DERIVATIVE CLAIMS UNDER THE COMPANIES ACT 2006: IN NEED OF REFORM?

Qamarul Jailani[*]

Abstract: This article examines the derivative claim regime under Part 11 of the UK Companies Act 2006 with a view to identifying key problematic areas and thereafter providing suggestions for reform. This will be done through three broad areas of focus. Firstly, this article focuses on the current provisions in Part 11 and identifies two problematic requirements: the need for a *prima facie* case to be established and the requirement for the court to consider an applicant's good faith. This article argues that both of these requirements are unnecessary and should accordingly be removed. Next, this article will focus on key omissions from Part 11. In doing so, it will be shown that the failure to expressly provide for both multiple derivative claims and a requirement for court permission to discontinue or settle a claim is regrettable. As such, both issues should be expressly provided for in the statutory framework. Lastly, this article will show that the issue of costs currently plays a significant role in deterring potential derivative claimants. Accordingly, this article will propose the introduction of a mandatory indemnity order and the conferral of discretion on the courts to financially reward successful derivative claimants.

A. INTRODUCTION

A useful starting point for a conceptual understanding of derivative claims is the principle that a company has a legal personality which is separate and distinct from its members.[1] It follows from this principle that where a wrong has been committed against a company, it is the company, not its members, that has the right to pursue a claim against the wrongdoers.[2] That said, given that it is normally the board of directors that decides, as part of their general powers of management, whether the company should pursue a claim against the wrongdoers,[3] difficulties may arise when the wrongdoers are members of the board and are in a position to prevent the company from commencing a claim against them in respect of their wrongdoing. This would be the case where the wrongdoers constitute a majority of the board or are able to influence the majority of the board. Nevertheless, provided that certain necessary preconditions are met, it may be possible for a shareholder in such a situation to commence a derivative claim against the wrongdoer directors. A derivative claim essentially refers to a claim brought by a

[*] LL.M. (Distinction) University College London, LL.B. (Magna Cum Laude) Singapore Management University.

[1] *Salomon v A Salomon & Co* [1897] AC 22 (HL) 51.

[2] *Foss v Harbottle* (1843) 2 Hare 461, 490; 67 ER 189, 202.

[3] Brenda Hannigan, *Company Law* (4th edn, OUP 2016) 527, citing *Breckland Group Holdings v London and Suffolk Properties* [1989] 4 BCC 542 (Ch).

shareholder on behalf of the company. As its name suggests, the right of a shareholder to pursue such a claim is derived from the right of the company to claim in respect of the wrong that has been committed against it.

It is perhaps unsurprising from the foregoing discussion that derivative claims usually arise when there has been a breach of duty by a director or directors, and the company is prevented from commencing an action against the director(s) in respect of the breach.[4] In this regard, derivative claims, in theory, operate as a key tool of corporate governance by providing a platform for the enforcement of directors' duties, deterring directorial wrongdoing, providing an avenue for companies to be compensated for any harm caused by directorial wrongdoing, and serving a gap-filling role by clarifying the scope of permissible directorial conduct through judicial decisions.[5] Nonetheless, an underlying tension that is inherent in any derivative claim regime is the need to strike the right balance between allowing companies to operate effectively on a day-to-day basis without unnecessary interference from shareholders, and the need to protect shareholders by providing them with an avenue for redress in appropriate circumstances.[6]

Given the importance of derivative claims, this article seeks to examine the derivative claim regime under Part 11 of the UK Companies Act 2006 (CA 2006) with a view to identifying key problematic areas and thereafter providing suggestions for reform. The scope of this article will involve not only an examination of some of the current provisions of Part 11 of the CA 2006, but also an analysis of some key omissions from Part 11, as well as important procedural rules which apply to a derivative claim commenced under Part 11 (currently set out in the provisions of the Civil Procedure Rules (CPR) governing derivative claims rather than in Part 11 itself). Further, given that it will not be feasible, due to space constraints, to holistically address all the possible concerns with respect to the statutory derivative regime, this article will focus on selected issues which are of key importance and accordingly merit greater attention.

There are several objectives behind the reform proposals set out in this article. First, they seek to remove any unnecessary complexity, and to establish a balanced and fair procedure for derivative claims. Further, these proposals are also aimed at ensuring that the legal framework on derivative claims does not prevent or discourage claimants

[4] Saleem Sheikh, *Company Law Handbook 2016* (Bloomsbury Professional 2016) para 18.2.
[5] Arad Reisberg, *Derivative Actions and Corporate Governance* (OUP 2007) 74.
[6] Jill Poole and Pauline Roberts, 'Corporate Wrongs and the Derivative Action' [1999] JBL 99, 101.

from pursuing meritorious claims while, at the same time, making sure that concerns regarding the risk of a proliferation of vexatious and unmeritorious claims are addressed.

The structure of this article is as follows. First, this article will provide an introductory overview of the legal framework governing derivative claims. Thereafter, this article will examine two key problematic provisions in Part 11 of the CA 2006: the requirement for a *prima facie* case to be established;[7] and the need for a court to have regard to whether a derivative claimant is acting in good faith.[8] Next, this article will assess two key issues which are not addressed by Part 11 of the CA 2006, impeding its effectiveness. These are 'multiple derivative claims' and the requirement to obtain the court's permission to discontinue or settle a derivative claim. Lastly, this article will examine the issue of costs as a barrier to commencing derivative claims, an issue which, as will be shown, the CA 2006 does not resolve. In adopting the foregoing framework, this article argues that the current regime in the CA 2006 on derivative claims is unnecessarily complex, incomplete, and is likely to discourage appropriate claims from being commenced. This creates a necessity for reforms to the current regime, as discussed in further detail below.

B. AN OVERVIEW OF THE LEGAL FRAMEWORK

This section of the article will provide a brief overview of the legal framework governing derivative claims, so as to provide the necessary background context before proceeding with the rest of the article. To do so, the section will first outline the main aspects of the derivative claim regime under common law. This will be followed by an examination of the key problems with the common law regime. This examination will not only help provide an understanding of some of the policy motivations behind the introduction of the statutory derivative claim regime, but will also be relevant to the discussion on 'multiple derivative claims' contained in Part D of this article. Lastly, this section will also provide a brief overview of the statutory derivative claim regime under the CA 2006.

1. Derivative Claims at Common Law

Prior to the introduction of the statutory derivative regime, a derivative claim could only be commenced under common law. To do so, a shareholder had to establish a

[7] Companies Act 2006, s 261(2).
[8] ibid s 263(3)(a).

prima facie case that the company was entitled to the relief claimed and that the claim fell within one of the 'exceptions' to the rule in *Foss v Harbottle*.[9] As explained by Jenkins LJ in *Edwards v Halliwell*,[10] there are two aspects to the rule in *Foss*.[11] First, the proper plaintiff in an action for a wrong alleged to have been committed against the company is *prima facie* the company itself.[12] Second, no individual shareholder is allowed to bring an action where the alleged wrong is a matter which can be made binding on the company and all its shareholders by a majority of the shareholders.[13]

There are, however, four 'exceptions' to the rule in *Foss* under which a shareholder can sue. These are where the act complained of (i) was *ultra vires*; (ii) was in violation of a requirement that it could only be validly done or sanctioned by a special majority of the members; (iii) was an invasion of the claimant's personal rights as a member; or (iv) amounted to a fraud against the company and the wrongdoers were in control of the company.[14] The last 'exception' is commonly referred to as the 'fraud on the minority' exception, even though the 'fraud' in question would have been committed against the company and not the minority shareholders.[15] Notwithstanding the foregoing, it has been recognised that the first three 'exceptions' are not true exceptions to the rule in *Foss* since they are essentially concerned with the direct rights of shareholders[16] and thus simply instances where the rule in *Foss* does not apply.[17] In this regard, only a claim commenced pursuant to the 'fraud on the minority' exception can accurately be regarded as a derivative action since it is concerned with enforcing the company's rights and obtaining a remedy for the company.[18]

