GETSADZE & PATEISHVILI

Newsletter

June 2010
№14

Law Office Getsadze & Pateishvili LLC
5/II Pekini ave, flat 2, 0171 Tbilisi, Georgia
Phone/Fax: +995 32 21 33 63, +995 32 21 33 73; Website: www.g-p.ge, E-mail: office@g-p.ge

Protection of Minority Shareholders under UK Law

Introduction

This essay will discuss minority shareholder protection under the English Law. There are two main legal tools available to minority shareholders: a derivative claim and an unfair prejudice petition. It is submitted here that, though the remedies may overlap, nevertheless they serve different goals. Derivative action is focused on breaches of strict legal duties owed by the directors to the company, while unfair prejudice remedy is granted when the unlawful conduct of the controllers or even lawful conduct, but in breach of some informal agreements, unfairly prejudices a shareholder. Hence, the aim of this essay is not to argue in favour of one of the remedies. The author will try to compare them and identify their strong and weak sides.

1. The Scope of the Two Remedies

Section 994 (1) of the Companies Act 2006 provides that a member of a company may petition when: a) "the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interest of members generally or of some part of its members (including at least himself) or b) that an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial." It is obvious that, by reference to the "conduct" of the company's affairs, the scope of the section extends not only to the directors but to the controllers of the company in general. [1]

A derivative claim on the other hand is concentrated on directors' behaviour. It "may 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 the company."[2] The action belongs to the company. The court has to do justice to the company, i.e. the shareholders as a whole in a solvent company. Therefore a shareholder does not have an indefeasible right to bring an action on behalf of the company. [3]

---

[1] Paul L Davies, *Gower and Davies: The Principles of Modern Company Law* 8th Edition (Sweet & Maxwell 2008) at 682

[2] Companies Act 2006, section 260 (3); The section defines "directors" as including former and shadow directors at s. 260 (5) (a) and (b)

[3] Arad Reisberg, *Judicial control of derivative actions*, I.C.C.L.R. 2005, 16(8), 335-339 at 337; see also: J. Payne, *Clean Hands in Derivative Actions* [2002] C.L.J. 76;

Though the statute does not confine such protection to minority shareholders, it is clear that the latter are main subject of protection as far as majority shareholders are themselves in control and have other leverages to influence the decision-making process. Important novelty in statutory derivative claim in comparison with the common law rule in *Foss v Harbottle* [4], is that the former allows a claim to be brought in respect of negligent act and even when the director has not benefited from such an act or omission.

In short, derivative claim is confined to breaches of directors' duties, whereas the scope of s 994 protection is wider and extends beyond the *'independent illegalities'*.[5] It renders certain acts unlawful that are not illegal apart from the section.

As Lord Hoffmann noted, the concept of 'fairness' was intended to confer "a very wide jurisdiction upon the court"[6] and that the parliament deliberately chose this concept "to free the court from technical considerations of legal right and to confer a wide power to do what appeared just and equitable."[7] His Lordship drew a parallel [8] between the notion of 'fairness' and the explanation of "just and equitable" provided by the decision in *Ebrahimi v Westbourne Galleries Ltd* [9]. That case was concerned with a petition for winding-up of the company under the "just and equitable" provisions.[10] Lord Wilberforce noted that the "just and equitable" provision enabled the court to subject the exercise of legal rights to equitable considerations, "...considerations, that is, of a personal character arising between one individual and another, which may make it unjust, or inequitable, to insist on legal rights, or to exercise them in a particular way."[11] Furthermore, Lord Hoffman constrained the boundaries of the then section 459 of the Act by stating that 'fairness' should be understood not as an indefinite concept but in the realm of equitable doctrines.[12]

Unfair prejudice petition is generally used in small companies, often referred to as quasi-partnerships, where the business is carried out based on common understandings of the shareholders. Most often, such 'understandings' (or informal, unwritten contracts) concern a participation of a particular shareholder in the management of the

---

[4] (1843) 2 Hare 461

[5] Paul L Davies, *Gower and Davies: The Principles of Modern Company Law* 8th Edition (Sweet & Maxwell 2008) at 684

[6] *Re Company* (1986) B.C.L.C. 382 at 387-388

[7] *O'Neill v Phillips* [1999] 1 W.L.R. 1092 at 1098

[8] *O'Neill v Phillips* [1999] 1 W.L.R. 1092 at 1099-1100

[9] [1973] A.C. 360

[10] section 122(1)(g) of the Insolvency Act 1986

[11] *Ebrahimi v Westbourne Galleries Ltd* [1973] A.C. 360 at 379

[12] *O'Neill v Phillips* [1999] 1 W.L.R. 1092 at 1100

company.[13]

The Court in *Re Saul D Harrison & Sons Plc*[14] admitted the existence of legitimate expectations that the members of the company have "out of a fundamental understanding between the shareholders which formed the basis of their association but was not put into contractual form".[15] However, unfair prejudice jurisdiction was not confined only to those situations. Lord Hoffman by stating that "unfairness may consist in a breach of the rules or in using the rules in a manner which equity would regard as contrary to good faith"[16] accepted that the petition may be used in respect of the breaches of strict legal rights, such as a breach of the articles.[17] Thus corporate wrongs could found petitions seeking personal relief but until recently could not have sought redress for the company itself.

The decision in *Clark v Cutland*[18] changed the whole picture. In that case substantial corporate relief was granted on unfair prejudice petition. This is where unfair prejudice jurisdiction overlaps with that of derivative action and poses a serious threat to the viability of the latter.

2 .Overlap of the Two Remedies

a. Restrictive line

The two cases discussed below are the examples of the courts' endeavour to delineate the boundaries of the remedies. These two cases represent a strict attitude adopted by the courts toward employing unfair prejudice petitions to seek redress for the company.

---

[13] Lord Wilberforce in *Ebrahimi v Westbourne Galleries Ltd* [1973] A.C. 360 at 379 stated that the existence of unfair prejudice petition itself is "a recognition of the fact that... there is room in company law for recognition of the fact that behind it, or amongst it, there are individuals, with rights, expectations and obligations inter se which are not necessarily submerged in the company structure.....".

