sup> rule which

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<sup>40</sup> *ibid* 194.

<sup>41</sup> Rahmani (n 33) 279; See also, Wedderburn (n 10) 198: ‘The law had long recognised majority rule as a fundamental principle concerning corporations, so that there was no difficulty in expressing majority rule as the justification for the refusal to interfere in internal management’.

<sup>42</sup> *ibid* 279.

<sup>43</sup> Derek French, Stephen Mayson and Christopher Ryan, *Mayson, French & Ryan on Company Law* (31<sup>st</sup> edn, OUP 2014) 548.

<sup>44</sup> *Re Kong Thai Sawmill (Miri) Sdn Bhd* [1978] 2 MLJ 227.

<sup>45</sup> *ibid* 229.

<sup>46</sup> Wedderburn (n 10) 194.

<sup>47</sup> Wedderburn (n 10) 198; KW Wedderburn, ‘Shareholders’ Rights and the Rule in *Foss v Harbottle* (continued)’ (1958) 16 CLJ 93, 96; Jennifer Payne, ‘A Re-Examination of Ratification’ (1999) 58 CLJ 604, 604; 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 197, 198; Paul L Davies and Sarah Worthington, *Gower & Davies Principles of Modern Company Law* (9<sup>th</sup> edn, Sweet & Maxwell 2012) 619.

<sup>48</sup> Hirt (n 47) 198.

<sup>49</sup> *Foss* (n 5).

bars minority shareholders from suing for wrongs done to the corporation, subject to certain exceptions.<sup>50</sup>

However, the principle of majority rule suffers from difficulties as, by giving the exclusive power to majority shareholders to decide on litigation matters, it can sometimes be seen as unjust for minority shareholders. This is due to the fact that those who are in a more advantaged position in the company (in this context, the majority shareholders) can often use their powers to abuse the interests of those who are in a least advantaged position (in this context, the minority shareholders). Although, as examined in chapter two,<sup>51</sup> in a corporate democracy it is entirely proper to give the power to decide on litigation matters to those who hold the majority of shares, if they exercise their powers to abuse the interests of the minority shareholders, then it is entirely relevant for the law to provide effective devices to protect minority shareholders from such an abuse. In other words, where minority shareholders are denied justice, the law should then provide effective mechanisms that can bring justice to them when such an abuse or exploitation of power by the majority shareholders occurs. However, before embarking on an enquiry to further examine the majority rule and its deficiencies, it is firstly relevant to begin with a brief analysis of the facts of the *Foss v Harbottle* case. This will help the thesis to further understand the policy behind *Foss* and its deficiencies.

In *Foss*, two of the minority shareholders of the Victoria Park Company took an action on behalf of themselves and all other shareholders against the company's directors claiming that the latter had fraudulently misused the company's assets by causing the company to purchase land from them at an unfairly inflated value. The question that arises in this case was whether the two minority shareholders had locus standi to bring an action on behalf of the company against the wrongdoing directors. On the facts, Sir James Wigram V-C held that the injury caused by the directors was 'an injury not to the Plaintiffs exclusively...[but] an injury to the whole corporation by individuals whom the corporation entrusted with powers to be exercised only for the good of the corporation'.<sup>52</sup> As a result, the court refused to allow the two minority shareholders to bring an action on behalf of the company, as in the court's opinion, the proper person to sue for wrongs done to the company was the company itself and not the individual shareholders. As Sir James Wigram V-C observed:

'In law the corporation and the aggregate members of the corporation are not the same thing for a purpose like this; and the only question can be whether the facts alleged in this case

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<sup>50</sup> See French, Mayson and Ryan (n 43) 548.

<sup>51</sup> See Text to n 220 in ch 2.

<sup>52</sup> *Foss* (n 5) 490.

justify a departure from the rule which, *prima facie*, would require that the corporation should sue in its own name and in its corporate character, or in the name of *someone whom the law has appointed to be its representative*'.<sup>53</sup>

The vital issue that derives from the above paragraph relates to one of the most fundamental principles of UK company law, the principle of separate legal personality, on which the *Foss v Harbottle* rule was based. As mentioned above, it has long been recognised that the company is a separate legal person from its members with its own separate duties and liabilities.<sup>54</sup> However, this principle suffers from difficulties. This is due to the fact that the corporation, as an artificial legal person, needs human agents to act on its behalf.<sup>55</sup> But, who can be regarded as 'someone whom the law has appointed to be its representative'?

One possible answer to this question would be to say that the litigation decision should be left to the board of directors.<sup>56</sup> This is due to the fact that the board, having the power to manage and control the affairs of the company as a whole,<sup>57</sup> should also have the power to litigate in the company's name. As examined in chapter two,<sup>58</sup> the directors, in discharging their powers to manage and control the affairs of the company, owe duties 'to the company' itself and not to individual shareholders.<sup>59</sup> The significance of this point raises the question as to who can enforce directors' duties. It is a fundamental principle that 'only a person who has a legal right can enforce that right'.<sup>60</sup> As Kershaw stated, 'the right to take legal action to obtain a remedy where a legal obligation has been breached belongs to the person who is the recipient of that legal obligation'.<sup>61</sup> Since the directors' duties are owed to the company itself, it is asserted that 'they are enforceable only by those who can claim to be the company or to act on its behalf',<sup>62</sup> normally the board of directors or the shareholders in general meeting.

However, by giving the board of directors the exclusive power to decide on litigation matters, this raises significant problematic issues. One of the problems is whether the board will

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<sup>53</sup> *ibid* 490-491 (emphasis added).

<sup>54</sup> *Salomon* (n 29) 30.

<sup>55</sup> *Hirt* (n 35) 76.

<sup>56</sup> *Davies and Worthington* (n 47) 644.

<sup>57</sup> See article 3 of the Model Articles for private and for public companies in SI 2008/3229: 'Subject to the articles, the directors are responsible for the management of the company's business, for which purpose they may exercise all the powers of the company'.

<sup>58</sup> See Text to n 160 in ch 2.

<sup>59</sup> Companies Act 2006, s 170(1); See also *Davies and Worthington* (n 47) 506.

<sup>60</sup> *David Kershaw, Company Law in Context* (2<sup>nd</sup> edn, OUP 2012) 589.

<sup>61</sup> *ibid* 589.

<sup>62</sup> *Paul L Davies, Introduction to Company Law* (2<sup>nd</sup> edn, OUP 2010) 189.

decide in favour of litigation to sue the wrongdoing directors.<sup>63</sup> The wrongdoing directors, as Davies and Worthington argue,

‘may be a majority of the board or may be able to influence a majority of the board, and the same incentives which operated to cause the directors to breach their duties in the first place may cause them to utilize their board positions so as to suppress litigation against them’.<sup>64</sup>

If that is the case, then the board might be sceptical to decide in favour of litigation to sue the wrongdoing directors, albeit whether the decision to sue would be for the company’s benefit to do so.<sup>65</sup> This is probably because the wrongdoing directors have a say on the board’s decisions and therefore it is unlikely to vote against themselves.<sup>66</sup> Therefore, as Davies and Worthington argue, ‘it would obviously be unsound policy to leave such decisions exclusively with the board of the company’.<sup>67</sup>

A solution to this problem would be to only allow the directors who have not involved with the wrongdoing (the disinterested directors) to decide whether to sue against the wrongdoing directors or not.<sup>68</sup> However, one might be sceptical about how independent the disinterested directors are in relation to the wrongdoing allegations.<sup>69</sup> This is due to the fact that the disinterested directors might be asked to take a litigation decision against their fellow directors: people who they consider as close friends ‘with whom they share a sense of corporate camaraderie’.<sup>70</sup> Thus, the board (both interested and disinterested directors) seems to be an unsuitable body to take the litigation decision against the wrongdoing directors. This, of course, raises the following question: If both interested and disinterested directors are not suitable to take the litigation decision then, who is the most suitable body to do so?<sup>71</sup>

Under the *Foss* rule,<sup>72</sup> the power to decide whether to sue the wrongdoing directors or not should normally be given to those who hold the majority of shares in general meeting (the

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<sup>63</sup> Arad Reisberg, ‘Theoretical Reflections on Derivative Actions in English Law: The Representative Problem’ (2006) 3 European Company and Financial Law Review 69, 76.

<sup>64</sup> Davies and Worthington (n 47) 644.

<sup>65</sup> *ibid* 644.

<sup>66</sup> Kershaw (n 60) 591.

<sup>67</sup> Davies and Worthington (n 47) 645.

<sup>68</sup> Kershaw (n 60) 591.

<sup>69</sup> *ibid* 591.

<sup>70</sup> *ibid* 591; However, there are some circumstances where the board of directors will no longer include the wrongdoers due to a change of the company’s management (see *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134). There are also some other circumstances where, in case where the company becomes insolvent, the power to manage the company is given to a liquidator and thus the power to litigate against the wrongdoing directors is passed to the liquidator (See Insolvency Act 1986, s 212).

<sup>71</sup> See Hans C Hirt, ‘The company’s decision to litigate against its directors: legal strategies to deal with the board of directors’ conflict of interest’ (2005) JBL 159, 163.

<sup>72</sup> *Foss* (n 5).

majority of shareholders).<sup>73</sup> Indeed, as mentioned above, the courts have long shown their unwillingness to interfere with the internal disputes that arise between the members of the company, simply because those who hold the majority of shares in a company ‘are believed to be better placed to adjudicate internal issues within the company’.<sup>74</sup> However, it could be argued that the view to give majority shareholders the power to decide on litigation matters is in contrast to what Greer LJ said in *Shaw & Sons (Salford) Ltd v Shaw*:<sup>75</sup>

‘If powers of management are vested in the directors, they and they alone can exercise these powers. The only way in which the general body of the shareholders can control the exercise of the powers vested by the articles in the directors is by altering their articles, or, if opportunity arises under the articles, by refusing to re-elect the directors of whose actions they disapprove’.<sup>76</sup>

As Greer LJ argues, ‘[the general meeting] cannot themselves usurp the powers which by the articles are vested in the directors any more than the directors can usurp the powers vested by the articles in the general body of shareholders’.<sup>77</sup> From Greer LJ’s statement, it seems clear that the majority of shareholders in the general meeting should not interfere with the powers given to the board to manage the company’s affairs.<sup>78</sup> However, although the judgment in *Shaw* recognises that the board of directors have the exclusive power to ‘start, discontinue, or prevent legal proceedings in the name of the company’,<sup>79</sup> it could be argued that this approach is problematic in the sense that, giving the exclusive power to the board to decide on litigation matters, wrongs would remain unredressed as no other party in a company will be able to bring justice on behalf of the company. Therefore, by giving the power to the majority of shareholders to take litigation decisions, this might eliminate injustices where possible.

The power of the majority of shareholders in general meeting to decide on litigation matters can also be found from the current model sets of articles (for both public and private companies) where they provide that the shareholders in general meeting may, by special resolution, instruct the board of directors ‘to take, or refrain from taking specified action’<sup>80</sup>

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<sup>73</sup> See Hirt (n 71) 163.

<sup>74</sup> Julia Tang, ‘Shareholder remedies: demise of the derivative claims?’ (2012) 1 UCL Journal of Law and Jurisprudence 178, 180.

<sup>75</sup> *Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113; See also Davies and Worthington (n 47) 645.

<sup>76</sup> *ibid* 134.

<sup>77</sup> *ibid* 134.

<sup>78</sup> See *Automatic Self-Cleaning Filter Syndicate Co v Cuninghame* [1906] 2 Ch 34 (CA); *Quin & Axtens v Salmon* [1909] 1 Ch 311 (CA).

<sup>79</sup> Wedderburn (n 10) 201.

<sup>80</sup> Article 4(1) of the Model Articles (both private and public companies).

provided that ‘no such special resolution invalidates anything which the directors have already done before the passing of the resolution’.<sup>81</sup>

However, giving the decision-making power to the majority shareholders in general meeting might sometimes be regarded as unjust and unfair, especially in circumstances where they use their voting powers to benefit themselves at the expense of the company and the minority shareholders. It is here that the inconsistencies and gaps of the ‘majority rule’ principle begin to become apparent. This is due to the fact that, in private companies, those who hold the majority of shares are also, usually, the directors of the company. In these circumstances, it is entirely proper to say that the directors (who are also the majority shareholders) are unlikely to vote in favour of a litigation decision that goes against them for wrongs they have caused to the company.<sup>82</sup> Therefore, if the power to litigate is left exclusively in the hands of the majority shareholders in general meeting, then there is a risk that they might exercise their powers to abuse the interests of the company and its minority shareholders.<sup>83</sup> This leaves the position of those who are in a least advantaged position than the majority shareholders particularly bleak (in this context the minority shareholders).<sup>84</sup>

Although it has been established above that the minority shareholders are bound by the decisions of the majority, it could be argued that the ‘majority rule’ principle is unable to prevent injustice to minority shareholders as it fails to consider that, in some situations, those who are in a more advantaged position in a company (the majority shareholders) can exercise their powers to the detriment of those who are in a least advantaged position (the minority shareholders). Therefore, by giving the exclusive power to the majority shareholders to decide whether to sue the wrongdoers or not, it may have the consequence of turning the *Foss* rule ‘into a shield for the controllers, rather than a weapon for use by the members to secure the “shareholders’ control” which it was meant to facilitate’.<sup>85</sup>

The power of the majority shareholders in general meeting to control and influence the litigation decisions is also evidenced by the fact that, under section 168 of the CA 2006, the majority shareholders are able to remove directors at any time by ordinary resolution. The provision is of immense importance as it allows majority shareholders in general meeting to interfere with the board’s decisions. It is most likely that the board would follow the views of the majority shareholders due to their fear that the majority of shareholders might remove the

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<sup>81</sup> Article 4(2) of the Model Articles (both private and public companies).

<sup>82</sup> Arad Reisberg, *Derivative Actions and Corporate Governance* (OUP 2007) 78.

<sup>83</sup> Alan Dignam, *Hicks & Goo’s Cases & Materials on Company Law* (7<sup>th</sup> edn, OUP 2011) 424-425.

<sup>84</sup> Reisberg (n 63) 75; Reisberg (n 82) 79.

<sup>85</sup> Wedderburn (n 10) 200.

directors from their office by ordinary resolution.<sup>86</sup> In such circumstances, it could be argued that, if majority shareholders are left with the exclusive power to control and influence the board, injustices might occur as the majority shareholders may exercise their powers to abuse the interests of the company and its minority shareholders. Indeed, as Reisberg argues,

‘if the [majority] rule is enforced in every situation, there will be manifest injustice as wrongdoers go unpunished and managerial wrongdoing is not redressed. Investors will be at the mercy of the majority who are advancing their own interests at the expense of the company’.<sup>87</sup>

In order to achieve justice, it is therefore relevant not to leave the litigation decision exclusively in the hands of the board and/or the general meeting as this carries the risk of abuse or exploitation of the interests of the company and its minority shareholders. One possible solution to this problem would be to give minority shareholders the right to take an action on behalf of the company. This is the so-called ‘derivative action’.<sup>88</sup> Such action is ““derivative” in the sense that the right to sue belongs not to the party actually bringing the action, but is “derived” from that of the company’.<sup>89</sup> Therefore, giving the minority shareholders the right to bring a derivative action does not involve giving them the right to act ‘as the company’ but it will give them the right to take an action to enforce the company’s right ‘on behalf of the company’ to claim against the wrongdoing directors.<sup>90</sup>

However, while giving minority shareholders the locus standi to take a derivative action on behalf of the company might prevent injustices in the commercial context, it does not guarantee that minority shareholders will bring such action to promote the commercial interests of the company, as it may be brought to advantage their own personal interests instead of the company’s interests.<sup>91</sup> It has been argued that, a minority shareholder, as owner of a smaller percentage of shares, has little financial incentives to take a derivative action on behalf of the company.<sup>92</sup> This is due to the fact that when taking a derivative action on behalf

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<sup>86</sup> However, special voting rights might protect the directors against the power of the general meeting to remove them from their office (see *Bushell v Faith* [1970] AC 1099 (HL)).

<sup>87</sup> Reisberg (n 82) 79; See also *Nurcombe v Nurcombe* [1985] 1 WLR 370, 378, 432.

<sup>88</sup> Kershaw (n 60) 592.

<sup>89</sup> Matthew Berkahn, ‘The Derivative Action in Australia and New Zealand: Will the Statutory Provision Improve Shareholders’ Enforcement Rights?’ (1998) 10 Bond Law Review 74, 74.

<sup>90</sup> Kershaw (n 60) 592.

<sup>91</sup> David Kershaw, ‘The Rule in *Foss v Harbottle* is Dead; Long Live the Rule in *Foss v Harbottle*’ (2013) LSE Law, Society and Economy Working Paper 5/2013, 10 <[http://www.lse.ac.uk/collections/law/wps/WPS2013-05\\_Kershaw.pdf](http://www.lse.ac.uk/collections/law/wps/WPS2013-05_Kershaw.pdf)> accessed 11 July 2015; See also Reisberg (n 82) 83; Davies and Worthington (n 47) 647.

<sup>92</sup> Davies and Worthington (n 47) 647.

of the company, recovery goes to the company itself and not to the minority shareholder.<sup>93</sup> Therefore, as Davies and Worthington argue,

‘the return to that person will be, at most, a percentage of the recovery which reflects the percentage of the shares of the company that person holds. So, litigation brought by such a person runs a risk of being motivated by concerns other than to increase the value of the company’s business’.<sup>94</sup>

It could be argued that, due to these problems, while it is relevant for the minority shareholders to have locus standi to bring derivative actions on behalf of the company, it is also essential for the law to provide effective control mechanisms that will ensure that the action taken by the minority shareholders was for the interests of the company as a whole and not for some other personal incentives.<sup>95</sup> As mentioned above, neither the board nor the general meeting is the appropriate body to decide whether the litigation decision has been brought for the interests of the company.

In such a case, another decision-making body should be found to oversee whether derivative actions have been brought for the interests of the company and one possible solution to that is to give the litigation decision to an external body, such as the court, to decide.<sup>96</sup> As Almadani argues, ‘there must be an external body which has the capacity to judge and resolve any dispute on request. This external body cannot be other than the court, which would grant a relief on any ground *whenever justice so requires*’.<sup>97</sup> This is due to the fact that the court is an entity ‘independent, just and disinterested in any conflict’, and therefore it is more capable than any other body in the company to decide whether the action taken was brought for the interests of the company or not.<sup>98</sup> Therefore, the role of the court would be to provide relief ‘whenever justice so requires’ by balancing the interests of those who are in a more advantaged position in a company (the board of directors and the majority shareholders in general meeting) with those who are in a least advantaged position (the minority shareholders). Leaving the litigation decision in the hands of the court to decide, this also benefits the company as a whole because where such conflicts occur, the court, as a control mechanism, will be able to ensure that justice has been done to the company. Indeed, as

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<sup>93</sup> *ibid* 647.

<sup>94</sup> *ibid* 647-648.

<sup>95</sup> Kershaw (n 60) 593.

<sup>96</sup> *ibid* 593.

<sup>97</sup> Mahmoud H Almadani, ‘The Reform of Minority Shareholder Protection in Saudi Arabia and Dubai in Private Companies’ (PhD thesis, University of Leeds 2011) 47 (emphasis added).

<sup>98</sup> *ibid* 47.

Almadani argues, ‘while this means that the court will be more involved with companies’ internal management over litigation, it is only done to ensure that justice occurs’.<sup>99</sup>

It is therefore not surprising that the Law Commission, in its proposals to reform the old common law derivative action, assigned the litigation decision to the courts.<sup>100</sup> However, before embarking on an enquiry to examine these proposals, it is firstly essential in the following sections to analyse and examine the ‘exceptions’ to the *Foss* rule provided by the common law, that gave minority shareholders, in special circumstances, the right to bring a derivative action on behalf of the company.

#### 4.2.3. *The exceptions to the Foss v Harbottle rule*

Despite the decision in *Foss v Harbottle*, that the proper person to sue for wrongs done to the company is the company itself, some ‘exceptions’ to the rule in *Foss* were developed in which an individual shareholder, under special circumstances, was able to commence a derivative action on behalf of the company. This is due to the fact that the harsh application of the *Foss* rule, that prevented individual shareholders from taking an action on behalf of the company, was seen to be unjust and unfair for the individual shareholders. By not allowing individual shareholders to bring an action on behalf of the company, wrongs would remain unredressed as those who are in a more advantaged position (the board and the general meeting) than the minority shareholders in the company, are unlikely to vote in favour of the litigation, especially if the wrong done to the company has been caused by them. It has therefore been recognised by Sir James Wigram V-C that:

‘If a case should arise of injury to a corporation by some of its members, for which no adequate remedy remained, except that of a suit by individual corporators in their private characters, and asking in such character the protection of those rights to which in their corporate character they were entitled, I cannot but think that... *the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue*’.<sup>101</sup>

Relying upon Sir James Wigram V-C’s proposition expressed in *Foss*, four exceptions have been developed ‘to ameliorate against the possible injustice that such a rule would cause to minority shareholders’.<sup>102</sup> These are: where the alleged wrong is ultra vires the company; where the transaction complained of could be validly done or sanctioned only by a special resolution and could not, therefore, be sanctioned by a simple majority; where personal rights

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<sup>99</sup> *ibid* 49.

<sup>100</sup> Law Commission (n 2) para 6.13.

<sup>101</sup> *Foss* (n 5) 492 (emphasis added).

<sup>102</sup> Paul Von-Nessen, SH Goo and Chee K Low, ‘The statutory derivative action: now showing near you’ (2008) 7 JBL 627, 627.

of members are infringed; and where what is complained of amounts to ‘fraud on the minority’ and those responsible for the fraud are in control of the company.<sup>103</sup>

From these four exceptions, only the fourth exception, namely the ‘fraud on the minority’, has been recognised as a true exception to the *Foss* rule.<sup>104</sup> This is due to the fact that the remaining three exceptions are concerned with shareholders’ personal rights (already discussed and analysed in chapter three) while the ‘fraud on the minority’ exception is concerned with corporate rights.<sup>105</sup> Therefore, for the purpose of this chapter, only the corporate exception – ‘fraud on the minority’ – will be further examined and analysed in the following sections.

#### 4.2.3.1. The ‘fraud on the minority’ exception

In *Edwards v Halliwell*,<sup>106</sup> Jenkins LJ pointed out that

‘where what has been done amounts to what is generally called in these cases a fraud on the minority and the wrongdoers are themselves in control of the company, the rule is relaxed in favour of the aggrieved minority who are allowed to bring what is known as a minority shareholders’ action on behalf of themselves and all others’.<sup>107</sup>

This is the so-called ‘fraud on the minority’ exception that aimed to allow an individual shareholder to commence a derivative action on behalf of the company. The rationale behind the necessity to establish such an exception to the *Foss* rule was because, as Jenkins LJ stated, if minority shareholders were denied the right to bring a derivative action, ‘their grievance could never reach the court because the wrongdoers themselves, being in control, would not allow the company to sue’.<sup>108</sup> Jenkins LJ recognised that, although the ‘fraud on the minority’ exception was not relevant in *Edwards* case, it is essential to have this exception because it shows that ‘the rule is not an inflexible rule and it will be relaxed where necessary in the interests of justice’.<sup>109</sup>

From the above, it seems that in order for an individual shareholder to commence a derivative action on behalf of the company, it was required for him to satisfy two essential conditions derived from the ‘fraud on the minority’ exception: (i) that the wrong done to the company falls within the category of ‘fraud’ and (ii) that the wrongdoers against whom relief was

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<sup>103</sup> *Edwards* (n 7) 1064-1065.

<sup>104</sup> Alan Dignam and John Lowry, *Company Law* (8<sup>th</sup> edn, OUP 2014) 197.

<sup>105</sup> Editorial, ‘A statutory derivative action’ (2007) 28 *Company Lawyer* 225, 225.

<sup>106</sup> *Edwards* (n 7).

<sup>107</sup> *ibid* 1067.

<sup>108</sup> *ibid*.

<sup>109</sup> *ibid*.

sought were in control of the general meeting and because of that no action could be taken against them in the name of the company. It is therefore relevant to further examine these two conditions in the following sections as this will help the thesis to show the failure of the common law to provide justice to minority shareholders.

#### 4.2.3.1.1. Meaning of 'fraud'

One of the most significant difficulties of the 'fraud on the minority' exception was that no clear explanation has been provided as to the meaning of 'fraud'.<sup>110</sup> Various attempts have been made by the judiciary to clarify the meaning of 'fraud', but none of them seem to have produced a definite and clear answer. Sir Megarry V-C in *Estmanco (Kilner House) Ltd v Greater London Council*<sup>111</sup>, for example, defined 'fraud' in this context as 'comprising not only fraud at common law but also fraud in the wider equitable sense of that term'.<sup>112</sup> Lord Davey also in *Burland v Earle*<sup>113</sup> recognised that 'fraud' includes situations 'where the majority are endeavouring directly or indirectly to appropriate to themselves money, property, or advantages which belong to the company, or in which the other shareholders are entitled to participate'.<sup>114</sup> Similarly, Wedderburn took the view that the derivative action lay where the directors acted 'mala fide' or misappropriated corporate 'property or opportunities'.<sup>115</sup> Therefore, attempts by the majority to divert a company's business to a third party<sup>116</sup> or to themselves amounted to a fraudulent conduct, and thus a minority shareholder was allowed to pursue a derivative action on behalf of the company against the wrongdoers.<sup>117</sup>

On the other hand, however, mere negligence on the part of directors did not amount to a 'fraud' if the wrongdoers had not benefited themselves as a result of their negligence.<sup>118</sup> A minority shareholder was not able to bring a derivative action on the grounds of mere negligence and this was due to the fact that mere negligence was capable of being ratified by the majority of shareholders at the general meeting.<sup>119</sup> In *Pavlides v Jensen*,<sup>120</sup> for example, a minority shareholder took an action against the wrongdoing director of the company alleging that the director had sold a mine to another company at a considerably important low value.

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<sup>110</sup> See Fang Ma, 'A Comparative Analysis of Minority Shareholders' Remedies in Anglo-American Law and Chinese Law: Lessons to be Learnt' (DPhil thesis, University of West England 2009) 44.

<sup>111</sup> *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2.

<sup>112</sup> *ibid* 12.

<sup>113</sup> *Burland* (n 8).

<sup>114</sup> *ibid* 93.

<sup>115</sup> Wedderburn, 'Derivative Actions and Foss v Harbottle' (1981) 44 MLR 202, 206.

<sup>116</sup> See *Menier v Hooper's Telegraph Works* (1874) 9 Ch App 350.

<sup>117</sup> See *Cooks v Deeks* [1916] 1 AC 554 (PC); *Reisberg* (n 82) 91.

<sup>118</sup> *Pavlides v Jensen* [1956] Ch 565.

<sup>119</sup> See *Regal (Hastings) Ltd* (n 70).

<sup>120</sup> *Pavlides* (n 118).

The minority shareholder however was not able to challenge the director for his wrongdoing as no evidence had been found that the director had benefited himself from his negligence. Although damage had been caused to the company due to the director's negligence, this was regarded as irrelevant in this case. The complexity of recognising mere negligence as a fraudulent conduct was recognised by Lord Goldsmith where he stated that:

'There is a deficiency in the current law in relation to *Foss v Harbottle*; in certain circumstances, it would be possible to use the derivative claim where the complaint was of negligence by the directors but only, as I understand the law, if it could be shown that the directors – or at least the majority of shareholders – had profited from the negligence, which would not always be the case'.<sup>121</sup>

At common law, therefore, negligence was able to fall within the category of 'fraud' only if it was proved that the wrongdoers had benefited themselves from their negligence. This was recognised by Templeman J in *Daniels v Daniels*<sup>122</sup> who seemed to extend the meaning of fraud to situations where directors exercised their powers 'intentionally or unintentionally fraudulently or negligently in a manner which benefited themselves at the expense of the company'.<sup>123</sup>

It seems from the above that no clear explanations have been provided as to the meaning of 'fraud' and this resulted in making it more difficult for minority shareholders to bring derivative actions against the wrongdoers. Due to the uncertainties surrounding the meaning of fraud, it could be argued that the common law has failed to provide justice to minority shareholders. Even if the minority shareholders were able to prove that the directors' wrongdoings fell within the category of 'fraud', there was another obstacle for them to bring a derivative action; that is, to prove that the wrongdoers were also in control of the company. It is therefore not surprising that Sealy described the minority shareholders as an 'unfavoured litigant': 'Time and again he is sent away with no answer, as often as not with a rebuke for troubling the court'.<sup>124</sup>

#### 4.2.3.1.2. Meaning of 'wrongdoer control'

As Lord Davey in *Burland v Earle*<sup>125</sup> acknowledged, the court's desire is 'to give a remedy for a wrong which would otherwise escape redress'.<sup>126</sup> It has been recognised that when a wrongdoing director was also in control of the company, it was essential to allow a minority

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<sup>121</sup> HL Deb 27 February 2006, vol 679, col GC11.

<sup>122</sup> *Daniels v Daniels* [1978] Ch 406.

<sup>123</sup> *ibid* 414.

<sup>124</sup> Len Sealy, 'The Problems of Standing, Pleading and Proof in Corporate Litigation' in BG Pettet (ed), *Company Law in Change* (Stevens & Sons 1987) 2.

<sup>125</sup> *Burland* (n 8).

<sup>126</sup> *ibid* 93.

shareholder to bring a derivative action on behalf of the company otherwise wrongs would remain unredressed due to the fact that the company would be unlikely to pursue proceedings against the wrongdoing director.<sup>127</sup> In cases where a wrongdoing director was not in control of the company, it was established that the proper claimant to bring an action against the wrongdoer was the company itself and not the individual shareholders. In order for a minority shareholder to be able to bring a derivative action on behalf of the company, it was required for him to show that the wrongdoer was in control of the company. This is the so-called ‘wrongdoer control’ requirement.<sup>128</sup>

It could be argued that in private small companies, it was not difficult for the courts to establish who had de jure control of the company, as it was easy to identify those who held the majority of shares. Contrary to small private companies, the court struggled to find a de jure control in a public listed company which had numerous of shareholders and therefore the courts were not able to identify who was in control of the company.<sup>129</sup> This difficulty arises from the fact that, in public listed companies, it is not unusual for a shareholder who holds only 20% or 30% of the shares to be able to control the company.<sup>130</sup>

This raises the question whether the courts were prepared to accept de facto control of wrongdoers in circumstances where they did not hold the majority of shares in the company but, due to their voting powers, were able to control the company.<sup>131</sup> The Court of Appeal in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*<sup>132</sup> was conscious about the difficulties of a de facto control of public companies and because of that was prepared to accept that the term ‘wrongdoer control’

‘embraces a broad spectrum extending from an overall absolute majority of votes at one end, to a majority of votes at the other end made up of those likely to be cast by the delinquent himself plus those voting with him as a result of influence or apathy’.<sup>133</sup>

However, the Court of Appeal in *Prudential* was unconvinced about how practical the ‘de facto control’ test would be, ‘particularly if it involves a full-dress trial before the test is applied’.<sup>134</sup> It could therefore be argued that, while the Court of Appeal in *Prudential* was prepared to extend the concept of ‘wrongdoer control’ to ‘de facto control’, it failed to clarify

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<sup>127</sup> *ibid*; See Reisberg (n 82) 92.

<sup>128</sup> See *Russell v Wakefield Waterworks Co* (1875) LR 20 Eq 474, 482.

<sup>129</sup> Reisberg (n 82) 92.

<sup>130</sup> *ibid* 92-93.

<sup>131</sup> See Boyle (n 11) 27.

<sup>132</sup> *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 (CA).

<sup>133</sup> *ibid* 219.

<sup>134</sup> *ibid* 221; See also Boyle (n 11) 28.

the meaning of ‘wrongdoer control’.<sup>135</sup> Therefore, due to the complexities and uncertainties surrounding the meaning of both the ‘wrongdoer control’ and fraud’, it is not surprising that statutory reforms have been proposed.