2. Problems with the Common Law Regime

Despite the theoretical possibility of shareholder recourse through a derivative claim under common law, there are several serious problems with the common law regime on derivative claims which significantly limit the protection that it offers to shareholders. In this regard, the Law Commission had, after conducting an extensive inquiry into

[9] *Prudential Assurance v Newman Industries (No 2)* [1982] Ch 204 (CA) 221-222.
[10] [1950] 2 All ER 1064 (CA).
[11] ibid 1066.
[12] ibid.
[13] ibid.
[14] ibid 1067.
[15] Alan Dignam and John Lowry, *Company Law* (9th edn, OUP 2016) 186.
[16] Editorial, 'A Statutory Derivative Action' (2007) 28 CoLaw 225, 225.
[17] Alan Dignam, *Hicks & Goo's Cases and Materials on Company Law* (7th edn, OUP 2011) 428.
[18] Editorial (n 16) 225.

shareholder remedies, concluded that the rule in *Foss* and its exceptions are 'inflexible and outmoded'.[19]

The Law Commission identified four key problems with the common law regime on derivative claims. First, the rule in *Foss* cannot be found in any rules of court, but only in case law, much of which was decided many years ago.[20] As the Law Commission pointed out, to obtain a proper understanding of the rule in *Foss*, one would need to examine the various cases spanning over 150 years, thus rendering the law in this area 'virtually inaccessible except to lawyers specialising in the field'.[21] Second, although a derivative claim can only be commenced if the wrongdoers are in control of the company, the meaning of 'control' is unclear.[22] In this regard, the Law Commission noted that while 'control' is not limited to a situation where the wrongdoer holds a majority of the company's shares, there is limited guidance on the other circumstances that would evidence 'control'.[23] Furthermore, even where *de facto* control exists, as may be the case in widely-held companies where a sizeable number of shareholders tend to vote with the directors or not vote at all, this would be difficult to establish.[24] The third problem is that the scope of the derivative claim is too limited in that a shareholder is not able to commence a claim in respect of negligence by a director unless it could be shown that the director obtained a benefit from their negligence.[25] Lastly, the Law Commission was concerned that the requirement for a derivative claimant to demonstrate a *prima facie* case on the merits, in order to establish their standing to bring the action, could result in a mini-trial at the preliminary stage of the claim. This would consequently increase the length and costs of the litigation.[26]

3. The Statutory Derivative Claim Regime

Given the significant shortcomings of the common law regime on derivative claims, it is unsurprising that the Law Commission recommended the introduction of a 'new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue the action'.[27]

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[19] Law Commission, *Shareholder Remedies* (Law Com CP No 142, 1996) (LC Consultation Paper) para 14.1.
[20] ibid para 14.2.
[21] ibid para 4.35.
[22] ibid para 14.2.
[23] ibid para 4.14.
[24] Andrew Keay and Joan Loughrey, 'Derivative Proceedings in a Brave New World for Company Management and Shareholders' [2010] JBL 151, 172.
[25] LC Consultation Paper (n 19) para 14.3.
[26] ibid para 14.4.
[27] Law Commission, *Shareholder Remedies* (Law Com No 246, 1997) (LC Report) para 6.15.

Under the CA 2006, a derivative claim is defined in section 260(1) as 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'. Further, section 260(3) provides that a derivative claim under the CA 2006 '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'. Thus, in contrast to the position under common law, a derivative claim under the CA 2006 can be brought against a director on grounds of negligence, regardless of whether the director had benefitted personally from the alleged negligence.[28] Further, there is no requirement for a derivative claimant to demonstrate that the wrongdoers control the company.[29]

Under the CA 2006, a member who wishes to bring a derivative claim must apply to the court for permission to continue it.[30] To obtain such permission, the applicant member must satisfy a two-stage procedure. At the first stage, the court must be satisfied that there is a '*prima facie* case for giving permission' to continue the derivative claim.[31] Where the court is not satisfied that there is a *prima facie* case, it must dismiss the application.[32]

If an applicant succeeds at the first stage, the court is then required at the second stage to determine whether it should grant permission to continue the claim. Section 263(2) sets out a list of circumstances in which permission must be refused, which includes the situation where the court is satisfied that 'a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim'.[33] Otherwise, the court has the discretion to allow continuance, but in deciding whether to do so must take into account a number of specified considerations set out in sections 263(3) and 263(4). These include 'whether the member is acting in good faith in seeking to continue the claim',[34] and 'the importance that a person acting in accordance with section 172 (duty to promote the success of the company) would attach to continuing it'.[35]

[28] Explanatory Notes to the Companies Act 2006, para 491.
[29] ibid.
[30] Companies Act 2006, s 261(1).
[31] ibid s 261(2).
[32] ibid s 261(2)(a).
[33] ibid s 263(2)(a).
[34] ibid s 263(3)(a).
[35] ibid s 263(3)(b).

C. PROBLEMATIC PROVISIONS IN THE COMPANIES ACT 2006 ON DERIVATIVE CLAIMS

Having considered some of the factors that led to the introduction of the statutory derivative regime and, thereafter, the legal framework on derivative claims contained in Part 11 of the CA 2006, this article shall now proceed to examine the statutory derivative regime with a view to identifying key problematic areas and thereafter providing suggestions for reform. As mentioned earlier, given that it will not be possible, due to space constraints, to holistically address all the possible concerns in relation to the statutory derivative regime, this article will focus on selected issues which, as will be shown later, are of significant importance and accordingly merit greater attention.

This section will focus on examining two key problematic provisions which are currently contained in Part 11 of the CA 2006. Specifically, the requirement under section 261(2) for the court to be satisfied that there is a '*prima facie* case for giving permission' to continue the derivative claim, and the requirement under section 263(3)(a) for the court to consider whether the applicant 'is acting in good faith in seeking to continue the claim'. As will be shown, these provisions create much uncertainty and may result in unnecessary time and costs being incurred in the application process. On this basis, this article argues that they should be removed.

1. *The Requirement for a Prima Facie Case*

As mentioned earlier, at the first of the two-stage procedure for an applicant to obtain the permission of the court to continue a derivative claim, the court must be satisfied that there is a *prima facie* case for the giving of such permission.[36] The requirement for a *prima facie* case was added late in the legislative process by the House of Lords so as to allow the courts to dismiss unmeritorious claims at an early stage without involving companies.[37] Notwithstanding this, a closer examination will show that the requirement for a *prima facie* case is problematic and of limited usefulness. Therefore, this article argues that it should be removed.

a) Problems with the Requirement for a Prima Facie Case

The first problem with the requirement for a '*prima facie* case' in section 261(2) is that it creates uncertainty since the meaning of the term is unclear, with the CA 2006 not providing any definition or guidance. Further, the cases thus far have not been clear or

[36] ibid s 261(2).
[37] HL Deb 9 May 2006, vol 681, col 883.

consistent on what a '*prima facie* case' requires,[38] and this can be seen from the observations made in *Iesini v Westrip Holdings*[39] and *Stimpson v Southern Private Landlords Association*[40] regarding section 261(2). In *Iesini*, Lewison J explained that 'the *prima facie* case to which [section 261(2)] refers is a *prima facie* case 'for giving permission'… [which] necessarily 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.)'.[41] While Lewison J was of the view that the focus in section 261(2) is on whether a company has a good cause of action which arises out of a director's wrongdoing, this appears to be inconsistent with the decision in *Stimpson* in which Mark Pelling QC (sitting as a High Court judge) stated that a court is required to consider, among other things, the factors set out in sections 263(3) and (4) in determining whether a *prima facie* case has been established.[42] Therefore, it is unclear, for example, whether the requirement for a *prima facie* case will be met where a company has a good cause of action which arises out of a director's breach of duty, but the applicant is deemed not to be acting in good faith for the purposes of section 263(3)(a). In any case, the term '*prima facie* case' was not defined in either *Iesini* and *Stimpson*, nor in the other cases dealing with section 261(2), so it remains uncertain as to what the first stage specifically requires.

