# IS THE DEMAND REQUIREMENT OBSOLETE? HOW THE UNITED KINGDOM MODERNIZED ITS SHAREHOLDER DERIVATIVE PROCEDURE AND WHAT THE UNITED STATES CAN LEARN FROM IT

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## INTRODUCTION

For many investors, buying ownership in a corporation is an attractive alternative to placing money in lower-yield accounts.[1] Shareholders, ranging from low-income workers to wealthy businesspersons, purchase stock in a corporation to realize a greater return on their investment.[2] In doing so, shareholders put their trust in the board of directors to manage the corporation, and their investment, wisely.[3] Unfortunately, sometimes directors make unwise or even reckless decisions that adversely affect the corporation. This was especially apparent in 2008 with the collapse of many financial and banking giants due, in part, to careless investment decisions by corporate management.[4] For example, institutions such as Bear Stearns and AIG suffered tremendous losses due to ill-advised investment decisions, which led to government intervention in an attempt to stave off a greater global collapse of the financial markets.[5] In both instances, shareholders

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1 *See* LAW COMM'N FOR ENGLAND & WALES, SHAREHOLDER REMEDIES, CONSULTATION PAPER NO. 142, para. 1.1 (1996), *available at* http://www.lawcom.gov.uk/docs/cp142.pdf [hereinafter CONSULTATION PAPER 142]. *See also* U.S. Sec. & Exchange Comm'n, Determine Your Risk Tolerance, http://www.sec.gov/investor/pubs/roadmap/risk.htm (last visited Mar. 25, 2010).

2 *See*, *e.g.*, CONSULTATION PAPER 142, *supra* note 1, ¶ 1.1.

3 *See* Mohammed B. Hemraj, *The Business Judgment Rule in Corporate Law*, 15 INT'L CO. & COM. L. REV. 192, 192-93 (2004).

4 *See Shareholder Sues Lehman Brothers*, BBC NEWS, June 20, 2008, http://news.bbc.co.uk/2/hi/business/7464946.stm; *see also* Michael Orey, *Wall Street Bailout: Now, the Lawsuits*, BUSINESSWEEK, Sept. 22, 2008, *available at* http://www.businessweek.com/bwdaily/dnflash/content/sep2008/db20080921_633015.htm?chan=rss_topStories_ssi_5; *see also In re* Citigroup Shareholder Derivative Litig., 964 A.2d 106, 106 (Del. Ch. 2009) (alleging directors' "fail[ure] to adequately protect the corporation from exposure to the subprime lending market").

5 Janet Whitman, *Bear, AIG Sued Over Subprime Exposure*, N.Y. POST, Nov. 21, 2007, *available at* http://www.nypost.com/seven/11212007/business/bear_aig_sued_over_subprime_exposure_

filed derivative litigation against the directors of AIG and Bear Stearns because of overexposure to subprime mortgages, which cost both companies "more than $1 billion each in losses."[6] Moreover, since 2002 there has been over 1,300 corporate fraud convictions, 200 of which were CEOs or Presidents.[7] In the wake of these corporate calamities, the United States has an opportunity to re-examine shareholder remedies and, in particular, the use of shareholder derivative litigation as a means of recovery for corporate wrongdoing.

Shareholder derivative litigation is one possible avenue for shareholders to seek recourse when directors' actions have harmed the corporation. Essentially, a shareholder derivative action allows a shareholder to monitor and remedy harm inflicted upon the corporation by management.[8] It serves to "deter managerial misconduct" by "punishing corporate fiduciaries for self-dealing transactions and other forms of behavior that injure the corporation."[9] In the United States, generally, a shareholder must demand that the board of directors initiate a claim against a wrongdoing director before commencing litigation.[10] In many cases, it gives the directors discretion in determining whether to proceed with litigation or not, and in doing so, creates potential conflict of interest concerns.[11]

The apparent inadequacies of traditionally complex procedures and director control, to the contrary, have led other countries to reevaluate their shareholder derivative procedures. For example, the

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795365.htm; *Why AIG Was Aided and Not Lehman Brothers*, READINGEAGLE.COM, Sept. 18, 2008, *available at* http://www.readingeagle.com/article.aspx?id=106343. *See also* Am. Int'l Group v. Greenberg, 965 A.2d 763, 774-76 (Del. Ch. 2009) (alleging that executives engaged in financial and transactional wrongdoing).

