Derivative Actions

Taking matters into one’s own hands or when is it possible to make a claim when you are not the legal owner of the right of action?

Introduction

1. Thank you for coming this evening for my talk on derivative actions. In case anybody has come under a misapprehension, this talk is not, at least not directly, about derivatives, in the sense used in the City, though it is conceivable that there may be circumstances in which the holders of such instruments might seek to try and bring a derivative action. Derivative actions is however a subject I know a great deal about having taken, what is now the leading case on derivative actions, to the Supreme Court, *Roberts v Gill* [2011] 1 AC 240.

2. If anybody has tried to read the case, they will have realized that I lost at every stage, albeit with the help of Leslie Blohm QC in the Supreme Court. It was a fascinating case, that was one of the very the last ever petitions considered by the House of Lords and the first major decision of the Supreme Court in the fields of professional negligence, limitation and trusts.

3. I am not however going to bore you with the details of the case, which would require a detailed excursion into the law of limitation and procedure. For those of you interested I have included in your pack a copy of the report of the case in Appeal Cases and a recent article I have written on the case for Trusts and Trustees.

4. Rather I am going to use this talk to outline, in hopefully quite short order, the fundamental principles of derivative actions and procedural considerations in the different circumstances in which they can arise.
Principles

5. A derivative action is an exception to the general rule that the only person entitled to enforce a cause of action is the person recognized at law as being entitled to do so.

6. The words at law are of significance. Before the Judicature Acts a cause of action was a concept known only to the law, equity had suits, not actions. A cause of action was, and still is, so far as the law is concerned "...simply a factual situation the existence of which entitles one person to obtain from the Court a remedy from another person." - Letang v. Cooper [1965] 1 QB 232 per Diplock L.J. at pp.242-3.

7. There are 2 elements to this definition (i) factual, something has in fact happened which (ii) entitles someone to obtain a remedy from the court. That person is the person entitled to the right of action, which is personal property – i.e. a chose in action.

8. In a derivative action someone other than the owner of the right of action is entitled or permitted by the court to pursue the cause of action on behalf of the owner, standing in his shoes.

9. The typical claimant in a derivative action is a beneficiary of a trust or estate, shareholder in a company, individual partner in a partnership, member of a trade union or, where there is an insolvency situation a creditor. A typical cause of action to be pursued by way of derivative action is breach of fiduciary duty by an office holder of the entity which the claimant is interested in or a tracing claim, but it can apply to an ordinary claim against a third party, which for some reason the entity can’t or won’t pursue.

10. The fundamental concept that is that a derivative action is an example of a court of equity providing a remedy in order to prevent injustice.

11. For companies, the famous case of Foss v Harbottle (1843) 2 Hare 461 laid down the general rule that only the company is entitled take action in respect of wrongs committed against the company. But this was only ever a general rule and as the
Master of the Rolls Sir George Jessel said in *Russell v. Wakefield Water Works Company* (1875) LR 20 Eq 474 it is “not a universal rule; that is, it is a rule subject to exceptions, and exceptions depend very much on the necessity of the case; that is the necessity for the court doing justice”.

12. In the same judgment he explained that the basis for the rule in *Foss v Harbottle* is that, though company property is trust property in the sense that the agents of the company only hold the property on trust to apply it to the special purposes of the company – i.e. a form of purpose trust, the shareholders do not therefore have any proprietary interest in the assets of the company for the time being, merely being the ultimate beneficiaries of the trust. In other words the shareholders only gain a proprietary interest in the balance of the assets of the company once the winding up the company’s business is complete.

13. Such a situation is not however unique to companies and similar arrangements arise for instance in partnerships and the administration of Estates. With partnerships during the continuance of the partnership with the partnership property belongs to the partners as a body who hold the assets on trust for the purposes of the partnership and the individual partners only have the right to insist that the assets are applied to such purposes unless and until the business of the partnership is wound up and they become entitled to any balance of the partnership assets. Similarly in the administration of Estates the personal representatives of the deceased’s hold the assets of the estate on trust to apply the assets for the purposes of administering the estate and it is only once the administration is complete that the beneficiaries obtain a vested interest in the assets that make up the estate.

14. Again in each of these cases the general rule is that it is for the partners or the personal representatives of the deceased to take any action on behalf of the partnership for the estate.

15. The courts long before companies became a commonplace vehicle for enterprise allowed partners or the beneficiaries of trusts and estates to take action in exceptional circumstances.
16. Before turning to the circumstances in which such claims can be maintained it is worth considering the position where the beneficiary does have a vested interest in the chose in action.

