IN the context of increasing shareholder activism in the UK, it is interesting to reflect upon the apprehension that greeted the introduction of the statutory regime for derivative claims in the Companies Act 2006 (the Act). There were some fears that this development, alongside the wide discretion afforded to the courts in assessing the existence of unfairly prejudicial conduct, might herald a wave of new shareholder litigation. However, as explained below, these fears seem not to have materialised.

In this article we consider some of the key English cases which illustrate how judges have sought to keep derivative claims and unfair prejudice petitions within measured bounds since the Act. We also briefly touch upon other alternative avenues shareholders may use to assert their rights.

The regime for redress

Before reviewing the cases it is helpful to recap the two main methods shareholders may use to protect their rights.

Sections 260 to 264 of the Act provide the statutory footing for derivative claims which previously existed at common law (replacing the problematic Foss vs. Harbottle jurisprudence). The
distinguishing feature of a derivative claim is that the action, though initiated by a shareholder, is brought in the name of the company and permission of the court is required to continue the claim.

Section 994 of the Act, meanwhile, replicates the wording of section 459 of the Companies Act 1985 which previously governed unfair prejudice petitions. Unlike a derivative action, a section 994 petition is brought in the name of the shareholder who will allege that the company’s affairs are being conducted in a manner which is unfairly prejudicial to the company’s shareholders.

While not the focus of this article we should also briefly mention the separate common law principle deriving from Allen vs. Gold Reefs of West Africa Ltd whereby any alteration to a company’s articles must be approved by the requisite number of shareholders voting bona fide and for the benefit of the company as a whole. The principle was recently considered by the Court of Appeal in Arbuthnott vs. Bonnyman and others. While the Arbuthnott judgment is a useful reminder that the Allen principle remains a freestanding right, the reality is that any resolution which offends the Allen principle will almost inevitably also be unfair and prejudicial for the purposes of section 994.

**Establishing sufficient misconduct**

A common feature of both derivative claims and unfair prejudice petitions is that the extent of any misconduct will be an important consideration when judicial discretion is being exercised.

In bringing a derivative claim there is no firm threshold with regard to establishing misconduct. Instead, the courts will take into account the six non-exclusive factors under section 263(3) of the Act, combined with the strength of the overall case. Lesini vs. Westrip Holdings Ltd and Stainer vs. Lee are useful examples. In the first case, the judge emphasised the importance of the derivative action being based on an act or omission involving negligence, default or breach of duty by a director. As the directors had followed the advice of eminent professionals, the judge considered that they had not been negligent or breached their duties. The strength of the claim against the board was so weak that no director, acting in accordance with section 172, would pursue the claim. In the second case, the court declined to exercise its power to grant permission to proceed with the claim to trial, but instead only granted limited permission until after disclosure. Although the court was satisfied that Mr Stainer had a “well arguable” case, that position would need to be reconsidered once disclosure was exchanged. It was also apparent in Stainer that the level of recovery is a relevant consideration. The weaker the claim, the greater the amount of potential recovery must be in order to secure permission to continue.

In Kleanthous vs. Paphitis, Mr Kleanthous, a shareholder in Ryman Group Limited, complained
that the directors (Mr Paphitis and others) had committed serious and fraudulent breaches of their fiduciary duties by acquiring the lingerie chain La Senza, themselves, when Ryman decided not to proceed with the purchase. A number of matters listed under section 263 were of significance – in particular, very strong weight was accorded to the fact that independent committees established by the company had specifically chosen not to pursue the claim. It was also significant that the Ryman Group had kept detailed records, including minutes of board meetings, which recorded the reasons the directors gave for not wanting to acquire La Senza but were prepared to support Mr Paphitis’ acquisition of it.

Even if a shareholder has a strong case (which Mr Kleanthous did not) considerable caution will be applied if a company has already actively considered the position, with the benefit of independent advice, but chosen not to pursue a claim.

Similarly, in unfair prejudice petitions, any alleged mismanagement must be sufficiently serious to amount to unfairly prejudicial conduct. In Martin Boughtwood vs Oak Investment Partners XII the claimant and defendant agreed to run a business developing in-wheel electric motors as a ‘quasi-partnership’. Both parties argued that the other was culpable of unfair prejudice. It was found that an attempted coup by the defendant was unconstitutional and his destructive interference in management was sufficient to amount to unfairly prejudicial conduct, whereas the claimant’s breaches of
its disclosure obligations as a quasi-partner in two respects was not. Essentially, mere mismanagement was not enough to establish unfairly prejudicial conduct. The court will also not second-guess decisions which in hindsight turn out to have been unwise.