### 4.3. Statutory reforms

Having analysed the rule in *Foss* and its failure to provide justice to minority shareholders, before embarking on an enquiry to examine the effectiveness of the new statutory derivative procedure, it is firstly of immense importance to briefly discuss the statutory reforms that led to the introduction of the new statutory derivative procedure under the Companies Act 2006. The complexities and deficiencies of the *Foss* rule led the Law Commission in its Report on *Shareholder Remedies*<sup>136</sup> to propose statutory reform with the aim to replace the common law derivative action with a new statutory derivative procedure with more modern, flexible and accessible criteria for determining whether a member of a company may bring a derivative claim.<sup>137</sup> As the Law Commission argued, ‘in an age of increasing globalisation of investment and growing international interest in corporate governance, great transparency in the requirements for a derivative action is in our view highly desirable’.<sup>138</sup> The Law Commission therefore considered that ‘the derivative procedure should be rationalised and modernised’.<sup>139</sup>

This is due to the fact that, according to the Law Commission, the rule in *Foss* and its exceptions were, in certain respects, ‘inflexible and outmoded’.<sup>140</sup> There were four significant problems of the *Foss* rule that led the Law Commission to propose statutory reform. First, the *Foss* rule ‘cannot be found in rules of court, but only in case law, much of it decided many years ago’.<sup>141</sup> Indeed, the Law Commission acknowledged that, in order to gain a better understanding of the *Foss* rule, ‘one needs to examine numerous reported cases decided over a period of 150 years, thus the law in this respect is virtually inaccessible’, except to the lawyers who have specialised in this area of law.<sup>142</sup> Secondly, it was relevant under the *Foss* rule that, in order for an individual shareholder to be able to bring an action on behalf of the company to recover damages suffered by the company, to prove that the wrongdoers were in control of the company. This was found to be a significant problem, as the meaning of ‘control’ is ambiguous.<sup>143</sup> Thirdly, it was not possible under the rule in *Foss* to bring a

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<sup>135</sup> Ma (n 110) 47.

<sup>136</sup> Law Commission (n 2).

<sup>137</sup> Law Commission (n 2) para 6.15.

<sup>138</sup> *ibid* para 6.9.

<sup>139</sup> *ibid* para 6.12.

<sup>140</sup> Law Commission, *Shareholder Remedies* (Law Com CP No 142, 1996) para 14.1.

<sup>141</sup> *ibid* para 14.2; See also Law Commission (n 2) para 6.4.

<sup>142</sup> *ibid* para 4.35.

<sup>143</sup> *ibid* para 14.2; See also Law Commission (n 2) para 6.4.

derivative action by reason of mere negligence of a director unless it was possible to prove that negligence conferred a benefit on the controlling shareholders, or that the failure of other directors of a company to commence an action constituted a fraud on the minority.<sup>144</sup> The final problem addressed by the Law Commission is that ‘the standing of the member to bring a derivative action has to be established as a preliminary issue by evidence which shows a prima facie case on the merits’.<sup>145</sup> As the Law Commission acknowledged, ‘without effective case management this can result in a mini trial which increases the length and cost of the litigation’.<sup>146</sup>

For the reasons stated above, it is not surprising that statutory reforms have been put forward for a new statutory derivative procedure. To tackle the problems of the common law, the Law Commission proposed to allocate the litigation decision to someone external of the company, namely the court.<sup>147</sup> These proposals were largely endorsed by the Company Law Review Steering Group (‘CLRSG’)<sup>148</sup>, and were later embodied (though not all) in the Companies Act 2006 when the new statutory derivative procedure was introduced. It is therefore relevant in the following section to examine the effectiveness of the new statutory derivative action under the CA 2006 in providing ‘commercial justice’ to minority shareholders, something that the common law has failed to do so.

#### **4.4. The statutory derivative action and the role of ‘commercial justice’**

##### *4.4.1. Introduction*

In recent years, the law on derivative actions in the UK has faced significant statutory reforms due to the failure of the common law derivative action under the *Foss v Harbottle*<sup>149</sup> rule and its exceptions to provide justice to minority shareholders.<sup>150</sup> The uncertainties surrounding the exact meaning of ‘fraud on the minority’ and ‘wrongdoer control’ boosted the UK Parliament to introduce a new statutory derivative procedure under Part 11 of the Companies Act 2006, following the Law Commission’s recommendations to provide ‘a new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue the action’.<sup>151</sup> In comparison with the common law rules, the new statutory derivative procedure introduces a broad range of circumstances in which a member of a company may

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<sup>144</sup> *ibid* para 14.3.

<sup>145</sup> *ibid* para 14.4.

<sup>146</sup> *ibid* para 14.4.

<sup>147</sup> Law Commission (n 2) para 1.12; See Davies and Worthington (n 47) 648.

<sup>148</sup> Company Law Review Steering Group (CLRSG), *Modern Company Law for a Competitive Economy: Completing the Structure* (London, DTI November 2000).

<sup>149</sup> *Foss* (n 5).

<sup>150</sup> See Law Commission (n 2).

<sup>151</sup> *ibid* para 6.15.

take a derivative action.<sup>152</sup> One of the principal objectives for enacting a new statutory derivative action was to reinforce legal measures to prevent directors from causing harm to the company and by doing so it improved redress for minority shareholders by allowing them to commence proceedings on behalf of the wronged company.<sup>153</sup>

However, although it was anticipated that with the introduction of the new statutory derivative procedure under the CA 2006 more modern, flexible and accessible criteria would be provided to determine whether a member of a company might pursue a derivative claim, the evidence so far suggests that this is not the case.<sup>154</sup> Indeed, although more than a few cases have considered the new statutory derivative procedure in varying depths,<sup>155</sup> there are still some concerns regarding the interpretation and application of the new statutory derivative action.<sup>156</sup>

In the absence of clear explanations as to how the new statutory derivative action operates, the aim of the following sections will be to clarify the actual purpose and role of derivative actions and see whether those actions can, or are likely to, achieve the objectives at which they aim. For the purposes of this thesis, it is essential that the courts' approach in recent cases should be identified and examined in this section. The aim of this section is expected to discover the future developments of the new statutory derivative procedure, particularly in terms of the courts' future approach, to develop clearer principles and procedures through the examination of a new body of case law. The aim of the following sections is therefore to evaluate the impact of the new statutory derivative action in light of the courts' recent approach since the introduction of Part 11 of the CA 2006. This will help the thesis to examine the effectiveness of the UK statutory derivative action in achieving justice for minority shareholders.

#### *4.4.2. Statutory derivative action – the framework:*

One of the core foundational provisions of the new statutory derivative action is section 260 of the CA 2006, which provides that derivative claims may be brought by 'a member of a company' on behalf of the company against the wrongdoing directors for acts or omissions

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<sup>152</sup> See Companies Act 2006, s 260.

<sup>153</sup> Demetra Arsalidou, 'Litigation culture and the new statutory derivative claim' (2009) 30 *Company Lawyer* 205, 205; Paul Sykes, 'The continuing paradox: a critique of minority shareholder and derivative claims under the Companies Act 2006' (2010) 29 *Civil Justice Quarterly* 205, 209.

<sup>154</sup> Keay and Loughrey (n 1) 153.

<sup>155</sup> See *Franbar Holdings Ltd* (n 3); *Iesini* (n 3); *Kiani* (n 3); *Mission Capital Plc* (n 3); See also Keay and Loughrey (n 1) 153.

<sup>156</sup> Keay and Loughrey (n 1) 153.

that constitute breaches of duty owed to the company.<sup>157</sup> Particularly, section 260(1) of the CA 2006 defines derivative claims as proceedings brought ‘by a member of a company – (a) in respect of a cause of action vested in the company, and (b) seeking relief on behalf of the company’.<sup>158</sup> It seems from the above that a member of a company has now been conferred the locus standi to bring derivative actions on behalf of the company, something that was quite difficult for an individual shareholder under the common law derivative action.

With respect to the term ‘member’, although a definition is provided under section 112 of the CA 2006,<sup>159</sup> section 260(5) extends the conferral of locus standi to persons who are not members of the company but to whom shares in the company have been transferred or transmitted by operation of law.<sup>160</sup> This is a significant development, as it seems to mirror a similar provision provided under the umbrella of the ‘unfair prejudice’ remedy.<sup>161</sup> However, as will be examined later on,<sup>162</sup> this section has one, arguably, important omission: to allow members of the parent company to bring a derivative action on behalf of the parent’s subsidiary. This is an issue that will be further analysed and discussed in section 4.6 of this chapter.

Another significant provision of the new statutory derivative action is section 260(3) which, in contrast to the common law rules, provides a broader range of types of breaches in which a member of a company may be able to pursue a derivative claim against the wrongdoing director. As section 260(3) provides, a derivative claim may be brought by a member of a company only ‘in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of a company’. This seems to cover a wider range of breaches than existed under the common law rules, as there is no longer a requirement for a member of a company to show ‘fraud on the minority’ and ‘wrongdoer control’. Section 260(3) now allows a member of a company to bring a derivative claim for any alleged breach of directors’ duties, which can now be found under Chapter 2 Part 10 of the CA 2006.<sup>163</sup>

One of the most significant improvements on the law of derivative actions is the inclusion of negligence in the types of breaches for which a derivative claim may be brought. The

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<sup>157</sup> Directors’ duties can now be found under Chapter 2 of Part 10 of the Companies Act 2006.

<sup>158</sup> See also John Birds et al, *Boyle & Birds’ Company Law* (9<sup>th</sup> edn, Jordan Publishing 2014) 665.

<sup>159</sup> Companies Act 2006, s 112: ‘(1) The subscribers of a company’s memorandum are deemed to have agreed to become members of the company, and on its registration become members and must be entered as such in its register of members. (2) Every other person who agrees to become a member of a company, and whose name is entered in its register of members, is a member of the company’.

<sup>160</sup> See also John Birds et al (eds), *Annotated Companies Legislation* (OUP 2010) 316.

<sup>161</sup> Companies Act 2006, s 994(2); See also Birds et al (n 160) 316.

<sup>162</sup> See section 4.6.

<sup>163</sup> See Reisberg (n 82) 135.

inclusion of negligence is significant because it is now recognised that any breach of a director's duty of care and skill can form the basis for a member of a company to bring a derivative claim, although such conduct might be capable of being ratified by the general meeting.<sup>164</sup> It is also relevant because there is no longer a requirement to distinguish between mere negligence,<sup>165</sup> which under the 'fraud on the minority' exception was not recognised as 'fraud' and therefore a member of a company was not able to bring a derivative claim, and negligence benefiting the wrongdoing directors,<sup>166</sup> which was recognised as 'fraud'.<sup>167</sup> As a result of section 260(3), a member of a company is now able to bring a derivative claim on the grounds of negligence, without the requirement to show that the wrongdoing director has benefited from his negligence. As Lord Hodgson of Astley Abbotts acknowledged, in permitting derivative claims on the grounds of negligence, this shows that the new statutory derivative action may in fact go further than existing rules under the common law.<sup>168</sup> According to Lord Hodgson of Astley Abbotts,

'given the uncertain nature of the common law position, and since the provisions of Clause 239 [now section 260] cannot possibly take account of all the nuances reflected in the lines of cases on exceptions to the rule in *Foss v Harbottle*, it is fair that the new statutory procedure may make it easier for shareholders to bring claims'.<sup>169</sup>

The Law Commission explained the rationale behind this change on the basis that although shareholders 'take the risk that those who manage companies may make mistakes, we do not consider that they have to accept that directors will fail to comply with their duties'.<sup>170</sup>

Therefore, giving the flexibility to members of a company to bring derivative claims on the grounds of negligence could be regarded as a welcome development of the law on derivative actions, as it allows minority shareholders to get justice for wrongs done to the company without the necessity to show that wrongdoers have received benefits from their negligence. The purpose for enacting the statutory derivative action was therefore to make it easier for members of a company to bring a derivative claim in contrast to the complexities of the common law derivative action.<sup>171</sup>

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<sup>164</sup> See Companies Act 2006, s 239: '(1) This section applies to ratification by a company of conduct by a director amounting to negligence, default, breach of duty or breach of trust in relation to the company. (2) The decision of the company to ratify such conduct must be made by resolution of the members of the company'; Reisberg (n 82) 136.

<sup>165</sup> *Pavlides* (n 118).

<sup>166</sup> *Daniels* (n 122).

<sup>167</sup> Reisberg (n 82) 136.

<sup>168</sup> HL Deb 27 February 2006, vol 679, col GC3.

<sup>169</sup> *ibid.*

<sup>170</sup> Law Commission (n 2) para 6.41.

<sup>171</sup> See Reisberg (n 82) 136.

On the other hand, as Lord Hodgson of Astley Abbots argued, some people expressed their fear for a ‘double whammy’.<sup>172</sup> Their concern was that ‘in Part 10, directors’ duties are widened, while Part 11 makes it easier for shareholders to commence actions against directors’.<sup>173</sup> In other words, they feared that derivative actions might give greater flexibility for shareholders to bring derivative claims against the directors, and therefore increase shareholder litigation, and this might result in reducing the number of people willing to take directorships.<sup>174</sup> In response to that, the Attorney-General, Lord Goldsmith, made several points. First, he made it clear that the purpose of the CA 2006 was not to introduce any significant change of principle to the law of derivative actions.<sup>175</sup> Secondly, he described derivative actions as a ‘fail-safe mechanism’ rather than ‘a weapon of first resort’.<sup>176</sup> Although recovery goes to the company and not to individual shareholders, it is the individual shareholders, who bring the derivative claim, who may be required to bear heavy legal costs.<sup>177</sup> Thirdly and more importantly, tight judicial control will be available to control the cases brought under the new statutory derivative procedure.<sup>178</sup> Fourthly, and lastly, the derivative action under CA 2006 will be completely different from the US-style shareholder class action brought in the name of a group of shareholders.<sup>179</sup>

As Lord Goldsmith acknowledged, it is not expected that there will be any substantial increase in the number of derivative claims by placing derivative action on a statutory footing, and neither does the Law Commission believe that.<sup>180</sup> More importantly, he stated that,

‘There will continue to be tight judicial control of such cases and we would expect the judiciary to be circumspect when reaching decisions about application; in particular, we would expect the judiciary to continue to take the view that a disagreement between members should usually be resolved under the company’s constitution without recourse to the courts. The procedure that we have set out provided proper safeguards in that respect’.<sup>181</sup>

The aim of the Government for having a tight judicial control was ‘to strike a careful balance between protecting directors from vexatious and frivolous claims and protecting the rights of shareholders’.<sup>182</sup> As Lord Goldsmith acknowledged, ‘it would be dangerous to move too far

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<sup>172</sup> HL Deb 27 February 2006, vol 679, col GC2.

<sup>173</sup> *ibid.*

<sup>174</sup> HL Deb 27 February 2006, vol 679, cols GC2-GC3.

<sup>175</sup> *ibid* col GC4.

<sup>176</sup> *ibid.*

<sup>177</sup> *ibid.*

<sup>178</sup> *ibid* col GC5.

<sup>179</sup> *ibid.*

<sup>180</sup> *ibid.*

<sup>181</sup> *ibid.*

<sup>182</sup> *ibid.*

against either of those interests'.<sup>183</sup> It is therefore entirely proper to say that, in order to achieve justice, there should be an effective mechanism that balances the interests of those involved within the company. It seems from the above that the aim of the Government, by placing derivative actions on a statutory footing, was to achieve that balance.

Another significant development of the law on derivative actions is the fact that section 260(3) now allows a member of a company to bring a derivative action against the director or against a third party, or both. Such a cause of action will only be allowed in circumstances where the harm caused to the company arose from an act involving a breach of duty on the part of the director.<sup>184</sup> Examples of such cause of action have been provided by the Explanatory Notes on the Companies Act 2006, and these are: (1) for knowing receipt of money or (2) property transferred in breach of trust, or (3) for knowing assistance in a breach of trust.<sup>185</sup>

Lord Goldsmith also identified two useful examples to show the significance of allowing a member of a company to bring a derivative claim against a third party. The first of his examples concerns situations where, as a result of a breach of director's duty, the company's property passed to the hands of a third party, which the third party is required to give back. Some of the examples are where the company's property has been transferred in breach of trust or the third party has been giving knowing assistance.<sup>186</sup> Under those situations, a derivative claim may possibly be brought not only against the director of a company but also against the third party.

Lord Goldsmith's second hypothetical example concerns a profitable company as a victim of a tort by a third party. In such a case, the directors of a company might decide not to bring an action against the third party. According to Lord Goldsmith, 'these directors, although otherwise committed to the well-being of the company, on this occasion do not wish – for bad reason and ulterior motive – to enforce the remedy for tort'.<sup>187</sup> He continued by stating that, 'they would in those circumstances be in breach of duty, but that breach of duty would not have given rise to the claim; in the words of the [CA 2006], the claim is not "arising from an actual or proposed act or omission...by a director"'.<sup>188</sup> As Lord Goldsmith argued, it would

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<sup>183</sup> *ibid.*

<sup>184</sup> See Explanatory Notes to the Companies Act 2006, para 494.

<sup>185</sup> *ibid.*

<sup>186</sup> HL Deb 27 February 2006, vol 679, col GC10.

<sup>187</sup> *ibid.*

<sup>188</sup> *ibid.*

not be unlikely under these situations for a member of a company to commence proceedings against the third party.<sup>189</sup>

The significance of allowing a member of a company to bring a derivative claim against a third party was also recognised by Lord Grahame where he stated that:

‘there may well be cases of wrongdoing by a director against whom proceedings could be brought by the derivative process; he could have acted in cahoots with a third party – there is simply a conspiracy between the third party and the director. The provision would enable proceedings to be brought against both or either as appropriate; *that would certainly meet the justice of the case*. I cannot really see any advantage in restricting, limiting or barring that derivative process against the third-party conspirator who, on this hypothesis, is not a director of the company’.<sup>190</sup>

It could be argued that, in order to achieve justice, it was relevant for the Government to propose this change, as, if individual shareholders were unable to bring a derivative claim against third parties, wrongs would remain unredressed. This would have been regarded as unfair and unjust for both the company and its minority shareholders. If Lord Grahame was to ask to take a position regarding this matter, he would probably say that, although third parties do not owe fiduciary duties to the company, when a third party violates the property of the company, then there should be an effective mechanism to compensate the company from the wrongdoing.

Section 260(4) is also an interesting and significant provision of the CA 2006 as it provides that ‘it is immaterial whether the cause of action arose before or after the person seeking to bring a derivative claim became a member of the company’. Although there were significant concerns during the Committee Stage regarding whether such a provision would create a proliferation of vexatious or near-vexatious litigation in the UK,<sup>191</sup> Lord Grahame argued that it is not right to allow the complaint only to past or previous shareholders of a company as shareholders can buy and sell shares in the company on a regular basis.<sup>192</sup> According to Lord Grahame,

‘Once you buy shares, you are party to a changing contract and you derive all the benefits and rights associated with that contract. The fact that you arrive later than earlier on the scene should not in principle deprive you of the entitlement of that contractual bargain. That is not consistent with company law experience’.<sup>193</sup>

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<sup>189</sup> *ibid.*

<sup>190</sup> HL Deb 27 February 2006, vol 679, col GC11 (emphasis added).

<sup>191</sup> Baroness Goudie argued that ‘companies will need to seek more legal advice as the likelihood of litigation increases, management will be diverted from normal management activities and UK businesses will become more risk-averse and less profitable’: *ibid* cols GC11-GC12.

<sup>192</sup> *ibid* col GC13.

<sup>193</sup> *ibid* col GC13.

This view seems to be supported by Milman as he argued that

‘Incoming shareholders tend to get the benefit of successful management actions and, quite naturally, will suffer from past mistakes that affect the company adversely—therefore they have a legitimate right in principle to initiate derivative proceedings’.<sup>194</sup>

It could therefore be argued that section 260(4) provides a significant development of the law on derivative actions as it allows incoming shareholders to bring a derivative action on behalf of the company to remedy the wrongs done to the company. There is no reason why such provision should not exist as it prevents commercial injustices where possible. It is worth mentioning that, as Lord Goldsmith argued, ‘it is the people who are members at the time that they wish to bring proceedings that bring those proceedings. You cannot sell on your shares and then seek to bring a derivative claim in the name of the company at that stage’.<sup>195</sup>

Another significant development of the law on derivative actions is the fact that under section 260(5) it is now recognised that ‘shadow directors’ can also be liable in the same way as de jure directors and be subject to a derivative claim by members of a company.<sup>196</sup> While the general duties specified in sections 171 to 177 of the CA 2006 are undoubtedly owed by those who have been formally appointed as the de jure company’s directors, it is now recognised that such duties are also owed by shadow directors to the extent that ‘the corresponding common law rules or equitable principles so apply’.<sup>197</sup> It seems that the rationale behind allowing a minority shareholder to commence proceedings against a shadow director is to hold those who have a real influence over the affairs of the company accountable for wrongs done to the company.<sup>198</sup> It could therefore be argued that Parliament’s intention to include shadow directors in section 260(5) was to eliminate commercial injustices where possible. However, the extent to which shadow directors owe fiduciary duties to the company is still unclear. For the purpose of this thesis, it is therefore essential to further examine the policy behind this issue in the following section.

#### *4.4.2.1. Shadow directors and fiduciary duties*

Before considering whether a person acting as a shadow director owes any fiduciary duties to the company, it is firstly relevant to briefly discuss as to who can be regarded as a shadow director. Section 251(1) of the CA 2006 defines a shadow director as ‘a person in accordance

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<sup>194</sup> David Milman, ‘The Company Law Reform Bill: statutory derivative claims and the future of shareholder protection’ (2006) 13 Co LN 1, 2.

<sup>195</sup> HL Deb 27 February 2006, vol 679, col GC15.

<sup>196</sup> See Reisberg (n 82) 142.

<sup>197</sup> Companies Act 2006, s 170(5).

<sup>198</sup> Stephen Griffin, ‘Confusion surrounding the characteristics, identification and liability of a shadow director (2011) 24 Insolvency Intelligence 44, 44.

with whose directions or instructions the directors of a company are accustomed to act'.<sup>199</sup> As Griffith argued, in taking into account the literal meaning of the above statutory provision, it might be expected that a shadow director is someone who has the power to exercise dominant and controlling influence over the affairs of the company and that his directions and instructions are likely to be followed by the company's board.<sup>200</sup> In addition, he argued that, 'the term "shadow" would imply that a person who acts as a shadow director will operate in a hidden capacity – that is, the shadow director will not be considered as a part of the internal management of the company'.<sup>201</sup>

The statutory definition of a 'shadow director' was considered in the Court of Appeal in the leading case of *Secretary of State for Trade and Industry v Deverell*<sup>202</sup> where Morritt LJ stated that:

'The definition of a shadow director is to be construed in the normal way to give effect to the parliamentary intention ascertainable from the mischief to be dealt with and the words used. In particular, as the purpose of the Act is the protection of the public and as the definition is used in other legislative contexts, it should not be strictly construed because it also has quasi-penal consequences in the context of the Company Directors Disqualification Act 1989... The purpose of the legislation is to identify those, other than professional advisers, with real influence in the corporate affairs'.<sup>203</sup>

However, as Morritt LJ argued, it is not a prerequisite to exercise such influence over the entire field of the company's affairs and that, although it is adequate to show that de jure directors 'cast themselves in a subservient role or surrendered their respective discretions', it is not required to show that they had done this in all situations.<sup>204</sup> As Morritt LJ argues, 'such a requirement would be to put a gloss on the statutory requirement that the board are "accustomed to act" "in accordance with" such directions and instructions'.<sup>205</sup> Morritt LJ also emphasised that, although advice given in a professional capacity is excluded from the statutory definition, it appears to him that advice given on a regular basis may be included within the statutory definition. For Morritt LJ, the term 'advice' seems to share the same characteristics with 'directions' and 'instructions' as all three terms 'share the common feature of "guidance"'.<sup>206</sup> Furthermore, Morritt LJ recognised that whilst a person acting as a shadow director might frequently lurk in the shadows, this is not an essential prerequisite to

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<sup>199</sup> However, 'a person is not to be regarded as a shadow director by reason only that the directors act on advice given by him in a professional capacity': Companies Act 2006, s 251(2).

<sup>200</sup> Griffin (n 198) 45.

<sup>201</sup> *ibid.*

<sup>202</sup> *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340.

<sup>203</sup> *ibid* 354.

<sup>204</sup> *ibid.*

<sup>205</sup> *ibid.*

<sup>206</sup> *ibid.*

identify this person as a shadow director.<sup>207</sup> However, beyond the statutory definition provided by Morritt LJ in this case, no definite definition has been provided as to who can be regarded as a shadow director.<sup>208</sup> It is not the intention of this research to further analyse the definition of a ‘shadow director’ but to examine whether a person acting as a shadow director owes any fiduciary duties to the company as a whole.

Under section 170 of the Companies Act 2006 it seems clear that the general duties<sup>209</sup> applied to de jure directors also apply to shadow directors. However, section 170(2) seems to provide that general duties only apply to shadow directors to the extent that ‘the corresponding common law rules or equitable principles so apply’. In this respect, as Griffin argued, section 170 of the CA 2006 ‘is couched in uncertainty because the corresponding common law rules etc. are, as a genus, sparse and vague with regard to identifying when liability should be attached to a shadow director’. Indeed, various cases that considered this matter did not come to a definite answer as to whether fiduciary duties should be imposed on shadow directors and if they should, in which circumstances.

The first case that considered whether shadow director owe fiduciary duties is *Yukong Line Ltd of Korea v Rendsburg Investments Corp of Liberia*.<sup>210</sup> In this case, negotiations had been made between Yukong (a Korean shipping company) and Marcan Ltd to enter into a charterparty. Marcan Ltd was the agent of Rendsburg Ltd (a Liberian company) and through its director, Mr Yamvrias, signed the charterparty with Yukong on Rendsburg’s behalf. Before Yukong delivered the ship, funds were removed from Rendsburg’s account and because of that, a breach of charterparty occurred. As a result, Yukong claimed against Rendsburg but due to the fact that Rendsburg had no money to pay the damages suffered by Yukong, Yukong decided to sue Mr Yamvrias, the director of Marcan Ltd as well as the sole beneficial owner of the shares in Rendsburg, alleging that Mr Yamvrias had breached his fiduciary duties owed by him as a shadow director of Rendsburg.

In this case, Toulson J held that Mr Yamvria ‘undoubtedly’ owed a fiduciary duty to Rendsburg. This is due to the fact that, ‘although he was not formally a director, he was a “shadow director” and controlled the company’s activities’.<sup>211</sup> Toulson J’s view on this matter has been endorsed by the Law Commissions’ consultation paper entitled as *Company Directors: Regulating Conflict of Interests and Formulating a Statement of Duties* where it

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<sup>207</sup> *ibid* 355.

<sup>208</sup> See *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638, for example, where the court recognised that it is essential to show that the majority of the board was accustomed to act on the directions of the shadow director.

<sup>209</sup> Specified in sections 171-177 of the Companies Act 2006.

<sup>210</sup> *Yukong Line Ltd of Korea v Rendsburg Investments Corp of Liberia* [1998] 1 WLR 294.

<sup>211</sup> *ibid* 311.

was pointed out that ‘the shadow director... can incur the liability of a de jure director under the general law where he effectively acts as a director through the people whom he can influence’.<sup>212</sup>

However, in contrast to Toulson J’s view, Lewison J in *Ultraframe (UK) Ltd v Fielding*<sup>213</sup> asserted that ‘the indirect influence exerted by a paradigm shadow director who does not directly deal with or claim the right to deal directly with the company’s assets will not usually... be enough to impose fiduciary duties upon him’.<sup>214</sup> To justify his decision, Lewison J referred to the case of *Bristol and West Building Society v Mothew*<sup>215</sup> where Millett LJ stated that a fiduciary is ‘someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence’.<sup>216</sup> For Lewison J, such a relationship does not exist between a shadow director and the company as, in contrast to a de jure or de facto director, a shadow director ‘does not undertake or agree to act in relation to the company in any such way’.<sup>217</sup>

Contrary to *Ultraframe*’s decision, Prentice and Payne argued that, given the extent of control and influence that someone needs to have in order to become a shadow director, ‘it would be odd if shadow directors were not subject to the full panoply of fiduciary duties’.<sup>218</sup> As a result, they came to the conclusion that

‘*Ultraframe* is not the last word on the question of whether fiduciary duties are owed by a shadow director, for the simple reason that Lewison J approached this question, wrongly it is submitted, on the basis that such duties are assumed rather than being imposed’.<sup>219</sup>

A stronger position has recently been taken by Newey J in *Vivendi SA v Richards*<sup>220</sup> where he stated that:

‘*Ultraframe* understates the extent to which shadow directors owe fiduciary duties. It seems to me that a shadow director will typically owe such duties in relation at least to the directions or instructions that he gives to the de jure directors. More particularly, I consider that a shadow director will normally owe the duty of good faith when giving such directions and instructions. A shadow director can, I think, reasonably be expected to act in the company’s

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<sup>212</sup> Law Commission, *Company Directors: Regulating Conflict of Interests and Formulating a Statement of Duties* (Law Com No 153, 1998) para 17.15.

<sup>213</sup> *Ultraframe (UK) Ltd* (n 208).

<sup>214</sup> *ibid* [1289].

<sup>215</sup> *Bristol and West Building Society v Mothew* [1998] Ch 1.

<sup>216</sup> *ibid* 18.

<sup>217</sup> *Ultraframe (UK) Ltd* (n 208) [1280].

<sup>218</sup> DD Prentice and Jenny Payne, *Directors’ fiduciary duties* (2006) 122 LQR 558, 562.

<sup>219</sup> *ibid* 562.

<sup>220</sup> *Vivendi SA v Richards* [2013] EWHC 3006 (Ch); [2013] BCC 771.

interests rather than his own separate interests when giving such directions and instructions’.<sup>221</sup>

The facts of this case were as follow. In *Vivendi*, Centenary Holdings III Limited (“the company”) entered into a consultancy agreement with Mr Richards where he agreed to faithfully serve the company and to act for its best interests. It is worth noting that Mr Richards had not been formally appointed as the company’s director and that the only director of the company was Mr Boch. Before the company went into liquidation, both Mr Boch and Mr Richards had caused the company to make several payments to third parties, which totalled more than £10 million. As a result, Vivendi brought a claim against Mr Boch and Mr Richards for their wrongdoing to the company, alleging that, by causing the company to make such payments to third parties, Mr Boch had breached his fiduciary duty of good faith to the company. Vivendi also argued that Mr Richards, as a shadow director, should also owe a fiduciary duty of good faith to the company, which according to Vivendi he had breached. The core issues of this case were whether Mr Richards was, in fact, a shadow director, and if so, whether he owed any duties to the company because of his wrongdoing.

Contrary to *Ultraframe*’s decision, Newey J held in *Vivendi* that Mr Richards was in fact a shadow director and because of that he was subject to a fiduciary duty to act in the company’s best interests. It was found that Mr Richard had exercised a dominant and controlling influence over the company’s affairs to the extent that, his directions and instructions had been followed by the only director of the company, Mr Boch. By doing so, he assumed a managerial responsibility and because of that he was subject to a fiduciary duty.

As Newey J argued, there were a number of significant reasons as to why a shadow director owes a fiduciary duty to the company, at least to some degree.<sup>222</sup> Firstly, a person acting as a shadow director is expected to act in relation to the affairs of the company and to ask the company’s de jure directors to use their powers that exist solely for the company’s interest. Secondly, a person who directs or instructs the company’s de jure directors in the expectation that they will be acted on could equally be defined as assuming responsibility for the affairs of the company. Thirdly, while Parliament has not treated shadow directors as directors for all purposes in the Companies Acts, some provisions<sup>223</sup> may likely reflect a perception that a person who acts as a shadow director can bear responsibility for the affairs of the company. Fourthly, according to Newey J, ‘there is a compelling analogy with the position of

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<sup>221</sup> *ibid* 806.