It is questionable whether it is even possible to provide a satisfactory definition of '*prima facie* case' for the purposes of section 261(2) given the uncertainty that has long existed in relation to the use of the term. As Morgan J pointed out in *Bhullar v Bhullar*, it is unclear what a '*prima facie* case' means notwithstanding that it is often used.[43] In this regard, Morgan J observed that the uncertainty in relation to the phrase had been recognised even in judicial decisions outside of the context of derivative claims.[44] For example, in *Armah v Government of Ghana*, Lord Reid noted that the term '*prima facie* case' is 'not self-explanatory' and hoped that 'a less ambiguous phrase' would be used in future legislation.[45]

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[38] Keay and Loughrey (n 24) 155.
[39] [2009] EWHC 2526 (Ch), [2010] All ER 108.
[40] [2009] EWHC 2072 (Ch), [2010] BCC 387.
[41] *Iesini* (n 39) [78].
[42] *Stimpson* (n 40) [46].
[43] [2015] EWHC 1943 (Ch), [2015] All ER 130 [23].
[44] ibid [23]-[24].
[45] [1968] AC 192 (HL) 229-230.

The second problem with the requirement for a '*prima facie* case' in section 261(2) is that this requirement does not appear to be necessary or effective since it is unlikely that applications will fail at this stage. As Gibbs points out, following his analysis of the cases on section 261(2), the courts have construed the requirement to establish a *prima facie* case very leniently, with the requirement being met in all of the cases examined.[46] An examination of the possible reasons for this seemingly low threshold adopted by the courts indicates that this trend is likely to continue. These reasons include judicial reluctance to throw out a remotely plausible case at the first stage especially given that the application can still be dismissed at the second stage;[47] the low likelihood that a claim will be so poorly compiled that it cannot even demonstrate a plausible case;[48] and the fact that the application at the first stage is normally based solely on the applicant's evidence without any independent input or rebuttal from the defendant(s) or the company.[49] The negative effect of this is two-fold. First, there is a risk that the reputation of the defendant director(s) may be adversely affected after the court agrees that a *prima facie* case has been established, notwithstanding the seemingly low threshold. Second, and more importantly, this results in unnecessary time and costs being incurred in the application process, contrary to the desired aim of the Law Commission of having a simpler, efficient, and cost-effective framework to deal with derivative claims.[50]

b) Reform Proposal

In view of the foregoing problems, this article argues that the requirement at the first stage to establish a *prima facie* case should be removed, with the application for permission to continue a derivative claim to be heard in a single stage.

As a preliminary point, the proposal to remove the requirement in section 261(2) for a *prima facie* case is unlikely to stoke fears of a radical change in the law given that the cases show that it is already possible, with the approval of the court, to dispense with the two-stage procedure so as to consider the application for permission to continue a derivative claim in a single hearing and to bypass the first stage entirely.

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[46] David Gibbs, 'Has the Statutory Derivative Claim Fulfilled Its Objectives?' (2011) 32 CoLaw 41, 43.
[47] Brenda Hannigan and others, *Hannigan and Prentice: The Companies Act 2006* (2nd edn, LexisNexis 2009) 87.
[48] John Lowry and Arad Reisberg, *Pettet's Company Law: Company Law & Corporate Finance* (4th edn, Pearson 2012) 260.
[49] Explanatory Notes to the Companies Act 2006, paras 492 and 495; 19C CPR Practice Direction 5; Andrew Keay and Joan Loughrey, 'The New Derivative Action under the Companies Act 2006' (2008) 124 LQR 469, 484.
[50] LC Report (n 27) paras 1.09-1.13.

This was the case, for example, in *Franbar Holdings v Patel*, where the claimant did not attempt to establish a *prima facie* case, with counsel for the defendant accepting that it was appropriate for the court to deal with the entirety of the application for permission to continue in a single hearing,[51] and in *Mission Capital v Sinclair*, where the parties agreed to combine the two-stage process, with the issue of a *prima facie* case subsequently not discussed.[52]

Further, the cases indicate that there is some judicial support for dispensing with the two-stage procedure. For example, Floyd J in *Mission Capital* described the decision of the parties to combine both stages as sensible,[53] while Mark Pelling QC (sitting as a High Court judge) in *Stimpson* went even further by overriding the defendant's objections to telescoping the two-stage process into one, considering the two-stage process, in which a *prima facie* case must first be established, to be 'unduly elaborate' in the circumstances of the case.[54] Mark Pelling QC instead approached the application by reference to section 263 and the factors contained therein in assessing whether the derivative claim should be permitted to proceed.[55]

The level of judicial enthusiasm regarding the dispensation of the two-stage procedure and bypassing the requirement for a *prima facie* case must, however, be put in perspective since such an approach was criticised by David Donaldson QC (sitting as a deputy High Court judge) in *Langley Ward v Trevor*.[56] Specifically, David Donaldson QC was of the opinion that the requirement at the first stage for a court to be satisfied that there is a *prima facie* case provides a filter which should not be dispensed with.[57] As David Donaldson QC explained, this requirement enables the court to 'make a properly informed decision whether it is right to put the company (and the potential defendant) to the expense and inconvenience of considering and contesting the application'.[58] Further, David Donaldson QC suggested that observing the requirement for a *prima facie* case could result in the elimination of a large number of claims at the first stage, which would then reduce the time and costs expended by the parties and the court.[59] This appears to be consistent with the aforementioned legislative

[51] [2008] EWHC 1534 (Ch), [2008] All ER 14 [24].
[52] [2008] EWHC 1339 (Ch), [2008] All ER 225 [36].
[53] ibid.
[54] *Stimpson* (n 40) [3].
[55] ibid.
[56] [2011] All ER 78 (Ch) [7].
[57] ibid [62].
[58] ibid.
[59] ibid [63].

intent of the first stage as a basis for allowing the courts to dismiss unmeritorious claims at an early stage without involving companies.

While the arguments raised by David Donaldson QC against the dispensation of the requirement to establish a *prima facie* case may, at first glance, appear attractive, they do not stand up to scrutiny.

First, it has already been shown earlier that in practice, it would be very rare for an application to fail at the first stage especially since the courts appear to have adopted a very low threshold in relation to the requirement to establish a *prima facie* case. Therefore, the assumption that the first stage can act as an effective filter against unmeritorious claims appears to be misplaced.

Second, and following from the foregoing, insistence on a strict observation of the first stage, notwithstanding its ineffectiveness as a filter, results in unnecessary time and costs being incurred in the application process, contrary to the desired aim of the Law Commission of having a simpler, efficient, and cost-effective mechanism to deal with derivative claims.[60] This is especially so given the prevailing uncertainty (discussed earlier) as to what the requirement for a *prima facie* case entails.

Lastly, a more effective filter, which allows the court to deny unmeritorious and frivolous claims from proceeding to a full substantive hearing, already exists in the form of the second stage of the application process and the factors which must be considered by the court thereunder pursuant to sections 263(3) and 263(4). This is particularly so in relation to section 263(2)(a), in which the court must refuse permission to continue a derivative claim if a person acting in accordance with the duty to promote the success of the company would not continue the claim, and section 263(3)(b), in which the court, in considering whether to grant permission to continue a derivative claim, must take into account the importance that a person acting in accordance with the duty to promote the success of the company would attach to continuing it. It is clear that a director acting in accordance with the duty to promote the success of the company would not seek to continue a derivative claim that is frivolous or unmeritorious, so there is no need for the same analysis to be repeated in both the first and second stage.