6 Whitman, *supra* note 5.

7 Steve Tobak, *How Much Does Corporate Fraud Cost You?*, CNET NEWS, June 30, 2008, http://news.cnet.com/8301-13555_3-9980276-34.html?tag=mncol;txt.

8 Meyer v. Fleming, 327 U.S. 161, 167 (1946).

9 Susanna M. Kim, *Conflicting Ideologies of Group Litigation: Who May Challenge Settlements in Class Actions and Derivative Suits?,* 66 TENN. L. REV. 81, 104 (1998).

10 19 AM. JUR. 2D *Corporations* § 1961 (2004). However, in some circumstances involving interested directors or wrongdoing, shareholders may not need to make a demand. *See infra* Part I.A.

11 *See* EDWARD BRODSKY & M. PATRICIA ADAMSKI, LAW OF CORP. OFFICERS & DIRECTORS: RIGHTS, DUTIES & LIABILITIES § 9:14 (1984 & Supp. 02/2007). In addition, the complexities of shareholder derivative procedure, in general, may lessen its efficacy as a tool for corporate governance. *See* Bernard Black et al., *Legal Liability of Directors and Company Officials Part 2: Court Procedures, Indemnification and Insurance, and Administrative and Criminal Liability (Report to the Russian Securities Agency)*, COLUM. BUS. L. REV., 2008, at 1, 29 [hereinafter *Legal Liability Part 2*] (suggesting that the demand requirement imposes an "extremely complex" procedure to determine when shareholder derivative litigation may proceed).

United Kingdom's Companies Act 2006 ("Companies Act") demonstrates an alternative approach to the demand requirement and procedural deference to the board of directors' decision concerning whether to initiate a claim.[12] The Companies Act does this by providing the judiciary with discretion in determining the validity of the claim.[13] The purpose of this new shareholder derivative procedure is to provide "more modern, flexible and accessible criteria for determining whether a shareholder can pursue an action" and to afford greater protection to shareholders' investments.[14] This newly enacted shareholder derivative procedure allows judges to make the determination of whether to continue a claim by using specific factors that incorporate several common-law principles.[15]

This article specifically focuses on the difficulties and complexities of the demand requirement in the United States.[16] The demand requirement, in some circumstances, can leave shareholders without recourse for harm done to the corporation and their investments.[17] Contrary to the demand requirement, the Companies Act offers a fresh perspective on shareholder derivative procedure. Of particular significance is the United Kingdom's attempt to insert judicial discretion and transparency into the initial determination of whether to continue the derivative litigation.[18]

This article is divided into three parts. Part I provides a brief overview of shareholder derivative procedure and the demand requirement in the United States, and shareholder derivative procedure in the United Kingdom prior to 2007. Part II details how the United

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[12] Companies Act, 2006, c. 46, § 263 (U.K.). All references to the "Companies Act" only refer to the 2006 legislation. Also, the use of the term "demand requirement," referring to shareholders' responsibility to first demand that the board of directors take action, does not imply that it is a universally necessary condition for shareholder derivative litigation. *See infra* Part I.A.

[13] *See* COMPANIES ACT 2006, EXPLANATORY NOTES para. 492, *available at* http://www.opsi.gov.uk/acts/acts2006/en/ukpgaen_20060046_en.pdf [hereinafter EXPLANATORY NOTES] (discussing the evidentiary procedure to pursue a derivative claim).

[14] *Id*. at 74.

[15] Companies Act, § 263(3). *See infra* Part II.A.

[16] In particular, this article focuses on Delaware's shareholder derivative procedure, which is the model procedure for many states. *See infra* Part I.A.

[17] *See* 19 AM. JUR. 2D *Corporations* § 1966. "By making a presuit demand upon the board, a shareholder concedes that the board is able to function on that question and waives the right to challenge the independence of a majority of the board to respond to the demand." *Id.* The complex procedure can also increase litigation costs due to the shareholders' failure to overcome necessary obstacles. *See* 13 WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5965 (perm. ed., rev. vol. 1995).

[18] Companies Act, § 263(3).