[14] [1995] 1 B.C.L.C. 14 *per* Lord Wilberforce at 19

[15] Later Lord Hoffman refined his position in *O'Neill v Phillips*, dispensing with the "legitimate expectation" test. His Lordship noted that "the concept of legitimate expectation should not be allowed to lead a life of its own, capable of giving rise to equitable restraints in circumstances to which the traditional equitable principles have no application" *O'Neill v Phillips* [1999] 1 W.L.R. 1092 at 1102

[16] *O'Neill v Phillips* [1999] 1 W.L.R. 1092 at 1099;

[17] Availability of unfair prejudice jurisdiction to wrongs done to the company was accepted by the courts prior to *O'Neill* case. See: *Re London School of Electronics Ltd.* [1986] Ch. 211; *Re Cumana Ltd.* [1986] B.C.L.C. 430.

[18] [2003] EWCA Civ 810; [2004] 1 W.L.R. 783; [2003] 4 All E.R. 733; [2004] B.C.C. 27; [2003] 2 B.C.L.C. 393

Lord Millet in *Re Charnley*[19] acknowledged that the same facts may found both an unfair prejudice petition and a derivative claim. Thus, according to his Lordship, the distinction between the two remedies does not lie in the wrongs complained of, rather in the nature of the complaint and the remedy sought by the shareholder. The essence of the complaint should be mismanagement on the part of the directors in order to bring a petition and not a "misconduct" which is a proper basis for a derivative claim.[20]

The same line was taken by the Hong Kong Court of Final Appeal. Lord Scott of Foscote NPJ in *Re Chime Corp*[21] considered *Re Charnley* and noted that when the essence of the claim was a misconduct rather than mismanagement it was abuse of process to use unfair prejudice petition instead of derivative claim.[22] But most interestingly, Lord Scott laid down two conditions when such circumvention was possible. He referred to Lord Hoffmann's famous *dicta* that "enabling the court in an appropriate case to outflank the rule in *Foss v Harbottle* was one of the purposes of [s.459]"[23]. Such 'outflanking,' according to Lord Scott is permissible, firstly when "it is clear at the pleading stage that a determination of the amount, if any, of the director's liability at law to the company can conveniently be dealt with in the hearing of the petition."[24]
And the second occasion is, when the remedy sought under an unfair prejudice petition is in correspondence with the remedy that would have been obtained in a derivative claim. If these two conditions were met it would be wasteful and inefficient to require the commencement of a derivative action.[25]
Thus the possibility of obtaining corporate relief via s 994 petitions was not rejected. On contrary, Lord Scott conceives the role of unfair prejudice petition as a substitute for a derivative claim in restricted circumstances when none of the justifications behind the derivative action is neglected and the integrity of the rule in *Foss v Harbottle* is maintained.

b. Demise of a derivative claim?!

Section 996 (2) of the Companies Act 2006 allows procedural corporate relief. It provides that the court may au-

---

[19] *Charnley Davies Ltd (No.2), Re* [1990] B.C.L.C. 760 Ch D

[20] See *per* Millett J. in *Charnley Davies Ltd* (No.2), Re [1990] B.C.C. 606 at 626

[21] [2004] 7 H.K.C.F.A.R. 546

[22] *Chime Corp, Re* [2004] 7 H.K.C.F.A.R. 546 at [63]

[23] *Re Saul D Harrison & Sons plc* [1994] B.C.C. 475 at 489

[24] *Chime Corp, Re* [2004] 7 H.K.C.F.A.R. 546 at [62]

[25] *Chime Corp, Re* [2004] 7 H.K.C.F.A.R. 546 at [62]

thorise bringing a derivative action. However, Lord Hoffmann in *Re Company*[26], addressed this issue and noted that it seemed to him inconvenient to commence another litigation which would require writ and separate pleadings hence duplicating proceedings. His Lordship noted that he "would be reluctant to come to the conclusion that this form of duplication was necessary unless it was clear that the Jurisdiction under sections 459 and 461 did not permit the whole matter to be dealt with upon the petition."[27] Lord Hoffmann's fear for the duplication of the proceedings should be read in one line with Lord Scott's decision. Neither of the judges purports to attach to s 994 petition the role of a derivative claim. Their main concern is to eschew unneeded procedural complexities.

Therefore Arden J.'s decision in *Clark v Cutland* to allow corporate redress via s. 994 petition should not be considered as revolutionary. Clearly the case was correctly decided[28]. All in all, nothing in the unfair prejudice jurisprudence prohibits granting substantial corporate relief. Lord Hoffmann had stated[29] before that the power given to the court to "make such order as it thinks fit" give the courts widest possible discretion.[30]
The case of *Clark v Cutland*, was commenced as a derivative action and later combined with unfair prejudice petition. The order for repayment of money to the company by the directors, who were in breach of fiduciary duties, was made on a petition. The company was also required to indemnify the costs in pursuance to *Wellester v Moir*[31] order. Arden J. did not give any explanation for such a decision. The derivative claim was in the background in *Gamlestaden Fastigheter AB v Baltic Partners Ltd*[32] as well. In the latter case which dealt with Jersey equivalent of section 994, the court accepted that corporate remedy can be pursued via unfair prejudice petition. Unfair prejudice petitions were also used for corporate redress in *Bhular v Bhular*[33] and in Scottish case *Anderson v Hogg*[34]. In the former case the court ordered the transfer to the company of property purchased by the

---

[26] *Company (No.005287 of 1985), Re* [1986] 1 W.L.R. 281

[27] *Company (No.005287 of 1985), Re* [1986] 1 W.L.R. 281 at 284

[28] *David Kershaw, Company Law in Context* (OUP, Oxford 2009) at 638

[29] *Company (No.005287 of 1985), Re* [1986] 1 W.L.R. 281 at 283

[30] Arden J. in *Re Marco Ipswich* (1994) 2 BCLC 354 "The jurisdiction under s. 459 has an elastic quality which enables the courts to mould the concepts of unfair prejudice according to the circumstances of the case".
see also: *Atlasview* [2004] 2 B.C.L.C. 191 at 206; *Lowe v Fahey* [1996] 1 B.C.L.C. 262 at 268; *Little Olympian*, *Re* [1994] 2 B.C.L.C. 420 at 429.

