KEY FACTS COMPANY LAW

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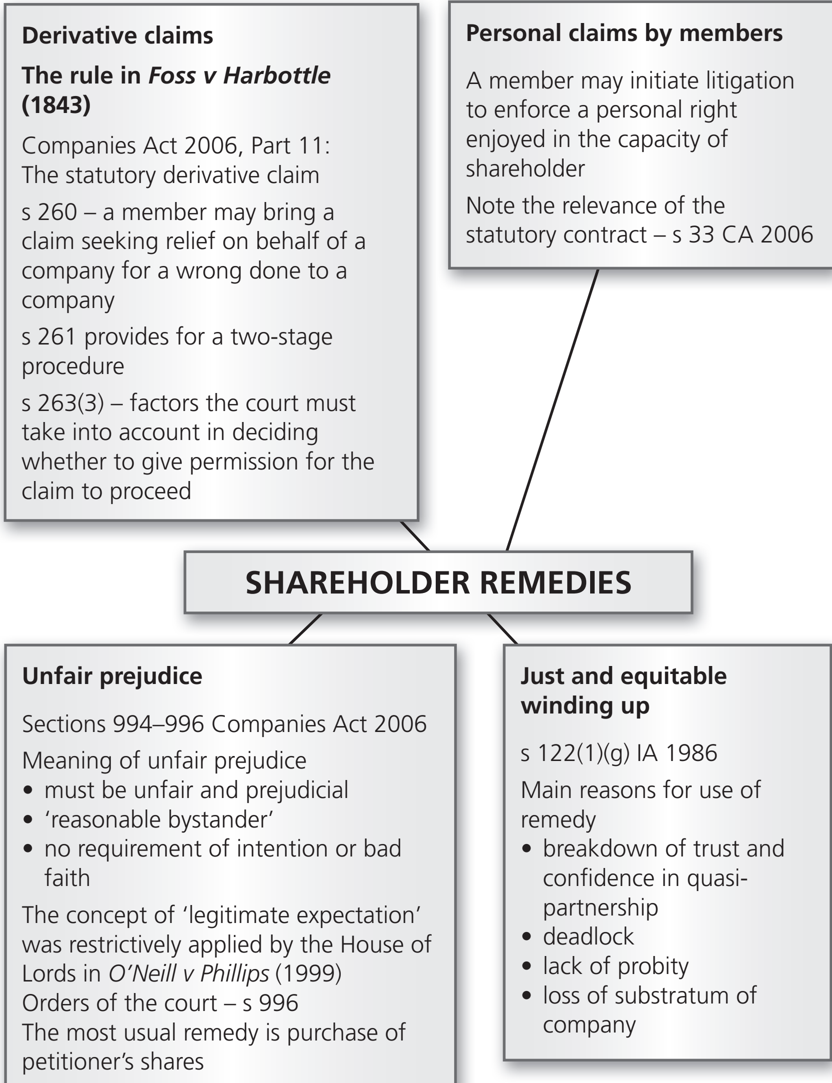
14

Shareholder remedies



14.1 Derivative claims

14.1.1 The rule in *Foss v Harbottle*

1. If a wrong is done to the company, the proper person to sue the wrongdoer is the company itself: this is the rule in *Foss v Harbottle* (1843).

2. There are three elements to the rule:
- the proper claimant in an action in respect of a wrong alleged to be done to a company is the company itself;
- the internal management principle: the courts will not generally interfere with matters of internal management of a company;
- where the alleged wrong is a transaction which was done irregularly, but where the irregularity could be cured by a simple majority of the members, no individual member can bring an action in respect of that transaction (*MacDougal v Gardiner* (1875)). In such a case litigation would be futile.

3. Responsibility for decision-making in a company lies with either the board of directors or the shareholders in general meeting, by consent of the majority.