For the foregoing reasons, the requirement to establish a *prima facie* case under section 261(2) should be removed, with the application for permission to continue a derivative claim to be heard in a single stage. This would eliminate the uncertainty,

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[60] LC Report (n 27) paras 1.09-1.13.

time, and costs associated with the problematic first stage of the application process and, in turn, encourage more shareholders to bring meritorious cases, but with sufficient existing safeguards against frivolous claims.[61]

2. *The Requirement for a Claimant to be Acting in Good Faith*

Another problematic provision in Part 11 of the CA 2006 is section 263(3)(a) under which the court is required to take into account, in deciding whether to grant permission to continue a derivative claim, whether the applicant 'is acting in good faith in seeking to continue the claim'. The focus on this provision is especially important since the reported cases show that a lack of good faith is frequently alleged.[62] In this section, it will be shown that section 263(3)(a) is inherently problematic and that its relevance in the context of derivative claims is conceptually questionable. On this basis, this article argues that section 263(3)(a) should be removed.

a) The Purpose of Section 263(3)(a) and Its Problems

At first glance, the requirement in section 263(3)(a), for a court to take into account whether the applicant 'is acting in good faith in seeking to continue the claim', appears to serve a useful purpose. As noted by Lord Glennie, the good faith requirement was designed to prevent derivative claims from being used to further the purposes of the claimant rather than of the company.[63] This would be the case, for example, when a derivative claim is used to further a personal vendetta[64] or as a 'greenmailing' attempt by a shareholder to pressure the company's management to purchase their shares at a premium.[65] Notwithstanding the foregoing, the good faith consideration in section 263(3)(a) is problematic for several reasons.

First, the requirement in section 263(3)(a) for a court to consider whether an applicant is acting in good faith may lead to uncertainty since the CA 2006 does not define the term 'good faith' or provide any guidance as to what it means. The absence of a definition of 'good faith' in Part 11 of the CA 2006 was intentional since the Law Commission was of the view that the term would be 'extremely difficult to define' but 'generally readily recognisable'.[66] While it is true that the concept of 'good faith' is not new, the problem is that the term is open-textured and has been given various meanings

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[61] Gibbs (n 46) 43.
[62] Edwin Mujih, 'The New Statutory Derivative Claim' (2012) 33 CoLaw 99, 101.
[63] *Alexander Marshall Wishart, Petitioner* [2009] CSOH 20, 2009 SLT 376 [33].
[64] Reisberg (n 5) 115.
[65] Keay and Loughrey (n 24) 168.
[66] LC Report (n 27) para 6.76.

in case law.[67] Further, it has been correctly pointed out that 'good faith' functions as a rhetorical device, rather than a substantive standard which offers a structured mode of analysis.[68] In this regard, the uncertainty that arises as a result of the utilisation of the 'good faith' consideration may not only have the effect of deterring a potential claimant, but may also lead to differences of judicial opinion and hence complexity of case law.[69]

Second, section 263(3)(a) may have the adverse effect of filtering out meritorious claims. Specifically, if the courts refuse to grant permission to continue in cases where a claim is motivated by the personal interests of the applicant or the applicant's ill-feelings, it is likely that most derivative claims will be frustrated since it is unlikely that any applicant would pursue a derivative claim to sue on behalf of the company in the absence of some personal incentive.[70] This is especially so in light of the significant costs disincentives involved in commencing a derivative claim, discussed in Part E of this article. While it is true that the good faith consideration under section 263(3)(a) is only one of the factors to be taken into account by a court in deciding whether to allow a derivative claim to continue, and is not a mandatory bar, it has been correctly pointed out that this factor is likely to carry significant weight since, in practice, it is very unlikely that a court would grant permission to continue a claim to an applicant that is deemed to be acting in bad faith.[71]

It may of course not always be the case that an applicant would be barred from pursuing a derivative claim just because they may have a collateral purpose or may derive other benefits in doing so. Indeed, in *Iesini*, *Hughes v Weiss*,[72] and *Mission Capital* the courts were satisfied that the applicants were acting in good faith in commencing their derivative claims notwithstanding the allegations of them having a collateral purpose in doing so. In *Iesini*, Lewison J concluded that the 'dominant purpose' of the claim was to benefit the company, and that it could not be said that 'but for' the collateral purpose, the claim would not have been brought.[73] In *Hughes*, the approach of the court was to identify whether the claim was brought 'for the purpose of' vindicating the company's rights or for some other ulterior purpose.[74] Lastly, in

[67] Arad Reisberg, 'Theoretical Reflections on Derivative Actions in English Law' (2006) 3 ECFR 69, 101.
[68] ibid 103.
[69] Poole and Roberts (n 6) 107.
[70] *Barrett v Duckett* [1993] BCC 778 (Ch) 786; Lowry and Reisberg (n 48) 273.
[71] Poole and Roberts (n 6) 107.
[72] [2012] EWHC 2363 (Ch), [2012] All ER 197.
[73] *Iesini* (n 39) [121].
[74] *Hughes* (n 72) [47].

Mission Capital, it was held that once there was a 'real purpose' in bringing the claim, the argument that an applicant was not acting in good faith cannot be maintained.[75]

Notwithstanding the foregoing, the approach adopted by the courts in *Iesini*, *Hughes*, and *Mission Capital*, to ensure that section 263(3)(a) does not filter out all cases in which the claimant may have a collateral purpose or may derive other benefits in bringing the claim, results in additional problems. First, the fact that a differently expressed test was used in each of these cases to ascertain whether the claimants were acting in good faith in commencing their derivative claim, against allegations that they had a collateral purpose for doing so, creates uncertainty as to whether these tests differ in substance and, if so, the appropriate test to be adopted in future cases. This in turn, creates a real risk of differing judicial opinions on these issues and consequently, complexity of case law. Second, regardless of whether the test to be adopted is the 'dominant purpose', 'but for', 'for the purpose of', or 'real purpose', this is likely to create significant difficulties for the courts in its application since it can be very challenging to clearly identify and distinguish a primary purpose from other secondary purposes.[76] This is evident from the struggles faced by the courts when dealing with the issue of the prohibition against financial assistance and having to determine whether financial assistance had been given for the 'principal purpose' of the acquisition of shares in a company.[77]

In any case, the third problem with section 263(3)(a) is that the issue of whether an applicant is acting in good faith is arguably irrelevant in the context of a derivative claim.[78] After all, the right to commence a claim against the wrongdoer(s) belongs to the company, and the derivative claim is commenced on its behalf.[79] Accordingly, any lack of good faith on the part of the derivative claimant should be irrelevant.[80] This is especially so since the court in such a case is concerned with doing justice to the company, and not to the derivative claimant.[81] Viewed from another perspective, the fact that an applicant may not have acted with full propriety should not, by itself, result

[75] *Mission Capital* (n 52) [42].
[76] Julia Tang, 'Demise of the Derivative Claim?' (2012) 1(2) UCLJLJ 178, 196.
[77] Companies Act 2006, ss 678(2), 678(4), 679(2), and 679(4); ibid.
[78] Jennifer Payne, '"Clean Hands" in Derivative Actions' [2002] CLJ 76, 81.
[79] ibid.
[80] ibid.
[81] ibid.

in the company being penalised and the wrongdoers escaping liability for their misconduct.[82]

b) Reform Proposal

In light of the foregoing problems, the requirement in section 263(3)(a) for a court to have regard to whether the applicant is acting in good faith should be removed.