17. Before the Judicature Acts were passed in the 1870s there was no question of the beneficial owner of an asset, such as the assignee of the benefit of a contractual debt, file being permitted to bring an action in the courts of law to enforce his rights. Rather his remedies lay in the courts of chancery.

18. After the Judicature Acts the problems created by different courts having different jurisdictions was solved by vesting both existing jurisdictions in the new High Court, which was then able to grant both legal and equitable remedies, being required by law to prefer equitable principles in the event of any conflict – section 49(1) Senior Courts Act 1981.

19. The result per Lord Macnaghten in William Brandt’s Sons v Dunlop Rubber Co. [1905] AC 454 was that no action should be dismissed for want of parties. In that case the equitable assignee of a debt was permitted to enforce the debt and obtain judgement even though the legal owner of the debt was not before the court. That was controversial as far as common lawyers were concerned who maintained that for the court’s jurisdiction to be engaged the legal owner needed to be before the court. That controversy was noted in Roberts v Gill but another nail has been driven into its coffin by a case in the Court of Appeal decided last Wednesday Kapoor v National Westminster Bank Plc [2011] EWCA Civ 1083 in which Lord Justice Etherton analysing a number of the same cases as we had to Roberts v Gill has held that the requirement to join the legal owner of the cause of action was procedural only and that “I do not shared the doubts and misgivings expressed by... the academic commentators”. It followed that the person entitled to recover the debt in court proceedings was the beneficial owner of the debt end he was the person entitled to vote in a creditors meeting call to consider the approval of an IVA, which was the issue in the case.
20. The same is true for one both joint owners of the shows an action, though in this situation the action should probably be stayed after issue to ascertain the views of the joint owners as to whether the action should proceed - *Harmer v Armstrong* [1934] Ch 65. This would entail a *Beddoes* type procedure.

21. In the same category I would put an unpaid creditor or legatee of an estate who can bring proceedings directly against someone who was wrong only received assets of the estate as a mere volunteer *Re Diplock* [1948] Ch 465 principles without joining the personal reps.

22. When talking about a true derivative action, one is therefore only talking about a situation where someone who does not have a vested interest in the cause of action wants to bring the proceedings. What then are the circumstances in which a derivative action can be maintained?

23. The very early cases from the 18th-century classically spoke of insolvency or collusion. As far as insolvency was concerned, if the legal owner could not pursue the action because of his own insolvency, then a creditor or beneficiary might be permitted to pursue the matter. Nowadays there are other remedies available in such circumstances, such as appointing receiver or replacing a personal representative or trustee. As we will see, if other remedies are available, this will be a factor against permitting a derivative action.

24. Collusion on the other hand was and remains the most likely circumstance in which a derivative action will be permitted. If the legal owner is himself involved in the wrongdoing, then as he is not going to sue or implicate himself and the beneficiary may be deprived of a remedy unless he is permitted to bring the action. In a trusts or estates situation it may well be the more appropriate remedy is to remove the offending trustee or personal representative. In a company or trade union situation, where the wrongdoers are in control or the majority of the shareholder or members are not interested, this however is not an option. Alternative remedies can however often be cumbersome and expensive and it is certainly my view that may well be circumstances where a good argument can be made out that pursuing a derivative
action is simpler and preferable in the interests of justice, often allowing the court to provide a bespoke procedure.

25. Before Roberts v Gill & Co the leading case in the context of trusts and estates was the Privy Council case of Hayim v Citibank [1987] AC 730 where it was held that:

   “a beneficiary had no cause of action against a third party save in special circumstances which embrace a failure, excusable or inexcusable, by the trustees in the performance of the duty owed to the beneficiary to protect the trust estate or to protect the interests of the beneficiary in the trust estate” - at 748F.

26. This passage was approved in Roberts v Gill, but it was explained as meaning no more than it will be permitted whenever justice demands.

27. As however it is an example of equity providing a remedy where no other reasonable route exists, as modern remedies have been developed, particularly in insolvency law and company law, the necessity on falling back on the inherent equitable jurisdiction, making an appeal to justice is much diminished. Indeed there is a particular problem in company law, because there has been a purported attempt to codify by statute the circumstances in which a derivative action can be brought, which has the potential to cause its own problems.

28. The bottom line, however, is that there are no hard and fast rules as to when a derivative action can be brought, it is an exercise of the prerogative jurisdiction delegated to the courts of chancery in the middle ages and will always remain to fill lacunae in the positive law and established remedies.

29. The only qualification for bringing a derivative action is per Lord Millett NPJ in Hong Kong Court of Final Appeal Waddington Ltd v Chan Chun Hoo Thomas and anor [2008] HKCU 1381, [2009] 2 BCLC 82, which was cited in Roberts v Gill, is a legitimate interest in the relief claimed sufficient to justify him in bringing proceedings to obtain it.
30. Indeed a derivative action in many ways resembles and can be regarded as the private law equivalent of a judicial review claim, where sufficient standing is the only qualification.