4. Difficulties may arise if the directors themselves are the wrongdoers since the right to litigate on behalf of the company is generally reserved to the board of directors (Art 3 of both the model articles for public companies and those for private companies limited by shares, *Breckland Group Holdings Ltd v London & Suffolk Property Holdings Ltd* (1989)).
- To resolve this difficulty, the courts have exceptionally allowed an individual member to bring a derivative claim on behalf of the company.
- A derivative claim is one where the right of action is derived from the company and is exercised on behalf of the company.
- A derivative claim is an exception to the proper claimant principle. It arises only when proceedings are not instigated by the company in circumstances where a member or members consider a claim should be made and the court is willing to ignore the proper claimant principle.

5. In the course of the consultation process leading to the 2006 Act the Law Commission recorded a number of criticisms of the rule in *Foss v Harbottle* and the derivative claim: *Shareholder Remedies* (Law Com 246,

1997). It recommended partial abolition of the rule and a new derivative claim. This view was accepted by the Company Law Review. The *Final Report* recommended that derivative claims should be restricted to breaches of directors' duties and that they should be put on a statutory footing.

14.1.2 The derivative claim at common law

1. Prior to the Companies Act 2006, the courts were prepared to allow a derivative claim to proceed where minority shareholders were able to establish 'fraud on the minority' and that the wrongdoers were in control of the company.
2. The fraud on the minority exception was used sparingly as the courts were reluctant to hear cases brought against a director or other wrong-doer by an individual member on behalf of a company for a number of reasons:
   - the derivative claim undermines the concept of majority rule;
   - there is judicial reluctance to become involved in disputes over management and business policy;
   - the floodgates argument, that is, the fear that allowing these claims would result in a flood of actions by minority shareholders;
   - difficulties of proof, leading to protracted litigation;
   - the cost of proceedings and the question of who should pay. The company will benefit if the action succeeds, but does not want to undertake litigation (*Wallersteiner v Moir (No 2)* (1975)). In appropriate circumstances the courts will make a *Wallersteiner* order, ordering the company to fund the litigation.
3. A restrictive view of the scope of the derivative claim was taken, for example in *Prudential Assurance Ltd v Newman Industries* (1981) where it was held that there should be a preliminary action to establish that a *prima facie* case could be made, thereby extending the proceedings.
4. Other instances where claims have not been successful include:
   - where the court took the view that a majority within the minority of shareholders who were independent of the wrongdoers did not want to proceed with the claim: *Smith v Croft (No 2)* (1988);
   - where a more appropriate way of dealing with the matter was available: for example, *Cooke v Cooke* (1997), where the claimant had also petitioned under what is now s 994 CA 2006; *Mumbray v Lapper* (2005), where either of the parties could have sought relief either

by winding up on the just and equitable ground or under s 994 (see section 14.3 below);
- where the claim was made for personal reasons rather than for the benefit of the company: *Barrett v Duckett* (1995);
- where the claim was based on negligence on the part of the directors (*Pavlides v Jensen* 1956)), which can be contrasted with *Daniels v Daniels* (1978) where the claim succeeded because the negligence had resulted in the wrongdoers making a profit and was therefore deemed to be self-serving.

5. The Companies Act 2006 Part 11, Chapter 1 ss 260–264 now makes provision for a statutory derivative claim.

14.1.3 The statutory derivative claim

1. Part 11, Chapter 1 CA 2006 puts the derivative claim on a statutory footing and provides for a more flexible framework to allow a shareholder to pursue an action.

2. Under s 260 a shareholder may bring a claim seeking relief on behalf of the company for a wrong done to the company.
- The claim may only be brought in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director, shadow director or former director of the company.
- The claimant is not required to show wrongdoer control.
- A claim may also be brought by an order of the court in proceedings under ss 994–996 (unfair prejudice).

3. Section 261 provides for a two-stage procedure:
- the member must make a *prima facie* case to continue the derivative claim;
- the court considers only the evidence presented by the claimant and if a *prima facie* case is not made the court will dismiss the case;
- if the evidence supports a *prima facie* case the court may then give permission for the derivative claim to be heard.