Kingdom's passage of the Companies Act offers an alternative to the demand requirement and similar barriers to shareholder derivative litigation. In addition, it explains how the new procedure will affect shareholders and long-held-corporate-law principles. Part III explains why the United States should consider the Companies Act as a possible alternative to the demand requirement, and provides specific examples for how the United States can improve shareholder derivative procedure. Lastly, this article concludes that the United States can benefit from a close examination of the Companies Act in an effort to improve shareholder protections.

## I. OVERVIEW OF SHAREHOLDER DERIVATIVE PROCEDURE IN THE UNITED STATES AND THE UNITED KINGDOM

Courts give great deference to a board of directors' decision not to pursue shareholder derivative litigation.[19] Generally, the initiation of shareholder derivative litigation is in response to a harm inflicted upon the corporation as a distinct entity, and, therefore, the presumption is that the corporation is the proper party to recover from that harm.[20] Likewise, a derivative suit only allows shareholders the ability to recover, indirectly, through their ownership interest in the corporation.[21] In this context, shareholders have attempted to use shareholder derivative litigation to redress a variety of harms done to the corporation by corporate management.[22]

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[19] *See* Foss v. Harbottle, (1843) 67 Eng. Rep. 189, 202. *See also* Hemraj, *supra* note 3, at 192.

[20] David W. Locascio, *The Dilemma of the Double Derivative Suit*, 83 NW. U. L. REV. 729, 729 (1989); 19 AM. JUR. 2D *Corporations* § 1944. "Although a corporation is generally a distinct entity from its stockholders . . . [a stockholder] may be entitled to bring a derivative suit, in the corporation's name." *Id*. *See* Foss v. Harbottle, 67 Eng. Rep. at 202. *See also* Shlensky v. Wrigley, 237 N.E.2d 776, 780 (Ill. Ct. App. 1968) (holding that the board of directors manages the corporation and courts can inquire into the basis of its decisions in only limited circumstances).

[21] Bernard Black et al., *Legal Liability of Directors and Company Officials Part 1: Substantive Grounds for Liability (Report to the Russian Securities Agency)*, 2007 COLUM. BUS. L. REV. 614, 715 (2007); Robert J. Riccio, *Conflicts of Interest in Derivative Litigation Involving Closely Held Corporations: An All or Nothing Approach to the Requirement of "Independent" Corporate Counsel*, 31 J. LEGAL PROF. 337, 338 (2007).

[22] Joseph Lee, *Shareholders' Derivative Claims Under the Companies Act 2006: Market Mechanism or Asymmetric Paternalism?*, 18 INT'L CO. & COM. L. REV. 378, 378 (2007). Shareholder derivative litigation has involved claims such as excessive executive compensation, corporate mismanagement, contentious executive decisions, securities-related misconduct,

### A. SHAREHOLDER DERIVATIVE PROCEDURE AND THE DEMAND REQUIREMENT IN THE UNITED STATES

In the United States, each state enacts its own corporate laws and regulations.[23] Fortunately, for the sake of uniformity, many states have modeled their corporate law on two sources: (1) The Model Business Corporation Act ("MBCA"),[24] and (2) Delaware law. [25] Several states have adopted provisions similar to Delaware's shareholder derivative procedure.[26] Due to its widespread influence, this article focuses mainly on Delaware law and procedure with some additional consideration to the MBCA.

Two important corporate law concepts interweave the fabric of shareholder derivative procedure. First, as a general principle of American corporate law, the corporation is "managed by or under the direction of [the] board of directors."[27] Second, due to the presumption that the board carries out its duties in good faith and for acceptable reasons, courts generally do not second-guess a well-intentioned business decision.[28] This is known as the "Business Judgment Rule."[29] Likewise, shareholders invest money into corporations upon the presumption that the board of directors will act in good faith and make informed business

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directors' employment, takeovers, and directors' failure to institute sufficient internal controls to guard against violations of the law. *Id*.

[23] 18 AM. JUR. 2D *Corporations* § 45 (2004).

[24] MODEL BUS. CORP. ACT (2002). The MBCA requires the shareholder to make "a written demand" upon the corporation in all derivative proceedings. *Id.* § 7.42.

[25] *See, e.g.*, DEL. CODE ANN. tit. 8 (2009); *see also* DEL. CH. CT. R. 23.1.