31. With an outline of the principles, or lack of, in relation to the circumstances in which a derivative action can be brought, I will now turn to the practice and procedure in particular areas of law.

**Companies**

32. I will start with companies because it is in the context of companies that one usually thinks of derivative actions and it appears to be one area in which attempts have been made to positively encourage them. Further the procedure, at least on face of it, is now entirely statutory and therefore most accessible.

33. If one goes back to Sir George Jessel in *Russell v Wakefield Water Works* the test was stated as the needs of justice and the Master of the Rolls gave examples of the sort of exceptional circumstances in which a derivative action might arise on the basis of the state authorities state of the authorities at that time. Firstly where shareholder was seeking to prevent the company doing something that was outside its powers and secondly when the company was refraining from bringing an action because of majority wrongdoer control. But these were only examples.

34. Over time what came to be known as the exceptions to the rule in *Foss v Harbottle* solidified into a tortuous set of criteria which have to be satisfied before a derivative action would be allowed. One is tempted to wonder whether this may have been the realisation of concerns expressed both by the senior and junior bar in the consultation the lead up to the Judicature Acts, that the doctrines and practice of equity would be threatened by it’s administration by a body of judges three quarters of whom were the common law judges.

35. Whatever may have been the reason for it, however, the subject derivative actions was revisited when the Law Commission reviewed shareholders remedies in the mid-1990s. Their concerns were twofold firstly that the exceptions to the rule in
Foss v Harbottle had become “rigid, old-fashioned and unclear.” And secondly that the most widely used remedy available to minority shareholders who are unhappy with the way the business was being run was to bring an unfair prejudice petition but experience had shown that such procedure was “cumbersome and expensive”.

36. The experience in America, where derivative actions are much more common and more readily allowed, is that they can be used as an effective check on corporate misbehaviour in both small and large companies. One example I came across in researching this lecture was a challenge to the remuneration package the management of the company had awarded themselves.

37. The proposal which was adopted was to provide a new procedure the derivative actions and statutory criteria to be applied when deciding whether or not to allow such a procedure.

38. The provisions contained in what is now part 2 chapter 1 of the companies act 2006. Section 260 (1) defines a derivative claim as being proceedings by a member of the company in respect than cause of action invested in the company and seeking relief on behalf of the company. By section 262 a derivative claim may only be bought in accordance with the statue provisions set out in that chapter or pursuant in order of court under section 994.

39. Pausing there it is to be noted that it has always been the case that relief may be granted under section 996 Companies Act 2006 on an unfair prejudice petition authorising civil proceedings to be brought in the name and on behalf the company by such personal persons and on such terms as the court may direct.

40. The second point to note if that section 261 defines a derivative claim as being proceedings brought by a member. The Hong Kong case I mentioned earlier, Waddington, in which Lord Millett made clear that one only needed a sufficient interest in the outcome to bring a derivative action was in fact a case where a member of the subsidiary company was permitted to bring a derivative action on behalf the holding company, the so-called double derivative action. A similar case in
this country would still be a common-law derivative action and not a derivative claim under the act.

41. Returning to the statutory provisions, section 260 (3) provides a derivative claim may be bought only in respect of the cause of action arising from an actual proposed act or omission involving negligence, default, breach of duty or breach of trust by a director or shadow director of the company. No doubt such breach of duty could be inexcusable or excusable, as in a trust case – *Hayim v Citibank*. Such a breach of duty does however have to be identified. The cause of action may be against the director or another person (or both). It is further immaterial whether the cause of action arose before or after the person seeking to bring or continue the derivative claim became a member of the company.

42. The person who brings a derivative claim must apply to the court permission to continue it –section 261 (1). The rules of court which regulate the making of such an application are set out in CPR Part 19.

43. Under CPR 19.9 which applies to derivative claim involving a company other body corporate or trade union requires that the company body corporate or trade union be made a defendant the claimant and after the issue the claim form the claimant cannot take any further step in the proceedings without the permission of the court other than those provided by for the rules or making an urgent application the interim relief.