4. Permission will be refused (s 263(2)) if the court is satisfied:
- that a person acting in accordance with s 172 (duty to promote the success of the company) would not wish the claim to proceed;
- in the case of an act or omission that is yet to occur, that the act or omission has been approved by the company;
- in the case of an act or omission that has occurred, that the act or

omission had been approved by the company beforehand or ratified afterwards: *Franbar Holdings v Patel* (2008).

5. Section 263(3) sets out the factors that the court must take into account in considering whether to grant permission to continue the claim. These include:
   (a) whether the member is acting in good faith;
   (b) the importance that a person acting in accordance with s 172 would attach to the claim;
   (c) where the act or omission is yet to occur, whether it is likely to be authorised or ratified by the company;
   (d) where the act or omission has occurred, whether it could be and is likely to be ratified by the company;
   (e) whether the company has decided not to pursue the action;
   (f) whether the act or omission in question gives rise to a claim that the member could pursue in his or her own right: see *Franbar Holdings Ltd v Patel* (2008).

6. Before the CA 2006 negligence alone, from which the director derived no personal benefit, was not sufficient to allow a derivative claim (*Pavlides v Jensen* (1956)). This restriction is not stated in s 260 and some commentators have expressed concern that this may result in large numbers of claims for negligence.

14.2 Personal claims

1. An individual shareholder may initiate litigation to enforce personal rights in relation to the internal management of the company. Such claims may arise in a number of situations.

2. Where a decision is taken that the company should enter into a contract that is outside the company's objects, a shareholder may bring an action to prevent the contract being concluded: *Simpson v Westminster Palace Hotel Co* (1860).

3. An action may be brought where the transaction requires a special majority but agreement has, for example, been achieved by an ordinary resolution: *Edwards v Halliwell* (1950).

4. Personal rights of a shareholder have been enforced where, for example:
   (a) dividends were paid in the form of bonds when the articles required payment in cash (*Wood v Odessa Waterworks Co* (1889));

(b) a member's vote was improperly rejected by the chairman of a general meeting (*Pender v Lushington* (1877));
(c) directors failed to allow a veto of a decision as provided in the articles (*Quin & Axtens Ltd v Salmon* (1909)).

In the context of the above examples, note the relevance of the statutory contract (s 33 CA 2006 discussed in chapter 4 above).

14.3 The 'no reflective loss' principle

1. In some circumstances, the loss suffered by the company may affect the shareholders or others, for example the share price may fall or the company may not be able to pay a dividend. The no reflective loss principle means that a member may not bring a personal action against the wrongdoer to recover a loss that just reflects the company's loss.

2. The principle ensures that a person can only be sued once for the damage caused and where the damage is caused to the company, the company is the proper claimant.

3. The principle applies even where:
- the member has a personal cause of action against the defendant: *Day v Cook* (2001);
- the company decides not to take action against the wrongdoer: *Johnson v Gore Wood & Co* (2003).

4. However, an exception to the rule exists where the failure to recover the loss is the fault of the wrongdoer. For example, in *Giles v Rhind* (2002) Rhind's wrongdoing had caused the company to go into liquidation. The company had started an action against Rhind but the administrator had been obliged to discontinue the claim for lack of funds. Giles, a shareholder, was able to claim.

14.4 Unfair prejudice

Section 994(1) CA 2006 provides that a member may petition the court 'on the ground 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 to some part of its members (including at least himself)'. This section (first enacted as s 75 CA 1980) replaced s 210 CA 1948 which provided a remedy for 'oppressive' conduct and had been very restrictively interpreted by the courts.

14.4.1 Who can petition?

1. A claim may be made by:
   - members of the company;
   - those to whom shares have been transferred by operation of law, for example personal representatives, trustees in bankruptcy.
2. A person may only petition as a member, but it is recognised that the interests of a member are not necessarily limited to constitutional rights. See for example *Re a company (No 00477 of 1986)* (1986). Furthermore, the 'interests of members' is not restricted to interests held in their capacity as members, as long as there is a sufficient connection with membership: *Gamlestaden Fastigheter AB v Baltic Partners Ltd* (2007). It should also be noted that 'interests' are wider than 'rights'.
3. There is no requirement of 'clean hands' (in contrast to the remedy under s 122(1)(g) Insolvency Act 1986: see section 14.5 below) but the conduct of the petitioner may affect the remedy (*Re London School of Electronics* (1986)) or the decision as to whether s 994 applies (*Woolwich v Milne* (2003)).