<sup>222</sup> *ibid* 805.

<sup>223</sup> See for example, Insolvency Act 1986, s 214(7).

promoters'.<sup>224</sup> It is accepted that the promoters, because of their acceptance and use of powers, owe fiduciary duties 'which so greatly affect the interests of the corporation'.<sup>225</sup> It can be argued that a shadow director can also decide to make use of his powers which 'greatly affect the interests of the corporation'.<sup>226</sup> Fifthly, the role of a shadow director in the affairs of a company may be as significant as that of a company's de facto director, and it is considered that de facto directors owe fiduciary duties. Sixthly, 'that a shadow director may not subjectively wish to assume fiduciary duties cannot matter as such'.<sup>227</sup> Finally, public policy points towards imposing fiduciary duties on shadow directors.

Aside from the above reasons provided by Newey J, the fact that there was a consultancy agreement between the company and Mr Richards, where he agreed to faithfully serve the company and to act for its best interests, also played a significant role to conclude that Mr Richards, as a shadow director, owed fiduciary duties to the company. By doing so, he undertook an express duty of loyalty to act on the company's behalf in relation to the directions and instructions he gave to Mr Boch, which the shadow director had breached.

It could be argued that *Vivendi's* decision is welcome as it clarifies that, those who are in a position to exert control and real influence (albeit indirectly) over the company's affairs, to the extent that their directions and instructions will be followed by the company's directors, should be imposed with fiduciary duties. As Griffin argues, 'if a shadow director was absent of regulation, such a person could evade procedures and duties designed to prevent the mismanagement of a company's affairs'.<sup>228</sup> This would have been regarded as unjust and unfair for both the company and its minority shareholders as it would have been difficult to pursue a claim to remedy wrongs done to the company by the shadow directors. It could therefore be argued that Parliament's intention to include shadow directors in section 170, could be regarded as a significant development of the law to avoid injustices were possible. The same could be argued for section 260(5) in which a member of a company is now able to commence proceedings against a shadow director.

#### *4.4.3. Procedural requirements: The application for permission to continue the derivative claim*

One of the most essential and interesting issues under the new statutory derivative claim is the fact that the court has now been given the discretion to decide whether to allow or not the

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<sup>224</sup> *Vivendi SA* (n 220) 805.

<sup>225</sup> *ibid.*

<sup>226</sup> *ibid.*

<sup>227</sup> *ibid.*

<sup>228</sup> Griffin (n 198) 44.

continuance of the derivative claim. Although the court has been given broad discretion to decide on this matter, its discretion is not without constraints.<sup>229</sup> Due to the various concerns raised that by placing derivative action on a statutory footing would open the floodgates of vexatious litigation by individual shareholders, discretion was vested in the court under section 260 of the CA 2006 to consider an application for a derivative claim in two stages.<sup>230</sup> At the first stage, the court must consider the evidence provided by the claimant to pursue a derivative claim, and if the evidence filed does not disclose a prima facie case for allowing the continuance of a derivative claim, then the court should dismiss the claim.<sup>231</sup> It is worth noting that the Law Commission in its Report did not recommend the inclusion of this stage,<sup>232</sup> and that this stage was added to the CA 2006 by the House of Lords at a later stage,<sup>233</sup> in the belief that this would enable the court to make a prompt decision as to whether to dismiss the derivative claim. At the second stage, when the company provides evidence, the court is required to take into account a number of factors in order to decide whether to dismiss the claim, and these factors can be found under section 263(2) and section 263(3) which will be further examined below.

However, although some courts in recent cases have followed the two-stage procedure provided under section 260 of the CA 2006,<sup>234</sup> some others have shown their reluctance to do so.<sup>235</sup> Indeed, in a number of recent cases, the courts seem to have entirely ignored the first stage as, in order to avoid needless delay and cost, the parties to the claim have sensibly agreed to deal with the application immediately at the second stage.<sup>236</sup> Due to this complexity, the aim of the following section will be to identify the gaps and inconsistencies of the new statutory derivative action as this will help the thesis to examine whether derivative actions can, in fact, achieve commercial justice to minority shareholders. In determining whether derivative actions can achieve commercial justice, it is necessary to examine the courts' recent approach by looking at the new cases.

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<sup>229</sup> Davies and Worthington (n 47) 655.

<sup>230</sup> French, Mayson and Ryan (n 43) 553.

<sup>231</sup> Companies Act 2006, s 261(2).

<sup>232</sup> Law Commission (n 2) paras 6.4, 6.71.

<sup>233</sup> HL Deb 9 May 2006, vol 681, cols 884-885.

<sup>234</sup> *Iesini* (n 3).

<sup>235</sup> *Mission Capital Plc* (n 3); *Franbar Holding Ltd* (n 3); *Stimpson v Southern Landlords Association* [2010] BCC 387; See also Daniel Lightman, 'Coming of Age' (2010) 160 NLJ 1750.

<sup>236</sup> In *Mission Capital Plc v Sinclair* [2008] EWHC 1339 (Ch), [2008] BCC 866, 874 (Ch D), for example, Floyd J stated that 'in this case the parties have sensibly agreed to combine the two parts of the process'; Also, in the Scottish case of *Wishart v Castlecroft Securities Ltd* [2009] CSIH 65; [2010] BCC 161, 187 Lord Reid acknowledged that 'in practice, the parties may agree to telescope this procedure by dealing with the application in its entirety at a single hearing'.

#### 4.4.3.1. Court permission – The first stage

The first stage of the permission process involves a court being satisfied that the evidence filed by the members of a company disclose a prima facie case that assures the court to grant a permission to continue with a derivative claim. The rationale behind the first stage was to enable the courts to decide promptly as to whether a permission application for a derivative claim should be allowed to proceed.<sup>237</sup> This process does not require the company's involvement.<sup>238</sup> The onus is therefore on the member of the company who made the claim to show that the evidence he or she provided discloses a prima facie case that allows the continuance of the derivative claim. If this is not established, then the court should dismiss the application for the derivative claim.<sup>239</sup> On the other hand, if the member of a company is successful, then the application for permission to continue the derivative claim will pass to the second stage where the court will ask the company to provide evidence as to why permission to proceed should not be allowed.<sup>240</sup> At this stage, the court should then need to decide whether the application for permission should be allowed or not.

In the past, the prima facie case test was frequently used as the initial test for interim injunctions' cases,<sup>241</sup> which is still used in some injunction hearings nowadays.<sup>242</sup> Under the common law derivative action, it was also recognised that a member of a company who commences a derivative claim was required to prove a prima facie case at a preliminary stage of the hearing.<sup>243</sup> However, notwithstanding the fact that the prima facie case test was frequently used in the past, its meaning is still unclear.<sup>244</sup> As Keay and Loughrey stated, 'neither in applications for leave at common law, nor in injunction applications in the United Kingdom, have the courts discussed in detail the meaning of the term, nor what exactly an applicant must do to establish a prima facie case'.<sup>245</sup> They then went on to argue,

'It has been suggested that what is required is that a substantial chance of success at the final hearing can be demonstrated. This might suggest that it is inevitable that there is some consideration of the ultimate merits of the case. Certainly, in injunction hearings, the application of the test led to a focus on the relative strengths of the parties' cases and, in many instances, meant a virtual trial within a trial. In order to establish a prima facie case an

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<sup>237</sup> Dignam and Lowry (n 104) 201-202.

<sup>238</sup> The decision of the court as to whether the applicant's evidence discloses a prima facie case will normally be taken without the involvement of the company: 19C PD 5.

<sup>239</sup> Dignam and Lowry (n 104) 202.

<sup>240</sup> Companies Act 2006, s 261(3); See also Keay and Loughrey (n 1) 153-154.

<sup>241</sup> See *Hoffmann-Law Roche (F) & Co v Secretary of State for Trade & Industry* [1975] AC 295, 338, 360 (HL); Keay and Loughrey (n 1) 154.

<sup>242</sup> Keay and Loughrey (n 1) 154.

<sup>243</sup> See *Prudential Assurance Co Ltd* (n 132) 221.

<sup>244</sup> Keay and Loughrey (n 1) 154; See *American Cyanamid Co v Ethicon Ltd* [1975] AC 396, 404 (HL).

<sup>245</sup> *ibid* 154; See Christine Gray, 'Interlocutory Injunctions Since Cyanamid' (1981) 40 CLJ 307, 307.

applicant in injunction applications had to establish a greater than 50 per cent chance of success'.<sup>246</sup>

In contrast to the applications of interim injunctions, the prima facie case test was applied in a less rigorous manner in the common law derivative action, as little evidence from previous case law have shown that this test was in fact a major difficulty for minority shareholders when taking a derivative action.<sup>247</sup> Indeed, in only a few cases had a member of a company failed to prove a prima facie case.<sup>248</sup> As Key and Loughrey asserted, the necessity to establish a prima facie case on the merits of the case set a low threshold for the applicant shareholders to meet at common law and all 'the courts will require is for the applicant to demonstrate: a credible case; a substantive claim; a genuine triable issue; or that his case is worthy of being heard in full'.<sup>249</sup>

As the cases in common law derivative action have not clearly established what is required under the first stage of the permission process, it is now relevant to turn to the cases decided under the new statutory derivative action of the CA 2006 as this will help the thesis to identify any gaps and inconsistencies of the first stage. In *Stimpson v Southern Landlords Association*,<sup>250</sup> for example, the court decided that it was not relevant to consider the first stage in order to decide whether permission should be given to continue with the derivative claim. While it was suggested by the defendants that the court should consider both stages of the permission process, and that it was relevant for the court to start by asking whether a prima facie case had been made out, the court's opinion was that it 'was unduly elaborate in the circumstances of this case'.<sup>251</sup>

Key and Loughrey criticised the court's approach in *Stimpson* by arguing that the court has 'set the bar far higher than would have been envisaged'.<sup>252</sup> This is due to the fact that the judge in *Stimpson* believed that, in determining whether the applicant member has a prima facie case, a court is bound to take into account the factors available under sections 263(3) and (4) of the CA 2006.<sup>253</sup> In contrast, Gibbs argues that what Key and Loughrey support is 'an unfounded argument'<sup>254</sup> as he believes that the relationship the court drew when considering

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<sup>246</sup> *ibid.*

<sup>247</sup> *ibid.*

<sup>248</sup> See *Smith v Croft (No 2)* [1988] Ch 114.

<sup>249</sup> Andrew Key and Joan Loughrey, 'Something old, something new, something borrowed: an analysis of the new derivative action under the Companies Act 2006' (2008) 124 LQR 469, 484.

<sup>250</sup> *Stimpson* (n 235).

<sup>251</sup> *ibid* 388.

<sup>252</sup> Key and Loughrey (n 1) 156.

<sup>253</sup> *ibid* 155.

<sup>254</sup> David Gibbs, 'Has the statutory derivative claim fulfilled its objectives? A prima facie case and the mandatory bar: Part 1' (2011) 32 Company Lawyer 41, 43.

*Stimpson* was between sections 263(2)(a) and 263(3), and not between sections 261 and section 263 as Keay and Loughrey argues, ‘and *Stimpson* clearly shows, is a low threshold for establishing a prima facie case’.<sup>255</sup> With respect, it could be argued that the real intention of Keay and Loughrey was to point out that the factors under section 263 of the CA 2006 should not be addressed at the first stage. This is due to the fact that the judge in *Stimpson* preferred to approach ‘the application by reference to section 263...as if the case had been considered initially because that reflected the procedural as well as the practical reality and would yield the fair and proper result’.<sup>256</sup> It could therefore be argued that Keay and Loughrey correctly stated that there is no connection in the CA 2006 between sections 261 and 263, as there is no requirement under section 261 that the factors under section 263 should be considered and addressed. According to Keay and Loughrey,

‘suggesting that [the factors] are relevant at the first stage makes the first stage far more substantial than it should be, particularly when one considers the position that existed prior to the enactment of the statutory derivative regime. It seems that the interpretation given to the regime is that there will be substantial hearing at both stages of the process. While one might expect this at the second stage hearing, which is inter parties, this is not desirable at the first stage, which is held ex parte. This could obviously increase costs and could well act as a deterrent to members instituting derivative actions’.<sup>257</sup>

They therefore conclude that ‘the first stage should be limited to making sure that a claim is not bogus and should involve the court ensuring that the applicant is a member of the company and the application relates to derivative proceedings’.<sup>258</sup>

Another interesting case is *Franbar Holdings Ltd v Patel*<sup>259</sup>. Although William Trower QC acknowledged that in the normal course of the application for permission to continue with a derivative claim the court would have been required to take into account whether the evidence provided by a member of the company disclosed a prima facie case, he instead decided to merge the two stages into one.<sup>260</sup> The procedure in *Franbar* has been ‘telescoped’ and this is due to the fact that the judge believed that it was more appropriate ‘to deal with the entirety of the application for permission to continue at a single hearing’.<sup>261</sup> Similarly, in *Mission Capital Plc v Sinclair*<sup>262</sup> the two stages were conflated into one under the agreement made between

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<sup>255</sup> *ibid.*

<sup>256</sup> *Stimpson* (n 235) 388.

<sup>257</sup> Keay and Loughrey (n 1) 157.

<sup>258</sup> Keay and Loughrey (n 1) 157.

<sup>259</sup> *Franbar Holdings Ltd* (n 3).

<sup>260</sup> *ibid* 892.

<sup>261</sup> *ibid.*

<sup>262</sup> *Mission Capital Plc* (n 3).

the parties. According to the court in *Mission*, the most important part to consider in establishing whether to continue with the derivative claim was section 263(2)(a).<sup>263</sup>

Only in *Iesini v Westrip Holdings Ltd*<sup>264</sup> did the court consider what is required to establish a prima facie case. Lewison J explained the first stage process in the following way:

‘The Act now provides for a two-stage procedure when it is the member itself who brings the proceedings. At the first stage, the applicant is required to make a prima facie case for permission to continue a derivative claim, and the court considers the question on the basis of the evidence filed by the applicant only, without requiring evidence from the defendant company. The court must dismiss the application if the applicant cannot establish a prima facie case. The prima facie case to which section 261(1) refers is a prima facie case “for giving permission”’.<sup>265</sup>

However, in *Iesini*, Lewison J seems to have taken a very rigorous approach in relation to the prima facie case as he stated that the first stage ‘entails a decision that there is a prima facie case both that the company has a good cause of action and that the cause of action arises out of a directors’ default, breach of duty (etc.)’, acknowledging that this was the decision that the Court of Appeal in *Prudential v Assurance Co Ltd v Newman Industries Ltd* required.<sup>266</sup>

Although this was true, the decision in *Prudential* was based on the common law rules of derivative action instead of the rules provided under the new statutory derivative procedure.<sup>267</sup> It could therefore be argued that the court’s approach in *Iesini* was wrong as it relied on the common law rules instead of what the new statutory derivative procedure required.<sup>268</sup>

Due to the ambiguities in relation to the concept of a prima facie case, some academics have criticised the existence of the prima facie case test. As Gibbs argues, it seems that the new cases already mentioned above, are developing in a way that implies the necessity to have a prima facie case test is unfounded and that the test for a prima facie case to be established is still unquestionably low.<sup>269</sup> According to Gibbs,

‘it would be beneficial for all those involved to skip the first stage. Since most claims involve small private companies, the reduction of costs resulting from not having to go through establishing a prima facie case may encourage more people to bring meritorious claims; but with sufficient safeguards at the second stage this will sufficiently protect against frivolous claims’.<sup>270</sup>

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<sup>263</sup> *ibid* 874.

<sup>264</sup> *Iesini* (n 3).

<sup>265</sup> *ibid* 521-522.

<sup>266</sup> *ibid* 522; See also Key and Loughrey (n 1) 156.

<sup>267</sup> Key and Loughrey (n 1) 156.

<sup>268</sup> *ibid*.

<sup>269</sup> Gibbs (n 254) 43.

<sup>270</sup> *ibid*.

This is due to the fact that, as Hannigan argues, it is unlikely for the courts to ‘throw out a remotely plausible case’ at the first stage.<sup>271</sup> According to Hannigan, given that the new statutory derivative procedure ‘is a new remedy introduced to facilitate shareholder claims’, the courts ‘would be inclined to allow shareholder claimants the opportunity for a second-stage consideration of their concerns, bearing in mind that it is still possible for the court to stop the proceedings at that stage’.<sup>272</sup>

In contrast to the above arguments, Goehre seems to have a different opinion in relation to the concept of a prima facie case test. As Goehre argues, having both stages of the permission process is essential as it helps in efficiency as well as it saves corporate resources until the court is satisfied at an earlier stage that the evidence provided by the shareholders discloses a prima facie case.<sup>273</sup> This allows the court to dismiss, at an early stage, shareholders’ weaker claims before the company’s involvement, and this saves the company from having to incur any expenses.<sup>274</sup>

Considering the above arguments, it could be argued that Parliament failed to provide clear guidelines as to what the role of the court is in the prima facie case test, and this might lead to unjust and unfair results. On the one hand, this prima facie case test could be considered as an effective mechanism to avoid vexatious litigations by members of the company who have brought the claim without considering the interests of the company as a whole. In deciding whether to dismiss an application for permission to continue with a derivative claim at this earlier stage, it is essential for the court to ask itself whether it is commercially just for the company as a whole to do so. If yes, then the court should dismiss the claim.

On the other hand, the court might believe that, based on the facts of the case, it is better to consider both evidence provided by the shareholders and the company to the claim as this will help the court to reach a more commercially just outcome. If that is the case, then there is no reason why the courts should not be able to combine both stages if this is done for the purpose to do justice to the case. In order to achieve justice, it is essential for the court to balance the interests of all the parties to the claim and if the court believes that merging the two stages together can bring justice to the case then there is no reason why the courts should not be allowed to do so.

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<sup>271</sup> Brenda Hannigan, *Company Law* (3<sup>rd</sup> edn, OUP 2012) 425.

<sup>272</sup> *ibid.*

<sup>273</sup> Kurt A Goehre, ‘Is the demand requirement obsolete? How the United Kingdom modernized its shareholder derivative procedure and what the United States can learn from it’ (2010) 28 *Wisconsin International Law Journal* 140, 166-167.

<sup>274</sup> Goehre (n 273) 166.

#### 4.4.3.2. *Criteria considered by the court – the second stage*

If the court is satisfied that a prima facie case has been established, then the shareholder will move into the second stage of the permission process. At this stage, the court is required to consider a range of criteria in order to decide whether to give permission to continue a derivative claim. These criteria can be found under section 263, which is one of the core provisions of the CA 2006. Under section 263, there are three main criteria that the court should consider. The court must not give permission to continue with the derivative claim if: (i) a person acting in accordance with section 172 (the duty to promote the success of the company) would not seek to continue the claim;<sup>275</sup> (ii) the cause of action arises from a wrongdoing that has been authorised by the company;<sup>276</sup> and (iii) the cause of action arises from a wrongdoing that was authorised by the company before it occurred, or has been ratified by the company since it occurred.<sup>277</sup> If, in the court's opinion, the above criteria are not satisfied then permission to continue a derivative claim should be refused. As these criteria play significant role as to whether a derivative claim will be continued or not, it is therefore essential to further examine these criteria in the following sections.

##### 4.4.3.2.1. *The duty under section 172*

The Law Commission in its Report on *Shareholder Remedies*<sup>278</sup> pointed out that it is essential for the court at this stage to consider the interest of the company before deciding whether to allow a derivative claim to continue. Therefore, the first criterion (and the most essential one) that the court should consider in deciding whether to permit the continuance of a derivative claim is that whether 'a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim'.<sup>279</sup> In other words, the court should ask itself whether the director of a company, acting in accordance with his core duty of loyalty under section 172, would determine that the continuance of a derivative claim would not promote the success of the company as a whole, having also considered the factors set out in section 172(1)(a)-(f). This list is not exhaustive, but highlights important areas that need to be taken into account, such as the interests of the employees of the company, the necessity to foster the business relationships of the company with the suppliers, customers and others and the impact of the company's operations on the community and the environment.<sup>280</sup>

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<sup>275</sup> Companies Act 2006, s 263(2)(a).

<sup>276</sup> Companies Act 2006, s 263(2)(b).

<sup>277</sup> Companies Act 2006, s 263(2)(c).

<sup>278</sup> Law Commission (n 2) paras 6.77-6.79.

<sup>279</sup> Companies Act 2006, s 263(2)(a).

<sup>280</sup> Companies Act 2006, s 172(1)(a)-(f); See also Reisberg (n 82) 151.

However, although section 172 is one of the most significant provisions of the CA 2006, its meaning is still unclear as no clear guidance has been provided by the UK Parliament as to its meaning.<sup>281</sup> It could therefore be argued that, due to the uncertainties regarding the meaning of section 172, the court might find it difficult to decide whether to allow the continuance of a derivative claim and hence difficult to provide justice to minority shareholders.

The most important thing regarding section 172 is that there is no clear meaning as to what ‘the success of the company’ means. What criteria should the court then take into account in determining whether the decision of the director of a company, acting in accordance with section 172, not to continue with a derivative claim was for the company’s success? As Lord Goldsmith stated, ‘the starting point is that it is essentially for the members of the company to define the objectives that they wish to achieve’.<sup>282</sup> According to Lord Goldsmith,

‘Success means what the members collectively want the company to achieve. For a commercial company, success will usually mean long-term increase in value. For certain companies, such as charities and community interest companies, it will mean the attainment of the objectives for which the company has been established. But one can be more refined than that. A company’s constitution and the decisions that a company makes can also go on to be more specific about what is the appropriate success model for the company’.<sup>283</sup>

But who is the right person to decide whether the decision not to continue with a derivative claim was for the success of the company? According to Lord Goldsmith, it is the directors of the company itself who have the discretion to determine and form a good faith judgment as to what is to be regarded as success of the company.<sup>284</sup> This view was also supported in the Guidance on Key Clauses in the Company Law Reform Bill<sup>285</sup> where it was stated that,

‘the decision as to what will promote the success of the company, and what constitutes such success, is one of the directors’ good faith judgment. This ensures that business decisions on, for example, strategy and tactics are for the directors, and not subject to decision by the courts, subject to good faith’.<sup>286</sup>

It seems from the above views that the Government has conferred an unfettered discretion on the directors to decide what will be regarded as the success of the company, provided that, by doing so, the director is acting in accordance with his duty of loyalty under section 172. This approach however is problematic, in the sense that, if the directors (both interested and

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<sup>281</sup> See Andrew Keay, ‘Enlightened shareholder value, the reform of the duties of company directors and the corporate objective’ (2006) LMCLQ 335; Andrew Keay, ‘Section 172(1) of the Companies Act: An Interpretation and Assessment’ (2007) 28 Company Lawyer 106.

<sup>282</sup> HL Deb 6 February 2006, vol 678, col GC255.

<sup>283</sup> *ibid* col GC255-GC256.

<sup>284</sup> *ibid* col GC256.

<sup>285</sup> Clause 64 of the Guidance to Key Clauses in the Company Law Reform Bill 2005.

<sup>286</sup> Clause 64 of the Guidance to Key Clauses in the Company Law Reform Bill 2005.

disinterested) assert to the court that they did in fact consider the success of the company as well as the factors listed under section 172(1)(a)-(f), it will be very difficult for a member of a company to challenge their decision not to continue with a derivative claim.<sup>287</sup> Such an approach is likely to result in commercial injustice, especially if the directors have themselves caused the wrongdoing to the company. The problems and difficulties in leaving the litigation decision exclusively in the hands of the board of directors have already been considered and discussed in section 4.2.2. It is therefore relevant for the law to provide effective mechanisms that will ensure that the decision taken as to whether to give permission to continue a derivative claim was commercially just for both the company and its minority shareholders. From the above, it seems that minority shareholders still face significant barriers in bringing a derivative claim.

#### 4.4.3.2.2. *Authorisation or Ratification*

In deciding whether permission to continue a derivative claim should be refused or not, it is also relevant for the court to take into account the issues of authorisation and ratification which can be found under section 263(2)(b) and 263(2)(c) of the CA 2006. It is a fundamental principle of company law that ‘those to whom duties are owed may release those who owe the duties from their legal obligations. Thus, the shareholders in a general meeting, *acting as the company*, ought in principle to be able to release the directors from their general duties’.<sup>288</sup> This can be achieved in two ways: either by authorising a director’s breach of duty or by ratifying it. In the case of authorisation, this applies where the cause of action arises from an act or omission that has yet to occur.<sup>289</sup> This normally requires the approval of the majority of shareholders in the general meeting,<sup>290</sup> but it could also include the approval of the board of directors where a breach of director’s duty to avoid conflict of interest occurs.<sup>291</sup>

Ratification, on the other hand, involves only the approval of the majority of shareholders in the general meeting in relation to acts or omissions that have already occurred.<sup>292</sup> ‘When a wrong has been done to the company’, ratification ‘is the mechanism which determines whether that wrong can be put right, if it can be, whether it will be; whether the wrongdoers ought to be released from their liability, and, ultimately, whether litigation can and will be commenced’.<sup>293</sup> It seems from the above that the majority of shareholders in the general

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<sup>287</sup> Keay (n 281) 110.

<sup>288</sup> Davies and Worthington (n 47) 619 (emphasis added).

<sup>289</sup> Companies Act 2006, s 263(2)(b).

<sup>290</sup> Companies Act 2006, s 263(2)(b).

<sup>291</sup> Companies Act 2006, s 175(4)(b).

<sup>292</sup> See Companies Act 2006, s 239(2) and s 263(2)(c).

<sup>293</sup> Payne (n 47) 604.

meeting have been vested with significant power to release a wrongdoing director from his breach of duty owed to the company. This is due to the fact that, if the general meeting decides to ratify a director's wrongdoing, there will no longer be a cause of action in respect of which a member of a company could bring a derivative claim on behalf of the company to remedy the wrongs done to the company.<sup>294</sup> This of course begs the question whether the general meeting is the most suitable body to make decisions regarding this matter.<sup>295</sup>

As already discussed above,<sup>296</sup> leaving the litigation decision exclusively in the hands of the general meeting poses significant problems as, usually, in private companies majority shareholders are also the directors of the company, and possibly the wrongdoers that have caused the wrong to the company. It is a fundamental principle of company law that shareholders are free to exercise their voting powers to benefit their own self-interests, irrespective of whether these are opposed to those of the company and other shareholders.<sup>297</sup> Shareholders are not subject to fiduciary duties similar to those imposed on company's directors and therefore they do not have any legal obligation when voting at a general meeting to consider the interests of the company as a whole. The same seems to apply when they exercise their voting powers to ratify directors' wrongdoing.<sup>298</sup> It has long been recognised that the motives of shareholders in the general meeting when ratifying directors' wrongdoing are irrelevant. As Jessel MR in *Pender v Lushington*<sup>299</sup> stated,

'A [shareholder] may be actuated in giving his vote by interests entirely adverse to the interests of the company as a whole. He may think it more for his particular interest that a certain course may be taken which may be in the opinion of others very adverse to the interest of the company as a whole, but he cannot be restrained from giving his vote in what way he pleases because he is influenced by that motive'.<sup>300</sup>

Under the common law derivative action, a wrongdoing director in his capacity as a shareholder was able to use his voting powers in the general meeting to ratify his own wrongdoings.<sup>301</sup> However, for the reasons already examined in section 4.2.2 of this chapter, this approach seems to have caused significant problems, as it was difficult for the individual shareholders to bring a derivative claim on behalf of the company to remedy the wrongs done to the company. If Nozick was asked to take a position regarding this matter, he would

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<sup>294</sup> Hannigan (n 271) 427-429.

<sup>295</sup> Payne (n 47) 608-609.

<sup>296</sup> Text to n 82.

<sup>297</sup> *North West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589, 593; *Carruth v Imperial Chemical Industries Ltd* [1937] AC 707, 765; *Peter's American Delicacy Co Ltd v Heath* (1939) 61 CLR 457, 504 (Australia HC); *Northern Counties Securities Ltd v Jackson and Steeple Ltd* [1974] 1 WLR 1133, 1144.

<sup>298</sup> Hirt (n 47) 200.

<sup>299</sup> *Pender v Lushington* (1877) 6 Ch D 70.

<sup>300</sup> *ibid* 75.

<sup>301</sup> *North West Transportation Co Ltd* (n 297) 593; See Hirt (n 47) 200.

probably say that allowing wrongdoers to vote as they see fit to ratify their wrongdoings in the general meeting, would result in commercial injustice for both the company and its minority shareholders. Rawls would also argue that by allowing those who are in more advantaged position than others in the company to use their powers to benefit themselves without taking into account the least advantaged members of the company, it would result in commercial injustice as inequalities are only justified when the more advantaged members are also taking into account the interests of the least advantaged members. It would therefore be interesting to see how Parliament has grappled with the above problems to eliminate commercial injustice where possible.

In response to these problems, the Company Law Review Steering Group ('CLRSG') proposed that decisions to ratify directors' wrongdoing should 'depend 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'.<sup>302</sup> The CA 2006 seems to have followed the recommendations of the CLRSG as it has tackled the common law problems regarding this matter by introducing a new statutory provision that recognises that ratification will be regarded as valid only if the votes of the wrongdoers are excluded.<sup>303</sup> However, although this can be regarded as a significant development of the law on derivative actions, the CA 2006 seems to have made only limited changes to the law on ratification, as many of the complexities of the common law derivative action in relation to the issue of ratification have been left almost wholly untouched.<sup>304</sup> Therefore, due to the complexities of the issue of ratification, the particular focus of this chapter will be based only on the law of ratification with some minor important references to the law on authorisation. The aim of the following sections is to examine the issue of ratification at common law and how the law on ratification has been developed after the introduction of the CA 2006. This will help the thesis to identify the gaps and inconsistencies of the current law regarding this issue.

#### *4.4.4. Derivative actions and ratification*

Over the years, the complexities of the law on ratification have caused much controversy and academic discussion in the past, and it still does.<sup>305</sup> As mentioned above, while major statutory reforms have been made with the introduction of the CA 2006, many of the

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<sup>302</sup> Company Law Review Steering Group, *Completing the Structure* (n 148) para 5.85.

<sup>303</sup> See Companies Act 2006, s 239.

<sup>304</sup> Christopher A Riley, 'Derivative claims and ratification: time to ditch some baggage' (2014) 34 *Legal Studies* 582, 583.

<sup>305</sup> Wedderburn (n 47); Wedderburn (n 115); Payne (n 47); Hirt (n 47); Brenda Hannigan, 'Limitations on a shareholder's right to vote – effective ratification revisited' (2000) *JBL* 493; Riley (n 304).

complexities of the law on ratification in common law have remained untouched. The complexities surrounding the law on ratification derived from the fact that the distinction between ratifiable and non-ratifiable wrongs is still unclear.<sup>306</sup>

Although it was recognised by the Law Commission that the ‘law on ratification is by no means clear’,<sup>307</sup> it failed to resolve the complexities of the issue of ratification as no major reforms were recommended regarding this matter. It is therefore essential in the following section to start by examining the issue of ratification at common law, as this will help the thesis to assess whether the new statutory derivative action under the CA 2006 is an effective mechanism that has tackled with these problems.