[31] [1975] Q.B. 373

[32] [2008] 1 B.C.L.C. 468

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

[34] *Anderson v Hogg* 2002 S.C. 190

directors in their private capacity and in breach of fiduciary duties. In the latter case a director was ordered to return money back to the company which was improperly paid to him.

However, as one commentator[35] argues, above cases should not be considered as undermining the rule in *Foss v Harbottle*. The cases were handled as if they were derivative actions. In *Gamlestaden* the corporate remedy was the only mechanism by which the relief could have been obtained. *Bhullar* and *Anderson* were derivative actions wrongly dealt within unfair prejudice jurisdiction.

As for *Clark v Cutland* the purchase of shares would have been just, only after the wrongdoer redressed the wrong done to the company and therefore the corporate relief was essential.

In this author's view future cases should follow Lord Millet's strict line and treat *Clark v Cutland* as a permissible exception to avoid the duplication of the proceedings identified by Lord Hoffmann and implied by Lord Scott.

3. Case for a derivative claim

The famous principle of *Foss v Harbottle*, rests on two main considerations. Firstly, it proclaims the fundamental rule of English Law that the company and not its shareholders can bring an action against the wrongs done to the company – a "proper plaintiff" principle. Secondly, it represents a long stance of English courts against any interference with companies' internal affairs and there acknowledgement of 'majority rule' principle[36]. As Lord Eldon colourfully noticed, the court "is not to be required on every occasion to take the management of every

---

[35] Brenda Hannigan, *Drawing Boundaries Between Derivative Claims and Unfairly Prejudicial Petitions* J.B.L. 2009, 6, 606-626

[36] As Lord Wilberforce stated in *Re Kong Thai Sawmill (Miri) Sdn Bhd* (1978) 2 MLJ 227, at p. 229: "Those who take interests in companies limited by shares have to accept majority rule". See also *per* Jonathan Parker J.

"The starting point is the proposition that in general the right of a shareholder to vote his shares is a right of property which the shareholder is free to exercise in what he regards as his own best interests. He is not obliged to cast his vote in what others may regard as the best interests of the general body of shareholders, or in the best interests of the company as an entity in its own right." – Jonathan Parker *J. In Re Astec (BSR) plc* (1998) 2 B.C.L.C. 556, 584-585; "The law is not so foolish as to prevent a shareholder from voting in his own interests provided that the resolution is not discriminatory." – Peter Gibson J. in *Re Ringtower Holdings plc* (1989) 5 B.C.C 82; "Unless some provision to the contrary is to be found in the charter or other 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 consequently upon the company, 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." Privy Council *North-West Transportation Co Ltd v Beatty* (1887) 12 App. Cas. 589 per Sir Richard Baggallay at 592

playhouse and brewhouse in the Kingdom."[37]

The main rationale behind the strict rule in *Foss v Harbottle*, which puts significant procedural burdens on the plaintiff, is to protect the company from unwanted and harmful litigation.

The action may be harmful for the company in different ways. The court should evaluate all those possible risks and threats to the company before granting the leave. For instance, while a shareholder succeeds in his action the company may suffer harm far outweighing the gain from the litigation. This may be caused by unwanted publicity[38] that may affect company's reputation and deter further investment.[39] The litigation may take too much of management time[40] or result in the departure of key personnel or the costs incurred by the company during the proceedings may not be worth the expense at all.[41] Moreover, even if the claim is successful directors may not be able to meet the judgement or the possibility of obtaining the remedy may not be clear either because of law or the scarcity of facts.

Derivative action can cause the problems to the directors' market. Individuals may lose incentives of becoming a director or high costs may become necessary attract managers. If the risk is too high company will be forced to provide adequate liability insurance or raise their salaries. But probably the main problem with the fear of litigation is that managers may be discouraged from taking risks which is so crucial for corporate entities' profit maximization. Thus to protect the company from malicious litigation should be an important concern for the courts.[42]

Procedural obstacles, particularly the two-stage process provided by the Act are aimed at screening out opportunistic litigants, or those situations when members having just "one share in the company, seek their 15 minutes of fame"[43].

---

[37] *Carlen v Drury* (1812) 1 V & B 154 at 158;

[38] Hollington, Robin, *Shareholders' Rights*, 4th ed. (2004, Sweet & Maxwell Ltd) at 222; J.Paul Sykes, *The Continuing Paradox: a Critique of Minority Shareholder and Derivative Claims under the Companies Act 2006*, C.J.Q. 2010, 29(2), 205-234 at 227

[39] Reisberg, Arad, *Derivative Actions and Corporate Governance*, Oxford: Oxford University Press, 2007.

[40] J. Payne, *Shareholders' Remedies Reassessed*, (2004) 67(3) M.L.R. 500 at 503; Hans C. Hirt, *The company's decision to litigate against its directors: legal strategies to deal with the board of directors' conflict of interest*, J.B.L. 2005, Mar, 159-208 at 165

[41] D.D. Prentice, *Wallersteiner v Moir: a decade later*, Conv. 1987, May-June, 167-176 at 168

[42] An example of a case where the petitioner was motivated by concerns other than to increase the value of the company's business is *Barrett v Duckett* [1995] B.C.C. 362, where the court held that the claim was not pursued *bona fide* on behalf of the company. see also: *Portfolios of Distinction Ltd v Laird* (2004) EWHC 2071 (Ch) *Konamaneni v Rolls-Royce Industrial Power (India) Ltd* (2002) 1 All E.R. 979

[43] Nicholas Grier, *Company Law*, 3ed. (2009) at 298

Besides, the Court of Appeal in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*[44] stated, that the individual shareholder will not always be in the best position to judge whether or not to commit the company's resources to the costly process of litigation.