While it may be argued that the removal of section 263(3)(a) would result in the proliferation of oppressive or vexatious claims which are motivated exclusively or primarily by the applicant's self-interest (such as the aforementioned 'greenmailing' claims commenced by a shareholder to pressure the company's management to purchase their shares at a higher price or claims by a competitor to disrupt the company's operations),[83] such an argument is unpersuasive.

As mentioned earlier, such claims are clearly not in the interest of the company, and will accordingly be prevented from continuing through the other factors to be considered at the second stage of the application process. This is particularly so in relation to section 263(2)(a) and section 263(3)(b) since it is clear that a director acting in accordance with the duty to promote the success of the company will not seek to continue a derivative claim that is vexatious or oppressive. Accordingly, the good faith consideration in section 263(3)(a) is not separately required to prevent such claims. Conversely, if a claim is in the interest of the company and the other criteria under section 263 are satisfied, it is difficult to see why an application to pursue a derivative claim should be barred merely because it also furthers, or is motivated by, the applicant's self-interest.[84] For the foregoing reasons, section 263(3)(a) should be removed.

D. SUPPLEMENTING THE STATUTORY REGIME ON DERIVATIVE CLAIMS

In this section, this article will examine two key issues that are currently not expressly provided for in either Part 11 of the CA 2006 or the relevant rules in the CPR relating to derivative claims. Specifically, neither the CA 2006 nor the CPR provides for multiple derivative claims, nor for a requirement that derivative claimants obtain the permission of the court to discontinue or settle a claim. As will be shown later, the

[82] Keay and Loughrey (n 49) 485-486.
[83] ibid 489.
[84] ibid 488.

failure to expressly provide for both these issues is problematic and negatively impacts on the effective functioning of the derivative claim regime. Accordingly, this article argues that both these issues should be expressly provided for.

1. *Multiple Derivative Claims*

As the Law Commission points out, a multiple derivative claim arises when a shareholder in a parent company brings a derivative claim on behalf of a subsidiary or associated company within a group of companies.[85] In this regard, a claim by a shareholder of a parent company on behalf of a subsidiary is referred to as a 'double' derivative claim and, if on behalf of a subsidiary of the aforementioned subsidiary, a 'triple' derivative claim.[86]

The importance of multiple derivative claims lies primarily in the fact that their availability helps to prevent a situation where a wrong suffered by a subsidiary company goes unredressed, and the wrongdoers escape liability, because neither the parent company nor the board of directors of the subsidiary will commence an action in respect of the wrongdoing.[87] This may be the case where the wrongdoers are in control of both the subsidiary company that has suffered a wrong as well as its parent company, and are thus in a position to prevent a claim from being commenced against them in respect of their wrongdoing. In this regard, and as Briggs J pointed out in *Universal Project Management Services v Fort Gilkicker*, 'once it is recognised that the derivative action is merely a procedural device designed to prevent a wrong going without a remedy then it is unsurprising to find the court extending *locus standi* to members of the wronged company's holding company, where the holding company is itself in the same wrongdoer control'.[88] In doing so, the availability of multiple derivative claims also provides a valuable means of ensuring that wrongdoers are not insulated from liability through the use of additional corporate layers and their control of the corporate structure.[89]

a) *The Companies Act 2006 Does Not Provide for Multiple Derivative Claims*

Notwithstanding the importance of multiple derivative claims, such claims cannot be pursued under the CA 2006. This is because section 260(1) requires that proceedings

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[85] LC Consultation Paper (n 19) para 16.51.
[86] ibid.
[87] Sarah Worthington, *Sealy and Worthington's Text, Cases, & Materials in Company Law* (11th edn, OUP 2016) 695.
[88] [2013] EWHC 348, [2013] Ch 551 [24].
[89] Pearlie Koh, 'Derivative Actions "Once Removed"' [2010] JBL 101, 102-103.

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'.[90] This, by definition, accordingly excludes multiple derivative claims from the scope of the CA 2006.[91] As a result, such claims can only be pursued under common law.[92]

The fact that the CA 2006 is silent on the issue of multiple derivative claims is consistent with the recommendation of the Law Commission that there should not be any express provision dealing with multiple derivative claims.[93] The Law Commission was of the view that it would not be 'helpful or practicable' to do so and that situations calling for its use would be 'extremely rare'.[94] Interestingly, the Company Law Review Steering Group (CLRSG) took a different view, recommending that multiple derivative claims be brought within the statutory framework.[95]

b) Problems with the Current Legal Framework and a Reform Proposal

This article agrees with the CLRSG, and takes the position that the CA 2006 should be amended to expressly allow multiple derivative claims to be commenced under the CA 2006. This could be achieved, for example, by adopting the approach set out in section 236 of the Australian Corporations Act 2001, in which standing to commence a derivative claim is not limited to a member of the company that has suffered a wrong, but includes a member of a related company within the corporate group. The rationale for this proposal is that the current legal framework, under which multiple derivative claims must be commenced under common law, is unsatisfactory and problematic. There are two separate, but overlapping, reasons for this.

First, requiring multiple derivative claims to be commenced under common law would mean that such claims would be subject to the same serious problems that plague the common law regime on derivative claims generally. As mentioned earlier, these problems include: having to contend with the complicated legal framework and rules of the common law relating to derivative claims; the possible difficulties in establishing wrongdoer control; and the fact that a claim cannot be commenced in respect of negligence by a director unless it can be shown that such negligence conferred a benefit on the director. Requiring multiple derivative claims to be commenced under the

[90] emphasis added.
[91] *Gilkicker* (n 88) [31]-[35].
[92] ibid [44]-[49].
[93] LC Report (n 27) para 6.110.
[94] ibid.
[95] CLRSG, *Developing the Framework* (URN 00/656, 2000) para 4.133.

problematic common law framework is especially questionable in the contemporary economic context in which multi-layered corporate group structures are commonly used, and may thus result in wrongs suffered by subsidiary companies going unredressed and the wrongdoers escaping liability through the use of additional corporate layers.

Second, and following from the foregoing, the exclusion of multiple derivative claims from the CA 2006 results in the problem of having a separate derivative regime for multiple derivative claims existing in parallel to the statutory regime, which is both unnecessary and unhelpful. As Briggs J pointed out in *Gilkicker,* the conclusion that Parliament had put in place a statutory regime for derivative claims by members of a wronged company alongside an 'obscure, complicated and unwieldy' common law regime for derivative claims by others 'does not commend itself as an exercise in commonsense'.[96] Further, it has also been argued that the existence of two parallel derivative regimes can cause confusion especially since different rules apply to them notwithstanding that they both pertain to derivative claims.[97] This is contrary to the desire of the Law Commission to simplify the law in relation to such claims.