#### 4.4.4.1. Ratification at common law

As examined above, the issue of ratification has caused a great deal of controversy and academic discussion over the years. As Wedderburn argued, ratification is an area whose ‘tentacles creep into every part of company law’.<sup>308</sup> The complexities and inconsistencies of the issue of ratification derived from the fact that the common law derivative action had adopted what has been named a ‘transaction-based’ approach.<sup>309</sup> In determining whether a resolution to ratify a director’s breach of duty was effective, it was essential to consider the character of the original wrongdoing, particularly whether the wrongdoing amounted to ‘fraudulent’ conduct, instead of considering the wrongdoers’ potential use of their voting powers.<sup>310</sup> As Davies and Worthington stated, ‘the question which has bedeviled the common law was...which breaches of duty by a director were capable of being ratified’.<sup>311</sup>

It has long been recognised that breaches of directors’ duties that amounted to a ‘fraudulent’ conduct were not capable of being ratified.<sup>312</sup> As noted above,<sup>313</sup> the real exception noted by Jenkins LJ in *Edward v Halliwell*<sup>314</sup> to the rule of *Foss* was ‘fraud on the minority’. In his seminal article *Shareholders’ Rights and the Rule in Foss v Harbottle*, Wedderburn reached the conclusion that ‘fraud’, in the context of ‘fraud on the minority’, lies ‘in the nature of the transaction [rather] than in the motives of the majority’.<sup>315</sup> In other words, ‘fraud’ refers to the nature of the wrongdoing, rather than whether the wrongdoers have fraudulently exercised

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<sup>306</sup> See Payne (n 47).

<sup>307</sup> Law Commission (n 2) para 6.81.

<sup>308</sup> Wedderburn (n 115) 212.

<sup>309</sup> See Riley (n 304) 583.

<sup>310</sup> *ibid.*

<sup>311</sup> Davies and Worthington (n 47) 625.

<sup>312</sup> Birds et al (n 58) 663.

<sup>313</sup> Text to n 104.

<sup>314</sup> *Edwards* (n 7).

<sup>315</sup> Wedderburn (n 47) 96.

their voting powers in their capacity as shareholder to benefit their own self interests instead of those of the company. The law on ratification in common law was therefore based on the nature of the wrongdoing, and not on the motives of the wrongdoers to ratify their own wrongdoings when voting at a general meeting.<sup>316</sup>

However, the transaction-based approach adopted in common law was not left without its criticisms. It has been argued that the transaction-based approach was ineffective because it failed to clarify ‘what characteristics made a wrong sufficiently egregious to constitute “fraud” in the first place’.<sup>317</sup> As Baxter argued, the category of fraud ‘comprises a ragbag of miscellaneous fiddlings which seem to defy all attempts to form them into recognisable juridical classes’.<sup>318</sup> It has long been recognised that expropriating the property of the company to advantage personal interests, amounted to a fraud on the minority.<sup>319</sup> According to Davies and Worthington, the property of the company is ‘something in which all the shareholders of the company have a (pro rata) interest. Therefore, a resolution by the majority of shareholders to ratify directors’ breaches of duty, which would offend this principle of equality, is ineffective’.<sup>320</sup> However, in practice, this principle is easier to formulate than to apply, due to the uncertainties as to the exact meaning of ‘corporate property’. The uncertainties as to the meaning of ‘corporate property’ became apparent from the judgment of Lord Davey in *Burland v Earle*,<sup>321</sup> where he defined ‘corporate property’ as ‘money, property or advantages which belong to the company or in which other shareholders are entitled to participate’.<sup>322</sup> Due to the uncertainties of the transaction-based approach, it was found to be extremely difficult to draw a satisfactory line between fraudulent and non-fraudulent wrongs.

The complexities surrounding the transaction-based approach adopted in common law were also apparent in its treatment on the issue of negligence.<sup>323</sup> Under the common law, mere negligence was not recognised as fraudulent conduct and therefore it was capable of being ratified by the majority of shareholders at a general meeting.<sup>324</sup> Indeed, in *Daniels v Daniels*,<sup>325</sup> the court has recognised that, what has been called as ‘self-serving’ negligence, is not capable of being ratified and that fraud exists where wrongdoing directors ‘use their

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<sup>316</sup> Payne (n 47) 614.

<sup>317</sup> Riley (n 304) 586.

<sup>318</sup> Colin Baxter, ‘The true spirit of *Foss v Harbottle*’ (1987) 38 Northern Ireland Legal Quarterly 6, 14.

<sup>319</sup> See *Burland* (n 8) 93.

<sup>320</sup> Davies and Worthington (n 47) 625.

<sup>321</sup> *Burland* (n 8).

<sup>322</sup> *ibid* 93.

<sup>323</sup> Riley (n 304) 587.

<sup>324</sup> *Pavlides* (n 118).

<sup>325</sup> *Daniels* (n 122).

powers, intentionally or unintentionally, fraudulently or negligently, in a manner which benefits themselves at the expense of the company'.<sup>326</sup>

Due to the complexities of the transaction-based approach, Riley argues that the cure to the uncertainties of the transaction-based approach can be achieved 'through its replacement with what has been termed as "voting-based" approach' as 'this would abandon the distinction between fraud and non-fraudulent wrongs'.<sup>327</sup> According to Riley, 'since the voting-based approach avoids the distinction between fraud and non-fraud, prevents self-interests voting and permits all wrongs to be ratified, it promises to avoid the defects in the transaction-based approach' already mentioned above.<sup>328</sup> It is therefore essential in the following section to examine how the UK Parliament has tackled the problems of the transaction-based approach in common law when introducing the CA 2006.

#### 4.4.4.2. Ratification under the Companies Act 2006

In analysing the above issues, this raises the following question: To what extent did the UK Parliament successfully resolve the complexities and inadequacies of the transaction-based approach in common law when introducing the new statutory derivative action? Although the Law Commission has stressed the importance of the issue of ratification to the scope of derivative actions when acknowledging that 'it is not always clear when ratification will be effective',<sup>329</sup> however, it declined to propose further reforms to tackle these problems. The Law Commission did, nevertheless, stress that ratification should still continue to be an absolute bar for individual shareholders when bringing a derivative claim.<sup>330</sup> What would amount to effective ratification would be determined in accordance with the existing law, a position that the Commission itself conceded raised the '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 had been (or may be) ratified'.<sup>331</sup>

Contrary to the Law Commission, the CLRSG<sup>332</sup> was more reluctant to offer recommendations for further reform in relation to the principles governing the issue of ratification. In its consultation paper, *Developing the Framework*,<sup>333</sup> the CLRSG recognised

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<sup>326</sup> *ibid* 414.

<sup>327</sup> Riley (n 304) 597.

<sup>328</sup> *ibid* 597-598.

<sup>329</sup> Law Commission (n 140) para 5.2.

<sup>330</sup> Law Commission (n 2) para 6.84.

<sup>331</sup> *ibid* para 6.81.

<sup>332</sup> Company Law Review Steering Group (CLRSG), *Modern Company Law for a Competitive Economy: Developing the Framework* (London, DTI March 2000).

<sup>333</sup> *ibid*.

that ‘modernisation and simplification’ of the law on ratification may be appropriate and that, moreover, the ‘principles which should apply are clear’.<sup>334</sup>

From the CLRSG’s recommendations, it seems that its preferable approach was the ‘voting-based’ approach. This is due to the fact that, according to the CLRSG, in determining whether permission should be given for a derivative claim, it is relevant to establish whether any decision taken by the company not to sue ‘has been taken by, or was dependent on, the votes of the wrongdoers or those under the influence of the wrongdoers’.<sup>335</sup> If the decision is reached in this way, then ‘it should clearly not be valid to preclude a derivative action’.<sup>336</sup> Ratification taken independently of the wrongdoers was envisaged as sufficient to preclude a derivative action, and that conclusion ‘did not inherently depend on the character of the conduct complained of’.<sup>337</sup> These views survived largely intact in the CLRSG’s next consultation paper, *Completing the Structure*.<sup>338</sup> Decisions to ratify should ‘depend 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’.<sup>339</sup>

The CLRSG’s recommendations seem to have been followed by the CA 2006 when the new statutory derivative claim was introduced. Contrary to the common law, it is without doubt that under the CA 2006, a derivative claim may be brought by a member of a company for any breach of director’s duty, irrespective of whether the nature of the transaction amounted to a fraudulent wrong or not, as there is no longer a requirement to prove that the wrong caused to the company amounted to a fraudulent conduct.<sup>340</sup> However, it is worth noting that section 239 of the CA 2006 provides that ‘this section does not affect... any rule of law as to acts that are incapable of being ratified by the company’. This provision seems to show that the CA 2006 falls back to the common law rules and by doing so, it inevitably preserves all the uncertainties surrounded the transaction-based approach. It could therefore be argued that the CA 2006 failed to tackle the problems of the common law as to the meaning of fraud and the distinction between ratifiable and non-ratifiable wrongs.<sup>341</sup> As Riley argues, ‘for a reform

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<sup>334</sup> *ibid* 4.134.

<sup>335</sup> *ibid* 4.135.

<sup>336</sup> *ibid* 4.136.

<sup>337</sup> *ibid* 4.135.

<sup>338</sup> Company Law Review Steering Group, *Completing the Structure* (n 148).

<sup>339</sup> *ibid* 5.85.

<sup>340</sup> See Companies Act 2006, s 260(3).

<sup>341</sup> Riley (n 304) 603.

process lasting [10] years, and aiming to produce a more certain and comprehensible body of law, this is a sad indictment of its efforts'.<sup>342</sup>

However, while the CA 2006 failed to tackle the problems of the common law, it did try to provide solutions to the problem and this has been done in the following way. It is now a requirement under sections 239(3) and (4) of the CA 2006 that any ratification of a director's breach of duty should be an 'unconnected' one; that is, a resolution to ratify the director's wrongdoing will be regarded as valid only if it passed without the votes of the wrongdoer or any person connected with him. However, the scope of this reform was not left without its criticisms, as it seems to be limited in several ways.<sup>343</sup> First, the requirement to exclude 'connected persons' from voting only applies to the case of ratification, as no such requirement exists in relation to the law of authorisation. As Hannigan argues, 'this might be tempting for the wrongdoers to use their voting powers ahead of time to seek authorisation for their breach of duty'.<sup>344</sup> Secondly, the CA 2006 seems to exclude only the votes of persons who are connected to the wrongdoing directors. It is worth noting that when the Company Law Reform Bill<sup>345</sup> was originally drafted, there was a requirement that any ratification should be disinterested; that is, ratification would be effective only if the resolution was taken without the votes of members 'with a personal interest, direct or indirect, in the ratification'. Concerns, however, have been raised as to the ambiguity of the terminology of 'a personal interest, direct or indirect, in the ratification'. The category of 'connected persons' on the other hand, seems to have been defined in exhaustive detail under the CA 2006.<sup>346</sup> However, as Riley argues,

'while the category of "connected persons" may be more certain, it also gives the court substantially less flexibility in determining whether it is inappropriate for a particular shareholder to join in the vote, given the specific details of his relationship to a wrongdoer, or his interest in the transaction in question'.<sup>347</sup>

According to Riley, it seems that the category of 'connected persons' 'was simply not designed for the purpose of excluding some members from voting on matters in which they have an illegitimate personal interest'.<sup>348</sup> As Riley argues,

'it was, rather, designed to extend the definition of a director, in situations in which liability was being imposed on directors for benefits that they might have improperly secured. It

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<sup>342</sup> *ibid.*

<sup>343</sup> *ibid* 602.

<sup>344</sup> Hannigan (n 271) 429.

<sup>345</sup> Company Law Reform HL Bill (2005-2006) 34, cl 216(4).

<sup>346</sup> See Companies Act 2006, ss 252-256.

<sup>347</sup> Riley (n 304) 602.

<sup>348</sup> *ibid.*

catches those who, in virtue of being benefited, benefit a director. It does not catch all those who, for example, may be so influenced by, or so dependent upon, a director, that they cannot be trusted to vote in the best interests of the company. To take but one example, the definition of connected persons does not include those who have a close business relationship (other than being members of a partnership) with a director'.<sup>349</sup>

However, although the scope of this reform was not left without its criticisms, it could be argued that this is a significant development of the law on derivative actions as it precludes those who have caused the wrong to the company from ratifying their own wrongdoings. The new statutory derivative action can therefore be seen as an effective mechanism to achieve commercial justice to minority shareholders as the exclusion of wrongdoers from voting (including persons who are connected with the them) has reduced 'the danger of biased corporate decisions and unfair treatment of minority shareholders'. Allowing wrongdoers to vote at a resolution to ratify their own wrongdoings is unjust and unfair for individual shareholders, as it would have been difficult for them to bring a derivative claim to remedy the wrongs done to the company. It is therefore essential for the law to develop such mechanisms that prevent wrongdoers from taking an unjust advantage at the expense of the company and its minority shareholders in order to avoid commercial injustices where possible. Of course, there is still an open window for further improvement due to the difficulties already raised above regarding how effective the independence of the disinterested directors is to avoid commercial injustices. This is an issue that will be further analysed in chapter five where a discussion of the US experience regarding this matter will be provided.

#### 4.4.4.3. *Franbar Holdings Ltd v Patel*<sup>350</sup>

Having analysed the issue of ratification and its complexities, it is now relevant to see how ratification was applied in practice under the new case law. *Franbar* is an important case to be examined, as it is the only case that dealt with the issue of ratification in further detail after the introduction of the new statutory derivative procedure. The facts of this case were as follow. Franbar Holdings Ltd ('Franbar') was a minority shareholder in Medicentres (UK) Ltd ('Medicentres') owing 25% of the company's shares with the remaining 75% of shares held by Casualty Plus Ltd ('CP'). Two directors were appointed by CP to join the board of Medicentres. It was alleged by Franbar that CP's appointed directors had caused business opportunities for Medicentres to be diverted to CP and by doing so they had breached their

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<sup>349</sup> *ibid.*

<sup>350</sup> *Franbar Holdings Ltd* (n 3).

duties owed to Medicentres. As a result, Franbar brought a derivative claim against CP's appointed directors on behalf of Medicentres.<sup>351</sup>

Counsel for the two defendant directors argued that CP was likely to ratify their wrongdoings because CP was the majority shareholder of Medicentres and therefore was able to use its voting power in favour of a resolution to ratify directors' wrongdoings. In deciding whether permission should be given to continue with the derivative claim, the court had to consider whether such ratification would be effective. As section 239 of the CA 2006 provides, ratification will be effective only if it is passed without the votes of wrongdoers or any persons who are connected with them. It was therefore argued that CP's votes could only be disregarded if CP was a person connected to the defendant directors. In *Franbar*, although CP had appointed the two defendant directors to join the board of Medicentres, the court held that no evidence had been found that proved that CP was a person connected to them in accordance with section 254 of the CA 2006.<sup>352</sup> Counsel for the defendant directors argued that the provisions dealing with connected persons of the CA 2006 seem to have replaced the common law rules that specific wrongs were not capable of being ratified. It was clear that, if a resolution was passed without the votes of the wrongdoers or any persons connected with them, all wrongs were capable of being ratified. As CP was not found to be a connected person to the wrongdoers, it was therefore able to ratify their wrongdoings.<sup>353</sup>

Contrary to these contentions, William Trower QC argued that the connected person provisions in section 239 of the CA 2006 were not intended to replace the common law principle 'that breach of duty by a director is incapable of ratification where it constitutes a fraud on the minority in circumstances in which the wrongdoers are in control of the company'.<sup>354</sup> As William Trower QC argued, section 239(7) expressly preserves any rule of common law in relation to acts that are not capable of being ratified by a resolution at a general meeting.<sup>355</sup> He therefore concluded that the connected person provisions in section 239(3) and (4), instead of replacing the common law rules, have imposed 'additional requirements for effective ratification which draw on existing equitable rules but which impose more stringent demands'.<sup>356</sup> This is due to the fact that, at common law, the wrongdoers or any persons connected to them were able to ratify wrongs that were capable of

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<sup>351</sup> It is worth mentioning that Franbar also brought proceedings for breach of a shareholder's agreement against CP and an unfair prejudice petition under section 994 of the CA 2006 against CP and the two defendant directors.

<sup>352</sup> *Franbar Holdings Ltd* (n 3).

<sup>353</sup> *ibid.*

<sup>354</sup> *ibid* 897.

<sup>355</sup> *ibid.*

<sup>356</sup> *ibid.*

being ratified. By contrast, under section 239 of the CA 2006, it seems that even ratifiable wrongs are not capable of being ratified by the wrongdoers.<sup>357</sup>

He then went on to argue that Sir Richard Baggallay's words in *North West Transportation Co Ltd v Beatty*<sup>358</sup> remained good law,<sup>359</sup> namely that the resolution to ratify will be regarded as effective provided that 'such affirmance or adoption is not brought about by unfair or improper means, and it not illegal or fraudulent or oppressive towards those shareholders who oppose it'.<sup>360</sup> In criticising *Franbar*'s case, Key and Loughrey argued that William Trower QC's above comments

'seem to be directed at the act of ratification itself rather than the wrongs which preceded it. They would be apposite where ratification had been achieved through wrongdoer control of the general meeting and seems to reintroduce the concept of wrongdoer control into the derivative action, though the 2006 Act itself makes no reference to this'.<sup>361</sup>

Although there is no longer a requirement under CA 2006 to prove wrongdoer control,<sup>362</sup> it seems that William Trower QC in *Franbar* did have wrongdoer control in mind as he stated that the issue was 'whether ratification has the effect that the claimant is being improperly prevented from bringing the claim on behalf of the company'.<sup>363</sup> This would be the case

'where the new connected person provisions are not satisfied, but there is still actual wrongdoer control pursuant to which there has been a diversion of assets to persons associated with the wrongdoer, albeit not connected in the sense for which provision is made by s 239(4)'.<sup>364</sup>

It could be argued that by bringing up the issue of wrongdoer control as a requirement to bring a derivative claim, this confuses the matters further as it makes it more difficult for the courts to know what criteria they should take into account when deciding whether to allow a member of a company to continue with a derivative claim. In addition, as mentioned above, there were two views as to when a resolution for ratification would be regarded as effective or not: the transaction-based approach and the voting-based approach.<sup>365</sup> It seems that William Trower QC in *Franbar* was not actually clear as to which one of the two approaches he favoured as the best approach for the courts to follow when deciding whether permission should be given to continue with a derivative claim. This is due to the fact that, on one hand,

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<sup>357</sup> Key and Loughrey (n 1) 163.

<sup>358</sup> *North West Transportation Co Ltd* (n 297).

<sup>359</sup> *Franbar Holdings Ltd* (n 3) 897.

<sup>360</sup> *North West Transportation Co Ltd* (n 297) 594.

<sup>361</sup> Key and Loughrey (n 1) 163.

<sup>362</sup> Although there is judicial and academic comment to the contrary. See *Stimpson* (n 235); Kershaw (n 91) 10.

<sup>363</sup> *Franbar Holdings Ltd* (n 3) 897-898.

<sup>364</sup> *ibid* 898.

<sup>365</sup> Key and Loughrey (n 1) 164; See Payne (n 47) 612; Hirt (n 47) 202.

William Trower QC accepted that ‘some of the complaints made by Franbar may well be incapable of ratification’,<sup>366</sup> which makes one think that William Trower QC was in favour of the transaction-based approach, but on the other, he said that such complaints were ‘incapable of ratification on the votes of Casualty Plus, more particularly if it was done with the intention of driving down Medicentres’ earnings and reducing the amount payable to Franbar on exercise of the option’.<sup>367</sup> Although Keay and Loughrey argued that ‘this suggests that ratification might have been effective if it could have been achieved through the votes of shareholders other than Casualty Plus, and thus suggests that he adopted the voting-based approach’,<sup>368</sup> it could be argued that William Trower QC has not actually expressly stated in *Franbar* whether he prefers the transaction-based approach or the voting-based approach. This makes the law on derivative actions unnecessarily complicated and difficult.

The failure of the UK Parliament to provide clear guidelines as to whether the courts should consider the transaction-based approach or the voting-based approach has created uncertainties that require further reforms. Although Parliament has recognised that the role of the courts is essential in determining whether to allow a member of a company to continue with a derivative claim, it failed to clarify the actual role and function of the courts in this context. As mentioned above, Lord Davey in *Burland v Earle*<sup>369</sup> recognised that the court’s desire is ‘to give a remedy for a wrong which would otherwise escape redress’.<sup>370</sup> It is the intention of the thesis to argue that the role of the courts should be to remedy commercial injustices through the use of derivative actions. This could be achieved by allowing the courts to follow an overarching guiding principle of ‘commercial justice’ already developed in chapter two, as this will give flexibility to the courts to decide whether allowing a derivative claim or not is commercially just for the company as a whole. The courts should therefore take into account ‘commercial justice’ when considering the stages provided under the CA 2006 and by doing so, this will help the courts to determine whether commercial justice has been achieved.

Although such an overarching guiding principle has not been recognised so far in the context of derivative actions, it is worth noting that the importance of considering justice when deciding whether to allow a derivative claim has been recently stressed by Briggs J in

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<sup>366</sup> *Franbar Holdings Ltd* (n 3) 898.

<sup>367</sup> *ibid.*

<sup>368</sup> Keay and Loughrey (n 1) 164.

<sup>369</sup> *Burland* (n 8)

<sup>370</sup> *ibid* 93.

*Universal Project Management Services Ltd v Fort Gilkicker Ltd & Ors* ('UPSM').<sup>371</sup> In *UPMS*, Briggs J recognised that multiple derivative actions should be allowed because of his desire to do justice to minority shareholders in corporate groups otherwise the wrongs caused to the subsidiary would have remained unredressed. However, before examining the importance of the *UPMS* case, it is firstly relevant to briefly examine in the following section the factors under section 263(3) of the CA 2006 that the court should also consider when exercising its discretion whether to allow the continuance of a derivative claim.

#### **4.5. Section 263(3) – List of factors that the court should consider in exercising its discretion to allow a derivative claim**

The court, in exercising its discretion as to whether to allow the continuance of a derivative claim, needs to also consider a list of factors specified under section 263(3) of the CA 2006. This list is not exhaustive; that is, it does not exclude the court to consider other factors that in its discretion are relevant, such as the company's employee's position<sup>372</sup> and the solvency of the company.<sup>373</sup>

The first factor that the court needs to consider is whether the member bringing a derivative claim is acting in good faith.<sup>374</sup> The motives of the company's member seeking to bring such a claim are therefore relevant for the court to decide whether to allow the continuance of such a claim.<sup>375</sup> It was recognised in *Iesini* that if the 'dominant purpose' of the member in bringing the claim was for the company's best interest, despite receiving some benefits from doing so, then it is unlikely for the court to decide that the claim was not brought in good faith.<sup>376</sup> Indeed, the fact that the member might have some commercial interests from taking the claim would not necessarily make the court to refuse the claim as long as the claim was taken for the best interest of the company.<sup>377</sup> However, if the member seeking to continue the claim was involved in the wrongdoing, then the court will decide that this member is not the proper claimant to bring such a claim.<sup>378</sup> In addition, it has been recognised that when a member of a company is seeking to continue the claim with the purpose to advance his

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<sup>371</sup> *Universal Project Management Services Ltd v Fort Gilkicker Ltd & Ors* [2013] EWHC 348 (Ch); [2013] Ch 551.

<sup>372</sup> See *Stimpson* (n 235) [37].

<sup>373</sup> See *Cinematic Finance Ltd v Ryder* [2012] BCC 797.

<sup>374</sup> s 263(3)(a).

<sup>375</sup> See *Barrett v Duckett* [1995] 1 BCLC 243, 250.

<sup>376</sup> *Iesini* (n 3) 532.

<sup>377</sup> See *Hughes v Weiss* [2012] EWHC 2363 [47]; *Parry v Bartlett* [2011] EWHC 3146 (Ch); [2012] BCC 700 [86].

<sup>378</sup> *Iesini* (n 3) 532.

personal interests instead of the company's interests, for example his interests as the company's creditor, then such a person is not acting in good faith.<sup>379</sup>

The second factor that the court needs to take into account is the importance that a company's director acting in accordance with section 172 would attach to continue the claim.<sup>380</sup> As was already examined above,<sup>381</sup> section 263(2)(a) requires the court to consider whether a director acting in accordance with section 172 would not seek to continue the derivative claim and if the director would not want to continue it, then the court will not give its permission.

Accepting that a company's director acting in accordance with section 172 would want to continue the derivative claim, then the court should move on to assess the importance that a company's director would attach to continue such a claim.<sup>382</sup> The court will particularly consider the issue from the hypothetical director perspective, acting in the way he considers would be most likely to promote the success of the company.<sup>383</sup> In other words, the court will assess the commercial considerations that a hypothetical director will regard as relevant to continue the claim. In *Franbar Holdings v Patel*,<sup>384</sup> for example, the court stated that

'the hypothetical director acting in accordance with s 172 would take into account a wide range of considerations when assessing the importance of continuing the claim. These would include such matters as the prospects of success of the claim, the ability of the company to make a recovery on any award of damages, the disruption which would be caused to the development of the company's business by having to concentrate on the proceedings, the costs of the proceedings and any damage to the company's reputation and business if the proceedings were to fail'.<sup>385</sup>

It is worth mentioning that in *Kleanthous v Paphitis*,<sup>386</sup> the decision of the court not to permit a derivative claim was influenced by the fact that an independent body of non-executive directors believed that such a claim should not be continued, as their position was seen to be somewhat akin to that of a hypothetical director.

In addition, pursuant to sections 263(3)(c) and (d), the court also needs to consider whether the wrong allegedly committed by the company's director is likely to be authorised or ratified by the company. As the issue of authorisation and ratification was already discussed in sections 4.4.3.2.2 and 4.4.4, no further examination is needed at this point.

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<sup>379</sup> See *Abouraya v Sigmund & Ors* [2014] EWHC 277 (Ch).

<sup>380</sup> s 263(3)(b)

<sup>381</sup> See 4.4.3.2.1.

<sup>382</sup> See s 263(3)(b).

<sup>383</sup> See *Hughes* (n 377) [54]: 'Success' may mean ensuring a 'fair distribution of benefits' to the company's members.

<sup>384</sup> *Franbar Holdings Ltd* (n 3).

<sup>385</sup> *ibid* [36].

<sup>386</sup> *Kleanthous v Paphitis* [2011] EWHC 2287.

The fifth factor under section 263(3)(e) requires the court to consider whether the company has decided not to pursue the derivative claim. As mentioned in section 4.2.2, both the board of directors and the shareholders in the general meeting have been given the power to take litigation decisions. The court should therefore consider their decision not to take any action against the wrongdoing directors. By doing so, the court should assess the opinion of either the board or the majority of shareholders about the benefits of not taking such a claim. The decision of the courts in this matter will depend on the quality of the board or the majority of shareholders' decision considering issues such as whether the decision was taken by interested or disinterested directors. For example, in *Kleanthous v Paphitis*<sup>387</sup>, the court, in reaching its decision not to allow a derivative claim, considered the fact that the company's board had set up a committee of disinterested directors who in their opinion, such a claim would not be in the company's commercial interests. As a result, the court refused to give its permission to continue the derivative claim.

The final factor, which can be found under section 263(3)(f), focuses on whether there is a cause of action that a member of a company could pursue in his own personal right rather than on behalf of the company. Perhaps the most obvious claim that a member of a company might bring in his own right is the unfairly prejudicial petition under section 994 of the CA 2006. Before the introduction of the CA 2006, it has been recognised by Gibson LJ in *Barrett v Duckett*<sup>388</sup> that if an alternative remedy exists, then the court will not permit the continuance of a derivative claim. It was therefore argued that the existence of an alternative remedy was an absolute bar to derivative claims. However, in the recent case of *Hughes v Weiss*,<sup>389</sup> His Honour Judge Keyser QC (sitting as a judge of the High Court) allowed a derivative claim to proceed, irrespective of the existence of an alternative remedy (in this case, the existence of a voluntary winding up and an unfairly prejudicial petition under section 994 of the CA 2006). This is an important and interesting case as the trial judge came to the conclusion that, although the availability of an alternative remedy is an important factor, it was not an absolute bar to a derivative claim before the introduction of the CA 2006.<sup>390</sup> In this case, a derivative claim was found to be more appropriate than an unfairly prejudicial petition under section 994 of the CA 2006 as the member of the company was merely seeking a remedy for the company for misfeasance and not the purchase of the member's shares.<sup>391</sup> It could be argued that the

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<sup>387</sup> *ibid.*

<sup>388</sup> *Barrett v Duckett* [1995] BCC 362, 367.

<sup>389</sup> *Hughes* (n 377).

<sup>390</sup> *ibid* [61]; See *Parry* (n 377); *Phillips v Fryer* [2012] EWHC 1611 (Ch); David Milman, 'Protection of minority shareholders in the post-Companies Act 2006 era' (2012) *Company Law Newsletter* 1.

<sup>391</sup> *ibid* [66]; See *Kleanthous* (n 386) [80]-[81] where a permission of a derivative claim was refused because there was a suspicion that the member seeking to bring a derivative claim has chosen to bring such a claim to

court in this case has achieved ‘commercial justice’ as the court seems to have considered the commercial interests of both the claimant and its company to pursue such a claim.

Having briefly examined the factors that the court need to consider under section 263(3) of the CA 2006 when deciding whether to allow the continuance of a derivative claim, it is now relevant in the following section to examine the issue of multiple derivative actions; a recent and an important development on the law of derivative actions.

## **4.6. Multiple Derivative Actions in the UK Revisited**

### *4.6.1. Introduction*

As analysed above, the law on derivative actions has recently been developed significantly to provide more effective protection for minority shareholders against the abuse or expropriation of the board and the majority of shareholders in general meeting. The complexities surrounding the *Foss* rule and its exceptions boosted Parliament to replace the rule with the new statutory derivative action introduced by the CA 2006. However, one arguably significant omission of the CA 2006 is that no provision was made for ‘multiple derivative action’; an action taken by a member in a parent company on behalf of the subsidiary company for wrongs caused to the latter.<sup>392</sup> As no provision was made for multiple derivative actions it could easily be argued that such actions are not recognised in the UK and that only an ‘ordinary derivative action’ is allowed to be brought,<sup>393</sup> i.e. only ‘a member of a company’ can commence proceedings ‘in respect of a cause of action vested in the company, and seeking relief on behalf of the company’.<sup>394</sup>

Although a number of respondents to the Law Commission’s proposals had thought to include a provision for multiple derivative actions in the CA 2006, the Law Commission was reluctant to do so. This is due to the fact that the Law Commission was not persuaded that such a provision would be ‘helpful or practicable’ to be included.<sup>395</sup> It was argued by the Law Commission that, the circumstances where such actions would be helpful or practicable were ‘likely to be extremely rare and that any rule attempting to deal with [multiple derivative actions] would be complicated and unlikely to be able to cover every conceivable

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obtain the benefit of a costs indemnity order. In this case, it was found that the existence of an unfairly prejudicial petition remedy under section 994 was a relevant factor for the court to refuse permission of the derivative claim as the unfairly prejudicial petition was more appropriate than a derivative claim.

<sup>392</sup> SH Goo, ‘Multiple Derivative Action and Common law Derivative Action Revisited: A Tale of Two Jurisdictions’ (2010) 10 *Journal of Corporate Law Studies* 255, 255; See also Law Commission (n 2) para 6.109.

<sup>393</sup> An ordinary derivative action is an action brought by a member of the company on behalf of the company for wrongs caused by the wrongdoers to the company; See Arad Reisberg and DD Prentice, ‘Multiple derivative actions’ (2009) *LQR* 209, 209; See also Tan Cheng-Han, ‘Multiple derivative actions’ (2013) *LQR* 337, 337.

<sup>394</sup> Companies Act 2006, s 260.