If unfair prejudice petitions can be used to claim corporate relief and make the company to pay for the costs incurred, those concerns mentioned above should be adequately addressed. A proper mechanism against malicious and misguided shareholders should be implemented to avoid "opening a Pandora's box to every disenchanted individual in the country"[45]

Besides procedural difficulties and the risk of frivolous and vexatious litigation, derivative claims are of considerable importance in terms of investor confidence. It is also a significant tool in the hands of minority shareholders in order to have their say in the company run by the majority rule. Derivative Action is considered as "a form of pleading originally introduced on the ground of necessity alone in order to prevent a wrong going without redress"[46]

Several benefits may be identified from a successful derivative claim. Reisberg[47] discusses two main justifications for derivative actions – compensation paid to the company and deterrence of shareholders from future wrongdoings due to the cautious of managers not only in the company concerned, to cause harm to the company in the fear of the litigation. Though it is difficult to calculate this effect as far as it is related to subconscious, subjective reactions of the directors it may be the main justification behind derivative claims.

4. Procedures

a. Locus standi

Derivative claim as well as s 994 petition may be brought by a current member and also by persons to who shares of the company have been transferred or transmitted.[48] A member can bring an action derivatively with

---

[44] [1982] Ch. 204; [1982] 2 W.L.R. 31; [1982] 1 All E.R. 354

[45] Lord Sharman, Hansard, HL Vol.681, col.885 (May 9, 2006)

[46] *Smith v Croft (No 2)* [1988] Ch 114, 185 *per* Knox J.

[47] Reisberg, Arad, *Derivative Actions and Corporate Governance*, Oxford: Oxford University Press, 2007 at 59

[48] CA 2006...

respect to wrongs done to the company before he was a member. The subject of multiple derivative claims will be dealt with below.

It is argued by some commentators[49] that after the decision in *Clark v Cutland*, it is possible to bring a petition for the conduct that occurred before the petitioner was a shareholder as well. It's possible where the relief sought is a corporate one.

The flexibility of petitions can be seen from the decision in *Atlasview Ltd v Brightview Ltd*, where the indirect right of a beneficial owner of the shares in bringing s 994 petition was acknowledged by the court. Though such owner could not bring the petition himself, the nominee who had no economical interest in the value of the shares was allowed to bring a petition on behalf of the beneficiary.

And finally, Section 994 can be used by Secretary of State in the circumstances provided by the Act.[50]

Due to all the problems associated with derivative action and discussed in section 3 of this essay, courts have been reluctant to allow any litigation brought derivatively. Common law rule in *Foss v Harbottle* put huge burdens on litigants thus making such claims extremely difficult to succeed. Derivative action was possible only were "fraud on the minority" was established, where the wrong could not have been ratified and the wrongdoer control prevented the company, "the proper plaintiff", to bring the claim itself.

For decades, legal scholars criticised the rule. Lord Hoffmann named it - "a fire-breathing and possibly multiple-headed dragon".[51]

The Companies Act 2006 introduced a new, statutory derivative claim, replacing harsh common law rule with a more flexible tool. Though the statutory provisions considerably simplified the procedures, many procedural difficulties are still in place. The principle that only the company can litigate, "the cornerstone taken from common law"[52], is still maintained.[53]

---

[49] Jennifer Payne, Sections 459-461 *Companies Act 1985 in flux: the future of shareholder protection*, C.L.J. 2005, 64(3), 647-677 at 655

[50] CA 2006 s 995

[51] Hollington, Robin, *Shareholders' Rights*, 4th ed. (2004, Sweet & Maxwell Ltd) preface

[52] Mahmoud Almadani, *Derivative Actions: Does the Companies Act 2006 Offer a Way Forward?*, Comp. Law. 2009, 30(5), 131-140 at 132

[53] "There is no reason to believe that the statutory derivative action will prove popular simply due to greater transparency as the substantive issues are clearer, when the procedural complexity remains." Pauline Roberts, Jill Poole, *Shareholder Remedies - Corporate Wrongs and the Derivative Action*, J.B.L. 1999, Mar, 99-125 at 118

b. Leave requirements

After the enactment of Companies Act 2006 a derivative claim may be brought only under the statute and also authorised by the courts in pursuance with s. 996 (2).[54]
The section requires from the court to consider the application in two stages. At the first stage, claimant must show a prima facie case. Even if the claimant discloses prima facie case the court may order the claim to continue only on such terms as it thinks fit.
The court must deny the permission in following situations: Firstly, where an act or omission which has not occurred yet, was authorised by the company, or where such an act or omission already took place and it had been authorised or consequently ratified by the company. Such bar can be avoided if the claimant shows fraud or wrongdoer control.[55]

The second bar to the claim is when the court thinks that a person acting in accordance with s. 172, i.e. a duty to promote the success of the company for the benefit of its members, would not seek to continue the claim.[56]
Making out the first stage does not necessarily mean that the claim will ultimately succeed. On the second stage the court will give directions to the company to file evidence for a contested hearing of the application. Following factors must be considered by the court before granting the leave: the importance a person acting under the s. 172 would attach to the continuance of the claim; whether the shareholder is acting in good faith; whether the act or omission complained about is likely to be ratified or if the act or omission has not occurred whether it is likely that it will be authorised or ratified by the majority; whether the company has decided not to pursue the claim; the views of disinterested members.[57]

Derivative claim is a tool to do justice to the company or as Lord Davey described it in *Burland v Earle*[58] a "mere matter of procedure in order to give a remedy for a wrong which would otherwise escape redress". Hence

---

[54] Procedures that should be followed by shareholders in derivative action are provided by the Civil Procedure Rules 1998 from 19.9 to 19.9F

[55] Editorial, *A statutory derivative action*, Comp. Law. 2007, 28(8), 225-227

[56] Companies Act 2006 ss 263 (2) (a)

[57] There is also a requirement for a notice which the claimant must send to the company members informing them about the litigation and submit to the court a witness statement confirming such notification. At this stage company's attendance at the hearings is not necessary - Civil Procedure Rules 19.9A(4)