For the foregoing reasons, the CA 2006 should be amended to expressly allow for multiple derivative claims to be commenced under the CA 2006. First, doing so would avoid the need to subject such claims to the problematic common law regime on derivative claims. Further, the implementation of the proposal would also remove the problem of having a parallel derivative regime for multiple derivative claims, along with the resulting uncertainty that it creates. Lastly, allowing for multiple derivative claims to be commenced under the CA 2006 would also align the UK with other common law jurisdictions in which multiple derivative claims are incorporated within the statutory framework, such as in Canada,[98] Singapore,[99] Australia,[100] and New Zealand.[101]

2. Discontinuance or Settlement of Claims

The second key issue that is currently not addressed by the CA 2006 or the CPR is a requirement for a claimant to obtain the permission of the court to discontinue or settle

[96] *Gilkicker* (n 88) [34].
[97] Andrew Keay, 'Assessing and Rethinking the Statutory Scheme for Derivative Actions under the Companies Act 2006' (2016) 16 JCLS 39, 47.
[98] Canada Business Corporations Act 1985, s 239(1).
[99] Companies Act (Chapter 50), s 216A(1).
[100] Corporations Act 2001, s 236(1).
[101] Companies Act 1993, s 165(1).

a derivative claim. This is notwithstanding the recommendation of the Law Commission for such a requirement to be expressly provided for.[102] In this section, it will be argued that the absence of such a requirement is problematic and that the CPR should accordingly be amended to expressly provide for this requirement.

a) The Risk of Collusion

As the Law Commission correctly pointed out, the absence of a requirement for a derivative claimant to obtain the permission of the court to discontinue or settle a derivative claim is problematic since it 'could give rise to serious possibilities of collusion, with the [defendant] directors buying off the claimant in disregard of the rights of the company and its members'.[103] In this regard, there is also a risk that the claimant may agree to discontinue or settle the claim against the defendant on terms disadvantageous to the company, but which may be beneficial to themselves.[104] Such terms could include, for example, a purchase of the claimant's shares at a price significantly above their market value[105] and the payment of a small amount of financial compensation by the defendant to the company which does not adequately reflect the harm suffered by the company or is disproportionately low, having regard to the expected probability of the claimant succeeding in the derivative claim and the probable compensation that may be awarded following a successful claim.[106]

The possibility that the defendant may 'buy off' the derivative claimant and that the claimant may agree to discontinue or settle the claim against the defendant on terms disadvantageous to the company, but which may be advantageous to themselves, is especially problematic given that the claimant is legally only acting in a representative capacity, on behalf of the company. Further, the company and all the other shareholders would be bound by both the decision of the claimant to discontinue or settle the claim, and the terms of such discontinuance or settlement, even though they may only be indirectly represented in the derivative claim.[107] In this regard, it has been suggested that the risk of such 'strategic' behaviour on the part of derivative claimants is an especially real one in relation to claimants that only have a small level of shareholding in the company since they arguably have less incentive to consider the impact of any

[102] LC Consultation Paper (n 19) para 17.10; LC Report (n 27) para 6.107.
[103] LC Report (n 27) para 6.107.
[104] Daniel Prentice, 'Wallersteiner v Moir: A Decade Later' [1987] Conv 167, 175.
[105] Saleem Sheikh, *A Guide to the Companies Act 2006* (Routledge-Cavendish 2008) 1055.
[106] Arad Reisberg, 'Israel: Promoting the Use of Derivative Actions' (2003) 24 CoLaw 250, 255.
[107] ibid.

discontinuance or settlement on the company and the other shareholders, or to prioritise the interests of the company and the other shareholders over their own.[108]

b) Possible Solutions Under the Current Legal Framework

Two possible, but imperfect, solutions to the aforementioned problems can be found in rule 19.9F of the CPR and section 261(4)(a) of the CA 2006, both of which give courts the discretion to make an order that court permission is to be obtained before a claim is discontinued or settled.[109] The basis for the courts to do so is clearly set out in rule 19.9F, which provides that 'where the court has given permission to continue a derivative claim, the court may order that the claim may not be discontinued, settled or compromised without the permission of the court'. The basis for the courts to make such an order under section 261(4)(a) is stated less explicitly, although it does provide that a court, on hearing an application for permission to continue a derivative claim, may 'give permission… to continue the claim on such terms as it thinks fit', which could conceivably include the requirement that court permission be obtained before the claim is discontinued or settled.

Nevertheless, rule 19.9F of the CPR and section 261(4)(a) of the CA 2006 do not provide a perfect or efficient solution to the problem since whether or not an order will be made that court permission is required before a claim is discontinued or settled is left entirely to the discretion of the courts.[110] In order to address the risk of collusion and the claimant agreeing to discontinue or settle the claim on terms disadvantageous to the company, the courts will have to proactively impose an order that court permission be obtained before a claim is discontinued or settled.[111] This is especially since the parties to the claim who are contemplating a collusive arrangement are unlikely to request that such a condition be imposed.[112] Unfortunately, it does not appear that the courts have imposed such a condition in any of the cases in which permission had been given to continue a derivative claim.[113] Accordingly, the risk, under the current legal framework, of collusion and that a derivative claimant may agree to discontinue or settle the claim against the defendant(s) on terms disadvantageous to the company is a real one.

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[108] Reisberg (n 5) 49.
[109] Victor Joffe and others, *Minority Shareholders: Law, Practice and Procedure* (5th edn, OUP 2015) 78.
[110] Keay (n 97) 50.
[111] Daniel Lightman, 'Two Aspects of the Statutory Derivative Claim' [2011] LMCLQ 142, 150.
[112] ibid.
[113] ibid.

c) Reform Proposal

For the foregoing reasons, this article argues that rule 19.9F of the CPR should be amended to expressly provide for the requirement for a claimant to obtain the permission of the court to discontinue or settle a derivative claim. This would ensure that the courts have the opportunity to scrutinise the full terms of any settlement (including details of any benefits to be provided to the claimant) and evaluate its fairness.[114] This will significantly reduce the risk of collusion and the likelihood of a derivative claimant agreeing to discontinue or settle the claim against the defendant(s) on terms disadvantageous to the company. Further, the implementation of this proposal will also place the UK in consistency with many other jurisdictions in which court permission is required to discontinue or settle a derivative claim such as in Australia,[115] the United States,[116] Singapore,[117] Hong Kong,[118] Canada,[119] and New Zealand.[120]

E. COSTS

Having examined two key problematic provisions that are currently contained in Part 11 of the CA 2006 on derivative claims and two important issues which appear to be missing from Part 11, this article will now explore the issue of costs as a barrier to commencing derivative claims. The issue of costs is an important consideration in any analysis of a derivative claim regime since even the most comprehensive statutory derivative regime will be ineffective if it cannot be accessed due to the high cost of pursuing a claim and the lack of funding.[121]

In this section, this article will first show that the issue of costs currently plays a significant role in dissuading potential claimants from commencing a derivative claim. Thereafter, this article will examine the current legal framework in relation to the issue of costs and, in doing so, show that it does not satisfactorily address the aforementioned problem, with Part 11 of the CA 2006 notably not containing any express provisions on costs. Instead, the issue of costs is only partially addressed

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[114] Reisberg (n 106) 254.
[115] Corporations Act 2001, s 240.
[116] Federal Rules of Civil Procedure, r 23.1(c).
[117] Companies Act (Chapter 50), s 216B(2).
[118] Companies Ordinance (Cap. 622), s 735.
[119] Canada Business Corporations Act 1985, s 242(2).
[120] Companies Act 1993, s 168.
[121] Arad Reisberg, 'Derivative Actions and the Funding Problem' [2006] JBL 445, 467.

through rule 19.9E of the CPR which, as will be shown later, is problematic. Accordingly, two suggestions for reform will be made.

1. *Costs as a Disincentive to Commencing Derivative Claims*

The issue of costs presents a significant disincentive on the part of any shareholder contemplating a derivative claim for three reasons.

First, given that a losing litigant will normally be ordered to pay the costs of the successful party,[122] there is a risk that a derivative claimant will have to pay both their own expenses in pursuing the claim as well as the legal costs of the defendant if the claim is unsuccessful. This risk of being saddled with significant legal costs is thus likely to deter a potential claimant unless they are highly confident of succeeding in the claim.[123]

Second, derivative claims do not provide a shareholder with any direct remedy that would make pursuing a claim worthwhile from a financial perspective.[124] This is because any damages recovered pursuant to a successful claim will go to the company, even though it is the claimant shareholder that bears the risks of having to incur heavy legal costs, especially if they lose.

