

# DERIVATIVE CLAIMS

UNDER PART 11 OF THE COMPANIES ACT 2006



PAUL BROOK COMMERCIAL BARRISTER & MEDIATOR

ZENITH CHAMBERS, 10 PARK SQUARE, LEEDS

# **Derivative Claims: the new law**

## **Source:**

CA 2006: Part 11, Chapter 1, Sections 260-264

## **Commencement:**

1 October 2007

# Derivative Claims: the new law

## Context:

Part 11 sits alongside the following provisions of CA 2006:

- Part 10: Directors' duties; and
- Part 30: Protection from unfair prejudice.

All in force, with exception of sections 175-177 (duty to avoid conflicts of interest; duty not to accept benefits from third parties and duty to declare interests in proposed transactions)

# Background

Law Commission: “Shareholders remedies” Cm.3769 (1997);

## **Foss –v- Harbottle (1843) 2 Hare 461**

- the court would not intervene in the case of an internal irregularity if matter could be ratified or condoned through internal procedures; and
- where a wrong was done to a company, proper claimant was the company itself and no the derivative action would be available. Member would either have to ask the board or the company, in general meeting, to commence litigation in the company's name.

# Background

General principles in Foss –v- Harbottle were displaced where:

- wrongdoers were in control of the company; and/or
- the wrong alleged to have been done to the company was not capable of ratification by a general meeting of shareholders.

Attitude of disinterested shareholders became an important factor in availability of derivative claim at common law.

# Derivative claims: the new law

## Overview:

### Part 11:

- displaces the old law with a derivative claims code; but
- draws on the common law principles and earlier practice which are built into the code.

# What is a derivative claim ?

## Section 260

A derivative claim is a claim 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.

## Who may bring a derivative claim ?

Derivative claims can be brought by:

- a member of the company; and
- a person who is not a member of the company but to whom shares have been transmitted or transferred by operation of law. (c.f. Part 30)

Part 11 regulates the availability of derivative claims so that:

- a former member has no right to bring a derivative claim; but
- a claim can be brought by a member even if the cause of action arose before he became a member.

# How may a derivative claim be brought ?

A derivative claim may only be brought:

- under Part 11; or
- or in pursuance of an order of the court in proceedings for protection against unfair prejudice under Part 30.

A derivative claim at common law is no longer available.

# What types of claim can be brought ?

A derivative claim may only be brought in respect of a cause of action arising from an actual or proposed act or omission of a director of the company involving:

- negligence;
- default;
- breach of duty;
- breach of trust.

# Against whom can a derivative claim be brought ?

A derivative claim can be brought against:

- a director of the company; or
- a third party; or
- both.

The basis of claims against third parties is not defined but are likely to be for:

- knowing assistance in a breach of duty by a director and/or
- knowing receipt of corporate property in breach of trust.

# Who is a director under Part 11 ?

CA s.250 defines a director to include any person occupying the position of director, by whatever name called.

Section 260(5) expressly extends the definition of “director” under Part 11 so as to include:

- a former director; and
- a shadow director (CA s.251).

## Limit on liability of former directors

Liability for breach of the general duties to the company under Part 10 is controlled by CA s170(2).

A person who ceases to be a director continues to be subject:

- (a) to the duty to avoid conflicts of interest as regards the exploitation of any property, information or opportunity of which he became aware at a time when he was a director; and
- (b) to the duty not to accept benefits from third parties as regards things done or omitted by him before he ceased to be a director.

## Liability of shadow directors

The liability of a shadow director for breach of the general duties under Part 10 is dealt with in Section 170(5). This provides:

*“The general duties apply to shadow directors where, and to the extent that, the corresponding common law rules or equitable principles so apply.”*

# Permission to continue a derivative claim

Part 11 permits derivative actions to be continued in three types of case:

- where a member of a company brings a derivative claim (CA s 261);
- where a member wishes to take over a claim brought by the company (CA s262); and
- where a member wishes to take over a claim which is being continued as claimant by another member (CA s264).

Permission is required in each instance.

# Claims brought by a member

Section 261 requires the member who wishes to pursue a derivative action to apply for permission following the issue of the claim form.

The relevant procedure is set out in CPR 19.9A and the supporting Practice Direction.

## Continuing a claim brought by the company

A member may apply for permission to continue the claim on the ground that:

- the manner in which the company commenced or continued the claim amounts to an abuse of the process of the court;
- the company has failed to prosecute the claim diligently; and
- it is appropriate for the member to continue the claim as a derivative claim.

The application for permission to continue this type of claim is to be made in accordance with **CPR Part 19.9B**.

# Taking over another member's claim

Section 264 applies where a member of the company {"the claimant"} has either:

- brought a derivative claim; or
- continued as a derivative claim a claim brought by the company; or
- has continued a derivative claim under Section 264.

## Taking over another member's claim

In a case within s 264, another member may apply to the court for permission to continue the claim on the ground that:

- the manner in which the proceedings have been commenced or continued by the claimant amounts to an abuse of the process of the court;
- the claimant has failed to prosecute the claim diligently; and
- it is appropriate for the member to continue the claim as a derivative claim.

Application for permission to continue this type of claim is to be made in accordance with **CPR Part 19.9B**.

## Features common to each case

If the court decides that the application and supporting evidence do not disclose a prima facie case for the giving of permission, the court:

- must dismiss the application; and
- may make any consequential orders which it considers appropriate.

Initial consideration is on the papers alone.

## Features common to each case

If the permission application is not dismissed for failing to disclose a prima facie case for permission, the court:

- may give directions as to the evidence to be provided by the company; and
- may adjourn the proceedings to enable the evidence to be obtained.

## Features common to each case

On hearing the application the court may:

- give permission to continue the claim;
- refuse permission and dismiss the application;
- adjourn the proceedings on the application and give such directions as it thinks fit.

# Power to grant permission

Power to grant permission:

- cases under s.261 and 262: subject to s.263;
- cases under s.264: not subject to s.263.

Discretion in cases under s.264 is open ended.

## The section 263 criteria

The court must refuse permission if satisfied:

- that a person acting in accordance with CA s.172 (the duty to promote the success of the company) would not seek to continue the claim; or
- where the cause of action arises from an act or omission that is yet to occur, that the act or omission has been authorised by the company, or
- where the cause of action arises from an act or omission that has already occurred, that act or omission-
- was authorised by the company before it occurred, or
- has been ratified by the company since it occurred.

# Promoting the success of the company

The question for the court ?

Would a director acting subjectively to promote the success of the company not seek to continue the claim ?

# Authorisation/ratification

- actual authorisation or ratification is required;

NB: change to common law position

- authorisation or ratification must be secured legitimately.

NB: factual evidence of the dealings within the company admissible.

# The discretionary factors

- whether the member is acting in good faith in seeking to continue the claim;
- the importance that a person acting in accordance with the duty to promote the success of the company would attach to continuing the claim;
- where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be:
  - (a) authorised by the company before it occurs; or
  - (b) ratified by the company after it occurs;
- where the cause of action arises from an act or omission which has already occurred, whether the act or omission could be, and in the circumstances would be likely to be ratified by the company;
- whether the company has decided not to pursue the claim;
- whether the act or omission gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.

# The discretionary factors

Under section 263(4), the court is directed to have particular regard to any evidence before it of the views of members who have no direct or indirect personal interest in the matter.

# When will derivative claims be brought ?

- when the company has suffered a loss;
- irrelevant whether the errant director has made a profit or not;
- when the member does not have a viable claim under Part 30;
- when Part 30 does not provide an appropriate remedy;
- in the absence of a remedy under any shareholders' agreement.