[58] [1902] AC 83 at 93

the procedures are drafted to make sure that the litigation is in the best interests of the company. On the other hand, unfair prejudice petition was created for personal claims, in order to protect primarily the shareholder whose interests where unfairly prejudiced. The statute should facilitate such shareholders to redress the wrongs done to them. Therefore no requirement for obtaining a leave exists in unfair prejudice petitions. If generosity for leave requirements with regard to petitions can be understood on this ground, it becomes quite odd why certain kind of hurdles should not be in place when a petitioner is seeking remedy for the company, and why courts should not ask whether a particular litigation is better for the company as a whole to be brought or not.[59]
In such situations, it is submitted here, the courts should take into account the collective position of other, disinterested shareholders to make sure that the litigation is in the interests of the company. An enquiry should also be made on whether the wrong has been ratified or not by the members thus respecting the principle of the majority rule.[60]

5. Reflective Loss

When the company and the shareholder have a claim against directors with regard to one and the same set of facts, a principle of 'no reflective loss' will bar the latter from bringing an action derivatively. Arden J in *Day v Cook* was clear about this issue: "the company's claim, if it exists, will always trump that of the shareholder".[61] The principle was employed by the Court of Appeal in *Prudential*, where it was held that the shareholder could not "recover a sum equal to the diminution in the market value of his shares, or equal to the likely diminution in dividend, because such a "loss" is merely a reflection suffered by the company. The shareholder does not suffer any personal loss. His only "loss" is through the company, in the diminution in the value of the net assets of the company, in which he has (say) a 3 per cent shareholding".[62]

---

[59] Strike-out application by the respondent serves as a leave requirement stage for unfair prejudice petitions, though as a much weaker mechanism. See: Civil Procedure Rules 1998, Part 3, r. 3.4. see also: Jennifer Payne, *Sections 459-461 Companies Act 1985 in flux: the future of shareholder protection*, C.L.J. 2005, 64(3), 647-677 at 658. for an example of successful strike-out application see - cf. *Re Baltic Real Estate Ltd. (No. 1)* [1993]

[60] J. Payne, *Shareholders' Remedies Reassessed*, (2004) 67(3) M.L.R. 500 at 505

[61] [2001] EWCA Civ 592 at [38], *per* Arden J.

[62] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch. 204 at 223

The decision in *Prudential* was approved by the court in *Johnson v Gore Wood & Co*[63].
However, *Giles v Rhind*[64] conceded an exception to the principle. Where it is a defendant's wrongdoing that prevents the company from bringing an action a shareholder may claim the loss. Arriving to this decision Chadwick L.J. referred to Lord Bingham's words in *Johnson v Gore Wood*: "the court must be astute to ensure that the party who has in fact suffered loss is not arbitrarily denied fair compensation".[65] The same logic was followed by the court in *Perry v Day*[66].
While English courts adopted a liberal attitude towards this principle, Lord Millet sitting in Hong Kong Court of Final Appeal in *Waddington Ltd v Chan Chun Hoo Thomas*[67] vigorously rejected any exception to the principle which makes it quite possible that English courts will refuse the exception in the future. His Lordship referred to a rhetoric question provided in *Prudential* case: "How can the failure of the company to pursue its remedy against the robber entitle the shareholder to recover for himself?".[68] He held that the House of Lords in *Johnson v Gore Wood* applied the principle not only where the company had the right to sue but also where it had declined or failed to sue.

There are several policy considerations for this principle. First of them is a risk of double recovery on the part of shareholder if he recovers the amount reflecting his own loss and subsequently the company decides to pursue the claim thus benefiting the shareholder indirectly. Secondly, if the whole loss cannot be recovered by the wrongdoer and a shareholder sues in his personal capacity this would result in unequal recovery among the shareholders. And probably the main justification for the principle is the protection of creditors. The latter can be prejudiced by taking though lost but recoverable company assets, from corporate to shareholder pockets.

---

[63] [2001] A.C. 1. Lord Bingham identified three propositions that were supported by different authorities not only from the UK. Firstly, where the company suffers a loss by a breach owed to it, only the company may sue with regard to that loss. Secondly, if a company sustains a loss and has no cause of action, a shareholder, provided he or she has such cause may sue in respect to it even if the loss is in a diminution in the shareholding value. And finally, where a company and a shareholder suffer distinct losses they both may recover those losses but neither can recover the loss caused to the other. See also: Gardner v Parker (2004) EWCA Civ 781, para. 33 per Neuberger L.J. - summary of relevant principles from previous cases

[64] [2002] EWCA Civ 1428

[65] [2001] A.C. 1 at 36

[66] [2004] EWHC 3372 (Ch) Neuberger L.J in *Gardner v Parker* [2004] EWCA Civ 781 held that the principle applied not only when the claimant was acting in the capacity of a member, but also as an employee or creditor of the company.

[67] [2008] HKCU 1381

[68] *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch. 204 at 223

The main remedy under s 994 petition is a buy-out order. The goal of the petitioner has "in essence become an exit remedy, which ensures that an aggrieved shareholder can leave the company with proper compensation."[69] However the court "may make such order as it thinks fit",[70] including monetary compensation to the petitioner. In this respect the most important question that arises is whether the "no reflective loss" should apply. Court in *Atlasview Ltd*. v. Brightview Ltd[71] tried to answer this question though could not manage to cover the issue to the necessary extent. Jonathan Crow, relying on the decisions prior to *Johnson v Gore Wood*, in that case merely conceded that "no reflective loss" principle had no application with regard to unfair prejudice petitions. For this conclusion the judge gave three reasons: firstly, that courts while dealing with s 994 petitions have never applied this principle, though this issue had not arisen in those cases.[72] Secondly, in Jonathan Crow's view introduction of unfair prejudice remedy was intended to protect shareholders in the situations going beyond the independently illegal acts and to allow this principle to have a place in such petitions would take most of the value of the latter. And finally, the judge noted that employing this principle would constrain a petitioner to the cumbersome mechanism of derivative claim. But in the wake of *Clark v Cutland*, those arguments lose their weight.