While it is possible that a shareholder who commences a derivative claim may obtain an indirect financial benefit if the price of the shares of the company increases following a successful claim (which may be the case, for example, where the company receives substantial damages or financial compensation from the defendant as a result of the claim),[125] a share price appreciation following a derivative claim is not guaranteed and is subject to several factors.[126] For one, a shareholder may not always succeed in a derivative claim and it would not, in any case, be easy for a shareholder to assess the likelihood of success especially at the preliminary stage of deciding whether to commence a claim. Further, it is also possible that a derivative claim may have the converse effect of a reduction in share price.[127] This is especially since the claim could negatively impact on the company's reputation and cause a loss of confidence in the company directors.[128] In addition, studies have shown that even when there is an

[122] CPR 44.2(2)(a).
[123] John Lowry, 'Reconstructing Shareholder Actions: A Response to the Law Commission's Consultation Paper' (1997) 18 CoLaw 247, 253.
[124] Reisberg (n 121) 446.
[125] Daniel Fischel and Michael Bradley, 'Role of Liability Rules and the Derivative Suit in Corporate Law' (1985) 71 Cornell LRev 261, 278.
[126] Keay (n 97) 44.
[127] ibid.
[128] ibid.

increase in share price following a successful derivative claim, the extent of such increase, and consequently its overall effect on shareholder wealth, is generally insignificant.[129] Accordingly, the cost of pursuing a derivative claim is very likely to outweigh the indirect financial benefit which a shareholder may obtain as a result of the claim, if any.

Lastly, even assuming that a claimant can obtain an indirect financial benefit through a share price appreciation following a successful derivative claim, the fact that all shareholders will obtain such benefit, notwithstanding that it is the claimant shareholder that bears the costs and risks of pursuing the claim, gives rise to a free-rider problem.[130] Specifically, a potential claimant, being aware that the other shareholders will free-ride on these efforts, has a strong incentive to leave it to another shareholder to commence a derivative claim.[131] If, however, all shareholders share this perspective, then it may be the case that no shareholder will step forward to commence a claim even when such a claim is clearly in the benefit of the company.[132]

2. *Problems with the Present Legal Framework on Costs*

As mentioned earlier, Part 11 of the CA 2006 does not contain any provision which expressly address the aforementioned problems in relation to the issue of costs. Instead, rule 19.9E of the CPR provides a partial solution to these problems by providing courts with the discretion to order the company 'to indemnify the claimant against liability for costs incurred in the permission application or in the derivative claim or both'. This appears to reflect the decision in *Wallersteiner v Moir (No. 2)* in which it was observed that 'it is open to the court in a stockholder's derivative action to order that the company indemnify the plaintiff against the costs incurred in the action'.[133] Notwithstanding the foregoing, a closer examination will reveal that rule 19.9E of the CPR is problematic and does little to address the concerns identified earlier with respect to the issue of costs.

First, it is unclear when, and under what circumstances, an indemnity order will be made under rule 19.9E in favour of an applicant since both the CA 2006 and the CPR are silent on this issue.[134] Further, the case law is not entirely clear or consistent

[129] Fischel and Bradley (n 125) 282; Arad Reisberg, 'The Choice of Objectives and the Social Meaning of Derivative Actions' (2005) 6 EBOR 227, 248.
[130] Keay (n 97) 44.
[131] Reisberg (n 121) 446.
[132] ibid.
[133] [1975] QB 373 (CA) 407 (Scarman LJ).
[134] Arad Reisberg, 'Funding Derivative Actions: A Re-Examination of Costs and Fees as Incentives to Commerce Litigation' (2004) 4 JCLS 345, 362.

on when a court will exercise its discretion to grant an indemnity order. In this regard, while the cases of *Stainer v Lee*[135] and *Iesini*[136] suggest that an indemnity order should 'normally' be made once the applicant has obtained the permission of the court to proceed with the derivative claim, both cases do not clearly explain the exceptions to this general rule. Further, the approach suggested in both *Stainer* and *Iesini* does not appear to be consistent with the fact that an indemnity order had been granted only in approximately a quarter of the cases in which court permission to continue the derivative claim was obtained, which includes cases decided after *Stainer* and *Iesini*.[137] Accordingly, the absence of prospective certainty as to whether a court will grant a cost indemnity order will likely dissuade shareholders from commencing a derivative claim.

Second, the cases show that even when a cost indemnity order is granted, it is likely to be limited in scope and will not cover the full cost of pursuing the claim.[138] This was the case, for example, in *Stainer*, where the indemnity order was limited to £40,000, with the claimant having to obtain the permission of the court if they wished to extend the scope of the indemnity.[139] Similarly, in *Kiani v Cooper*, the court only granted a heavily circumscribed cost indemnity order since it was of the view that the claimant should be required to assume part of the risk of litigation.[140] Again, this is likely to weigh heavily on the mind of a shareholder who is contemplating whether to commence a derivative claim.

Lastly, another important limitation with respect to cost indemnity orders is that such an order does not, by itself, provide a positive incentive to commence a derivative claim.[141] Instead, such orders provide a basis for restoring a derivative claimant's financial position to what it would have been had they not decided to pursue the derivative claim.[142] In this regard, the Law Commission's view that the possibility of a cost indemnity order provides a 'significant incentive' to commence a derivative claim[143] is mistaken since such an order does not confer any additional financial benefit on a derivative claimant or result in them being financially better off than they would

[135] [2010] EWHC 1539 (Ch), [2010] All ER 56 [56].
[136] *Iesini* (n 39) [125].
[137] Keay (n 97) 57.
[138] ibid.
[139] *Stainer* (n 135) [56].
[140] [2010] EWHC 577 (Ch), [2010] All ER 97 [49].
[141] Reisberg (n 134) 355.
[142] Reisberg (n 5) 233.
[143] LC Consultation Paper (n 19) para 18.1.

have been had they not commenced the claim. Conversely, a derivative claimant faces a very real risk of incurring a substantial financial loss for the reasons mentioned earlier.

It is thus clear from the foregoing discussion that there is a significant risk that the issue of costs may discourage appropriate derivative claims from being commenced. Further, even where a claim has already been commenced, if a court does not grant a cost indemnity order to a claimant who has obtained court permission to continue their claim, or provides one which is limited or heavily circumscribed, there is a risk that the claimant may then choose not to pursue the claim.[144] In both instances, this would undermine the ability of derivative litigation to function as a key tool of corporate governance, in the ways set out at the start of this article. To address this problem, this article suggests that two changes should be made to the current legal framework.

3. *Reform Proposal 1: Mandatory Indemnity Order*

Firstly, this article proposes that rule 19.9E of the CPR should be amended to provide for the right of a derivative claimant to obtain an indemnity order once court permission to continue the claim has been obtained, regardless of the eventual outcome.[145] The indemnity order should cover the full costs incurred by the claimant in pursuing the derivative claim, provided that they are reasonable and proportionate. In contrast to the present position in which the decision as to whether to grant an indemnity order is left entirely to the discretion of the courts without any prescriptive guidance as to how such discretion should be exercised, the use of a mandatory indemnity order will provide shareholders with more certainty that they will not suffer a significant financial loss in pursuing a meritorious derivative claim.

At the same time, by limiting the scope of the indemnity order to costs that are reasonably incurred and proportionate, this ensures that companies are not saddled with significant legal costs as a result of the claimant incurring excessive expenses in pursuing the claim. This is consistent with the general position under rule 44.3(1) of the CPR in which the courts, will not 'allow costs which have been unreasonably incurred or are unreasonable in amount' when making a cost order. In this regard, rule 44.3(5) of the CPR provides additional clarity on the factors that should be taken into account in assessing whether the costs incurred are proportionate.

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[144] Keay (n 97) 58.

[145] Mahmoud Almadani, 'Derivative Actions: Does the Companies Act 2006 Offer a Way Forward?' (2009) 30 CoLaw 131, 138.