44. Under CPR 19.9A in relation to a derivative claim involving a company an application for permission to continue the claim must be made at the same time as the claim form is issued. The claimant must not however make the company a respondent to the permission application, though the company must be notified of the application. The rule anticipates that the application for permission will in the first instance be dealt with on paper, if dismissed the claimant can renew the application at an oral hearing as on an appeal, but if the application is not dismissed then the court will order that the company and any other appropriate parties be made respondents to the application.
45. The criteria for granting permission are set out in section 263. Section 263 (2) sets out a number of circumstances in which the applications permission must be refused (a) if a person acting in accordance with the duty to promote the success of the company would not seek to continue the claim or (b) the cause of action arises from act or omission that is yet to occur, that the act or omission has been authorised by the company, or (c) where the cause of action arises from act or omission that has already occurred, that the act or omission – (1) was authorised by the company before it occurred, or (2) has been ratified by the company since it occurred.

46. Then in section 263 (3) a number of factors set out the court must take into account (a) whether the members act in good faith in seeking to continue the claim – or in other words are not pursing it for some collateral advantage (though an element of collateral advantage may be acceptable - *Iesini v Westrip Holdings Ltd* [2011] 1 BCLC 498) (b) the importance that a person acting in accordance with section when his duty to promote the success the company would attach to continuing it (c) where the course of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be one authorised by the company before it occurs, or (2) ratified by the company after it occurs (d) where the cause of action arises from an act or omission that has already occurred, with the act or omission could be, and in the circumstance would be likely to be, ratified by the company (e) whether the companies decided not to pursue the claim (f) but the act or omission in respect of which the claimant is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf the company.

47. There is then the somewhat problematic provision in section 263 (4) in considering whether to give permission the court shall have particular regard to any evidence with forgers to the views of members of the company will have no personal interest, direct or indirect, in the matter. As recently pointed out by Mr Justice (now Lord Justice) Lewison in *Iesini* on the face of it members of the company necessarily have an interest in the matter.
48. There is now a substantial body of case law on the application but the new provisions. There is not scope in this lecture for a review of all the authorities, which have in any event been authoritatively reviewed by Lewison J in *Iesini v Westrip Holdings Ltd* [2011] 1 BCLC 498. Just a couple of points, though it used to be thought that the availability of an alternative remedy was an absolute bar to bringing a derivative action, that is no longer the case, and the availability of such a remedy, e.g. a unfair prejudice petition, is just one factor to be taken into account. There are 2 routes to a derivative action either under an unfair prejudice petition, which may be more appropriate where the company has properly authorised the conduct, albeit unfairly.

49. If permission is obtained to bring a derivative claim, then the claimant will generally be entitled to an indemnity in respect of their costs from the company and in a company case, as in other cases, it will always be an important consideration whether further assets should be risked in the proceedings.

50. There are additional provisions in CPR19.9C in relation to applications for permission to continue a derivative claim in respect of other corporate bodies or trade unions that adopts the companies act procedure with necessary changes.

**Insolvent companies**

51. A creditor or contributory can always seek permission under section 212 Insolvency Act 1986 to bring misfeasance proceedings against directors or former directors or other office holders, including a liquidator or administrator.

52. Otherwise one would expect a creditor or contributory’s primary remedy to be to put the relevant office holder in funds to pursue any action, take an assignment of the cause of action or obtain authorization to bring proceedings in the company’s name.

53. It is not however impossible that there may be circumstances in which a derivative action might be appropriate. Indeed the inference from *Waddington* is that a
derivative action analysis would have been preferable to the fudge that was *Giles v Rhind* [2003] 1 BCLC 1.

**Trusts and Estates**

54. Derivative actions in relation to trusts and estates are not specifically covered by the rules, but in *Roberts v Gill* it was held that the procedural requirement in CPR19.9 that the legal owner be made party to the proceedings applied by analogy.

55. The important factors will again be whether or not there are alternative remedies.

56. Perhaps a good example, though in my view often misrepresented, is the well known or infamous case of *Ingall v Moran* [1944] KB 160, where proceedings under the Fatal Accidents Act which were started purportedly as administrator of an estate but before obtaining a grant, was struck out as a nullity, by which time the limitation period had expired.

57. In that case Goddard LJ pointed out that there was old authority that a derivative action might be brought by a beneficiary before anybody had obtained a grant of administration in order to protect the estate, although the modern procedure would probably be to seek to have a receiver appointed.

58. In many cases it may still be preferable to put a trustee, executor or administrator in funds to bring the action; negotiate an assignment of the cause of action; obtain authority to bring proceedings in the name of trustee; seek the appointment of a receiver; or bring administration proceedings etc. If, however, none of the more usual procedures are likely to bear fruit or perhaps would be unduly cumbersome and expensive, it may be legitimate to start derivative proceedings, if only in order to bring matters to a head. If so, then consideration should be given to seeking an immediate stay in order to undertake a Beddoe’s type process to determine whether the action should be proceeded with at all, and if so by whom and upon what terms, taking into account all interested parties’ positions.

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