14.4.2 Meaning of 'unfairly prejudicial conduct'

1. Conduct must be both unfair and prejudicial (*Re BSB Holdings Ltd (No 2)* (1996)).
2. However, in contrast to the way the courts interpreted s 210 of the 1948 Act, the terms 'unfair' and 'prejudicial' have been given a very wide interpretation.
3. The courts have employed the concept of the reasonable bystander in determining unfair prejudice.
4. There is no need, in proving unfairness, to show either intention or bad faith (*Re RA Noble & Sons (Clothing) Ltd* (1983)). The test is whether it could be reasonably considered that the conduct unfairly prejudiced the petitioner's interests.
5. Prejudice does not necessarily require a reduction in the value of the petitioner's shareholding and may be shown in a number of ways:
   (a) Exclusion from management, if this breaks a mutual understanding about the management of the company: *Re a Company (No 00477 of 1986* (1986)); *Richards v Lundy* (2000)). However, this will not be

unfairly prejudicial if the directorship is unlawful, as in *Hawkes v Cuddy* (2007) where it was in breach of s 216 Insolvency Act 1986.

(b) Failure to pay dividends duly declared: *Re Sam Weller & Sons Ltd* (1990); failure by directors to even consider payment of a dividend to shareholders when they themselves were well remunerated: *Re McCarthy Surfacing Ltd* (2008).

(c) Payment of excessive remuneration to directors: *Re Cumana* (1986).

(d) Diversion of corporate assets, financial benefit or corporate opportunity (*Re London School of Electronics Ltd* (1986)); *Little Olympian Each-ways Ltd (No 3)* (1995).

(e) Packing the board with directors having interests adverse to the company (*Whyte, Petitioner* (1984)).

6. In general, mismanagement will not amount to unfair prejudice (*Re Elgindata Ltd* (1991)), but serious or gross mismanagement has been considered prejudicial (*Re Macro (Ipswich) Ltd* (1994)).

7. The section has been interpreted to include not only a breach of the company's constitution, but also a failure to meet the 'legitimate expectations' of a member or members. In the case of small private companies, the legitimate expectations may be outside of the constitution (*Re Saul D Harrison & Sons Ltd* (1994); *Richards v Lundy* (2000)). However, the courts have not been willing to recognise legitimate expectations beyond the constitution, as it appears in its public documents, in the case of public companies (*Re Blue Arrow plc* (1987); *Re Tottenham Hotspur plc* (1994)).

8. In *O'Neill v Phillips*, the House of Lords had the first opportunity to consider the unfair prejudice provisions, including the application of the concept of 'legitimate expectations' and held:

- the phrase 'legitimate expectation' should be interpreted restrictively;
- 'equitable considerations', which may be wider than the shareholder's strict constitutional rights, could be taken into account in appropriate circumstances.

9. In this case, although the petitioner might have had an expectation that his shareholding would be increased and the profit shared equally, the majority shareholder (Phillips) had made no unconditional promise to do this and it was therefore not unfairly prejudicial to the petitioner that it was not done.

14.4.3 The orders of the court

1. It is important to note the scope and flexibility of the orders available to the court. The court has freedom to make whatever order is deemed appropriate in the circumstances, but some specific orders are set out in s 996 CA 2006. These are:
   - to regulate the company's affairs in future (*Re Harmer Ltd* (1958), a case heard under the 'oppressive conduct' provision s 210 CA 1948);
   - to order the company to do or refrain from doing something;
   - to authorise civil proceedings to be brought in the name and on behalf of the company;
   - to require the company not to make alterations to its articles without the leave of the court;
   - to order the purchase of the petitioner's shares, at a price that reflects the value of the company.
2. The most common remedy is an order of the court for the purchase of the petitioner's shares. See *Grace v Biagiola* (2006) for a discussion of the remedy. The following principles are applied:
   - the shares are normally purchased at their full value and are not discounted to reflect the fact that they represent a minority holding;
   - the conduct of the petitioner (for example if he or she was in any way to blame for the breakdown) may be relevant and the shares may be discounted to reflect this;
   - usually the valuation will be calculated as at the time of the order, but the court has discretion in fixing the date and may fix it at the time of the petition;
   - if the parties cannot agree, the price should be set by an independent valuer.