[26] CAL. LAW REVISION COMM'N, DEMAND AND EXCUSE IN SHAREHOLDER DERIVATIVE ACTIONS: CONSULTANT'S BACKGROUND STUDY 1 (Nov. 7, 1995), http://www.clrc.ca.gov/pub/1995/M95-72.pdf; Seth Aronson et al., *Shareholder Derivative Actions: From Cradle to Grave*, *in* CORP. L. & PRAC. COURSE HANDBOOK SER.: SEC. LITIG. & ENFORCEMENT INST. 261, 289-92 (Practising L. Inst. Sept.-Oct. 2008) (noting that federal courts also apply analogous rules to Delaware's shareholder derivative procedure). *See also* FED. R. CIV. P. 23.1.

[27] DEL. CODE ANN. tit. 8, §141(a); MODEL BUS. CORP. ACT § 8.01(b) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors."). One significant responsibility of the board includes managing shareholder equity in a conscientious manner. *See* Elizabeth A. Nowicki, *Not in Good Faith*, 60 SMU L. REV. 441, 447-49 (2007) (describing directors' responsibilities to manage assets owned by shareholders).

[28] *See In re* Walt Disney Co. Derivative Litigation, 907 A.2d 693, 746-47 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006); *see also* Gagliardi v. TriFoods Int'l, 683 A.2d 1049, 1052 (Del. Ch. 1996).

[29] The rule intends to protect the board of directors' ability to handle the affairs of the corporation and allows courts to defer to the business judgment of the directors in the exercise of their broad discretion in making corporate decisions. 3A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1036 (perm. ed., rev. vol. 2002).

decisions that will benefit the corporation and raise shareholder value.[30] Together, these principles have shaped the shareholder derivative process in the United States.

As managers of the corporation, the board of directors is the "brain and nerve centre of the corporate body."[31] By its very nature, shareholder derivative litigation "encroaches on the board of directors' power to manage and control the corporation."[32] Since the directors manage the corporation and its assets, including claims that the corporation may have against a wrongdoer, it is solely within the board of directors' authority to bring an action to recover for harm done to the corporation.[33] Consequently, shareholder derivative litigation has remained a rare instance where shareholders may sue on behalf of the corporation. The claims asserted by the shareholders are those of the corporation, brought on behalf of the corporation due to the board of directors' decision not to enforce the claims.[34] If the litigation proceeds, the corporation is the rightful beneficiary to any resulting recovery.[35] By initiating a claim, the shareholders only represent the corporation's interests in recouping damages inflicted by directors, rather than any individual claims a shareholder may have against a director.[36]

To ensure that corporations have the ability to grow and prosper, directors need some level of protection in order to make tough management decisions without repercussion or the threat of litigation.[37] The business judgment rule provides that protection.[38] Shareholder derivative claims in the United States must allege more than negligence to overcome the presumption that the board of directors has made a good faith determination, in the best interest of the corporation.[39] Accordingly,

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30 D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 277-78 (1998).

31 Hemraj, *supra* note 3, at 192.

32 RALPH C. FERRARA ET AL., SHAREHOLDER DERIVATIVE LITIGATION: BESIEGING THE BOARD §3.01 (Law Journal Press) (1995) [hereinafter FERRARA].

33 *Id*.

34 *See* FED. R. CIV. P. 23.1 (explaining the process of bringing a claim); *see also* DEL. CH. CT. R. 23.1; *see also* DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE § 1.1 (Thomson West 2003).

35 Locascio, *supra* note 20, at 729.

36 "The corporation on whose behalf an action is brought by a stockholder to redress a wrong to the corporation is the real party in interest, and the stockholder who brings the suit is only a nominal plaintiff." 19 AM. JUR. 2D *Corporations* § 1949 (2009).

37 *See In re* Citigroup, 964 A.2d at 139.

38 *See In re* Walt Disney, 907 A.2d at 746-47.