<sup>395</sup> Law Commission (n 2) para 6.110.

situation'.<sup>396</sup> As a result, it was suggested that no provision should be made for multiple derivative actions, as, in the opinion of the Law Commission, such actions are 'best left to the courts to resolve'.<sup>397</sup> Therefore, when the new statutory derivative action was enacted under the CA 2006, the viability of multiple derivative actions was not addressed nor 'had it been authoritatively determined judicially'.<sup>398</sup>

However, in contrast to the Law Commission's recommendations, it has recently been recognised that multiple derivative actions should be allowed in the UK as the entire abolition of these actions provide injustice to minority shareholders of corporate groups.<sup>399</sup> It seems that the Law Commission failed to recognise that, in current times, many corporate structures are in group forms and that many companies 'often conduct their affairs through a multiplicity of subsidiaries, which are often no more than assets wholly controlled and, in practice, virtually indistinguishable from the holding company'.<sup>400</sup> In order to avoid injustice to minority shareholders of corporate groups where possible, it is essential for the law to provide effective devices for minority shareholders in a parent company which will allow them to bring an action on behalf of the parent's subsidiary company, otherwise wrongs would remain unredressed.<sup>401</sup>

This was recognised by the *Universal Project Management Services Ltd v Fort Gilkicker Ltd & Ors* ('*UPSM*'),<sup>402</sup> the first reasoned decision of an English court to allow multiple derivative actions. The trial judge, Briggs J, held that the CA 2006 did not remove multiple derivative actions at common law and that such actions are possible to be brought by an individual shareholder in a Limited Liability Partnership ('LLP') on behalf of a company wholly owned and controlled by that LLP. For the purposes of this thesis, it is therefore of immense importance to provide a critical analysis of the *UPMS* case as this will help the thesis to reach the final conclusion why the UK law needs multiple derivative actions and whether 'commercial justice' has been achieved.

The purpose of the following sections will be to critically analyse the issue of multiple derivative actions in the UK and to provide solutions. The sections will be divided in the following way. First, an examination of the importance of multiple derivative actions will be provided. Secondly, an examination of the *UPMS* case will be given, as the decision of this

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<sup>396</sup> *ibid.*

<sup>397</sup> *ibid.*

<sup>398</sup> Goo (n 392) 256.

<sup>399</sup> *Universal Project Management Services Ltd* (n 371) 564 (Briggs J).

<sup>400</sup> Goo (n 392) 258.

<sup>401</sup> See *Burland* (n 8) 93.

<sup>402</sup> *Universal Project Management Services Ltd* (n 371).

case will provide significant guidelines on the issue of multiple derivative actions. Finally, concluding remarks will be provided.

#### 4.6.2. *The importance of multiple derivative actions*

As mentioned in section 4.2.1.2, one of the most fundamental principles of UK company law is that of separate legal personality in which a company, when incorporated, is recognised as a separate legal person from its members, with its own separate rights and liabilities.<sup>403</sup> As a result, in the context of derivative actions, it was recognised that, where a wrong is done to the company, the proper person that has the locus standi to bring an action against the wrongdoing directors is the company itself and not its members.<sup>404</sup>

However, in practice, this approach was regarded above<sup>405</sup> as problematic and unjust in the sense that those who have the power to control and manage the affairs of the company (both the board and the general meeting), and therefore are acting ‘as the company’, are unlikely to vote in favour of a litigation decision to remedy the harm caused to the company, especially where the wrong done to the company has been caused by them. As Lord Denning recognised in *Wallersteiner v Moir (No. 2)*:<sup>406</sup>

‘But suppose [the company] is defrauded by insiders who control the affairs – by directors who hold a majority of the shares – who can then sue for damages?... In one way or another some means must be found for the company to sue. Otherwise the law would fail in its purpose. Injustice would be done without redress’.<sup>407</sup>

Due to these problems, it is therefore not surprising that statutory reforms have been proposed with the aim to give individual shareholders the locus standi to bring derivative actions on behalf of the company. Indeed, under section 260(1) of the CA 2006, ‘a member of a company’ is now able to commence proceedings ‘in respect of a cause of action vested in the company, and seeking relief on behalf of the company’.<sup>408</sup> This means that the locus standi to bring an action against the wrongdoing directors for wrongs done to the company is now conferred on a member or members of the wronged company. This is the so-called ‘ordinary derivative action’.<sup>409</sup> In the context of ‘multiple derivative actions’, however, this raises the question of whether a member in a parent company is able to take an action on behalf of the

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<sup>403</sup> *Salomon* (n 29).

<sup>404</sup> *Foss* (n 5).

<sup>405</sup> Text to n 82.

<sup>406</sup> *Wallersteiner v Moir (No. 2)* [1975] QB 373.

<sup>407</sup> *ibid* 390.

<sup>408</sup> Companies Act 2006, s 260(1).

<sup>409</sup> *Universal Project Management Services Ltd* (n 371) 558; See also James Bailey and Jan Mugerwa, ‘Multiple derivative actions in company law: can you or can’t you?’ (2013) *Company Lawyer* 302, 303.

parent's subsidiary company for wrongs done to the subsidiary.<sup>410</sup> Such a multiple derivative action,

'may be appropriate where a shareholder in one company (A), can show that the directors of company A and of a subsidiary (B) or related company (C), (which may not be a direct subsidiary or a direct investment of company A), have wrongly prevented the enforcement of a cause of action vested in subsidiary B or related company C'.<sup>411</sup>

From the wording of section 260(1) of the CA 2006 above, it seems clear that 'multiple derivative actions' are excluded and therefore a claim made by a member in a parent company on behalf of the subsidiary for wrongs done to the subsidiary is not recognised under the UK law.<sup>412</sup> This is due to the fact that a member in a parent company 'cannot be said to be a member of the subsidiary company in which the cause of action is vested'.<sup>413</sup> However, although multiple derivative actions are not recognised under section 260(1) of the CA 2006, it is worth noting that in a number of reported cases prior to the CA 2006,<sup>414</sup> the courts seem to have recognised the conferral of locus standi to members in a parent company to commence proceedings against the parent's subsidiary company.<sup>415</sup> These cases however did not fully analyse the issue of multiple derivative actions and therefore it remained unclear whether such actions should be allowed or not.

The question as to whether a member in a parent company is allowed to bring an action on behalf of the parent's subsidiary was considered in the Court of Final Appeal of Hong Kong in *Waddington Ltd v Chan Chun Hoo Thomas and others*<sup>416</sup> where it was decided that multiple derivative actions should be allowed. In this case, a minority shareholder in a parent company (Playmates Holding Ltd) took a derivative action on behalf of the parent's sub-subsidiary companies (Profit Point Ltd and Autoestate Properties Limited) which were wholly owned by the parent's subsidiary company (Playmates International), which was also wholly owned by the parent company. The reason for taking such action was because the minority shareholder in a parent company alleged that the chairman and executive director of both the parent and the other companies within the group had caused the sub-subsidiaries to enter into a number of transactions which were for the director's personal benefit (and not for the sub-subsidiaries benefit) and by doing so a breach of his fiduciary duties to the sub-subsidiaries

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<sup>410</sup> Law Commission (n 140) para 16.51; See also Boyle (n 11) 85; Reisberg (n 82) 202.

<sup>411</sup> Law Commission (n 140) para 16.51; See also Boyle (n 11) 85; Reisberg (n 82) 202.

<sup>412</sup> Bailey and Mugerwa (n 409) 303-304.

<sup>413</sup> *ibid* 304.

<sup>414</sup> *Wallersteiner* (n 406); *Halle v Trax BW Ltd* [2000] BCC 1020 (Ch D); *Truman Investement Group v Societe General SA* [2003] EWHC 1316 (Ch); *Airey v Cordell* [2007] Bus LR 391.

<sup>415</sup> *Universal Project Management Services Ltd* (n 371) 558; See also Reisberg and Prentice (n 393) 210; Goo (392) 259.

<sup>416</sup> *Waddington Ltd v Chan Chun Hoo Thomas and others* [2009] 2 BCLC 82.

companies occurs. The main question in this case was whether the minority shareholder in a parent company was able to bring a derivative action on behalf of the parent's sub-subsidiary companies for wrongs done to the latter.

There were three objections that the appellant (the director) raised when this case was heard in the Court of Final Appeal of Hong Kong. The first objection was that the derivative action brought by the minority shareholder in a parent company contravened two of the fundamental principles of company law: (i) that, due to the separate legal personality principle, the company is recognised as a distinct legal person from its members, and (ii) that, in general principle, the directors owed duties to the company itself and not to its members, let alone to the members of its parent company.<sup>417</sup> However, as Lord Millett argued in *Waddington Ltd*, the appellant's first objection is 'seriously weakened by the fact that other Commonwealth countries have all legislated to introduced multiple derivative actions without finding it necessary to make any significant changes to company law to accommodate them'.<sup>418</sup>

The appellant's second objection was that such actions are in fact two derivative actions, one by a member in a parent company on behalf of the parent against its subsidiary for its failure to take an action against the wrongdoers and the other by the parent company on behalf of its subsidiary for wrongs done to the latter.<sup>419</sup> The appellant also argued that, 'neither action is maintainable', first because no duty is owed by the subsidiary company to its parent to take a derivative action against the wrongdoing directors, and secondly because the subsidiary is under the control of the parent company and hence no intervention is needed by the members of the parent company to bring an action on behalf of its subsidiary.<sup>420</sup> However, as Lord Millett argued, the appellant's objection that multiple derivative actions are in fact two derivative actions was unsound.<sup>421</sup> This is due to the fact that, in the opinion of Lord Millett, multiple derivative actions are not two or more derivative actions but 'a single action on behalf of the company in which the cause of action is vested',<sup>422</sup> in this context the subsidiary company. For Lord Millett, the most important question in this case was whether a member in a parent company is allowed to bring a derivative action on behalf of the parent's subsidiary.<sup>423</sup> As Lord Millett argued, this question, which was the subject matter of the

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<sup>417</sup> *ibid* 101.

<sup>418</sup> *ibid* 102.

<sup>419</sup> *ibid* 101-102.

<sup>420</sup> *ibid* 102.

<sup>421</sup> *ibid*.

<sup>422</sup> *ibid*.

<sup>423</sup> *ibid*.

appellant's third objection, 'is simply a question of locus standi' which 'lies at the heart of the case'.<sup>424</sup>

In taking into account the appellant's third objection, where he argued that there is a general principle that only a member of a company could take an action on its behalf and that a member in a parent company has no title or interest in the shares of the parent's subsidiary, Lord Millett argued that the cases which established this principle were focused only on the character of the plaintiff's shareholding where it was established that only a current and legal shareholder is allowed to bring a derivative action. For Lord Millett, however, *Waddington Ltd* was concerned with a different issue: 'the identify of the company of which [the plaintiff] must be a shareholder'.<sup>425</sup>

According to Lord Millett, the only significant question in this case was whether a member in a parent company had locus standi to bring an action on behalf of the parent's subsidiary. In answering this question, 'the court must ask itself whether the plaintiff has a legitimate interest in the relief claimed sufficient to justify him in bringing proceedings to obtain it'.<sup>426</sup> In Lord Millett's opinion, the answer was plainly 'yes' as 'any depletion of a subsidiary's assets causes indirect loss to its parent company and its shareholders'.<sup>427</sup> Thus, as Lord Millett argued, the minority shareholder of a parent company had a 'legitimate or sufficient interest' to take a derivative action on behalf of the parent's subsidiary as he had suffered a real, albeit indirect, loss.<sup>428</sup> In justifying his decision, Lord Millett pointed out the following:

'The reflective loss which a shareholder suffers if the assets of his company are depleted is recognised by the law even if it is not directly recoverable by him. In the same way the reflective loss which a shareholder suffers if the assets of his company's subsidiary are depleted is recognised loss even if it is not directly recoverable by him. The very same reasons which justify the single derivative action also justify the multiple derivative action. To put the same point another way, if wrongdoers must not be allowed to defraud a parent company with impunity, they must not be allowed to defraud its subsidiary with impunity'.<sup>429</sup>

It could be argued that *Waddington* was correctly decided as it has conferred the locus standi on the minority shareholder of the parent company to take an action on behalf of the parent's subsidiary company against the wrongdoing director, which the parent failed to do so. From this case, it seems that it was essential for the court to do justice to the subsidiary company by

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<sup>424</sup> *ibid.*

<sup>425</sup> *ibid* 103.

<sup>426</sup> *ibid* 103 (Lord Millett).

<sup>427</sup> *ibid.*

<sup>428</sup> *ibid.*

<sup>429</sup> *ibid* 103-104.

allowing the minority shareholder of the parent company to bring a derivative action to right the wrongs done to the parent's subsidiary, otherwise wrongs would remain unredressed.

Over the years, there has also been much academic debate regarding the importance of recognising multiple derivative actions in the UK. According to Koh, 'the prevalence of corporate groups should mean the continuing relevance of such "multiple" derivative actions', as 'the availability of such actions provides at least a threat to wrongdoers thinking of insulating themselves from liability for breach of duties by the addition of corporate layers'.<sup>430</sup> In addition, Reisberg in his book *Derivative Actions and Corporate Governance*<sup>431</sup> argues that 'the need to expose fraud and serious abuse in groups of companies would seem to require a more realistic approach' and that 'the particular needs of groups of companies should be considered and catered for'.<sup>432</sup> To justify his argument that favours the recognition of multiple derivative actions, Reisberg referred to the US case of *Brown v Tenney*,<sup>433</sup> where Chief Justice Moran acknowledged that, without multiple derivative actions, a shareholder in a parent company would 'be without a remedy, even where, as here, the [parent] company is the wrongdoer. The additional layer in the corporate structure would prevent the righting of many wrongs and would insulate the wrongdoer from judicial intervention'.<sup>434</sup>

It could be argued that this sits well with the derivative action's traditional *raison d'être*, which is to 'prevent a wrong going without redress'.<sup>435</sup> Indeed, as Cox argues, the derivative action's traditional *raison d'être* 'is the need to redress violations of a corporation's rights that other mechanisms do not remedy'.<sup>436</sup> Therefore, denying the right to bring such an action would dismiss the effectiveness of the derivative action as an effective mechanism to provide justice for minority shareholders. The importance of multiple derivative actions in the UK was also recently recognised by the *Universal Project Management Services Ltd v Fort Gilkicker Ltd & Ors ('UPSM')*;<sup>437</sup> the first reasoned decision of an English court which permitted multiple derivative actions. This case will be critically examined in the following section.

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<sup>430</sup> Pearlle Koh, 'Derivative actions "once removed"' (2010) 2 JBL 101, 102.

<sup>431</sup> Reisberg (n 82).

<sup>432</sup> *ibid* 202.

<sup>433</sup> *Brown v Tenney* 125 Ill 2d 348 (1988).

<sup>434</sup> *ibid* 356.

<sup>435</sup> *Smith* (n 248) 185; See also Reisberg (n 82) 18.

<sup>436</sup> James D Cox, 'Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures' (1984) 52 *George Washington Law Review* 745, 746.

<sup>437</sup> *Universal Project Management Services Ltd* (n 371); The conclusion and reasoning of Briggs J in *UPMS* was explicitly endorsed by David Richard J in *Abouraya v Sigmund & Ors* [2014] EWHC 277 (Ch).

#### 4.6.3. *The UPMS case: a new era begins?*

In *UPMS* the issue of multiple derivative actions was fully analysed and considered. The trial judge held that the CA 2006 did not remove multiple derivative actions at common law and that multiple derivative actions may be brought by members of an LLP on behalf of a company wholly owned by that LLP. The legal questions for decision in *UPMS* were: (1) whether multiple derivative actions were known to English common law before the introduction of the CA 2006; and, (2) if so, whether multiple derivative actions have survived after the introduction of the CA 2006.<sup>438</sup> It is therefore important to examine this case and see the reasons why multiple derivative actions should be allowed in the UK.

The facts of the *UPMS* case were as followed. The claimant, Universal Project Management Services Limited ('UPMS') and the second defendant, Mr Pearce, were the only shareholders (with equal shares) in the Askett Hawk Properties LLP ('LLP'). The first defendant to the claim, Fort Gilkicker Limited ('FGL'), was owned by the LLP with only two directors, Dr Frischmann and Mr Pearce. Dr Frischmann was also the only director of UPSM. FGL had an opportunity to obtain a development site but due to the disputes between the two directors of FGL over which architect to use on the redevelopment, the option expired. However, one of the directors of FGL, Mr Pearce, decided to form another company, Fort Gilkicker Properties Limited ('FGP'), which purchased the development site on similar terms as given to FGL.

As a result, UPMS brought an action against Mr Pearce alleging that he had misused a valuable business opportunity of FGL with the aim to advantage his own self-interests and, by doing so, he had breached his fiduciary duty owed to FGL. Such a cause of action was vested in FGL, which was unlikely to commence proceedings to sue against Mr Pearce, as the LLP was the only shareholder of FGL and Dr Frischmann and Mr Pearce were its only directors. As a result, UPMS sought to bring a derivative action on behalf of FGL. However, Mr Pearce argued that UPMS was not a member of FGL and therefore was not able to bring an action on behalf of FGL for wrongs done to FGL. He also pointed out that section 260 of the CA 2006 only allowed members of a company to commence proceedings on its behalf.

The *UPMS* decision is of immense importance for various reasons. As mentioned above, derivative actions at common law recognised the conferral of locus standi to members of a company in which the cause of action was vested. However, in a number of reported cases prior to the CA 2006,<sup>439</sup> the courts seem to have recognised the conferral of locus standi to members in a parent company to commence proceedings against the parent's subsidiary

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<sup>438</sup> *ibid* 555.

<sup>439</sup> *Wallersteiner* (n 406); *Halle* (n 414); *Truman Investement Group* (n 414); *Airey* (n 414).

company.<sup>440</sup> As Briggs J in *UPMS* argued, the fact that the courts have conferred locus standi to members of the parent's subsidiary company for wrongs done to the subsidiary was not surprising, as a 'derivative action is merely a procedural device designed to prevent a wrong going without a remedy'.<sup>441</sup> According to Briggs J, an applicant 'is not exercising some right inherent in [his] membership, but availing [himself] of the court's readiness to permit someone with a sufficient interest to sue as the company's representative claimant, for the benefit of all its stakeholders'.<sup>442</sup>

In justifying his argument, Briggs J referred to Lord Millett's reasoning in *Waddington Ltd v Chan Chun Hoo Thomas and others*<sup>443</sup> which helped him reach the conclusion that, following the law of Hong Kong, multiple derivative actions were recognised in the UK.<sup>444</sup> As Briggs J argued, a multiple derivative action is not a separate form of derivative action but rather 'a single piece of procedural ingenuity designed to serve the interests of justice in appropriate cases'.<sup>445</sup>

In reaching his decision, Briggs J considered the consequences if the CA 2006 did not do away with multiple derivative actions at common law. To come to this conclusion, Briggs J considered the statutory interpretation of Chapter 1 of Part 11 of CA 2006 to see whether the definition provided under section 260(1) of derivative actions applies only to ordinary derivative actions, or whether it could also be applied to multiple derivative actions.<sup>446</sup> Section 260(1) of the CA 2006 provides that a derivative action may only be brought by a 'member of a company in respect of a cause of action vested in the company, and seeking relief on behalf of the company'. This means that a person who is not a member of the company in which the cause of action is vested is not able to bring a derivative action.

With respect to the term 'member', although section 260(5) extends the locus standi to persons who are not members of the company but to whom shares in the company have been transferred or transmitted by operation of law, this does not also apply to a member of a parent company. It seems therefore that multiple derivative actions are excluded from section 260 of the CA 2006 and therefore a member of a parent company is not able to bring a derivative action on behalf of the parent's subsidiary company for wrongs done to the subsidiary.

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<sup>440</sup> *Universal Project Management Services Ltd* (n 371) 558.

<sup>441</sup> *ibid* 559.

<sup>442</sup> *ibid* 559.

<sup>443</sup> *Waddington Ltd* (n 416).

<sup>444</sup> *Universal Project Management Services Ltd* (n 371) 559.

<sup>445</sup> *ibid* 559-560.

<sup>446</sup> *ibid* 560-561.

As Briggs J argued, Parliament's intention when codifying derivative actions was to remove what were regarded as 'complicated, unwieldy and obscure' provisions of the common law and to replace those provisions with a clear and transparent code.<sup>447</sup> Based on this, Briggs J argued that it was not entirely logical that Parliament intended to abolish such an obscure and complicated regime to allow members of the wronged company to bring a derivative action, but to retain an equally complicated, unwieldy and obscure regime for others to bring such an action on behalf of the company, namely a member of the parent company.<sup>448</sup> For Briggs J, it was equally unpalatable to reach the conclusion that Parliament wished to narrowly define locus standi for all company derivative actions in such a way as to abolish 'a convenient procedural device for doing justice in case of wrongdoer control, in a modern context where multi-layered corporate structures with holding companies and subsidiaries are ever more common'.<sup>449</sup> As Briggs J argued, 'there is, on the face of it, no persuasive reason why Parliament should have wished to provide a statutory scheme for doing justice where a company is in wrongdoer control, but none where its holding company is in the same wrongdoer control'.<sup>450</sup>

In addition, applying the well-established relevant principles of construction of Chapter 1 Part 11 of the CA 2006, Briggs J came to the conclusion that Parliament did not expressly abolish the whole common law derivative action.<sup>451</sup> As Briggs J argued, 'the assertion that the remainder of the common law device was abolished fails because abolition was neither express nor a clear or necessary implication'.<sup>452</sup> According to Briggs J, if Parliament's intention was to entirely abolish the common law derivative action, it could easily have phrased section 260 of the CA 2006 so as to accomplish precisely that result or, alternatively, it could have chosen to follow the approach adopted in Australia under the Australian Corporations Act 2001, which expressly abolished the common law derivative action.<sup>453</sup>

Therefore, having found little assistance from both the Law Commission Report<sup>454</sup> and academic writers' analysis,<sup>455</sup> Briggs J came to the conclusion that the CA 2006 did not abolish multiple derivative actions at common law.<sup>456</sup> As Cheng-Han argues, Briggs J's

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<sup>447</sup> *ibid* 561.

<sup>448</sup> *ibid*.

<sup>449</sup> *ibid*.

<sup>450</sup> *ibid* 561-562.

<sup>451</sup> *ibid* 564.

<sup>452</sup> *ibid*.

<sup>453</sup> *ibid*.

<sup>454</sup> Law Commission (n 2) paras 6.109-6.110.

<sup>455</sup> Reisberg and Prentice (n 393); Goo (n 392); Koh (n 430); Daniel Lightman, 'Two Aspects of the Statutory Derivative Claim' (2011) LMCLQ 142.

<sup>456</sup> *Universal Project Management Services Ltd* (n 371) 563.

conclusion is ‘defensible’, and ‘furthermore has the merits of ensuring that an undesirable lacuna does not subsist in cases where a suitable minority shareholder of the wronged company is non-existent’.<sup>457</sup> It is therefore not surprising that Briggs J in *UPMS* stated that he came to this conclusion ‘with some relief’. Briggs J’s conclusion,

‘Not only does it address the manifest scope for real injustice which the abolition of any derivative action by members of a holding company would have entailed... but it ensures that English company law runs in this respect in harmony with the laws of Hong Kong, Singapore, Canada, Australia and New Zealand, all of which have, albeit by different methods, ensured that injustice...can properly be addressed’.<sup>458</sup>

From the above, it is beyond doubt that Briggs J allowed multiple derivative actions because of his desire to do justice to minority shareholders in corporate groups. It is therefore not surprising that Sir James Wigram V-C in *Foss v Harbottle* recognised that, when no adequate remedy is available, ‘the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue’.<sup>459</sup> Along similar lines, Briggs J felt that the extension of locus standi to members of a parent company to claim on behalf of the parent’s subsidiary is a reflection of the necessity to do justice when no alternative remedy is available to right the wrong done to the subsidiary company. It is therefore relevant for the law to provide effective devices that can bring justice to minority shareholders, and also to shareholders in corporate groups.

Another significant aspect of Briggs J’s judgment in *UPMS* was the fact that Briggs J recognised that members of an LLP may bring a derivative action on behalf of a company wholly owned by that LLP. According to Briggs J,

‘once it is recognised that the extension of locus standi beyond the immediate members of the wronged company is based upon the need to find a suitably interested claimant to pursue the company’s claim when it is disabled from doing so, the precise nature of the corporate body which owns the wronged company’s shares is of no legal relevance’.<sup>460</sup>

It seems from the above statement that, for Briggs J, the legal status of the LLP was irrelevant as the only thing that matters is to allow a person with sufficient interest to bring an action on behalf of the wronged company, when the wronged company is disabled from doing so. This is an issue that will be further analysed in the concluding chapter.

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<sup>457</sup> Cheng-Han (n 393) 338.

<sup>458</sup> *Universal Project Management Services Ltd* (n 371) 564.

<sup>459</sup> *Foss* (n 5) 492 (emphasis added).

<sup>460</sup> *Universal Project Management Services Ltd* (n 371) 565.

An issue that is significant to discuss at this point, is the decision reached in *Abouraya v Sigmund & Ors*,<sup>461</sup> a case which concerned a multiple derivative claim and fully endorsed the conclusions and reasoning of Briggs J in *UPMS*. Although *Abouraya* was considered under the old common law rules rather than the new statutory derivative procedure under Part 11 of the CA 2006, a brief consideration of this case is relevant. The importance in *Abouraya* is that a permission to continue a derivative claim was refused by the court on the ground that the claimant seeking to use such a remedy was trying to use it in his capacity as a shareholder of the parent company with the purpose to advance his position as a creditor of the wholly owned subsidiary.

In this case, it was shown that, even when a prima facie case exists at common law, the court has a discretion to decide whether to allow such a claim and in doing so it must satisfy itself that the claimant seeking to use such a remedy is the proper person and has ‘a legitimate interest in the relief claimed sufficient to justify him in bringing proceedings to obtain it’.<sup>462</sup> As David Richards J in *Abouraya* acknowledged,

‘financial or other loss to the shareholders, albeit normally of a reflective character, is essential to give a claimant shareholder sufficient interest in the proceedings to make the shareholder an appropriate claimant on behalf of the company, whether he is a member of that company or of its holding company’.<sup>463</sup>

In this case, the claimant failed to show that he had suffered any loss, albeit indirectly, in his capacity as a shareholder of the parent company as a result of the alleged wrongdoing. However, from the facts of this case, even if the claimant had established a prima facie case, there were other significant grounds for rejecting his application to continue a derivative claim.

It has long been recognised that the court will not permit the continuance of a derivative claim if it is being brought for an ulterior purpose.<sup>464</sup> An example of this is *Abouraya*, where it was held that it is inappropriate for the court to exercise its discretion to allow a derivative claim in circumstances where the claim’s real purpose was to advance the claimant’s interests in his capacity as a creditor of the subsidiary company.<sup>465</sup> As David Richards J argued, if the creditor was allowed to bring such a claim, ‘it would enable the claimant to use the happenstance of his shareholding in [the parent company] to advance his interests as a

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<sup>461</sup> *Abouraya* (n 437).

<sup>462</sup> *Waddington Ltd* (n 396) 103; See *Abouraya* (n 437) [24].

<sup>463</sup> *Abouraya* (n 437) [25].

<sup>464</sup> See *Barrett* (n 375) 250.

<sup>465</sup> *Abouraya* (n 437) [59] – [60].

creditor [of the subsidiary company]'.<sup>466</sup> In doing so, 'it would provide him with a means of enforcement not available to any other creditors, if there were any'.<sup>467</sup> As David Richards J stated, the law provides other remedies to assist creditors to advance their own interests in their capacity as creditors.<sup>468</sup> As a result, David Richards J came to the conclusion that it would not 'be a proper use of the derivative procedure to assist creditors or claimants who happened also to be shareholders but who, in that capacity, have no real interest in the outcome of the derivative claim'.<sup>469</sup>

It could be argued that *Abouraya*'s decision was a just decision as the court treated all the creditors equally instead of favouring the claimant who happened to be a shareholder of the parent company and therefore was in a more advantaged position than others. Although David Richards J did not refer to 'commercial justice', it seems that he had justice in mind when deciding this case, as it would have been unjust for the other creditors to allow the claimant to bring a derivative claim; a remedy which was not available to the other creditors in the subsidiary company.

As Rawls would have said, if he was asked to take a position in this matter, the fact that the claimant in *Abouraya* was in a more advantaged position than the other creditors due to his shareholding in the parent company, this does not justify the use of a derivative claim by the claimant to recover the debt owed to him as a creditor as this would have privileged the claimant's position over the other creditors and therefore treat the other creditors unequally.

To conclude, it seems that multiple derivative actions at common law have survived in the UK. For justice to be achieved, multiple derivative actions should be allowed in the UK. This was recognised by the *UPMS* case which achieved justice for minority shareholders by providing them with a remedy that enables them to pursue a multiple derivative action. This is an important development for the law. As the thesis argues, the law on derivative actions has now achieved its purpose: to achieve justice for minority shareholders, and the shareholders of corporate groups. The decision is welcome as it provides guidelines for future cases concerning the issue of multiple derivative actions. However, for a more effective protection a reform of the CA 2006 should be made to include a provision on multiple derivative actions.

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<sup>466</sup> *ibid* [60].

<sup>467</sup> *ibid*.

<sup>468</sup> *ibid*.

<sup>469</sup> *ibid*.

In taking into account what Briggs J has said in *UPMS*, and how other Commonwealth countries have legislated for multiple derivative actions,<sup>470</sup> one possible solution for reforming section 260 of the CA 2006 would be to include a provision that will provide the right of locus standi to: ‘any other person who, in the discretion of the court, has a sufficient interest to make an application under this Chapter’. The suggested provision should therefore look like:

‘s.260(1) This Chapter applies to proceedings in England and Wales or Northern Ireland in which a derivative claim may be brought by:

- (a) a member of a company (i) in respect of a cause of action vested in the company, and (ii) seeking relief on behalf of the company or,
- (b) any other person who, in the discretion of the court, has a sufficient interest to make an application under this Chapter’.

This will give flexibility to members in a parent company to bring an action on behalf of the parent’s subsidiary company, in circumstances where the parent company is disabled from doing so. Under the suggested provision above, the courts will have the discretion to develop the law to fit the changing times and to do justice to minority shareholders, and shareholders in corporate groups. As Lord Reid argued, ‘the law...shall be just and move with the times’.<sup>471</sup>

#### **4.7. Conclusion**

In conclusion, the purpose of this chapter was to analyse the effectiveness of the new statutory derivative procedure under the CA 2006 and see whether ‘commercial justice’ could be achieved for minority shareholders through the use of derivative actions. Having analysed the changes that have been made so far with the introduction of the new statutory derivative claim, the thesis came to the conclusion that, although the intention of the Parliament was to introduce more modern, flexible and accessible criteria for determining whether a member of a company may bring a derivative claim,<sup>472</sup> it failed to clarify the actual role and purpose of the new statutory derivative action.

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<sup>470</sup> See Canada Business Corporation Act (RSC, 1985, c. C-44), s 238: ““complaint” means – (b) any other person who, in the discretion of the court, is a proper person to make an application under this Part”; Australian Corporations Act 2001, s 236: ‘Persons who may bring proceedings on behalf of the company include members of the company or a related body corporate’.

<sup>471</sup> Lord Reid, ‘The Judge as Law Maker’ (1972-1973) 12 *Society of Public Teachers of Law* 22, 26.

<sup>472</sup> Law Commission (n 2) para 6.15.

Therefore, due to the inconsistencies of the new criteria to clarify the actual operation of the new statutory derivative action, this has created uncertainties as to which approach the courts should follow in considering whether to give permission to continue with a derivative claim. Although discretion has been given to the courts to consider the criteria mentioned above in deciding whether to allow a member of a company to continue with a derivative claim, Parliament also failed to provide clear clarifications as to the role and function of the courts in the context of derivative actions.

It is therefore the intention of the thesis to argue that the judiciary should have an overarching guiding principle in deciding whether to allow a derivative action to continue. The thesis believes that the overarching guiding principle that the courts should follow, should be what is in the interests of justice, in this context, 'commercial justice'. The theoretical framework developed in chapter two should not be considered as a definite concept of 'commercial justice' but as a flexible concept that fits with the changing times of the society. The purpose therefore of this overarching guiding principle of 'commercial justice' is to give the courts the flexibility to consider whether it is commercially just to allow a derivative claim to continue. The courts should consider commercial justice at every stage of the new statutory derivative action, as this will help them to reach the conclusion as to whether the decision to allow or not a derivative action was commercially just.