14.4.4 The future of the remedy?

1. The introduction of the 'unfair prejudice' provisions now contained in s 994 CA 2006 has given minority shareholders an important remedy.
2. However, it has been criticised for the length and complexity of cases and the cost involved in bringing a case (*Re Unisoft Group Ltd (No 3)* (1994)) and for the fact that it may allow minority shareholders to enforce their will over that of the majority (*Re a Company (No 004377 of 1986)* (1986).
3. In *O'Neill v Phillips* (1999) the House of Lords reviewed the development of the law relating to unfair prejudice and clarified many

important aspects. The influence of the decision can be seen in recent cases, for example *Re GN Marshall Ltd* (2001); *Re Phoenix Office Supplies Ltd* (2003).

14.5 Winding up on the just and equitable ground

1. The Insolvency Act 1986 (IA 1986) provides a rather drastic remedy for a dissatisfied shareholder, used mainly in situations involving small closely-held companies (quasi-partnerships) where the relationship of trust and confidence has broken down.
2. Section 122(1)(g) provides that the company may be wound up if the court is of the opinion that it is just and equitable that the company should be wound up.
3. Section 124 IA 1986 provides that an application can be made by anyone who is a contributory. A contributory is a person who is liable to contribute to the assets of a company in the event of its being wound up. A fully paid-up member who is not liable to contribute has to show that he or she has a tangible interest in the winding up.

14.5.1 Restrictions on the remedy

1. It is an equitable procedure, and there is therefore the requirement for 'clean hands' on the part of the petitioner. This means that misconduct by the petitioner himself with result in the remedy being refused.
2. Section 125(2) IA 1986 provides that the court may not order a winding up if there is an alternative remedy available to the petitioners, for example an offer to purchase the petitioner's shares at a reasonable price, and they have been unreasonable in not accepting it (*Re a Company (No 002567 of 1982)* (1983)). However, there have been circumstances where the alternative remedy has not been appropriate and the application for winding up has succeeded (*Virdi v Abbey Leisure* (1990)).

14.5.2 Reasons for applications for just and equitable winding up

1. Successful petitions have been made on the following grounds:
   - in the case of a quasi-partnership, that the relationship of trust and confidence has broken down (*Re Yenidje Tobacco Co Ltd* (1916)). The breach must be sufficiently serious to justify the winding up;
   - where deadlock exists in the management of a company (*Ng Eng Hiam v Hg Kee Wei* (1964));
   - lack of probity (*Loch v John Blackwood Ltd* (1924)) but the fact that directors are negligent and inefficient is not sufficient to show lack of probity (*Five Minute Car Wash Service Ltd* (1966));
   - loss of substratum of company (*Re German Date Coffee Co* (1882)).
2. In *Ebrahimi v Westbourne Galleries* (1973) Lord Wilberforce laid down general guidelines in cases involving quasi-partnerships and a break-down of trust. There must have been:
   - a breakdown of trust and confidence;
   - reasonable expectation on the part of the petitioner of taking part in the management of the company;
   - a restriction on the sale of shares so that the petitioner is 'locked into' the company.

14.5.3 Scope of the remedy

1. In some cases where unfair prejudice cannot be shown, the court has ordered a winding up (*Re RA Noble (Clothing) Ltd* (1983)).
2. But a petition was refused in *Re Guidezone Ltd* (2000) on the ground that the proposition that winding up on the just and equitable ground is wider than s 994 CA 2006 is inconsistent with *O'Neill v Phillips* (1999).