It is difficult to see why a company should not be required to pay for the reasonable costs incurred by a claimant in pursuing a derivative claim once they have obtained the permission of the court to continue it. After all, before a court grants permission to continue a derivative claim, it must consider the extensive list of factors set out in section 263 and be satisfied, among other things, that a director acting in accordance with the duty to promote the success of the company would continue the claim.[146] If so, it is questionable why the company should not be required to pay for the cost of the claim.[147] This is especially since a derivative claimant is acting on behalf of the company, with any recovery obtained pursuant to the claim accruing to the company.[148] Further, it has been persuasively argued that where a company obtains relief following a successful derivative claim but is not required to pay the costs incurred by the claimant in pursuing the claim, this amounts to unjust enrichment on the part of the company at the expense of the claimant since the company has essentially obtained the benefit of the claimant's efforts.[149]

4. *Reform Proposal 2: Rewarding Derivative Claimants*

It is clear from the previous discussion that the introduction of a mandatory indemnity order, for claimants who have obtained court permission to pursue their derivative claim, will help provide shareholders with more certainty that they will not suffer a significant financial loss in pursuing a meritorious derivative claim. Nevertheless, the analysis should not stop there since it has also been shown earlier that a cost indemnity order does not, by itself, produce a positive inducement to commence a derivative claim. Therefore, this article proposes that either the CA 2006 or the CPR should be amended to provide courts with the discretion to reward derivative claimants in monetary terms following a successful claim.[150]

With respect to the quantum of the reward, this can be limited to a reasonable percentage of the proceeds of a successful action or, in cases where the relief obtained by the company is non-monetary, a reasonable amount that is reflective of the benefit obtained by the company as a result of the successful claim.[151] With respect to the former, the court would direct the losing defendant to pay the allocated sum to the

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[146] Companies Act 2006, ss 263(2)(a) and 263(3)(b); *Iesini* (n 39) [86].
[147] Ian Ramsay, 'Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 UNSWLJ 149, 164.
[148] Reisberg (n 5) 249.
[149] Ramsay (n 147) 164.
[150] Reisberg (n 134) 373.
[151] Reisberg (n 5) 247.

claimant directly, while the latter would involve the court directing that a specified amount be paid to the claimant by the company. Both options produce a fair outcome since the amount of the claimant's monetary reward is directly derived from, and is proportionate to, the benefit that is obtained by the company.[152]

Further, the concept of providing a personal financial reward to a derivative claimant is not new and has been adopted in several jurisdictions,[153] such as Israel[154] and New Zealand.[155] Accordingly, there is a sizeable amount of foreign case law that can provide useful guidance in relation to any difficulties that may arise as to how the courts should exercise their discretion to reward derivative claimants. For example, in cases where the relief obtained by the company is non-pecuniary, reference may be made to Israeli case law in relation to the issue of how to calculate the quantum of reward in such a case since section 201 of the Israeli Companies Law 5759-1999 is broadly similar to the aforementioned proposal, providing that '[w]here the court rules in favor of the company, it may order the payment of a reward to the plaintiff taking into account, *inter alia*, the benefit derived by the company from filing the claim and winning it'. This may include, for instance, consideration of the severity and extent of the harm suffered by the company caused by the wrongdoers.[156]

a) Rationale

There are several reasons why the courts should be provided with a discretion to reward derivative claimants in monetary terms following a successful claim.

First, the same justifications for the implementation of a mandatory indemnity order mentioned earlier, including the fact that the derivative claimant has essentially worked for the benefit of the company,[157] similarly apply in this case. The difference here, however, is that even with the benefit of a cost indemnity order, the absence of a personal financial reward would mean that a derivative claimant would be in no better position than the other shareholders who had not made any effort to support the claim.[158]

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[152] ibid.
[153] ibid 249.
[154] Companies Law 5759-1999, s 201.
[155] Companies Act 1993, s 167(d).
[156] Arad Reisberg, 'Access to Justice or Justice Not Accessed: Is There a Case for Public Funding of Derivative Claims?' (2011) 37 BrookJInt'l L 1021, 1036.
[157] Reisberg (n 134) 373.
[158] ibid 374-375.

Second, and perhaps most importantly, the possibility of a financial reward provides shareholders with an incentive to commence a meritorious derivative claim. In this regard, it has been persuasively argued that the use of a financial inducement is consistent with the nature of derivative claims since it is both expected and hoped that a shareholder will initiate a claim.[159] After all, without the willingness of a shareholder to commence a claim, the effect may be that the wrong against the company goes unaddressed, with the company consequently not obtaining any remedy.[160] In addition, the possibility of a financial reward provides an efficient solution to the shareholder free-rider problem identified earlier since there would be a positive incentive for shareholders to commence a claim.

It is thus clear from the foregoing discussion that the implementation of both the proposals, for a mandatory indemnity order and for the courts to be given the discretion to provide successful derivative claimants with a financial reward, will play a significant role in addressing the serious problems associated with costs identified at the beginning of this section. In particular, these proposals will place derivative claimants on a more secure financial footing and make commencing a claim a sufficiently viable course of action. At the same time, and as explained earlier, there is sufficient protection against the commencement of vexatious and frivolous claims since such claims are clearly not in the interest of the company, and will accordingly be prevented by the courts from continuing through the factors to be considered at the second stage of the application process. This is particularly so in relation to section 263(2)(a) and section 263(3)(b) since it is clear that a director acting in accordance with the duty to promote the success of the company would not seek to continue a derivative claim that is vexatious or oppressive.

F. CONCLUSION

The statutory derivative regime under Part 11 of the CA 2006, in many respects, represents a significant improvement from the common law regime on derivative claims. Nevertheless, the statutory framework on derivative claims is not without its share of problems. In this regard, this article has sought to identify some of the key problems with the statutory derivative regime, and to thereafter provide suggestions for reform. This was done through three broad areas of focus.

[159] ibid 375.
[160] ibid.

First, this article focused on the current provisions set out in Part 11, and identified two problematic requirements which are: the need under section 261(2) for a *prima facie* case to be established; and the requirement under section 263(3)(a) for the court to have regard to an applicant's good faith in deciding whether to allow a derivative claim to continue. As shown earlier, both these requirements are unnecessary, and are likely to result, among other things, in uncertainty as well as additional time and costs being incurred in the application process. On this basis, both requirements should be removed.

Next, this article shifted its focus to key omissions from both Part 11 of the CA 2006 and the relevant procedural rules relating to derivative claims. In doing so, it was shown that the failure to expressly provide for both multiple derivative claims and a requirement for court permission to discontinue or settle a claim is regrettable. With regard to the former, this has resulted in the need for multiple derivative claims to be pursued under the problematic common law regime which, in turn, creates a significant risk that wrongs suffered by subsidiary companies may go unredressed, with the wrongdoers escaping liability through the use of additional corporate layers. As for the absence of a requirement for court permission to discontinue or settle a claim, this creates the risk of collusion between defendants and claimants, which could result in the former escaping liability and a settlement or discontinuance on terms disadvantageous to the company. For the foregoing reasons, both of these issues should be expressly provided for.

Lastly, this article explored the issue of costs in the context of derivative claims and, in doing so, showed that costs currently play a significant role in dissuading potential claimants from commencing a derivative claim. To address this problem, this article proposed the introduction of a mandatory indemnity order and for courts to be provided with the discretion to reward derivative claimants in monetary terms following a successful claim.

The problems identified in this article with respect to the current framework under the CA 2006 on derivative claims are serious and may adversely affect the effective functioning of the derivative regime. Accordingly, there is a strong impetus for these problems to be addressed, which can be done through the implementation of the proposals discussed earlier. Doing so will, in turn, help ensure that derivative claims can fulfil their potential as a key tool of corporate governance, in the ways set out at the start of this article.