As mentioned above, although such overarching guiding principle has not been accepted so far in the context of derivative actions, it has recently been acknowledged by Briggs J in the *UMPS* case that the concept of justice is vital to be considered in the context of derivative actions, otherwise wrongs would remain unredressed. Briggs J desire to do justice to the *UPMS* case led him to reach the conclusion that multiple derivative actions should be allowed because justice requires to do so. The same could apply to the ordinary derivative actions as their purpose and role should be to achieve justice where no other alternative remedy exists to right the wrongs done to the company. It would be unjust not to have such a mechanism that prevents wrongdoers from causing harm to the company. The role and purpose of derivative actions is therefore to right the wrongs done to the company and to achieve justice to minority shareholders.

If Rawls was asked to take a position regarding this matter, he would probably argue that in order for derivative actions to achieve commercial justice to minority shareholders, it is essential for the courts to balance all the interests involved within the company and not only to favour those who are in a more advantaged position, namely the directors and the majority shareholders. Parliament should therefore allow the courts the flexibility to balance those

interests by taking into account the overarching guiding principle of 'commercial justice' as this will ensure that the outcome of the case will be commercially just to all the parties within the company.

Nozick, on the other hand, would probably argue that as long as there is no fraud or coercion on the part of directors (including the majority shareholders) then there is no reason for the courts to allow a member of a company to continue with a derivative claim. Of course, it is not the intention of the thesis to re-introduce the common law concept of 'fraud', but to stress the point that if the directors have used their powers to benefit themselves at the expense of the company and its minority shareholders, then the role of the courts should be to allow a minority shareholder to continue with a derivative claim, to remedy the wrongs done to the company.

## Chapter 5. The derivative actions in the United States: are there any lessons to be learnt for the UK?

### 5.1. Introduction

Having analysed the effectiveness of the UK statutory derivative action under the Companies Act 2006 in protecting minority shareholders, it is now relevant to cross the Atlantic to examine how the US dealt with the issue of derivative actions, as this will help the thesis to examine whether any lessons can be learnt from the US experience that could help the UK to re-examine its statutory derivative procedure. The US model is interesting in the context of this debate, as derivative actions were seen to be more popular in the United States than in the United Kingdom. Another reason why it is important to examine the US system is because, although both the US and the UK are common law jurisdictions, derivative actions in the US are quite different from those of the UK.<sup>1</sup> Indeed, as Boyle stated, ‘the law of business corporations is one area where English law and American law differ to a very marked degree’.<sup>2</sup> Although many American cases during the nineteenth century seemed to have been influenced by the UK *Foss v Harbottle*<sup>3</sup> rule, the rules that applied on the US derivative actions are radically different from those of the UK.<sup>4</sup> It is worth noting that it is not the intention of the thesis to compare and analyse in detail the law on derivative actions in the US but to take the most essential elements and see whether any lessons can be learnt from the US experience. The comparison between the US system and the UK system on derivative actions can prove to be illuminating for the purposes of this thesis. This chapter is divided in the following way. First it aims to briefly examine the historical development of derivative actions in the United States, as this will help the thesis to introduce the principles that the thesis aims to examine. Secondly, it aims to examine to principle of ‘demand requirement’ that is currently adopted by the US corporate law and analyse whether the UK should adopt a similar approach. In addition, the thesis will then go on to examine the business judgment rule as an obstacle for minority shareholders to bring a derivative claim. Fourthly, the thesis aims to examine the possibility of introducing the use of special litigation committees in the UK and see whether there any advantages for adopting such an approach. Finally, concluding remarks will be provided.

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<sup>1</sup> Xiaoning Li, *A comparative study of shareholders’ derivative actions: England, the United States, Germany and China* (Kluwer 2007) 89.

<sup>2</sup> AJ Boyle, ‘The Minority Shareholder in the Nineteenth Century: A Study in Anglo-American Legal History’ (1965) 28 MLR 317, 317.

<sup>3</sup> *Foss v Harbottle* (1843) 2 Hare 461.

<sup>4</sup> Boyle (n 2) 317.

## 5.2. The historical development of derivative actions in the United States

For the purposes of this thesis, it would be neglectful not to start by briefly examining the historical roots of the US derivative actions. Traditionally, derivative actions in the US had a leading role to play in preventing wrongdoing directors from abusing the company and its minority shareholders, and still have.<sup>5</sup> It is therefore not surprising that Justice Jackson in *Cohen v Beneficial Indus. Loan Corp*<sup>6</sup> stated that US derivative actions are ‘the chief regulator of corporate management’.<sup>7</sup> This is due to the fact that derivative actions have their origins in the courts of equity, which have been developed with the purpose to give shareholders a powerful weapon to remedy abuses of corporate misconduct.<sup>8</sup> It could therefore be argued that the purpose of having derivative actions was to eliminate injustice were possible, as without the mechanism of derivative actions individual shareholders would have been unable to remedy the wrongs done to the corporation.

The most important decisions of the US courts in relation to the issue of derivative actions, made their first appearance in the first half of the nineteenth century. Since there were no relevant English authorities for the US court to follow at that time (as the well know UK *Foss* rule had not be decided yet), they had to resolve the problem of minority shareholders’ locus standi to bring such actions on behalf of the company by themselves.<sup>9</sup> Although *Taylor v Miami Exporting Co*<sup>10</sup> was the first case of this type of action that was successful, the court in this case had not fully discussed and analysed the issue of derivative action.

It was not until the decision of *Robinson v Smith*<sup>11</sup>, which had attracted greater attention on the issue of derivative action, where the opportunity was taken to further explore this issue. In this case, it was acknowledged by Chancellor Wallworth, that as a general rule, where corporate directors and officers are misappropriating or misusing corporate assets, then in such circumstances a derivative action should be brought in the name of the company to hold them accountable for their actions. Such an action is, usually, expected to be brought, either by the disinterested directors of the company on their own initiative or by the request of the majority of shareholders in general meeting. Although it has been acknowledged by the court that an action to remedy a wrong done to the company should be taken in the company’s

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<sup>5</sup> See Carole F Wilder, ‘The Demand Requirement and the Business Judgment Rule: Synergistic Procedural Obstacles to Shareholder Derivative Suits’ (1985) 5 Pace Law Review 633, 634.

<sup>6</sup> *Cohen v Beneficial Indus. Loan Corp.* 337 US 541 (1949).

<sup>7</sup> *ibid* 548.

<sup>8</sup> See Amy M Koopmann, ‘A Necessary Gatekeeper: The Fiduciary Duties of the Lead Plaintiff in Shareholder Derivative Litigation’ (2009) 34 Iowa J Corp L 895, 898.

<sup>9</sup> Boyle (n 2) 321-322.

<sup>10</sup> *Taylor v Miami Exporting Co.* (1831) 5 Ohio 162.

<sup>11</sup> *Robinson v Smith* 3 Paige 222 (NY Ch 1832).

name, it would never allow such wrong to remain unredressed just for the sake of form and thus, came to the conclusion that a derivative action should be permitted.<sup>12</sup>

The right of an individual shareholder to bring a derivative action to remedy a corporate wrong was firmly established by the Federal Supreme Court in *Dodge v Woolsey*.<sup>13</sup> It is therefore relevant to briefly examine the facts of the case, as this was regarded as the foundation case for shareholders' right to sue. This case involved a shareholder, Mr. Woolsey, of the Branch Bank of Cleveland ('the Bank') who brought a suit to prevent the Bank from paying, and the state of Ohio from collecting an alleging unconstitutional tax upon the Bank. By doing so, he named as defendants of the suit, the state's tax collector, George C. Dodge, the Bank itself and its directors. At the time the shareholder's suit was taken, it was recognised that the common law did not permit a shareholder to bring a suit to hold corporate directors accountable for their actions. The only alternative way for Mr. Woolsey in order to be able to bring a suit against the wrongdoers was to seek relief from equity, which fortunately for him, supplied the remedy missing at common law.<sup>14</sup> Indeed, it was acknowledged by the US Supreme Court (a decision by the majority) that individual shareholders have certain basic rights in regards to the management and control of the company where it stated that:

'It is now no longer doubted, either in England or the United States, that courts of equity, in both, have a jurisdiction over corporations, at the instance of one or more of their members, to apply preventing remedies by injunction, to restrain those who administer them from doing acts which would amount to a violation of charters, or to prevent any misapplication of their capital or profits'.<sup>15</sup>

It therefore seems that equity was the best alternative way for Mr. Woolsey, who had no locus standi at common law to bring an action against the defendants, as equity permitted Mr. Woolsey to bring an action on behalf of the Bank for wrongs caused to the Bank.<sup>16</sup> As compared to the UK common law rules, it seems that the US courts in both *Robinson* and *Dodge* took a more flexible approach towards individual shareholders in bringing derivative actions. Indeed, the US courts 'were prepared to allow the minority to sue whenever the directors refused to act in clear breach of their duty or, alternatively, whenever it could be shown that the corporation was under the control of the wrongdoers'.<sup>17</sup> As Prunty argued,

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<sup>12</sup> *ibid* 223; See Boyle (n 2) 322; AJ Boyle, *Minority Shareholders' Remedies* (CUP 2002) 38-39.

<sup>13</sup> *Dodge v Woolsey* 18 How (59 US) 331 (1855).

<sup>14</sup> See Ralph C Ferrara, Kevin T Abikoff and Laura L Gansler, *Shareholder Derivative Litigation: Besieging the Board* (Law Journal Press 2005) para 1.03.

<sup>15</sup> *Dodge* (n 13) 341

<sup>16</sup> See Ferrara, Abikoff and Gansler (n 14) para 1.03.

<sup>17</sup> Boyle (n 2) 322.

‘while English lawyers and judges focused their early debates of shareholders’ rights on technical matters of pleading and procedure, their American counterparts showed more concern with what, in the syntax of the law, are termed substantive rules’.<sup>18</sup>

One of the main reasons why the US courts took a more flexible approach regarding the issue of derivative actions as compared to the UK common law rules, is because, unlike in England where the company law principles derived from partnership rules, the corporate law principles in the United States developed independently.<sup>19</sup> Hence, UK company law principles such as the ‘majority rule’ and the ‘internal management’ who prevented courts from interfering with the internal affairs of the company were not seen as obstacles for the US courts to give a right to an individual shareholder to bring a derivative action.<sup>20</sup>

However, this did not necessarily mean that the courts were prepared to allow derivative actions without limitations. In *Dodge*, for example, before Mr. Woolsey brought the suit, a request was initially made by Mr. Woolsey to the board of directors of the Bank to prevent the alleged misconduct that has been caused to the Bank. This is due to the fact that, during that time, ‘increasing emphasis was laid on the need to exhaust any remedy within the corporation’ and because of that it was required for a minority shareholder, prior to institute a derivative action, to first make a demand to the board of directors to remedy the wrongs that has been caused to the corporation.<sup>21</sup>

Though there was no clear evidence that the US courts, during that time, have been influenced by the well-known UK *Foss* rule, it seems that in later US cases,<sup>22</sup> the rule in *Foss* had influenced their decisions on the issue of derivative actions.<sup>23</sup> In *Brewer v Proprietors of Boston Theatre*,<sup>24</sup> for example, the Massachusetts Supreme Court laid down for the first time the foundation for the US ‘demand requirement’ principle that required separate demands to be made by an individual shareholder to both the company’s board of directors and the majority shareholders in general meeting to commence proceedings against the wrongdoers. However, such a demand would be excused in cases where a fraudulent conduct or ultra vires acts are found.<sup>25</sup>

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<sup>18</sup> Bert S Prunty, ‘The Shareholders’ Derivative Suit: Notes on its Derivation’ (1957) 32 New York University Law Review 980, 985.

<sup>19</sup> George D Hornstein, ‘The Shareholder’s Derivative Suit in the United States’ (1967) JBL 282, 283-284.

<sup>20</sup> Li (n 1) 90.

<sup>21</sup> Boyle (n 12) 39; See Boyle (n 2) 322.

<sup>22</sup> See *Brewer v Proprietors of Boston Theatre* 104 Mass 378 (1870); *Hawes v Oakland* 104 US (14 Otto) 450 (1882).

<sup>23</sup> Boyle (n 12) 38-39.

<sup>24</sup> *Brewer* (n 22).

<sup>25</sup> *Brewer* (n 22) 386-387; See Boyle (n 12) 39.

The decision taken by the Supreme Court in *Hawes v Oakland*<sup>26</sup> was even more influenced by the *Foss* rule, as it seems that it is the only case that came closer to the *Foss* rule that any other US decisions had ever done.<sup>27</sup> This is due to the fact that Justice Miller in *Hawes* had established both substantive and procedural restrictions on the ability of individual shareholders to bring derivative actions, which were very similar to the restrictions placed under the UK *Foss* rule. In fact, Justice Miller requested that the causes of such actions should be limited to specific areas of directors' mismanagement, such as illegal acts, fraudulent transactions, or acts that has been exercised for their own benefit which would harmfully affect the company and its shareholders.<sup>28</sup>

Furthermore, Justice Miller had also placed numerous procedural requirements for individual shareholders who wanted to initiate a derivative action. First, it was required for the individual shareholder, before initiating such an action, to place demands on both the company's board of directors and the majority shareholders in the general meeting.<sup>29</sup> Secondly, in order for an individual shareholder to be able to bring a derivative action, it was required under the 'contemporaneous ownership requirement' to be a 'shareholder at the time of the transactions of which he complains, or that his shares have devolved on him since by operation of law'.<sup>30</sup> Thirdly, it was required for the individual shareholder to establish that 'the suit is not a collusive one to confer on a court of the United States jurisdiction in a case of which it could otherwise have no cognisance'.<sup>31</sup>

It could be argued that the first two of the procedural requirements imposed by Justice Miller are very similar to those imposed under the *Foss* rule. Although both jurisdictions follow different corporate rules and principles, it seems that the demand requirement poses the same difficulties with the UK 'majority rule' as it gives the discretion to the board and the general meeting to take litigation decisions as to whether to sue the wrongdoers for wrongs done to the corporation. However, as mentioned in chapter four, the strict application of *Foss* rule that prohibited courts from intervene with the internal affairs of the company has been replaced after the introduction of the Companies 2006, which now gives the courts the discretion to decide whether to allow a member of a company to continue with a derivative claim. The Companies Act 2006 has also extended the locus standi to persons who are not members of the company but to whom shares in the company have been transferred or transmitted by

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<sup>26</sup> *Hawes* (n 22).

<sup>27</sup> Boyle (n 12) 39-40; See Lynden Griggs and John P Lowry, 'Minority Shareholder Remedies: A Comparative View' (1994) JBL 463, 477.

<sup>28</sup> *Hawes* (n 22) 460.

<sup>29</sup> *ibid* 460-461.

<sup>30</sup> *ibid* 461.

<sup>31</sup> *ibid*.

operation of law.<sup>32</sup> As compared to the *Foss* rule, it also now recognises that incoming shareholders are able to commence proceedings as long as they become members at the time they wish to initiate such proceedings.<sup>33</sup>

However, as analysed in chapter four, although significant changes have been made after the introduction of Part 11 of the Companies Act 2006, there is still a room for further improvement on the law of derivative actions. It is therefore relevant to embark on an enquiry to examine some of the most essential elements of the US derivative actions and see whether any lessons can be learnt from the US experience that might help the UK to re-examine its statutory derivative procedure. For the purposes of the thesis, three essential requirements of the US derivative actions will be further examined and analysed in the following sections. These are: (a) the demand requirement, (b) the business judgment rule, and (c) the role of the special litigation committee.

### **5.3. The US current state of law on derivative actions**

Having summarised the historical development of the US derivative actions, it is now essential to examine the current state of law and see whether any lessons can be learnt from the US experience. Contrary to the UK derivative actions that are governed by the Companies Act 2006, the US corporate law is largely based upon state law, which means that the law that govern each state differs from each other.<sup>34</sup> However, although in the United States the law on derivative actions differs from state to state, they share some similar principles, and this can be seen from the fact that many states have enacted their corporate laws based on two dominant sources: (1) The Delaware General Corporation Law and (1) The Model Business Corporation Act ('MBCA').<sup>35</sup> There are three important principles that each state shares, and these are: (a) the demand requirement, (b) the business judgment rule, and (c) the role of the special litigation committee. It has long been recognised that these three principles provide both substantive and procedural difficulties for a minority shareholder to bring a derivative action.<sup>36</sup> The importance of examining those principles is therefore to see whether any lessons can be learnt from the US experience that could help the UK to re-examine its statutory derivative procedure. It is therefore the intention of the thesis to mainly focus on these three

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<sup>32</sup> See Companies Act 2006, s 260(1).

<sup>33</sup> See Companies Act 2006, s 260(4).

<sup>34</sup> Harald Baum and Dan W Puchniak, 'The derivative action: an economic, historical and practice-oriented approach' in Dan W Puchniak, Harald Baum and Michael Ewing-Chow (eds), *The Derivative Action in Asia: A Comparative and Functional Approach* (CUP 2012) 74.

<sup>35</sup> Kurt A Goehre, 'Is the demand requirement obsolete? How the United Kingdom modernised its shareholder derivative procedure and what the United States can learn from it?' (2010) 28 *Wisconsin International Law Journal* 140, 144; See Puchniak, Baum and Ewing-Chow (n 34) 75.

<sup>36</sup> See Ann Scarlett, 'Confusion and Unpredictability in Shareholder Derivative Litigation: The Delaware Courts' Response to Recent Corporate Scandals' (2012) 60 *Florida Law Review* 1, 7; See also Wilder (n 5).

principles by looking at both the Delaware General Corporation Law and the MBCA, but with more emphasis on Delaware law.

### 5.3.1. *The demand requirement and its rationale*

In the influential case of *Hawes v Oakland*,<sup>37</sup> it was decided by the Supreme Court that, prior to initiating a derivative suit, it is firstly essential for a claimant shareholder to:

‘show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of grievances, or action in conformity with his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be made apparent to the court’.<sup>38</sup>

From this case, the principle of ‘demand requirement’ emerged which requires claimant shareholders who wish to remedy the wrong caused to the corporation, to firstly put a demand on the company’s board of directors to initiate a lawsuit against the wrongdoers to recover from wrongs that have been caused to the corporation.<sup>39</sup> The rationale behind the demand requirement is to give the company’s board of directors the chance to consider and examine the disputes, before a lawsuit is brought to the court by an individual shareholder. This mirrors the fundamental principle of US corporate law that the company’s affairs ‘shall be managed by or under the direction of a board of directors’.<sup>40</sup> As the board is the ‘brain and nerve center of the corporate body’,<sup>41</sup> it is wholly up to their authority to decide whether to bring an action to recover for the wrong that has been caused to the corporation.

It seems that the well-known UK *Foss* rule was the main source of influence for the demand requirement, even though it has been developed in a different way from the *Foss* rule.<sup>42</sup> As examined in chapter four, the *Foss* rule recognises that the proper claimant to sue for wrongs done to the corporation is the corporation itself and not the individual shareholders, and hence the board, as agents of the corporation, has been given the discretion to bring an action against the wrongdoers to recover for the harm caused to the corporation.<sup>43</sup> It seems that the United States under the ‘demand requirement’ principle supports the idea that, as the wrong has been

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<sup>37</sup> *Hawes* (n 22).

<sup>38</sup> *Hawes* (n 22) 460-461.

<sup>39</sup> Goehre (n 35) 146.

<sup>40</sup> See Delaware Code Annotated Title 8 § 141(a) (2008): “The business and affairs of every corporation organised under this chapter shall be managed by or under the direction of a board of directors”; Model Business Corporation Act § 8.01(b) (2002): “All corporate powers shall be exercised by or under the authority of the board of directors of the 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, subject to any limitation set forth in the articles of incorporation”.

<sup>41</sup> Mohammed B Hemraj, ‘The Business Judgment Rule in Corporate Law’ (2004) 15 ICCLR 192, 192.

<sup>42</sup> Boyle (n 2) 323-325.

<sup>43</sup> *ibid.*

caused to the corporation then the cause of action belongs to the corporation and hence the board, acting as the company, should be given with the exclusive right to make litigation decisions.

On the one hand, one may argue that some useful practical benefits can be provided by the ‘demand requirement’ principle. One of those benefits is that, since the company’s board of directors is in a more advantaged position than that of an individual shareholder to assess whether an action should be taken against the wrongdoers, the litigation decision is therefore left in the hands of the ‘experts’.<sup>44</sup> Indeed, individual shareholders ‘usually have little knowledge of the facts involved and lack access to the books and records of the corporation. Directors are generally familiar with the actions complained of and are therefore in a better position to evaluate whether a claim is justified’.<sup>45</sup> In addition, the demand requirement ensures that all intra-corporate disputes remedies have been exhausted before allowing the courts to intervene, and this is significant as it avoids vexatious and unnecessary litigation taken by the individual shareholders.<sup>46</sup>

However, as analysed in chapter four, allowing the litigation decision exclusively in the hands of the company’s board is problematic, particularly in cases where the directors are alleged to have caused the wrong suffered by the corporation. Indeed, evidence shows that it is unlikely for the wrongdoing directors to sue themselves and therefore the wrong caused to the corporation will remain unredressed. It could therefore be argued that such an approach is ‘unjust’ as, by letting the company’s board of directors to exclusively deal with the litigation decision, no justice will be achieved as no other mechanisms will be left for the minority shareholders to right the wrongs caused to the company. Indeed, the issues that raise under the demand requirement ‘is that an interested board of directors may deny shareholders’ meritorious claims, resulting in an injustice to the corporation and its shareholders’.<sup>47</sup>

It is worth noting that, contrary to the United States demand requirement, the United Kingdom offers an alternative way, as it seems that with the introduction of the Companies Act 2006 it removed the strict application of the *Foss* rule that favoured an approach similar to the demand requirement – the ‘majority rule’ – into a more preferable derivative procedure, namely a procedure operated through an external body, the courts.<sup>48</sup> Though maintaining the core principles of company law and shareholder derivative litigation, the United Kingdom

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<sup>44</sup> Daniel R Fischel, ‘The Demand and Standing Requirements in Stockholder Derivative Action’ (1976) 44 U Chi L Rev 168, 171-172.

<sup>45</sup> *ibid.*

<sup>46</sup> *ibid* 171; See Ferrara, Abikoff and Gansler (n 14) para 3.02.

<sup>47</sup> Goehre (n 35) 168.

<sup>48</sup> *ibid* 167.

preferred to give the discretion to the courts to decide whether to grant a permission or not to continue with a derivative claim. As a result, the judge now stands as ‘an impartial decision maker’, who balances the evidence submitted to the court as well as considers the various criteria set out in section 262-263 of the Companies Act 2006.<sup>49</sup> As discussed in chapter four, the aim for introducing a statutory reform in the UK on the law of derivative actions was to provide a ‘more modern, flexible and accessible criteria for determining whether a shareholder can pursue an action’<sup>50</sup> as well as to provide better protection to the investments of the individual shareholders. It seems that by introducing the new statutory derivative procedure under the CA 2006, the United Kingdom aimed to find a middle way between managerial control and judicial control that on one hand guarantees a better protection for individual shareholders’ rights and interests and on the other reassures directors by confirming their managerial powers.<sup>51</sup> It could be argued that, from the point of view of ‘commercial justice’, ‘having a judicially guided shareholder derivative procedure... seems preferable as compared to requiring that shareholders demand that the board initiate the claim’,<sup>52</sup> as it is more likely for a minority shareholder to obtain justice for wrongs done to the corporation.

It is also worth noting that the UK Law Commission in its Report *Shareholder Remedies*, had suggested a similar procedure to that of the US demand requirement to be followed by the UK, where notice to the company was to be considered as a pre-condition to decide whether to grant permission to an individual shareholder to continue with a derivative claim.<sup>53</sup> The idea behind the Law Commission’s recommendation was to provide a 28 days grace period to the company to take the litigation decision, in which a derivative claim, during that time, would not have been able to be brought by an individual shareholder of a company.<sup>54</sup> Under the Law Commission’s recommendation, it seems that the company would have been given the opportunity to take litigation decision itself as to whether to enforce its rights against the wrongdoing directors or not, and thus avoid vexatious litigation by individual shareholders. Nonetheless, the Law Commission’s recommendation did not make it into the CA 2006. It could be argued that if the Law Commission’s recommendations were accepted, this would have made it more difficult for individual shareholders to bring an action to remedy the wrongs done to the company, as if those who are in control of the company are also the wrongdoers, it is unlikely that they will allow a litigation decision against themselves, and

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<sup>49</sup> *ibid.*

<sup>50</sup> Law Commission, *Shareholder Remedies* (Law Com No 246, 1997) para 6.15.

<sup>51</sup> Goehre (n 35) 169.

<sup>52</sup> *ibid* 168.

<sup>53</sup> Law Commission (n 50) para 6.58.

<sup>54</sup> Law Commission (n 50) para 6.58.

this would have ended up bringing back the strict application of the *Foss* rule that favoured the ‘majority rule’ principle.

As the rationale behind the US demand requirement is to avoid the courts from intervening with the corporation’s internal affairs until all the internal solution mechanisms have been exhausted, this approach raises one of the most important issues, and this is whether the demand requirement can be exempted, and if so, under what circumstances. It is therefore relevant in the following section to examine the procedure of the demand requirement and its exceptions.

#### *5.3.1.1. The procedure of the demand requirement and its exceptions*

When the company’s board of directors receive the demand by an individual shareholder to pursue an action against the wrongdoers, the board can choose one out of three courses of action to take: (1) accept the shareholder’s demand and initiate proceedings against the wrongdoers itself, (2) resolve the problem internally, or (3) reject the shareholder’s demand.<sup>55</sup> Evidence shows that it is more likely that the company’s board will decide to reject the shareholder’s demand.<sup>56</sup> If they do so, the shareholder then may ask for judicial review but must show that his demand was rejected by the board wrongfully. Some states recognise that an individual shareholder may forego to make a demand to the board, by arguing that demand must be excused.<sup>57</sup> In order to establish that the company’s board had wrongfully rejected his demand or that demand must be excused, it is relevant for the shareholder to effectively prove that the ‘business judgment rule’ does not apply to the decision taken by the company’s board.<sup>58</sup> The business judgment rule is a safeguard that assumes that the company’s directors had acted in a manner consistent with their fiduciary duties of good faith, loyalty and care.<sup>59</sup> Thus, in order to prove that the demand was wrongfully rejected by the company’s board, it must be proved by the individual shareholder that the majority of the company’s directors had breached their fiduciary duties.<sup>60</sup>

This is also very similar to an application of an individual shareholder to excuse the demand as in such cases, an individual shareholder is required to prove that the majority of the company’s directors were financially interested in the transaction, or not independent when

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<sup>55</sup> Scarlett (n 36) 596.

<sup>56</sup> Lisa M Fairfax, ‘Spare the Rod, Spoil the Director? Revitalizing Directors’ Fiduciary Duty Through Legal Liability (2005) 42 Hous L Rev 393, 408.

<sup>57</sup> See *Aronson v Lewis* 473 A 2d 805, 813-14 (Del 1984) (stating that demand can be excused when company’s directors are under influences that impede their discretion to act on the company’s behalf). The Model Business Corporation Act, however, states a universal requirement: Model Business Corporation Act (2002) §7.42.

<sup>58</sup> *Aronson* (n 57) 813-14.

<sup>59</sup> *ibid* 812.

<sup>60</sup> *ibid* 813.

taking the decision.<sup>61</sup> In other words, the demand may be excused if it is proved that the company's board of directors is disabled by a conflict of financial interest, and therefore in such a case the judge may assume that it is unlikely for the company's board to sue themselves. It has been recognised, for example, in Delaware that demand may be excused if the individual shareholder can prove that there is reasonable doubt that (1) the majority of the company's board has an interest in the transaction challenged by the individual shareholder; (2) there is an absence of independence by the majority of the company's board; or (3) the challenged transaction is not a result of a lawful exercise of business judgment.<sup>62</sup>

Nevertheless, it is worth mentioning that most of the states follow the Model Business Corporation Act ('MBCA'), which states a universal demand requirement that makes the demand requirement compulsory for an individual shareholder in every case and therefore a demand is not capable of being excused.<sup>63</sup> Even if an individual shareholder has some doubts regarding whether the company's directors are in fact disinterested or independent from the alleged misconduct, for those states that have adopted the MBCA, demand will still be required.<sup>64</sup> As compared to the approach followed in Delaware, it appears that the MBCA's approach limits the shareholder derivative litigation more than Delaware which allows demand to be excused in certain circumstances. However, this causes confusion in relation to the demand requirement's exceptions. As a result, this makes it more difficult for an individual shareholder to bring a derivative action to remedy wrongs to the corporation.

Another hurdle to the demand requirement exceptions is the 'business judgment rule' which plays an important role as to whether the courts will decide to permit an individual shareholder to use the demand requirement exceptions or not. It is therefore important to examine the rationale behind this rule and its implication on the law of derivative actions in the following section.

### *5.3.2. Business Judgment Rule*

In order to ensure that companies are able to grow and succeed, it is essential that some level of protection is provided to the company's directors, as without such a protection it will be difficult for them to make difficult management decisions without the threat of litigation.<sup>65</sup> This protection can be provided by the 'business judgment rule', which is a judge-made

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<sup>61</sup> *ibid* 814-815.

<sup>62</sup> *ibid* 812-14.

<sup>63</sup> Model Business Corporation Act (2002) §7.42

<sup>64</sup> States adopting this approach include Florida, Georgia, Michigan, Virginia, Wisconsin, New Hampshire, Arizona, Connecticut, Idaho, Maine, Mississippi, Montana, Nebraska, North Carolina, Texas, and Wyoming: See Ferrara, Abikoff and Gansler (n 14) para 3.01.

<sup>65</sup> Goehre (n 35) 145.

principle that has been extensively accepted and adopted as one of the fundamental principles of the US corporate law. According to the Delaware Supreme Court in *Aronson v Lewis*,<sup>66</sup> the business judgment rule is ‘a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company’.<sup>67</sup> It could therefore be argued that the business judgment rule ‘acts as a shield to protect directors from liability for their decisions’ if the requirements of the business judgment rule are satisfied, such as if they have taken their decisions on an informed basis, in good faith and in the honest belief that their decisions were taken in the corporation’s best interests, even if their decisions ‘may have turned out badly from the perspective of the corporation’.<sup>68</sup>

As Animashaun argues, the business judgment rule derives from the fundamental principle codified in section 141(a) of the Delaware General Corporation Law, which provides that those who are responsible to manage and control the corporation affairs are the directors themselves and not the shareholders.<sup>69</sup> According to Animashaun, the rule functions in the following way:

‘The directors... in making business decisions take risks, which occasionally lead to loss of the stockholder’s investment. Such losses and business decisions inevitably lead to lawsuits against the directors who allegedly caused the losses. It is therefore, essential that the directors be protected from personal ruin when they perform their duty according to the established rules. This is the function of the business judgment rule that shields the directors from judicial inquiry into action taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes’.<sup>70</sup>

In most circumstances, the business judgment rule functions to provide a ‘safe harbour’ for the company’s directors, as it ‘protects them from personal liability for claims made against them because of errors of judgment or business decisions which have affected the company in a negative manner’.<sup>71</sup> Since the purpose of the rule is to protect the company’s directors, this raises the important question as to what the requirements of the business judgment rule are in which the company’s directors must satisfy in order to be able to receive protection by this rule. Four conditions have been identified that need to be satisfied in order for the rule to

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<sup>66</sup> *Aronson* (n 57).

<sup>67</sup> *ibid* 812.

<sup>68</sup> *Li* (n 1) 146.

<sup>69</sup> Babatunde M Animashaun, ‘The Business Judgment Rule: Fiduciary Duties and Liabilities of Corporate Directors’ (1989) 16 *Southern University Law Review* 345, 346.

<sup>70</sup> *ibid*.

<sup>71</sup> Demetra Arsalidou, ‘Objectivity vs Flexibility in civil law jurisdictions and the possible introduction of the business judgment rule in English law’ (2003) 24 *Company Lawyer* 228, 231.

protect the company's directors.<sup>72</sup> For the purposes of the thesis, it is essential to briefly analyse those conditions.