It is not the purpose of this article to assess the merits of "no reflective loss" principle. This principle exists and probably after Lord Millet's strict position it will gain more power in the future. However, taking into account the possibility of corporate remedy under s. 994 petition it is hard to conceive why the principle should not apply when a petitioner is seeking compensation for damages (It is also arguable whether the buy-out order, the most popular personal remedy under s. 994, interferes in the sphere of reflective loss).

It is noteworthy that corporate remedy would be more appropriate than a personal one, when s 994 is used against the wrongs done to the company. This is true where personal remedy may result in recovering the same loss as suffered by the company.

6. Costs

---

[69] Hans-Christoph Hirt , *In What Circumstances Should Breaches of Directors' Duties Give Rise to a Remedy Under ss.459-461 of the Companies Act 1985?* Comp. Law. 2003, 24(4), 100-110 at 101

[70] Companies Act 2006, section 996 (1)

[71] [2004] EWHC 1056 (Ch); [2004] 2 B.C.L.C. 191. Cf

[72] Jonathan Crow referred to following cases: *Re Saul D Harrison* [1995] 1 B.C.L.C. 14; *Re A Company* [1986] B.C.L.C. 68

One of the main advantages of a derivative claim against remedies available under s. 994 has always been indemnity issue. According to the decision in *Wallersteiner v Moir* when the claimant is acting on behalf and for the benefit of the company, the latter must reimburse the costs assumed by the former. This issue is dealt by the court at the preliminary stage if the claimant shows his good faith and reasonableness of the action. The rationale behind this rule is that the rights, claimant is seeking to vindicate, are those of the company and the addressee of the potential remedy is the company. Lord Denning made it clear in *Wallersteiner v Moir* that "seeing that, if the action succeeds, the whole benefit will go to the company, it is only just that the minority shareholder should be indemnified against the costs he incurs on its behalf".[73] This rule works even when the action is unsuccessful as noted in the same case: "It is a well known maxim of the law that he who would take the benefit of a venture if it succeeds ought also to bear the burden if it fails"[74]. Thus the so-called *Wallersteiner v Moir* order serves as a serious incentive for a potential claimant.[75]

On the other hand in an unfair prejudice petition, where the claimant pursues personal relief, no such order is generally available. The relief is granted personally to the claimant and the rationale mentioned above does not apply here.

The problem of the costs with regard to s. 994 petition was addressed by the Law Commission. The report provides examples of long and costly litigations and states that "proceedings for relief from unfair prejudice often entail complex factual investigation and result in costly and cumbersome litigation, which is particularly detrimental to smaller companies".[76] In response to these concerns Lord Hoffmann with his decision in *O'Neill v Phillips* restrained the use of the petition in the cases where the shareholders were made a suitable offer for the purchase of their shares or the articles of the company contained the mechanism of such purchase.[77]

Interestingly, in the situations where the petitioner is bringing an action for the wrongs done to the company and especially when he seeks corporate remedy the question arises why he or she should not be indemnified by the company. It seems unjust that others will gain from the cumbersome litigation undertaken by one of the members.

The court in *Clark v Cutland*, while granting corporate relief under s. 996, ordered the company to indemnify the costs. This has never happened before with regard to unfair prejudice petitions. The argument by Arden J.

---

[73] [1975] Q.B. 373. at 391-392.

[74] [1975] Q.B. 373. at 392

[75] The rule is codified in CPR 19.9E

[76] The Law Commission Consultation Paper, *Shareholders' Remedies*, 1996 at paragraph 1.7

[77] *O'Neill v Phillips* [1999] 1 W.L.R. 1092 at 1107

was that "although the relief sought is claimed under section 461 (current s. 996), it is sought for the benefit of the company and that it is, therefore, open to (the claimant) to seek an order against the company for payment to him of any costs incurred by him".[78]

In deciding whether to give such an order Arden J referred to the nature of the relief sought, i.e. for whose benefit the remedy was sought.[79] However, in order to maintain the distinction between two remedies and avoid making derivative action absolutely redundant, some proposals were offered.[80] It is submitted here that it would be better to use both the nature of the wrong alleged and the nature of relief sought as two tests for ordering indemnification by the company when proceedings involve both personal and derivative cause of action.

7. Corporate Groups

Currently English law does not allow "multiple derivative action" to be brought by a shareholder of a parent company for the wrongs done to the subsidiary or sub-subsidiary. The Law Commission did not recommend any express provision for such actions and proposed to leave this issue to be decided by the courts who if necessary could allow such action to be commenced via s. 996(2) (c).[81] Though in other common law jurisdictions[82] DMAs are allowed, English has not adopted this mechanism, besides the risk that directors of the parent companies may refuse to take actions against breaches of the duties by the directors of subsidiaries and sub-subsidiaries and there may be no tool for parent company shareholders to redress those wrongs.

In this regard it would be interesting to discuss the Hong Kong case of *Waddington*, where Per Mr Justice Bokhary PJ and Mr Justice Chan PJ noted that "On the well established thinking as to why a single derivative action is maintainable, there is no reason why a multiple derivative action is not."[83]

In allowing multiple derivative action[84] Lord Millet referred to English case of Wellsteiner v Moir where the plaintiff brought two claims one seeking recovery for the company he was member of and the other that of its subsidiary. The court of appeal held that if damages could be recovered they would be paid both to the company and its subsidiary.

---

[78] *Clark v Cutland* [2004] 1 W.L.R. 783 at 794

[79] *Clark v Cutland* [2004] 1 W.L.R. 783 at 794

[80] Arad Reisberg, *Indemnity costs orders under s.459 petition?* Comp. Law. 2004, 25(4), 116-118

[81] The Law Commission Final Report, *Shareholders' Remedies*, 6.110

[82] In the USA see: Victor Joffe QC and James Mather, *The multiple derivative action: part 1*, (2009) 2 JIBFL 61; For the Hong Kong example see: *Waddington case supra n.* 68

[83] [2009] 2 BCLC 82 at 86

Furthermore, Lord Millet applied the justification of the derivative action in *Wallersteiner v Moir* to the situations where the wrongdoers through their control of the parent company also control the subsidiaries and defraud the latter.