39 BARBARA BLACK, CORPORATE DIVIDENDS AND STOCK REPURCHASES § 6:33 (Thomson West 2008) (1990).

a shareholder must allege that the director acted with gross negligence, bad-faith, or recklessness.[40] This initial step protects directors from claims alleging conduct that amounts to no more than ordinary negligence, encouraging business transactions without fear of retaliation.[41]

A significant encumbrance to shareholder derivative litigation is the demand requirement. The demand requirement is an American concept that requires shareholders to demand that the board of directors initiate a lawsuit to recover for harm done to the corporation.[42] It arose from the universal notion that the corporation is the proper party to recover and the board of directors, as manager of the corporation, has discretion to pursue recovery.[43] Upon the shareholders' demand to the board that it take action, the board may decide either that litigation is in the best interests of the corporation and proceed accordingly or, conversely, that it is not in the best interests of the corporation.[44] If the board refuses to sue, the business judgment rule solidifies its decision and the shareholders' claim will ultimately depend on whether they can prove that the board's refusal was wrongful.[45] Many shareholders opt not to make a demand on the board of directors because the board often decides that the litigation is not in the best interests of the corporation and, thus, a court is unlikely to alter the board's decision and disturb its business judgment.[46] Under this scenario, shareholders may be excused

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[40] The business judgment rule generally protects directors from judicial scrutiny unless there is "a showing of bad faith, fraud, self-dealing, or a conflict of interest on the part of the directors." 19 AM. JUR. 2D *Corporations* § 1949.

[41] *See* Brehm v. Eisner, 746 A.2d 244, 259 (Del. 2000); *In re* Citigroup, 964 A.2d at 130. *But see* Smith v. Van Gorkom, 488 A.2d 858, 893 (Del. 1985) (in which the Delaware Supreme Court found the directors liable for actions that appear to fall short of a gross negligence standard).

[42] *Legal Liability Part 2, supra* note 11, at 29.

[43] *See* 19 AM. JUR. 2D *Corporations* § 1961. "A demand on the corporate directors. . . .is necessary before a stockholder may maintain a suit on behalf of the corporation. . . .The requirement of demand upon directors is a matter of standing and is a condition precedent to the action." *Id*.

[44] DEMOTT, *supra* note 34, § 5:9.

[45] Patrick J. Ryan, *Strange Bedfellows: Corporate Fiduciaries and the General Law Compliance Obligation in Section 2.01(a) of the American Principles of Corporate Governance*, 66 WASH. L. REV. 413, 458 (1991). *See* Stephen A. Radin, *The New Stage of Corporate Governance Litigation: Section 220 Demands*, 26 CARDOZO L. REV. 1595, 1598 (2005) (citing two cases in which plaintiffs failed to allege wrongful refusal of a demand with particularity); Jin Zhu Yang, *Comparative Corporate Governance: Reforming Chinese Corporate Governance*, 16 INT'L CO. & COM. L. REV. 8, 13 (2005) (stating that shareholders are unable to bring the action unless they prove that the directors acted in bad faith or are personally involved in the alleged wrongdoing). *See also supra* text accompanying note 32.

[46] *See* Yang, *supra* note 45, at 13; *Legal Liability Part 2, supra* note 11, at 29. However, in states that follow the Model Business Corporation Act, a shareholder must make a "written demand"

from the demand requirement by pleading particularized facts that the directors' actions were contrary to the business judgment rule or that the directors were interested in the transaction, making a demand futile.[47]

This demand-excuse test further divides the initial shareholder derivative process, creating a complex procedure involving the court, the corporation, the shareholder, and, often times, special litigation committees.[48] A special litigation committee adds another layer in which the board appoints a committee of independent and disinterested directors to determine whether to pursue the litigation.[49] The board of directors can use such committees as a means to invalidate a shareholder's attempt to initiate the litigation in the demand-excused context.[50] Generally, a judge will defer to the determination made by the special litigation committee.[51] Essentially, the procedure makes it difficult for shareholders to proceed with a derivative claim, even in the demand-excused context. Moreover, though Delaware allows demand-excused derivative actions, a growing number of states have abolished it and require a demand in every shareholder derivative claim.[52]

### B. SHAREHOLDER DERIVATIVE PROCEDURE IN THE UNITED KINGDOM PRIOR TO 2007

Prior to 2007, a shareholder in the United Kingdom could bring shareholder derivative litigation on behalf of the company at common law.[53] Two principles, articulated in *Foss v. Harbottle*,[54] provide the

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prior to commencing a derivative proceeding and the proceeding "shall be dismissed by the court" upon a board of directors' finding that the proceeding is "not in the best interests of the corporation." MODEL BUS. CORP. ACT §§ 7.42-.44 (2002).