The first condition requires that the company's director must not have any financial interest with respect to the transaction.<sup>73</sup> So when a director has an interest in the subject matter of the transaction, then the business judgment rule is not applied. For example, if the transaction involves a company's purchase of a director's personal property, then if the company's director approved the transaction this would not be able of being protected under the business judgment rule.<sup>74</sup> However, there are some circumstances in which the interested director to the transaction may be protected from personal liability. These are: if the company's director can prove that the conflict of interest with respect to the transaction has been authorised by the majority of the company's directors who have no interest to the transaction ('the disinterested directors') or by the vote of disinterested shareholders after a full disclosure, then the rule will apply and the director will be able to get protection from personal liability.<sup>75</sup> In addition, the interested director can avoid personal liability under the protection of the business judgment rule if he can show that the alleged transaction is fair to the corporation.<sup>76</sup> In order for the 'business judgment rule' to provide protection to the decision made by the company's board of directors, it is required that the decision taken by the majority of the directors was taken independently, without dominant control of the director who was interested in the alleged transaction.<sup>77</sup> It could be argued that this is quite similar to the principle followed in the UK in relation to the issue of ratification in which a resolution to ratify a director's breach of duty will be regarded as valid only if the decision is passed by the votes of those who are disinterested in the transaction and by disregarding the votes of the wrongdoing director and any person connected with him.<sup>78</sup> As argued in chapter four, this is a significant development of the law on derivative actions as it seems to exclude the votes of those who have caused the wrong to the corporation and therefore this makes the process of ratifying a director's breach of duty more fair.

The second condition that must be satisfied for the purposes of the business judgment rule is that a company's director should make an informed decision.<sup>79</sup> The requirement for an informed decision 'focuses on the preparedness of a director or officer in making a business

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<sup>72</sup> *ibid.*

<sup>73</sup> American Law Institute's Principles of Corporate Governance, s 4.01(c)(1); See Arsalidou (n 71) 231.

<sup>74</sup> Arsalidou (n 71) 231.

<sup>75</sup> Li (n 1) 146.

<sup>76</sup> See Delaware General Corporation Law, s144(a); Model Business Corporation Act (2002) ss 8.61(b), 8.62, 8.63; See also Stephen M Bainbridge, *Corporation Law and Economics* (Foundation Press 2002) 310-320.

<sup>77</sup> Ferrara, Abikoff and Gansler (n 14) para 5.03.

<sup>78</sup> See Companies Act 2006, s 239(4).

<sup>79</sup> American Law Institute's Principles of Corporate Governance, s 4.01(c)(2); See Arsalidou (n 71) 231.

decision’.<sup>80</sup> In other words, the business judgment rule will not be applied unless it is proved that the company’s directors have informed themselves before making a decision on the basis of ‘all material information reasonably available to them’.<sup>81</sup> It is therefore relevant that significant material information needs to be carefully gathered and considered by the company’s director and also that the director took time to consider his decision. It was recognised that if ‘grossly negligence’ is found on the part of the company’s director, the business judgment rule will not be applied and therefore the director will not be protected from his personal liability.<sup>82</sup>

The third condition to the rule is that it is required that the company’s director had ‘rational relief’ when performing his duty. In other words, that the director truly believed that the transaction was for the company’s interests and also that the belief was objectively rational.<sup>83</sup> Finally, the fourth condition to the rule requires the director to take a business judgment decision in good faith.<sup>84</sup> It has been recognised, for example, that if a decision taken by a director of a company had breached the law and the director knew about this, then the director will not be able to receive protection under the business judgment rule.<sup>85</sup>

Having briefly analysed the rationale of the business judgment rule and its four conditions, it is relevant to examine in the following section as to whether such rule would be useful to be adopted in the UK.

#### *5.3.2.1. Should the UK adopt the business judgment rule?*

The issue that needs to be considered in this section is whether the business judgment rule should be adopted in the UK. As examined above, one of the main justifications of the business judgment rule is that ‘the business and affairs of every corporation... shall be managed by or under the direction of a board of directors’.<sup>86</sup> From this statement it clearly shows that the litigation decision should be left in the hands of the company’s board to decide and not to individual shareholders, or even the courts. A second justification for this rule is the fact that decisions regarding the affairs of the company are always risky and that the board often has to make vital decisions with inadequate information. Therefore, ‘second-guessing is

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<sup>80</sup> American Law Institute’s Principles of Corporate Governance, s 4.01(c)(2); See Melvin A Eisenberg, ‘The Duty of Care of Corporate Directors and officers’ (1989) 51 U Pitt L Rev 945, 960.

<sup>81</sup> *Aronson* (n 57) 812; See *Arsalidou* (n 71) 231.

<sup>82</sup> *Smith v Van Gorkom* 488 A 2d 858, 874-879 (Del 1985).

<sup>83</sup> American Law Institute’s Principles of Corporate Governance, s 4.01(c)(3); See *Li* (n 1) 146.

<sup>84</sup> American Law Institute’s Principles of Corporate Governance, s 4.01(c); See *Arsalidou* (n 71) 231.

<sup>85</sup> See American Law Institute’s Principles of Corporate Governance, s 4.01; See *Arsalidou* (n 71) 231.

<sup>86</sup> Delaware Code Annotated Title 8, § 141(a) (2008); See *Smith* (n 82) 872: ‘Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in 8 Del. C. § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors’.

especially dangerous under such circumstances'.<sup>87</sup> It has also been recognised that the courts are ill-equipped to take and evaluate business decisions in contrast to the board who are in a more advantaged position to better evaluate such decisions.<sup>88</sup>

Furthermore, it has been argued that making the company's directors personally liable for taking poor business decisions is counterproductive in various respects. Indeed, this might discourage people from wanting to become company's directors, as 'the potential liability would far exceed the compensation that would be received for such service'.<sup>89</sup> According to Arsh, people would refuse to accept directorship positions 'if the law exacted from them a degree of prescience not possessed by people of ordinary knowledge'.<sup>90</sup> Indeed, as Warwick argued, 'commerce would grind to a halt if the courts could second guess every decision of the directors or management'.<sup>91</sup> Therefore, in the absence of business judgment rule, people would feel unwilling to become directors.<sup>92</sup> This might also discourage current company's directors 'from engaging in risky behaviour, even when it would be in the interests of shareholders to do so'.<sup>93</sup> It could therefore be argued that the above justifications are quite persuasive as far as it goes as it is best to leave the litigation decisions in the hands of those who are dealing with the business of the company on a regular basis and have access to information regarding the affairs of the company. Indeed, no one would know better than the company's directors in relation to business decisions.

However, on the other hand, it could be argued that the business judgment rule gives significant power to the company's board of directors, and thus makes it more difficult for individual shareholders to hold directors accountable for wrongs that they have caused to the corporation. From the perspective of commercial justice, there should be a mechanism that balances the power of directors with the interests of the company as a whole. The business judgment rule mechanism does not do justice to the corporation as a whole as no such balance exist under this rule. If Rawls was to asked to take a position regarding this matter he would probably argue that laws should be drafted in a way that also consider the interests of those who are in a least advantaged position (the individual shareholders) than the directors and that

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<sup>87</sup> Julian Velasco, 'Structural Bias and the Need for Substantive Review' (2004) 82 Washington University Law Review 821, 831.

<sup>88</sup> *Auerbach v Bennett* 419 NYS 2d 920 (1979): 'The business judgment doctrine, at least in part, is grounded in the prudent recognition that courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments'.

<sup>89</sup> Velasco (n 87) 831.

<sup>90</sup> Samuel S Arsh, 'The Business Judgment Rule Revisited' (1979) 8 Hofstra Law Review 93, 97.

<sup>91</sup> LA Warnick, 'The Liabilities of the Inattentive Company Officer' (1988) 18 University of Western Australian Law Review 91, 94.

<sup>92</sup> Arsalidou (n 71) 232-233.

<sup>93</sup> Velasco (n 87) 831.

such laws should not favoured those who are in a more advantaged position than others. As examined in chapter two, inequalities regarding the distribution of goods and powers are only permitted if it is also for the benefit of the least advantaged members of the society, in this context the minority shareholders. Therefore, as it is likely that those who are in a more advantaged position may exercise their powers to benefit themselves at the expense of those who are in a least advantaged position then, in such circumstances the purpose of the law is to develop effective mechanisms that balances those interests without favouring one approach to the other. For that reason, it is not surprising why the Law Commission in its Report *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties* had rejected to adopt such rule in the UK company law.<sup>94</sup> There should be an effective mechanism in place, as Nozick would argue, that could compensate the company for the wrongs caused by the wrongdoers, otherwise wrongs would remain unredressed. It is therefore not surprising why the UK Parliament decided to remove the strict application of the *Foss* rule that favoured the ‘majority rule’ principle to a more flexible statutory derivative procedure operated through the judiciary. By doing this, the aim of the Parliament was to provide an effective balance between those who are in a more advantaged position (the board) with those who are in least advantaged position (the minority shareholders). It could therefore be argued that, as the business judgment rule is unlikely to do justice to the company as a whole, including its minority shareholders, then such rule should not be implemented into the UK company law.

### 5.3.3. *The emerging role of the special litigation committee*

In addition to the business judgment rule examined above, there is another significant hurdle for individual shareholders to bring a derivative action and that is the use of special litigation committees. The role of such committees, which are usually comprised of directors who are independent and disinterested on the alleged transaction, is to evaluate the individual shareholder’s claim to sue the wrongdoers and decide whether such a claim is for the corporation’s best interests. Contrary to the UK derivative actions, it is not unusual in the United States for the company’s board to appoint special litigation committees to review and evaluate whether a derivative claim is in the corporation’s best interests.<sup>95</sup> This is due to the

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<sup>94</sup> See Law Commission, *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties* (Law Com No 261, 1999) para 5.29.

<sup>95</sup> Adefolake O Adeyeye, *Corporate Social Responsibility of Multinational Corporations in Developing Countries: Perspectives on Anti-Corruption* (CUP 2012) 177.

fact that such committees have been described as more competent and appropriate body to make litigation decisions than the interested company's board of directors.<sup>96</sup>

Therefore, if in the opinion of the special litigation committee a derivative claim should not be allowed because such a claim is not in the best interests of the corporation then it is more likely that the courts would follow the decision taken by the special litigation committee.

Although the UK company law is not familiar with the use of special litigation committees, in the UK case of *John Shaw & Sons (Salford) Ltd v Shaw*,<sup>97</sup> an independent committee of the company's board of directors was appointed to deal with the company's litigation decisions and by doing so it excluded the votes of the wrongdoers from such decisions.<sup>98</sup> In addition, in *Smith v Croft (No 2)*<sup>99</sup> it was recognised that if a suitable independent organ is used to make litigation decisions, then the courts will be reluctant not to follow their decisions.

It could therefore be argued that the use of special litigation committees can provide practical benefits for the UK company law. One of the most significant benefits is that it provides fairer decision-making regarding whether an individual shareholder should be allowed to bring a derivative claim, as such decisions are usually taken by those who are independent and disinterested from the alleged transaction. By having an independent and disinterested body to decide on litigation matters, this makes the process fairer and just for all the parties involved in the alleged transaction. It therefore eliminates commercial injustices were possible as it ensures that the decision will be taken independently from those who have caused wrong to the corporation.

However, the use of special litigation committees has not left without its criticisms. The most significant problem of using such committees is the 'structural bias'.<sup>100</sup> As the company's board of directors, who might have an interest in the alleged transaction, usually appoints the members of the special litigation committee, the committee may then perceive its role 'as that of a buffer to which to shelter and protect management from hostile and litigious stockholders'.<sup>101</sup> Particularly, as Coffee and Schwartz argued, 'a derivative action evokes a response of group loyalty, so that even a "maverick" director may feel compelled to close ranks and protect his fellows from the attack of the "strike suits"'.<sup>102</sup> Therefore, it is likely

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<sup>96</sup> Ferrara, Abikoff and Gansler (n 14) para 8.01.

<sup>97</sup> *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113.

<sup>98</sup> See Paul L Davies and Sarah Worthington, *Gower & Davies Principles of Modern Company Law* (9<sup>th</sup> edn Sweet & Maxwell, London 2012) 645.

<sup>99</sup> *Smith v Croft (No 2)* [1988] Ch 114.

<sup>100</sup> John C Coffee and Donald E Schwartz, 'The Survival of Derivative Suit: An Evaluation and a Proposal for Legislative Reform' (1981) 81 *Columbia Law Review* 261, 283.

<sup>101</sup> *ibid.*

<sup>102</sup> *ibid.*

that the members of the special litigation committee, when taking a litigation decision, may act with a ‘there, but, for the grace of God go I’ approach and show more sympathy to their fellow directors.<sup>103</sup> Evidence supports that there is a likelihood of ‘structural bias’ as in a number of cases the appointed special litigation committees had suggested not allowing a claim against the wrongdoing directors.

One of the leading cases on this point is *Auerbach v Bennett*.<sup>104</sup> This case involved an individual shareholder who pursued to take a derivative action against the wrongdoing directors of General Telephone & Electronics Corporation (‘GTE’), as well as against the company’s auditors, alleging that the defendants should be made accountable for payments constituting bribes and kickbacks totaling more than \$11 million. As a result of the individual shareholder’s derivative action, the board of directors of GTE decided to appoint a special litigation committee to evaluate and review whether a derivative claim should be brought. In the opinion of the committee, it was not in the best interests of the corporation to allow a derivative claim against the company’s directors and the auditors. The committee argued that the auditors have acted in accordance with accepted auditing standards and in a good faith so there was no reason for continuing the claim against them. The committee has also argued that the company’s directors had not breach their duties as they had not gained any personal profit from the transaction and therefore the derivative claim should not be allowed.

The significant question that was raised in this case was whether the business judgment rule was able of being applied to protect the decision taken by the special litigation committee against the scrutiny of the courts. The special litigation committee was comprised of three persons who had joined the company’s board after the alleged transaction was made. The derivative claim was taken against four company’s directors out of fifteen directors. It was argued that the wrongdoing directors had not participated in any illegal transactions and that the remaining directors did not know about the alleged transactions. As a result, the court decided that the decision taken by the special litigation committee was beyond judicial scrutiny and that the business judgment rule was applied to protect its decision. However, it is worth noting that it was recognised that the court has the power to inquire the independence of the committee’s members as well as the appropriateness of the investigative procedures used by the committee to reach its decision. On the fact of the case, the Court of Appeal argued that there was nothing wrong with procedure used by the committee and therefore it

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<sup>103</sup> *Zapata Corp. v Maldonado* 430 A 2d 779, 787 (Del 1981).

<sup>104</sup> *Auerbach* (n 88).

came into the conclusion that the decision taken by the committee foreclosed further judicial scrutiny.

It could therefore be argued that both the business judgment rule and the use of special litigation committees on litigation matters are obstacles to an individual shareholder to bring a derivative action to remedy the wrongs done to the corporation.<sup>105</sup> Some academics have argued that the business judgment rule needs more scrutiny as it is essential to stop the unfortunate trend towards judicial abdication and board's immunity from personal liability.<sup>106</sup> This is due to the fact that there is a necessity for the derivative action to remain an effective mechanism that allows individual shareholders to bring an action to remedy the wrongs caused to the corporation.<sup>107</sup>

An interesting case on this point is *Zapata Corp v Maldonado*,<sup>108</sup> where it was recognised that the business judgment rule may not have the final say whether to allow a derivative action or not. This case was found to be an interesting one as it has been argued that the *Zapata's* decision preserves the derivative action as an effective tool for individual shareholders to remedy wrongs that has been caused to the corporation by the wrongdoing directors.<sup>109</sup> This case involved a derivative action brought by an individual shareholder against ten of the company's directors, alleging that the directors had breached their fiduciary duties. As a result of the derivative action, the company's board decided to appoint a special litigation committee, which was comprised of two new board's members, to investigate the matter further. In the opinion of the committee, the derivative action against the wrongdoing directors should not be allowed. The company then moved for dismissal or summary judgment. The summary judgment was rejected by the Chancery Court for the reason that the business judgment rule does not provide authority to reject individual shareholders' derivative actions and that every individual shareholder has a right to bring such actions in certain circumstances. As a result of the Chancery Court's decision, the company brought an interlocutory appeal before the Supreme Court of Delaware, which dismissed the decision of the Chancery Court to deny summary judgment.<sup>110</sup>

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<sup>105</sup> Adeyeye (n 95) 178; See George Dent, 'The power of directors to terminate shareholder litigation: the death of the derivative suit' (1980) 75 Nw UL Rev 96.

<sup>106</sup> Adeyeye (n 95) 178-179; See Janet Johnson, 'The business judgment rule: a review of its application to problems in illegal payment' (1980) 6 Journal of Corporation Law 481.

<sup>107</sup> *ibid* 179; See Johnson (n 106).

<sup>108</sup> *Zapata* (n 103).

<sup>109</sup> Leah Tompkins, 'Corporations – the court's independent business judgment will be applied to a decision of a committee of disinterested directors to dismiss a derivative suit alleging a breach of fiduciary duty by a majority of the corporations' directors' (1982) 27 Vill L Rev 1308, 1324.

<sup>110</sup> *Zapata Corp* (n 103) 785.

However, in relation to the role of the business judgment rule to dismiss individual shareholders' derivative actions, in the opinion of the Supreme Court, mere judicial inquiries into independence, good faith and reasonable investigation of the special litigation committee, were seen as not sufficient protection against potential abuse.<sup>111</sup> It was then established that a two-step test should be applied in all the circumstances where motions to dismiss a derivative action are filed. The first step involves an inquiry into the independence and good faith of the special litigation committee as well as reasonable bases of the supporting special litigation committee's conclusions. If these are not satisfied, then the court should reject the company's motion to dismiss a derivative action. However, if these are satisfied, then the court should proceed to step two which requires the court to apply its own independent business judgment to decide whether to dismiss a derivative action or not. Contrary to *Auberman* decision, it could be argued that *Zapata* took a more flexible approach towards protecting individual shareholders against the abuse of the wrongdoers and that 'commercial justice' has been achieved.<sup>112</sup>

This raises the question whether the use of special litigation committees should be adopted in the context of derivative actions in the UK. It could be argued that although such committees are not well-known in the UK company law, it seems that the Companies Act 2006 under section 239 follows a very similar approach as a resolution to ratify the wrongdoing of a director is valid only if the resolution is passed without taking into account the votes of the wrongdoers and any other person connected with them. As argued in chapter four, this is a significant development on the law of derivative actions as it ensures that those who have caused the wrongdoing will not be able to release themselves from their personal liability to the company. However, as argued above, the structural bias is a significant problem as it is not entirely clear whether those who vote in favour of a resolution are in fact independent and disinterested from the alleged transaction. The same applies to the special litigation committees as it not entirely clear that the members of those committees are actually independent to take rational decisions that could provide 'commercial justice' to both the company and its shareholders. It is therefore essential to investigate in the following section other possible solutions that may be able to resolve the litigation decision problem.

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<sup>111</sup> *ibid* 787.

<sup>112</sup> See Adeyeye (n 95) 180.

#### 5.3.4. *The minority shareholder group: an alternative approach to shareholder derivative litigation?*

Davies and Worthington in their seminal book *Gower & Davies Principles of Modern Company Law*,<sup>113</sup> proposed a very interesting solution to the litigation decision problem. As Davies and Worthington argued, one possible solution to this problem would be to leave the litigation decision in the hands of a group of shareholders, 'lying between the shareholders as a whole and the individual shareholder'.<sup>114</sup> This is the so-called minority shareholder group action. It is worth noting that such a device was not used in the context of derivative actions before. However, in one area of company law the minority shareholder group action was accepted and introduced under what is now Part 14 of the Companies Act 2006 which requires that the policy of the company to make political donations and incur political expenditure should be subject to an approval by the majority of shareholders at the general meeting. If this requirement is not satisfied then the company's directors (including shadow directors) will be liable to pay 'to the company the amount of the unauthorised donation or expenditure, with interest, and to compensate the company for any loss or damage sustained by it as a result of the unauthorised donation or expenditure having been made'.<sup>115</sup>

In such a case, a derivative claim could be brought under section 370 of the Companies Act 2006 but with one difference from the derivative claim under section 260; that is, the right to bring a derivative claim in the company's name is conferred not on individual shareholders but on an 'authorised group' of members,<sup>116</sup> meaning, in the case of a company limited by shares, 'the holders of not less than 5% of the nominal value of the company's issued share capital';<sup>117</sup> in the case of a company not limited by shares, to members not less than 5%,<sup>118</sup> or 'not less than 50 of the company's members'.<sup>119</sup> As Davies and Worthington argued,

'It seems that the aim of confining the right to sue to a small group of shareholders was to provide a realistic chance of enforcement action being brought whilst at the same time excluding individual shareholders from suing, who might be motivated by reasons which did not relate to the company's interests'.<sup>120</sup>

Although Davies and Worthington proposal is very appealing to be used in the context of derivative actions under section 260 of the Companies Act 2006 in public companies which have thousands of members and thus with this device they can avoid unnecessary litigation by

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<sup>113</sup> Davies and Worthington (n 98) 649.

<sup>114</sup> *ibid* 649.

<sup>115</sup> Companies Act 2006, s 369(2).

<sup>116</sup> Companies Act 2006, s 370(1)(a).

<sup>117</sup> Companies Act 2006, s 370(3)(a).

<sup>118</sup> Companies Act 2006, s 370(3)(b).

<sup>119</sup> Companies Act 2006, s 370(3)(c).

<sup>120</sup> Davies and Worthington (n 98) 650.

individual shareholders who may hold a very small percentage of shares in public companies, it could be argued that such an approach could be problematic in case of private companies. This is due to the fact that in case where a private company has only one majority shareholder and one minority shareholder who holds less than 5%, if the above approach is followed then the wrong that has been caused to the company will remain unredressed, as the individual shareholder will not be able to bring a derivative action unless there is a group of minority shareholders who hold not less than 5% of shares in the company. Also, this approach will cause significant problems to the issue of multiple derivative actions as, again, it will be difficult to find a group of minority shareholders who hold not less than 5% of shares in the parent's subsidiary company to be able to bring a derivative action against the wrongdoers for wrongs done to the parent's subsidiary.

#### **5.4. Conclusion: Are there any lessons to be learnt from the US experience?**

To summarise, the purpose of examining the US derivative actions and its principle was to see whether any lessons can be learnt from the US experience which the UK could learn and re-examine its own statutory derivative procedure. By examining three of the most important principles that are currently followed by the US, such as the demand requirement, the business judgment rule and the use of special litigation committees, the thesis came to the conclusion that in order to make the statutory derivative action in the UK more flexible and also able to provide justice to minority shareholder, no such principles should be adopted in the UK. By considering the demand requirement and its rationale which is mainly to bar minority shareholder from bringing a derivative claim, this would be an unsuitable principle to be used in the UK due to the fact that it will bring derivative actions back to the strict application of the *Foss* rule which its main purpose was to prevent minority shareholder from commencing derivative claims as it was believed that the most suitable body to make such a litigation decision was the majority of shareholders at the general meeting. In addition, by examining the business judgment rule, the thesis came to the conclusion that if the UK adopts such a rule then it will make it more difficult for the minority shareholder to remedy wrongs done to the corporation as the court will be more reluctant to allow a derivative claim in cases where the business judgment rule applies. Finally, although the use of special litigation committee is appealing, it poses significant structural bias problems, as it is not entirely clear as to whether the members of such committees are entirely independent and disinterested from the alleged transaction. Although special litigation committees are not well-known to the UK, such an approach is very similar to that with the case of ratification that requires that a resolution will be valid only if it passed without the votes of the wrongdoers and those who

are connected with them. In this chapter, the thesis also embarked on an enquiry to examine a possible solution to this problem by looking at the approach adopted under section 369-370 of the UK Companies Act 2006, which permits a group of minority shareholders (not individuals) to bring a derivative claim. As was argued above, although such an approach would be appealing for public companies, this poses significant practical problems for private companies as in situations where only one minority and one majority are in the company, then who should be able to bring a claim to remedy the wrongs done to the corporation?

## Chapter 6. Concluding remarks and suggestions

### 6.1. Summary

The main aim of this research was to examine and evaluate the effectiveness of the new statutory derivative action under the Companies Act 2006 and its role in achieving commercial justice for minority shareholders. One of the most important research questions of this thesis, which has received inadequate attention in the literature, was: Does the new statutory derivative action achieve ‘commercial justice’ to minority shareholders? In answering this question, it was essential for the thesis to embark upon an enquiry to develop its own theoretical framework for ‘commercial justice’, looking particularly at the theories of justice developed by both Rawls and Nozick. This examination was found to be essential as this helped the thesis to develop its own theoretical framework for ‘commercial justice’ by looking at the concept of justice from two different perspectives: ‘distributive justice’ and ‘corrective justice’. The aim for examining Rawls and Nozick theories of justice was not with the intention to examine the shortcomings of those theories but to use the main elements of these theories for the purpose of developing the concept of justice in the commercial context. One of the most important reasons for developing such a theoretical framework in chapter two is because the thesis has identified a gap in the literature on the law of derivative actions, which was important to be filled in through examining the concept of ‘commercial justice’.

As mentioned in chapter four, although significant changes have been made with the introduction of the new statutory derivative action under the Companies Act 2006 with the purpose to provide more modern, flexible and accessible criteria for determining whether a member of a company may bring a derivative claim, Parliament failed to provide clear explanations as to the actual scope and purpose of this action. It seems that Parliament preferred to leave this to the courts to decide by giving them the discretion to determine whether to grant a permission or not to a member of a company to continue with a derivative claim. However, this made it more difficult for the courts to determine what role they should serve when deciding whether to allow, and in which circumstances, a derivative claim. Although various criteria have been provided under the Companies Act 2006 for the courts to consider, no further explanation has been given by the Parliament as to what approach the courts should follow when determining whether to grant a permission or not to a member of a company to continue with a derivative claim. This has also been proved when the recent cases have been examined. In *Franbar*, for example, William Trower QC was not actually clear as to which approach he preferred to follow – transaction-based approach or voting-based

approach – when deciding whether permission should be given to a member of a company to continue with a derivative claim. In addition, cases such as *Mission* and *Stimpson*, have also shown the uncertainty of the courts as to whether they are required to follow both stages provided under sections 261 and 262 of the Companies Act 2006 or whether it is best to merge the two stages into one.

Due to the failure of Parliament to provide clear explanations on those issues, it was therefore the intention of this thesis to argue that the role of the courts should be to remedy commercial injustices through the use of derivative actions. To achieve this, the courts need an overarching guiding principle. That principle should be ‘commercial justice’ as developed in chapter two, as this will give flexibility to the courts but will enable and indeed require the courts to articulate the intellectual processes they have gone through in reaching their decisions.

Although such an overarching guiding principle has not been recognised and used so far in the context of derivative actions, it is worth noting that the importance of considering justice when deciding whether to allow a derivative claim has been recently stressed by Briggs J in *Universal* case, where he recognised that the role of derivative actions is actually to remedy wrongs that has been caused to the company and therefore by denying the right to bring a multiple derivative action would dismiss the effectiveness of the statutory derivative action as an effective mechanism to provide justice for minority shareholders, and also for shareholders in corporate groups. This case has proved to be a significant development of the law on derivative actions as it has actually clarified that the role and purpose of the new statutory derivative action is to achieve justice by providing a remedy to minority shareholders when injustice occurs. In other words, the role and purpose of the new statutory derivative action is to achieve ‘commercial justice’ to minority shareholders. It is therefore essential in the following sections to provide the main findings and contribution to this research as well as to answer the main research questions laid down in the introductory chapter.

## **6.2. Main findings and contribution to this research**

As mentioned above, the contribution of this research was to provide a clear understanding of the role and purpose of derivative actions and by doing so it embarked on an enquiry to develop a theoretical framework of ‘commercial justice’. In order to develop this theoretical framework in chapter two, it was relevant to firstly examine and analyse the concept of justice in the general context with particular focus on Rawls and Nozick’s theories of justice. It is

therefore relevant in this chapter to see how both theories of justice apply in the context of commercial law, particularly in the context of the law on derivative actions.

### *6.2.1. Application of Rawls's theory of justice in the context of derivative actions*

From what has been examined in chapter two, Rawls theory of justice mainly focuses on the just and equal distribution of society's most important goods, such as liberty and opportunity, income and wealth, arguing that unequal distribution of those goods is only justified where such an inequality is for the benefit of all members within the society, particularly to the least advantaged members of the society. His main aim was to identify the principles of justice that will structure the basic laws and institutions of a just society. By doing so, he embarked on an enquiry to begin with a thought experiment by imagining the principles of justice that would have been agreed upon by a group of free, equal and rational individuals coming together in what he calls as the 'original position' of equality.<sup>1</sup> Rawls' intention was to show that his principles of justice are the only principles that any group of free and rational individuals, who are concerned to further their own interests, would agree to in this initial position of equality. Rawls intention was therefore to set up a fair procedure of decision-making in the original position.

For Rawls, the key to this fair decision-making procedure is the so-called 'veil of ignorance'.<sup>2</sup> Behind the veil of ignorance, individuals do not know their class position or social status, their racial, ethnic or religious background, nor their natural talents or assets such as intelligence or strength. The important aim of restricting knowledge in the original position is to prevent biased outcomes in favour of the interests of particular individuals or classes of individuals. More specifically, the intention is to prevent biased outcomes in favour of those who are naturally stronger, more intelligent, were born into rich families, etc. Rawls argument is that it is unjust to reward these sort of arbitrary or unchosen inequalities and it is also unjust for those who are naturally disadvantaged to be condemned to unsatisfactory lives because of those disadvantages. In other words, the objective is to set up a society that is neutral with respect to chosen inequalities and committed to positively redressing unchosen inequalities.

In the context of company law, it could be argued that the least advantaged members of the company is the minority shareholders whereas the most advantaged members in a company are the majority of shareholders. This is due to the fact that majority shareholders, who have in their possession higher number of shares in contrast to minority shareholders, are able to control and influence the corporate decisions and hence they are in a more advantaged

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<sup>1</sup> John Rawls, *A Theory of Justice* (Harvard University Press 1971) 12.

<sup>2</sup> *ibid.*

position to impose their will when voting at a general meeting than the minority shareholders. As majority shareholders are in a more advantaged position to control and manage the affairs of the company they can easily exercise their voting powers to benefit themselves at the expense of the minority shareholders.

As mentioned in previous chapters, majority shareholders are in a stronger position than minority shareholders as they can use their voting powers to amend the articles of association, remove directors from the board and also influence decisions regarding the management of the company. This is so-called ‘majority rule’, which was strongly supported by the *Foss* rule. However, as mentioned in chapter four, the ‘majority rule’ principle suffers from difficulties as it can sometimes be regarded as unjust for minority shareholders due to the fact that it requires a concentration of power in the hands of the majority shareholder, who may exercise it abusively to favour their own interests. The common law derivative action has therefore failed to provide justice to minority shareholders, as it was incapable to consider the likely risks associated with any absolute exercise of majority rule. This therefore leads the thesis to ask the question: If we allow majority rule could that further commercial justice? In answering this question, it is firstly relevant to imagine what rules shareholders in the original position would choose to govern their own institution.

As mentioned in chapter three, ‘a company is, of its essence, a collective association in which the interests of different shareholders have to be balanced with and subject to the common interest in accordance with its constitution’.<sup>3</sup> In order to achieve such a balance, a company needs to establish a set of constitutional rules that specify who has the power and control to act and make decisions on the company’s behalf.<sup>4</sup> These rules can be found primarily in two places: the Companies Act 2006 and the articles of association. However, as mentioned in chapter three, due to the fact that the Companies Act 2006 remains silent on various issues regarding the regulation and function of the company, the articles of association are there to fill in the gaps of the statute. The significant of the company’s constitution contained in the articles of association is that members of a company are free to choose their own rules that will govern their company. For example, they are free to choose rules that set out the powers of the company and to determine how those powers are to be distributed between the different organs of the company, such as the board of directors and the shareholders in the general meeting.<sup>5</sup> The articles of association can therefore be regarded as a set of rules which the members of the company ‘have implicitly agreed or consented to as the rules that they, or at

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<sup>3</sup> Arad Reisberg, ‘Shareholders’ remedies: the choice of objectives and the social meaning of derivative actions’ (2005) 6 *European Business Organisation Law Review* 227, 331.