Lord Denning's justification of the derivative action in *Wallersteiner v Moir* applies as well to the case where the wrongdoers, who through their control of the parent company also control its subsidiaries, defraud a subsidiary or sub-subsidiary as it is to the case where they defraud the parent company itself. "In either case wrongdoer control precludes action by the company in which the cause of action is vested; and yet-- '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.'"[85]

Lord Millet also referred to American experience. Firstly, in *Brown v Tenney*[86] the Appellate Court of Illinois held that without the multiple derivative action the wrongdoer would be insulated by adding a further layer in the corporate structure. The decision in *Holmes v Camp* provided that[87]: "The free use of holding companies which has grown up in recent years would prevent the righting of many wrongs if an action like the present might not be maintained by a stockholder of a holding company."

It is to be hoped that Lord Millet's view will be followed by English courts and the corporate structure will not be a bar to claim a redress for the company to which the harm was done. As one commentator put it "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."[88]

It is not absolutely clear whether such action can be brought via the section 996(2). As Lord Millet noted in *Waddington*[89] he did not think such possibility existed.

In contrast, an unfair prejudice petition provides more flexible attitude towards wrongdoings within the corporate groups. The flexibility of section 994 petition was once again acknowledged by the Court of Appeal in *Gross v Rackind*[90]. The court, approved the first instance Judge's finding, who relying on *Nicholas v Soundcraft Electronics Ltd*[91], stated that " in the right circumstances acts in the conduct of a subsidiary's affairs can also

---

[84] "Multiple derivative action" as a term was criticized as being misleading by Lord Millet [2009] 2 BCLC 82 at 95

[85] *Waddington Ltd v Chan Chun Hoo Thomas and others* [2009] 2 BCLC 82 (footnote omitted)

[86] (1988) 125 Ill 2d 348, 532 NE 2d 230, Ill Sup Ct.

[87] (1917) 219 NY 359 the Supreme Court of New York

[88] Pearlie Koh, *Derivative Actions "once removed"*, J.B.L. 2010, 2, 101-106 at 102

[89] [2009] 2 BCLC 82 at 104

[90] [2004] EWCA Civ 815

[91] [1993] B.C.L.C. 360

be acts in the conduct of the holding company's affairs and can be relied on for the purposes of section 459". Hence the court accepted that not only the shareholders of a subsidiary company could be unfairly prejudiced by the conduct of a holding company's controllers, but the parent company shareholders could also rely on the petition "in the right circumstances".

8. Public Companies

In public companies unfair prejudice petition cannot be grounded on informal agreements identified by Lord Hoffmann in *O'Neill*, as far as it is extremely difficult to establish such understanding between the dozens of shareholders giving them legitimate expectations, say with regard to participation in the management of the company. As Jonathan Parker noted employing such test in the context of the public companies would serve as "a recipe for chaos"[92].

One commentator[93] notes that, while unfair prejudice petition is available with respect to public companies, the main reason why section s 994 (then s 459) is of little help for the shareholders in such companies is the lack of remedy. Save the situation in *McGuinness v. Bremner Plc*[94] where petitioners sought an order that the directors held a meeting earlier than suggested, the most popular remedy under s 994, i.e. purchase of minority shares at a fair value is freely available to the shareholders via the market.

As for derivative actions, the Law Commission in its Final Report stated that "if shareholder remedies are too readily available in those companies, this may lead directors to favour a course which provides benefits to shareholders rather than make a more balanced Judgment and take a decision which they would otherwise feel free to take." The Final Report suggests looking at a derivative action in public companies in the context of other control mechanisms such as "regulatory action, institutional investor attitudes, DTI inquiries, and so on."[95] In sum, unfair prejudice petition will probably continue to be very popular among small companies, while derivative claim will rarely be used with regard to publicly held companies when other mechanisms of control, identified above, fail to provide necessary protection.

---

[94] [1988] B.C.L.C. 673

[95] The Law Commission Final Report, *Shareholders' Remedies*, at footnote 25

Conclusion

We have seen that on most occasions an unfair prejudice petition is a more flexible tool than a derivative claim. The introduction of a more effective statutory mechanism for the shareholders than the rule in *Foss v Harbottle*, is still "unlikely to halt the decline of the derivative action in the face of an ever-stronger section" 994.[96] The latter is more popular as it allows personal relief; ratification and authorisation are no bars; there is no leave requirement; it offers wider protection with its broad notions of 'fairness' and that of 'conduct' extending not only to directors but to the actual controllers of the company. The scope of remedies available as we have seen is not delineated. Furthermore, a petitioner does not have to show good faith.[97] Finally, after *Clark v Cutland* even corporate remedy together with indemnification order may be obtained through the petition.

These advantages of section 994 petition over derivative claims urged lawyers to question the necessity of a derivative claim. It is submitted here that the two remedies serve different goals. A derivative claim is a mechanism to redress the wrong done to the company, whereas s. 994 petition's primary goal is to give a member relief from mismanagement.

Sometimes they do overlap, in particular when unfair prejudice petition seeks a corporate relief and thus assumes the role of derivative action, but it should be noted that only in order to avoid procedural complexities. If a proper screen-out mechanism is in place in such circumstances to protect the company, a mere fact that in rare situations section 994 will achieve the result contemplated for a derivative claim should not convince us to reject the latter as a viable legal tool.