47 *See* DEL. CH. R. 23.1(a). *See also* BRODSKY & ADAMSKI, *supra* note 11, § 9:7. "[D]emand is futile where a reasonable doubt exists that the board has the ability to exercise its managerial power, in relation to the decision to prosecute" *Id*. (citing Heineman v. Datapoint Corp., 611 A.2d 950 (Del. 1992)).

48 *See* Brehm, 746 A.2d at 256 (Del. 2000).

49 *Legal Liability Part 2*, *supra* note 11, at 29-30; BRODSKY & ADAMSKI, *supra* note 11, § 9.14.

50 19 AM. JUR. 2D *Corporations* § 1977.

51 *Id.*

52 Aronson, *supra* note 26, at 289-92 (stating that 19 states have already adopted a "universal" demand requirement); BRODSKY & ADAMSKI, *supra* note 11, § 9.13. *See also* MODEL BUS. CORP. ACT §§ 7.42-.44 (describing a universal demand requirement).

53 Rosemary Craig, *"The Enormous Turnip": A Discussion on the Companies Act 2006 Which Like Topsy in the Child's Fairy Tale Is Still Growing*, 29 CO. LAW. 360, 363 (2008). *See also* Companies Act, 2006, c. 46, § 265 (U.K.). Although Scotland maintains a faintly different shareholder derivative procedure than that of England, Northern Ireland, and Wales, for brevity, this article focuses on the latter.

foundations for shareholder derivative litigation in the United Kingdom. The first principle is a presumption that the proper plaintiff in the litigation is the corporation.[55] The second principle is that if the majority of shareholders disapprove of the litigation, the corporation cannot initiate the litigation.[56]

Since the majority of shareholders control the decision to initiate shareholder derivative litigation, it was important to understand who controlled the majority of shares. In many cases, the board of directors completely controlled the decision to initiate shareholder derivative litigation.[57] Scholars promote that the efficacy of this procedure reduces the amount of shareholder derivative claims and oppressive litigation, while enhancing the board's ability to manage the corporation.[58] Indeed, the restrictive rules in *Foss* made shareholder derivative litigation rare in the United Kingdom.[59]

Although *Foss v. Harbottle* produced strict limitations on the availability of shareholder derivative litigation, those restrictions have eased slightly since the 1843 ruling. Shareholder derivative litigation evolved to provide a remedy for shareholders when the company had suffered harm while the wrongdoers were in control of the company.[60] Furthermore, the shareholder had to demonstrate that there had been a fraud perpetrated on the minority shareholders and that there was no viable alternative remedy available.[61] In this context, shareholder derivative litigation was effectively restricted to minority shareholders seeking vindication for harm done to their interests in the corporation when the wrongdoers controlled the corporation.[62] This is the "fraud on the minority" exception to the rather preclusive principles in *Foss*.[63] It is

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[54] Foss v. Harbottle, (1843) 67 Eng. Rep. 189. *See also* Commentary, *A Statutory Derivative Action*, 28 CO. LAW. 225, 225 (2007) [hereinafter *Statutory Derivative*] (describing the principles as a "fundamental and well known rule of English Law").

[55] Wise v. Union of Shop, Distributive & Allied Workers, [1996] I.C.R. 691, 701 (Ch.) (quoting Edwards v. Halliwell, (1950) 2 All E.R. 1064, 1066-67 (A.C.)).

[56] *Id.*

[57] *See* Hans C. Hirt, *The Company's Decision to Litigate Against Its Directors: Legal Strategies to Deal with the Board of Directors' Conflict of Interest*, 2005 J. BUS. L. 159, 171 (2005).

[58] *Statutory Derivative*, *supra* note 54, at 225.

[59] *Id.*

[60] Andrew Keay & Joan Loughrey, *Something Old, Something New, Something Borrowed: An Analysis of the New Derivative Action Under the Companies Act 2006*, 124 L. Q. REV. 469, 475 (2008).

[61] *Id*. at 476.

[62] *Id*.