It also bears noting that any mismanagement for unfair prejudice purposes must also be connected to the affairs of the company, rather than the affairs of another shareholder. The most high profile dispute on this point remains the well-reported case of McKillen vs. Misland (Cyprus) Investments Ltd, in which the Court of Appeal confirmed that the breach of a pre-emption clause in a shareholder’s agreement or articles is unlikely to result in section 994 relief, as the breach relates to a dispute amongst shareholders rather than the conduct of the company’s affairs. While prejudice is a wide concept and unfairness is fairly elastic, the conduct must still relate to company management, rather than the actions of shareholders in their capacity as such. This can be a tricky hurdle to overcome.

Alternative remedies
Another recurrent issue is the relevance of alternative options or legal remedies. The reported cases have indicated that the courts are unlikely to grant permission to continue a derivative claim where there is an alternative, typically an unfair prejudice petition. In Franbar Holdings Ltd vs. Patel, Franbar (25 percent interest) alleged
that the directors of the company that had been appointed by Casualty Plus (the remaining interest) had improperly diverted business opportunities away from the company and wrongly suspended a director. In refusing permission, considerable weight was given to the fact that the applicant “should be able to achieve all that it can properly want through the section 994 petition and the shareholders’ action”. In *Kleanthous vs. Paphitis* a further powerful reason for refusing to grant permission was the availability of a remedy under section 994. Derivative claims tend to be a remedy of last resort.

*Fulham Football Club Ltd vs. Richards* confirms that the section 994 jurisdiction is not inalienable where there is a valid arbitration agreement. Fulham Football Club brought an unfair prejudice petition notwithstanding the Football Association Premier League and Football Association rules containing widely drafted arbitration clauses. In staying Fulham’s petition, the Court of Appeal confirmed that unfair prejudice petitions may be referred to arbitration in preference, and are not the preserve of the courts. This has resolved any uncertainty regarding the extent to which parties may agree to submit corporate disputes, in particular claims under company legislation, to arbitration.

**Majority shareholders**

Case law since the Act has also confirmed that the scope for majority shareholders successfully to bring claims will be extremely limited.

In *Cinematic Finance Ltd vs. Ryder*, Cinematic granted loans to, and became the sole and majority shareholder of, several investment companies. Its attempt subsequently to pursue a derivative action against the former directors of the investment companies for alleged breach of their fiduciary duties was refused as Cinematic had control over the companies and so any derivative action was unnecessary and inappropriate. The court did not say that permission would never be granted to a majority shareholder but confirmed that it would only be granted in exceptional circumstances. While the courts have displayed a slightly greater willingness to entertain actions initiated by majority shareholders...
shareholders in unfair prejudice petitions it still remains exceptional. This is unsurprising as a majority shareholder will generally have control over the composition of the board of directors and should be able to put right any prejudice that may have been suffered. That said, although rare, it is possible that there may be more complex situations, for example where a majority shareholder does not control board appointments because of provisions in the articles of association, and it is possible that an action by the majority shareholder could proceed.

**Alternative strategies**

Given the limits of litigation, what other strategies are open to shareholder activists to achieve their aims? While many will spend their time talking to the company to agree a consensus, others will be more vociferous. Such investors tend to escalate concerns by, for instance, making public statements in advance of shareholder meetings, requisitioning AGM resolutions, speaking at shareholder meetings, requisitioning shareholder meetings, proposing to change board membership, and exercising tactical voting by voting against or abstaining from voting on resolutions. Collective action by shareholders could also increase. The Investor Forum, which was established last year, has potentially provided a new platform for collective engagement by investors when company engagement is not satisfactory (although it has had a low profile to date).

Key to addressing shareholder concerns is engagement. Engagement gives shareholders the ability to air any concerns with the company and gives the company the opportunity to try and address any such concerns before matters become too hostile and potentially litigious.

**Conclusion**

While shareholders have powerful tools in their arsenal to protect their rights through litigation, in practice, as demonstrated by recent cases, any fear that there would be a wave of speculative claims has proven to be misplaced. The court has shown willingness to place limits on such claims. Of course, shareholders will continue to test the court’s approach in derivative claims and unfair prejudice petitions, although in the public company arena the tactics mentioned above are more likely than litigation.

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