Bibliography

Articles:

Arad Reisberg, *Indemnity costs orders under s.459 petition*? Comp. Law. 2004, 25(4), 116-118

Arad Reisberg, *Judicial control of derivative actions*, I.C.C.L.R. 2005, 16(8), 335-339

Brenda Hannigan, *Drawing Boundaries Between Derivative Claims and Unfairly Prejudicial Petitions* J.B.L. 2009, 6, 606-626

---

[96] J. Payne, *Bigger and Better Guns for Minority Shareholders* [1998] C.L.J. 36 at 37

[97] "Clean hands" doctrine is in place with derivative claims, which means that a shareholder cannot claim a redress for the company, for example, on the ground of ultra vires transaction, when he himself received benefit from that transaction - *Towers v African Tug Co* [1904] 1 Ch 558. See also *Barrett v Duckett* [1995] 1 BCLC 243. *Nurcombe v Nurcombe* [1985] 1 WLR 370

D.D. Prentice, *Wallersteiner v Moir: a decade later*, Conv. 1987, May-June, 167-176

Hans C. Hirt, *In What Circumstances Should Breaches of Directors' Duties Give Rise to a Remedy Under ss.459-461 of the Companies Act 1985?* Comp. Law. 2003, 24(4), 100-110

Hans C. Hirt, *The company's decision to litigate against its directors: legal strategies to deal with the board of directors' conflict of interest*, J.B.L. 2005, Mar, 159-208

J.Paul Sykes, *The Continuing Paradox: a Critique of Minority Shareholder and Derivative Claims under the Companies Act 2006*, C.J.Q. 2010, 29(2), 205-234

Jennifer Payne, *Bigger and Better Guns for Minority Shareholders* [1998] C.L.J. 36

Jennifer Payne, Clean Hands in Derivative Actions [2002] C.L.J. 76;

Jennifer Payne, *Section 495 and Public Companies*, L.Q.R. 1999, 115(Jul), 368-372

Jennifer Payne, *Sections 459-461 Companies Act 1985 in flux: the future of shareholder protection*, C.L.J. 2005, 64(3), 647-677

Jennifer Payne, *Shareholders' Remedies Reassessed*, (2004) 67(3) M.L.R. 500

JG MacIntosh, *The Oppression Remedy: Personal or Derivative?* (1991) 70 *Canada Bar Review* 29

Mahmoud Almadani, *Derivative Actions: Does the Companies Act 2006 Offer a Way Forward?*, Comp. Law. 2009, 30(5), 131-140

Paul F. Banta, *The New Indiana Business Corporation Law: "Reckless" Statute or New Standard?* 1987 Colum. Bus. L. Rev. 233 1987

Pauline Roberts, Jill Poole, *Shareholder Remedies - Corporate Wrongs and the Derivative Action*, J.B.L. 1999, Mar, 99-125

Pearlie Koh, *Derivative Actions "once removed"*, J.B.L. 2010, 2, 101-106

Victor Joffe QC and James Mather *The multiple derivative action: part 1*, (2009) 2 JIBFL 61

Victor Joffe QC and James Mather *The multiple derivative action: part 2*, (2009) 3 JIBFL 115

Cases:

Anderson v Hogg 2002 S.C. 190

Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] Ch. 204; [1982] 2 W.L.R. 31; [1982] 1 All E.R. 354

Atlasview Ltd. v. Brightview Ltd [2004] EWHC 1056 (Ch); [2004] 2 B.C.L.C. 191. Cf

Barrett v Duckett [1995] B.C.C. 362

Bhular v Bhular [2003] EWCA Civ 424

Brown v Tenney (1988) 125 Ill 2d 348, 532 NE 2d 230, Ill Sup Ct.

Clark v Cutland [2003] EWCA Civ 810; [2004] 1 W.L.R. 783; [2003] 4 All E.R. 733; [2004] B.C.C. 27; [2003] 2 B.C.L.C. 393

Day v Cook [2001] EWCA Civ 592

Ebrahimi v Westbourne Galleries Ltd [1973] A.C. 360; [1972] 2 W.L.R. 1289; [1972] 2 All E.R. 492; (1972) 116 S.J. 412

Foss v Harbottle (1843) 2 Hare 461

Gamlestaden Fastigheter AB v Baltic Partners Ltd [2008] 1 B.C.L.C. 468

Gardner v Parker [2004] EWCA Civ 781

Giles v Rhind [2002] EWCA Civ 1428

Gross v Rackind [2004] EWCA Civ 815

Holmes v Camp (1917) 219 NY 359

Johnson v Gore Wood & Co[2001] A.C. 1

Konamaneni v Rolls-Royce Industrial Power (India) Ltd (2002) 1 All E.R. 979

McGuinness v. Bremner Plc [1988] B.C.L.C. 673

Nicholas v Soundcraft Electronics Ltd [1993] B.C.L.C. 360

Nurcombe v Nurcombe [1985] 1 WLR 370

O'Neill v Phillips [1999] 1 W.L.R. 1092; [1999] 2 All E.R. 961; [1999] B.C.C. 600; [1999] 2 B.C.L.C. 1

Perry v Day [2004] EWHC 3372 (Ch)

Portfolios of Distinction Ltd v Laird (2004) EWHC 2071 (Ch)

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

Re Charnley Ltd (No.2), Re [1990] B.C.L.C. 760 Ch D

Re Chime Corp [2004] 7 H.K.C.F.A.R. 546

Re Company (No.005287 of 1985), Re [1986] 1 W.L.R. 281

Re Cumana Ltd. [1986] B.C.L.C. 430.

Re London School of Electronics Ltd. [1986] Ch. 211

Re Saul D Harrison & Sons plc [1994] B.C.C. 475

Smith v Croft (No 2) [1988] Ch 114, 185

Towers v African Tug Co [1904] 1 Ch 558

Waddington Ltd v Chan Chun Hoo Thomas [2008] HKCU 1381

Wellester v Moir [1975] Q.B. 373

Books:

David Kershaw, Company Law in Context (OUP, Oxford 2009)

Hollington, Robin, *Shareholders' Rights*, 4th ed. (2004, Sweet & Maxwell Ltd)

Nicholas Grier, *Company Law* (2009)

Paul L Davies, ***Gower and Davies: The Principles of Modern Company Law*** 8th Edition (Sweet & Maxwell 2008)

Reisberg, Arad, *Derivative Actions and Corporate Governance*, Oxford: Oxford University Press, 2007

Victor Joffe, *Minority Shareholders: Law, Practice and Procedure*, 3rd ed. (Oxford University Press, 2008)

Statutes:

Companies Act 2006

Companies Act 1982

Civil Procedure Rules 1998

Insolvency Act 1986

Konstantine Eristavi,

Attorney at Getsadze & Pateishvili Law Office