<sup>4</sup> David Kershaw, *Company Law in Context: Text and Materials* (2<sup>nd</sup> edn, OUP 2012) 79.

<sup>5</sup> *ibid* 81.

least a majority of them, believe at the optimal rules' of the company.<sup>6</sup> As Rawls would therefore argue, the articles of association contain the rules that members would choose to govern their collective association, namely the company. For Rawls, the purpose of the articles of association would be to establish the rules of social-cooperation that all members of the company would regard as fair and consistent with their own self-interests, and to which they would willingly give their consent to govern their company.

In the context of company law, however, this would be impossible to achieve, as majority shareholders would probably not agree to terms that limit their voting powers. As mentioned in chapter two, shareholders, in exercising their right to vote, are not trustees for the company and they can vote in their own self-interest, satisfying their own particular wishes, and prejudices, and without any personal obligation to consider or act in the best interest of the company. Therefore, no shareholder would agree to terms that minimise their freedom to exercise their voting powers as they think fit. For that reason, it could be argued that it is relevant for the Parliament to take Rawls's principles of justice into account and enact laws that can provide balance between those who are in a more advantaged position (the majority shareholders) and those who are in a least advantaged position (the minority shareholders). Parliament when drafting laws should consider that all parties in the transaction should be treated equally and if any of those who are in a most advantaged position try to abuse the rights of those who are in a least advantaged position, then there should be a remedy that can be used to provide justice to those who are in a least advantaged position. In a Rawlsian society, although majority shareholders would have the power to make decisions regarding the affairs of the company, special protections should be provided to ensure that the process would also be fair for the minority shareholders. Rawls would therefore argue that inequality is permissible, but only if it also benefits the minority shareholders. In other words, Rawls accepts inequality where the improvement in fortunes of those at the top simultaneously benefits those at the bottom. It is therefore necessary to establish laws that treat all members of the corporation equally otherwise this would lead to an unjust treatment of the least advantaged members (the minority shareholders). In the context of derivative actions, it could be argued that the new statutory derivative action is likely to achieve 'distributive justice' as compared to the common law rules, as it seems that Parliament has made significant changes (though there is still room for further improvement) with the purpose to balance the interests of the directors with the interests of the aggrieved minority shareholders who wish to seek justice to remedy wrong done to the company through the use of derivative actions.

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<sup>6</sup> *ibid* 79.

### 6.2.2. Application of Nozick's entitlement theory of justice in the context of derivative actions

The starting point for Nozick's entitlement theory of justice is that it differs starkly from Rawls's theory of justice. In his book, *Anarchy, State and Utopia*,<sup>7</sup> Nozick argues for the idea of a 'minimal state', which is based on just entitlements, and in which the notion of Rawls' social or distributive justice has no place.<sup>8</sup> For Nozick, the idea of justice was specifically based on rights, and he defined a just society as one in which individual rights were accorded the respect due to them.<sup>9</sup> Each individual, as he argues, has certain natural rights such as the enjoyment of life, health, liberty and possessions without interference from others, and the right to be compensated by any person who causes injury by violating one's natural rights.<sup>10</sup> In other words, each individual is autonomous and responsible and should be left free to live his or her own life, free from interference from others and when his or her natural rights are violated by others he or she should be compensated.<sup>11</sup>

For Nozick, freedom in the acquisition of property and in human association is a natural right in which the state must not adversely affect unless they are directly hurting others. Nozick's theory is based on the notion of natural freedom, where individuals have certain negative rights, which are rights against other people interfering coercively in their affairs and the right to property acquisition and accumulation.<sup>12</sup> Respect for 'human' rights is primary, and cannot be negated through 'the greater good'; protection of individual rights to property and association are rights whatever happens. Such rights can never be justifiably violated.<sup>13</sup>

In the context of company law, it could be argued that shareholders have certain negative rights and one of those negative rights is their voting right in which they can exercise as they see fit. Shareholders, as the owners of shares in the company's capital, they can use their voting powers to benefit their own self-interests. For Nozick, this would mean that the government should be prevented from imposing limitations on shareholders' voting rights. However, as it was argued in chapter two, this poses various difficulties as, if not such limitations exist, shareholders will be able to use freely their voting powers to advance their own interests at the expense of the minority shareholders and the company as a whole.

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<sup>7</sup> Robert Nozick, *Anarchy, State, and Utopia* (Basic Books, New York 1974).

<sup>8</sup> Ian McLeod, *Legal Theory* (Macmillan law masters, London 1999) 178.

<sup>9</sup> AK Gavai, *Business Ethics* (Himalaya Publishing House, Mumbai 2010).

<sup>10</sup> JG Riddall, *Jurisprudence* (2<sup>nd</sup> edn, OUP 2005) 217.

<sup>11</sup> Gavai (n 9).

<sup>12</sup> PA O'Hara, 'Insider trading in financial markets: legality, ethics, efficiency' (2001) 28 *International Journal of Social Economics* 1046, 1050.

<sup>13</sup> *ibid* 1050-1051.

As mentioned in chapter two, the legal and factual powers of shareholders give rise to the question of whether the shareholders have any obligation to use their power in a particular way or in pursue of specific goals. Generally speaking, shareholders are not under any obligation to focus on anything and are at liberty to pursue their own financial goals. As opposed to the board, which does not have a legitimate interest of its own and is given the duty of promoting the interests of the company, shareholders have a legitimate right to act and vote so as to further their own self-interest. However, this carries the risk of abuse or exploitation as majority shareholders may use their voting powers at the expense of the company or the minority shareholders interests. As mentioned in chapter two, due to this problem, the courts have imposed limitations on the exercise of majority shareholders' voting powers with the aim to protect the interests of the company and its minority shareholders. However, this leads to the question: Are these limitations enough to provide protection to minority shareholders?

By examining the limitations imposed on majority shareholders by the courts in chapter two, it could be argued that such limitations do not provide effective mechanisms to protect minority shareholders from the abuse and exploitation of the majority shareholders. It could be argued that those gaps can be filled in through the use of derivative actions. This is due to the fact that, in private companies, majority shareholders are usually also the directors of the company, and therefore any breach of their directors' duty this would allow the minority shareholder to bring a derivative claim. In addition, under the new statutory derivative action, 'shadow directors' will also held accountable if they have caused wrong to the company. This is a significant development of the law on derivative actions as it can hold accountable those who have a real influence (although behind the shadows) over the company's affairs, and majority shareholders are likely to be included in this category. It could therefore be argued that the new statutory derivative action is also likely to achieve 'corrective justice' to minority shareholders, as by allowing minority shareholders to bring a claim against the wrongdoers, the company will get compensated for the wrongs that have been caused to it by the wrongdoers.

### *6.2.3. The role of 'commercial justice' on the law of derivative actions*

In analysing the above theories of justice, this research has come to the conclusion that there is a need for the Parliament to enact laws that can both protect individual rights and also provide equal treatment to all the parties affected in the corporation. It could be argued that derivative actions can provide justice to minority shareholders (with some minor reforms) as with the introduction of the Companies Act 2006, Parliament has achieved to enact a new

statutory derivative procedure which balances the interests of those who are in a more advantaged position in the company (board of directors and majority shareholders) with those who are in a least advantaged position (minority shareholders).

Although there are still some doubts as to the interpretation and application of the new legislation, it could be argued that significant changes have been made that improved minority shareholders' protection. One of the most significant changes that have been made under the Companies Act 2006 was to widen the locus standi to include persons who are not members of the company but to whom shares in the company have been transferred or transmitted by operation of law.<sup>14</sup> It could be argued that this is a significant change as it shows more flexibility as to who can take an action on behalf of the company. However, although the new statutory derivative actions seems to be more flexible as compared to the common law rules, it failed to also extend the locus standi to members of a parent company to bring a derivative actions for wrongs done to the parent's subsidiary. Although it was recognised in *Universal* that multiple derivative actions are allowed in the UK, there is still relevant for Parliament to reform the law on derivative actions in order to include a provision for multiple derivative actions.

Another major change of the new statutory derivative action is that it widens the types of breaches under which a derivative claim may be brought. Under section 260(3) of the Companies Act 2006, a derivative claim can be brought only 'in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of company'. This covers a broader range of conduct than existed under the common law derivative action. The inclusion of negligence is also significant, as under the common law it was impossible for a minority shareholder to use mere negligence as a ground to take an action on behalf of the company. Therefore, the capacity of a minority shareholder to bring a derivative claim in respect of negligence represents a significant development of derivative actions as compared with the common law rules.

As already mentioned above, another significant inclusion to the new statutory derivative action under section 260 is that 'shadow directors' can also be regarded as liable in the same way as directors. As mentioned in chapter four, the intention behind permitting derivative claim against 'shadow directors' is to allow a claim to be made against a person who has real influence in the company and its affairs. Parliament's intention was to regulate and attach responsibility to a person who, although absent of a formal appointment to a company's board of directors, is nevertheless in a position to direct and carry real influence in the company's

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<sup>14</sup> Companies Act, s. 260(5).

activities. If shadow directors were absent of regulation, such a person would evade procedures and duties designed to prevent the mismanagement of a company's affairs. Parliament has therefore taken significant steps to eliminate injustices by imposing duties and obligations to those who are also influencing decisions regarding the company's affairs.

However, on the other hand, it could be argued that although significant developments have been made on the law of derivative actions, Parliament failed to actually clarify the role and purpose of the new statutory derivative action. By doing so, it made it difficult for the courts to decide which approach to follow in determining whether a minority shareholder should be allowed to continue with a derivative claim. Although the purpose of Parliament was to give the courts the discretion to decide whether permission should be given or not, it failed to provide clear explanations as to the role of the courts when looking at the various criteria provided under the Companies Act 2006. It seems that the burden has left to the courts to decide what factors they should take into account when deciding whether derivative actions should be allowed or not. This of course makes it harder for the courts to decide what criteria they should take into account in order to do justice to each individual case.

In the absence of a clear explanation as to the operation and role of derivative actions, it was therefore relevant in this research to develop a theoretical framework for 'commercial justice' that can be used as a guide for the courts when deciding whether to allow derivative actions or not. It is the intention of the thesis to argue that the courts should take into account commercial justice while looking at the various stages of the statutory derivative procedure, as this will enable the courts to do commercial justice in each individual case. The thesis does not suggest that commercial justice should be the sole criterion for the courts to follow but it should be used as a general guide or 'touchstone' for the courts when deciding whether to allow derivative actions or not. It could be argued that the role and purpose of derivative actions should be to enable commercial justice to be done to all, including minority shareholders, whose investment in a company is in a least advantaged position than the majority shareholders. Therefore the overarching principle for derivative actions should be 'commercial justice'. The courts, by taking into account the criteria laid down in the Companies Act 2006, should ask themselves whether 'commercial justice' has been achieved. It is essential therefore to mould the law on derivative actions to suit changing times and circumstances and this could be achieved if the courts adopt the overarching principle of 'commercial justice'.

Of course, some academics might argue that the concept of 'commercial justice' is too broad to be used for the purposes of derivative actions as it might be difficult to use such broad

concept in practice. In justifying the theory of ‘commercial justice’, it is therefore relevant to look at some other examples where other areas of law (particularly equity law) have used such unifying and broader concepts.

In the area of equity law, for example, a unifying concept of ‘unconscionability’ was used in *Bank of Credit and Commerce International (Overseas Ltd) (in Liquidation) v Akindele*<sup>15</sup> (‘BCCI’) that helped the courts decide the degree of knowledge required to find recipient liability. In *BCCI* the Court of Appeal rejected all of the pre-existing lines of authority and established a wholly new test, holding that liability for knowing receipt will only be imposed if the state of the recipient’s knowledge makes it unconscionable for him to retain the benefit of the receipt. The facts of the case involved employees of BCCI (Overseas Ltd) who entered in a fraudulent loan agreement with the defendant to receive \$6.68 million as a return on \$10 million he had paid to the bank. At the time of the transfer of the \$10 million there was nothing to suggest that BCCI was operating a fraudulent banking service. The sum was advanced under an artificial loan agreement designed to give the impression that certain dummy loans were performing as normal: this was clearly in breach of fiduciary duty by the employees of the bank. In 1991 the BCCI group of companies went into liquidation and the liquidator of the companies commenced proceedings against the defendant to recover their losses on the grounds that the defendant had become a constructive trustee of the money received under the fraudulent loan agreements. The basis of the liquidators’ claims were that the defendant had knowingly assisted in a breach of fiduciary duty and that the sum of \$6.68 million, which was an exceptionally high rate of return, was a knowing receipt of money in breach of fiduciary duty. The question before the Court of Appeal was essentially one relating to the state of mind of the defendant.

Nourse LJ undertook a review of the existing authorities with a view to finding exactly what state of mind was required on the part of a defendant in order to incur liability for knowing assistance. From what has been observed so far, the existing case law was not entirely clear. Possibilities ranged from the fivefold classification in *Baden v Societe Generale*<sup>16</sup> to the ‘want of probity’ requirement in *Re Montagu’s Settlement Trusts*<sup>17</sup> to the question of dishonesty as explained in *Agip (Africa) v Jackson*.<sup>18</sup> Having reviewed the authorities, Nourse LJ explained that dishonesty on the part of the recipient was not a prerequisite for liability for knowing

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<sup>15</sup> *Bank of Credit and Commerce International (Overseas Ltd) (in Liquidation) v Akindele* [2001] Ch. 437.

<sup>16</sup> *Baden v Societe Generale* [1983] 1 WLR 509: ‘(i) actual knowledge; (ii) wilfully shutting one’s eyes to the obvious; (iii) wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make; (iv) knowledge of circumstances which would indicate the facts to an honest and reasonable man; (v) knowledge of circumstances which would put an honest and reasonable man on inquiry’.

<sup>17</sup> *Re Montagu’s Settlement Trusts* [1987] Ch 264.

<sup>18</sup> *Agip (Africa) v Jackson* [1990] Ch 265.

receipt. Furthermore, Nourse LJ rejected that the fivefold classification by Peter Gibson J in *Baden* case should serve as a yardstick to measure the levels of knowledge for knowing receipt. Nourse LJ explained that:

‘...just as there is now a single test of dishonesty for knowing assistance, so ought there to be a single test of knowledge for knowing receipt. The recipient’s state of knowledge must be such as to make it unconscionable for him to retain the benefit of the receipt. A test in that form, though it cannot, any more than any other, avoid difficulties of application, ought to avoid those of definition and allocation to which the previous categorisations have led. Moreover, it should better enable the courts to give commonsense decision in the commercial context in which claims in knowing receipt are now frequently made’.<sup>19</sup>

Applying the test of ‘unconscionability’, Nourse LJ held that a defendant would only incur knowing receipt liability in circumstances where the state of mind of the defendant makes it unconscionable for him to retain the property. His Lordship considered that this test would enable the court to give common sense decisions in the commercial context. Applying the test in the present case, the defendant’s knowledge was not such as to make it unconscionable either for him to have entered into the transaction or for him to be entitled to retain the benefit of the profit which he received when he had enforced it; consequently, he was not liable for knowing receipt. What is also relevant from this case is that Nourse LJ also acknowledged that, although this broad concept of ‘unconscionability’ will face difficulties in application (such as many tests do), ‘it ought to avoid those of definition and allocation to which the previous categorisations had led’. Nourse LJ has therefore used this broader test to avoid the difficulties of previous existing case law categorisations. It could therefore be argued that the broad concept of ‘commercial justice’ developed in chapter two could also be used in the context of the law on derivative actions. ‘Commercial justice’ will not be easier than the concept of ‘unconscionability’ mentioned above but it can be used in a similar way to what Nourse LJ has done in *BCCI* case; as a guideline for the courts when evaluating whether derivative actions should be allowed or not.

As mentioned above, although such an overarching guiding principle has not been recognised or used in the context of derivative actions, it is worth noting that the importance of considering justice when deciding whether to allow a derivative claim has been recently stressed by Briggs J in *Universal* case. Though the issue of multiple derivative actions has been fully explored and analysed in chapter four, there are some issues that are of immense importance to further analyse in the following section.

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<sup>19</sup> *Bank of Credit and Commerce International (Overseas Ltd) (in Liquidation) v Akindele* [2001] Ch. 437, 455.

#### 6.2.4. Multiple derivative actions and the pursuit of justice

In the recent case of *Universal Project Management Services Ltd v Fort Gilkicker Ltd & Ors*<sup>20</sup>, Briggs J (former High Court judge) acknowledged the importance of ‘justice’ in determining whether multiple derivative actions should be allowed in the UK. As mentioned in chapter four, a member of the parent company (UPMS) brought an action against the wrongdoer directors of the parent’s subsidiary company. In this case, the subsidiary was a wholly-owned subsidiary. This means that all the shares of the subsidiary were owned by the parent company and thus the only shareholder of the subsidiary was the parent company itself.<sup>21</sup>

The question arose in this case, was whether UPMS should be allowed to take an action on behalf of the subsidiary. This is due to the fact that normally such a cause of action is vested in the subsidiary company. However, due to the fact that the parent company (AHP LLP) was its only shareholder, the subsidiary was unlikely to pursue such a claim against the wrongdoer director. In considering whether to allow multiple derivative actions, Briggs J acknowledged that the rationale behind derivative actions is ‘to enable justice to be done’<sup>22</sup> and therefore the locus standi should be extended to members of the parent company. As Briggs J argues, a derivative action is merely a procedural device designed to prevent a wrong going without a remedy.<sup>23</sup>

Therefore, although the Companies Act 2006 omitted to include a provision for multiple derivative actions, Briggs J saw no persuasive reason why Parliament would have chosen to enact a statutory scheme for doing justice where a company is in wrongdoer control, but not where it is holding company is in the same wrongdoer control.<sup>24</sup> In order, therefore, to do justice, Briggs J tried to fill this statutory gap by recognising multiple derivative actions in the UK. For Briggs, a multiple derivative action is a ‘single device of procedural ingenuity designed to service the interests of justice in appropriate case’.<sup>25</sup> The rationale for having multiple derivative actions is therefore to enable justice to be done by giving members of the parent company the right to sue on behalf of the parent’s subsidiary company, otherwise wrongs would go unredressed. In extending the locus standi to members of the parent

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<sup>20</sup> *Universal Project Management Services Ltd v Fort Gilkicker Ltd & Ors* [2013] EWHC 348 (Ch); [2013] 3 WLR 164.

<sup>21</sup> See Companies Act 2006, s.1159 (2): ‘A company is a “wholly-owned subsidiary” of another company if it has no members except that other and that other’s wholly-owned subsidiaries or persons acting on behalf of that other or its wholly-owned subsidiaries’.

<sup>22</sup> *Universal Project Management Services Ltd* (n 20).

<sup>23</sup> *ibid.*

<sup>24</sup> *ibid.*

<sup>25</sup> *ibid.*

company, Briggs J argues that ‘an applicant is not seeking to exercise some right inherent in membership, rather, he is availing himself of the courts’ readiness to prevent someone with a sufficient interest to sue as the company’s representative, for the benefit of all its stakeholders’.<sup>26</sup>

However, although Briggs J has extended the locus standi to ‘someone with a sufficient interest’, he failed to provide further clarification as to what sufficient interest means. As no clear explanation as to what sufficient interest means has been given, it is relevant in this final concluding chapter to shed some light on the issue. In doing so, particular focus will be given to the just and equitable winding up petition under the Insolvency Act 1896 as judges in this area of law have tried to provide an answer as to what ‘sufficient interest’ means.

#### *6.2.4.1. The meaning of ‘sufficient interest’ in the context of just and equitable winding up petition*

Under the Insolvency Act 1986, section 124 an application may be made by a ‘contributory’, who is defined as ‘every person liable to contribute to the assets of a company in the event of its being wound up’. In relation to a fully paid shareholder this has been interpreted as importing a requirement that he has a tangible or ‘sufficient interest’ in the company being wound up.<sup>27</sup> A sufficient interest will exist where the petitioner can demonstrate that, after payment of the company’s creditors, there will remain a monetary surplus for distribution amongst the company’s members.<sup>28</sup> In other words, a shareholder will not have such interest, if there will be no surplus assets to be distributed to shareholders. If that is the case, then the court will strike out the petition.

However, Oliver J in *Re Chesterfield Catering Co Ltd*<sup>29</sup> appeared to contemplate that the phrase ‘sufficient interest’ might encompass more than a monetary surplus:

‘However, it is I think clear that in referring to a ‘sufficient interest’ Jessel MR [in *Re Rica Gold Washing Co Ltd*] meant an interest by virtue of the petitioner’s membership. In order to establish his *locus standi* to petition a fully paid shareholder must... show that he will, as a member of the company, achieve some advantage, or avoid or minimise some disadvantage, which would accrue to him by virtue of his membership of the company’.<sup>30</sup>

In the context of what Briggs J have said in the *UPMS* case, ‘sufficient interest’ could be defined as an economic interest that a member of the parent company has on the assets of the

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<sup>26</sup> *ibid.*

<sup>27</sup> *Re Rica Gold Washing Co Ltd* (1879) 11 Ch D 36; See *Re Chesterfield Catering Co Ltd* [1977] Ch 373.

<sup>28</sup> *ibid* 42-43.

<sup>29</sup> *Re Chesterfield Catering Co Ltd* (n 27).

<sup>30</sup> *ibid.*

subsidiary, albeit indirect. However, it remains to be seen how the judges in future cases will define ‘sufficient interest’.

#### 6.2.4.2. *Locus standi*

Another interesting question that emerged from this case is: Should multiple derivative actions be restricted to wholly-owned subsidiary companies or should they also be allowed in circumstances where the parent company has a relatively small interest? As mentioned above, this case concerned a subsidiary company that is wholly owned by the parent company. It could be argued that this situation presents the strongest justification for providing such a remedy. This is due to the fact that the wrongdoers in control of both parent and subsidiary company will obviously not institute litigation against themselves. Unless a member of the parent is permitted to institute an action on behalf of the subsidiary, no one would be able to sue and relief would be impossible. In other words, no one would be able to bring justice to both the subsidiary company and its shareholders. As Blumberg et al argue, ‘the interposition of the additional corporate layer in the structure would have effectively insulated the alleged wrongdoers from judicial intervention’.<sup>31</sup> To prevent this from happening, it is therefore relevant to extend *locus standi* to ‘someone with a sufficient interest’ to remedy the wrongs done to the subsidiary company. In such a case, a member of the parent company could be an ideal applicant to claim on behalf of the subsidiary company.

However, on the other hand, in a situation where the subsidiary is not wholly-owned by the parent company, it seems that there are no persuasive reasons for allowing multiple derivative actions. This is due to the fact that in such circumstances there is ‘someone with sufficient interest’ to commence an action on behalf of the subsidiary company and this ‘someone’ is the minority shareholder of the subsidiary company. Accordingly, it is not necessary to create a cause of action in the shareholders of the parent in order to prevent insulation of the alleged wrongdoers from possible judicial scrutiny.<sup>32</sup>

In conclusion, although the English Parliament seems to be unwilling to extend the *locus standi* on the law of derivative actions, Parliament seems to have recognised the need to extend *locus standi* in other areas of law. In contract law, for example, historically the courts insisted that only parties to a contract may sue in relation to the contract. In other words, under the common law, a person who is not a party to a contract is not able to enforce the term of that contract, even where the contract was made for the purpose of conferring a benefit on that third party. This is the so-called privity rule. This position, however, has

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<sup>31</sup> Philip L Blumberg et al, *Blumberg on Corporate Groups* (2<sup>nd</sup> edn, Panel Publishers 2005) 44-5.

<sup>32</sup> *ibid.*

changed with the coming into force of the Contracts (Rights of Third Parties Act) 1999 ('the Act 1999') as it now enables third parties to sue for enforcement of a contract even though they are themselves not a party to the contract. Section 1(1) of the Act 1999 provides that 'a person who is not a party to a contract (a "third party") may in his own right enforce a term of the contract if – (a) the contract expressly provides that he may, or (b) subject to subsection (2), the term purports to confer a benefit on him.' It is not the intention of this research to further analyse what was the purpose behind this extension but to show that Parliament seems to show his willingness in other areas of law, such as contract law, to extend locus standi in order to avoid injustice to third parties who might have benefitted from a term of a contract. As Parliament has shown his willingness to extend locus standi in such circumstances, there is no persuasive reason as to why not such extension should also be made to members of the parent company, especially where no other person is available to take such action on behalf of the subsidiary.

#### 6.2.4.3. *Limited liability partnerships and derivative actions*

Turning away from the locus standi issue, another interesting question that the courts may be asked to address in future cases is whether an individual member of an LLP can be permitted to institute derivative proceedings on behalf of the LLP. In other words, does the new statutory derivative action apply to LLPs? The answer to this question is no. This is due to the fact that Part 11 of the Companies Act 2006 was not extended to allow members of an LLP to bring an action on behalf of the LLP.

However, it is worth mentioning that the principles underlying the rule in *Foss v Harbottle* were applicable to the LLPs, for the rule in *Foss v Harbottle* was not just a rule of law of companies but a rule of the law of associations, applicable to all associations which can bind themselves by decision of a simple majority of their members.<sup>33</sup> This of course has left a state of uncertainty and this can be seen from the fact that Briggs in the *UPMS* case forced to fall back upon the general principles of the common law derivative action in order to decide whether to allow multiple derivative actions or not. In the recent case of *Feetum v Levy*<sup>34</sup> there was some discussion as to whether the principle of *Foss v Harbottle* rule applied to LLPs. Although Jonathan Parker LJ concluded that on the facts of the particular case the issue did not arise, it is appear from his judgment that, in principle, the common law doctrine is applicable to LLPs.<sup>35</sup>

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<sup>33</sup> Geoffrey Morse et al, *Palmer's Limited Liability Partnership Law* (2<sup>nd</sup> edn Sweet & Maxwell, 2011) 198.

<sup>34</sup> *Feetum v Levy* [2006] Ch. 585, 605.

<sup>35</sup> *ibid.*

It is also worth noting that a set of rules somewhat similar to the company ones now applies to LLPs as a result of the Civil Procedure Rules rule 19.9, which is relating to derivative claims. Rule 19.9 applies, 'where a company, other body corporate or a trade union is alleged to be entitled to a remedy and a claim is made by a member of it for it to be given that remedy, whether under Chapter 1 of Part 11 of the Companies Act 2006 or otherwise'. The Civil Procedure Rules require the claimant to make an application to the court for permission to continue with a derivative claim, and the procedures to be followed to obtain a decision on that issue are those which apply in the case of companies.<sup>36</sup> Although the Companies Act 2006 offers no assistance in this matter, there appears to be no reason in principle why the LLPs should not be allowed to bring derivative actions under the Companies Act 2006. There is therefore need for further reform of the Companies Act 2006 in order to extend derivative actions to LLPs. As Briggs observed in the *UPMS*,

'once it is recognised that the extension of locus standi beyond the immediate members of the wronged company is based upon the need to find a suitably interested claimant to pursue the company's claim when it is disabled from doing so, the precise nature of the corporate body which owns the wronged company's shares is of no legal relevance, provided that it is itself in wrongdoer control and has some members at least who are interested in seeing the wrong done to the company put right'.<sup>37</sup>

#### 6.2.5. *Future challenges?*

This thesis has advanced arguments in favour of utilising the concept of 'commercial justice' developed in chapter two as a guideline for the courts when considering how to mould the statutory derivative action to the needs of modern society. The common law derivative action dated back some 175 years to the *Foss* rule and it may be that the new statutory derivative action will remain as the centerpiece of derivative actions for many years to come. So there is merit in the courts embracing a flexible concept which is capable of adapting to the changes in the society which it aims to serve. Commercial justice is such a concept. Yet flexibility can present problems.<sup>38</sup> Furthermore, certainty is often valued particularly highly in commercial contexts. So it is right to address possible concerns that 'commercial justice' is simply too vague to be of use. That is where the reference to unconscionability has a particular resonance. As mentioned above, unconscionability has been found to be useful in courts of

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<sup>36</sup> Civil Procedure Rules 19.9C (4), applying ss. 261, 262 and 264 of the Companies Act 2006 to bodies corporate which are not incorporated under the Companies Acts. It is worth noting that s. 263 of the Companies Act 2006 is not applicable to non-companies (r. 19.9C).

<sup>37</sup> *Universal Project Management Services Ltd* (n 20).

<sup>38</sup> See David Milman, 'The rise of the objective concept of "unfairness" in UK company law' (2010) 286 Co LN 1, 4.

equity notwithstanding its inherent vagueness as Margaret Halliwell has demonstrated<sup>39</sup> and of particular force in the present context is Nourse LJ's use of it in *Akindele*.

So, whilst this thesis accepts that there will be challenges to the courts as they turn to 'commercial justice', this thesis does not accept that those challenges are, or need to be, insuperable. Commercial justice has within it strands which are inherently in tension between themselves, as Rawls' and Nozick's starkly differing starting points, and by expressly referring to the tension the courts can deepen the level of their enquiry and thereby also deepen the level of their reasoning. By articulating why a court embraces one strand rather than another, that court will bring into the open the nature (as the court sees fit) of the tension and thereafter be able to articulate the reasons for preferring one strand to another. Inevitably as companies spread their reach across continents the courts will be confronted with new areas. For example if a German company takes over an English company commercial justice will have to grapple with the differing corporate governance regimes in Germany and England. It will be important in such contexts that the reasoning of the English court demonstrates sensitivity to the customs and beliefs which have lead each governance regime to differ: embracing the 'commercial justice' concept will provide one route by which they can do so.

#### 6.2.6. *Suggestions for further reforms*

In analysing the above issues, this research has come to the conclusion that there is a need to propose the following reforms:

- (a) As argued above, in the absence of clear explanations as to which approach the courts should follow when considering the various criteria set out in Companies Act 2006, it is the intention of the thesis to argue that there should be an overarching guiding principle of 'commercial justice' for the courts to follow, in which they will consider on a case by case analysis, as this will help the courts to do justice to each individual case. This will help them avoid difficulties in providing clear explanations as to the meaning of the various criteria that the courts should take into account.
- (b) In addition, the current grounds on which derivative actions may be granted do not expressly include a provision for multiple derivative actions. It is therefore relevant to extend locus standi for members of the parent company in order to be able to bring an action on behalf of the subsidiary company. The fact that Pt 11 derivative action

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<sup>39</sup> See Margaret Halliwell, *Equity and Good Conscience in a Contemporary Context* (Old Bailey Press 1997); Alison Dunn, 'Equity is Dead. Long Live Equity!' (1999) 62 MLR 140.

framework only allows simple and not multiple derivative actions has been described as shortcoming of the current framework.<sup>40</sup> As Lord Millett reasoned:

‘The very same reasons which justify the single derivative action also justify the multiple derivative action. To put the same point another way, if wrongdoers must not be allowed to defraud a parent company with impunity, they must not be allowed to defraud its subsidiary with impunity’.<sup>41</sup>

- (c) In examining the issue of multiple derivative actions, it also raises the question as to whether derivative actions should be applied to LLPs. As mentioned above, there is no persuasive reason as to why this remedy should not be extended to LLPs. Therefore, it is suggested that the new statutory derivative action should also be extended to ‘other bodies corporate’.

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<sup>40</sup> P Koh, ‘Derivative actions ‘once removed’ [2010] JBL 101.

<sup>41</sup> *Waddington Ltd v Chan Chun Hoo Thomas* [2008] HKEC 1498.

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