[63] *Id*.

a limited exception to the "proper plaintiff" rule, due to directors who are "normally responsible for making litigation decisions on behalf of the company improperly declin[ing] to sue."[64]

For the foregoing reasons, it was essential that shareholders show that the wrongdoers were in "control" when the corporation suffered the harm and that the wrongdoing constituted a "fraud." "Control" meant that the wrongdoers held a majority of the voting shares and "were in a position to prevent an action being brought to vindicate the rights of the company."[65] This overcame the presumption that the corporation was the proper plaintiff to initiate litigation.[66] Essentially, the shareholders would have to prove that initiating shareholder derivative litigation was proper because any other alternative would be futile due to the wrongdoers' control of the decision making process.[67] However, some courts took a less stringent view by accepting certain considerations in lieu of evidence that the wrongdoers actually held a majority of the shares.[68]

Likewise, the shareholders needed to show that the alleged wrongdoing amounted to a "fraud." The term, as understood in the shareholder derivative context, lends itself to a slightly different meaning than its common-legal understanding.[69] The key ingredient to the allegation of fraud was that the wrongdoers personally benefited, either directly or indirectly, from their harmful actions.[70] Hence, shareholder derivative litigation brought against directors due to mismanagement did not constitute "fraud"; however, diverting corporate opportunities for personal gain did constitute fraud.[71]

Although the United Kingdom never had a statutory-demand requirement like the United States, the pre-2007 shareholder derivative procedure created a substantially similar requirement. Inherent in the proper plaintiff rule espoused in *Foss* was the idea that only the corporation could sue to recover from the harm, not the shareholder.[72]

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[64] *Legal Liability Part 2*, *supra* note 11, at 26.

[65] Anthony L. Marks & William M. Rees, *Shareholders' Actions*, 2 INT'L CO. & COM. L. REV. 39, 40 (1991).

[66] *See* Foss v. Harbottle, (1843) 67 Eng. Rep. 189, 202.

[67] *See* Lynden Griggs & John P. Lowry, *Minority Shareholder Remedies: A Comparative View*, 1994 J. BUS. L. 463, 480 (1994).*See infra* text accompanying note 76.

[68] CONSULTATION PAPER 142, *supra* note 1, para. 4.14.

[69] *Id*. para. 4.9.

[70] *Id.*

[71] *Id*. para. 4.11.

[72] Foss v. Harbottle, (1843) 67 Eng. Rep. 189, 202.

Accordingly, any decision to initiate litigation at the discretion of a simple majority of the shareholders would bind the corporation.[73] Since the board of directors generally controlled the simple majority of shares in the corporation,[74] if the board decided not to pursue the lawsuit, the shareholders could not initiate litigation.[75]

Unless a shareholder could show the wrongdoers were in control at the time, judges were reluctant to allow a shareholder derivative claim to proceed.[76] Even if the shareholder could show that the wrongdoers were in control, the board could appoint an "independent organ," which could determine that the litigation should not proceed and effectively bar the claim.[77] This is ostensibly similar to the underlying principles of the demand requirement in the United States.[78] As discussed in the following section, this is just one of many commonalities between the United States and the United Kingdom's previous shareholder derivative procedure.

### C. SHARED CONCEPTS

The United States and the United Kingdom share several foundational concepts of corporate law, which lead to similarities in their shareholder derivative procedures. The following are a few aspects of shareholder derivative litigation, shared by the United States and the United Kingdom.

First, the use of shareholder derivative litigation is to recover for harm done to the corporation, rather than harm done to individual shareholders.[79] Even though corporations are substantially comprised of shareholder equity, corporate law has not correlated harm done to the corporation with harm done to the individual shareholder's investment.

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[73] CONSULTATION PAPER 142, *supra* note 1, paras. 4.2-.5. *See also infra* text accompanying note 76.

[74] Hans C. Hirt, *Ratification of Breaches of Directors' Duties: The Implications of the Reform Proposal Regarding the Availability of Derivative Actions*, 25 CO. LAW. 197, 198 (2004).

[75] *Id*. "[A]fter the ratification of a director's breach of duty the company will no longer have a cause of action, as the wrong will have been cured." *Id*.

[76] Keay & Loughrey, *supra* note 60, at 475-77.

[77] CONSULTATION PAPER 142, *supra* note 1, para. 5.1.

[78] *Cf*. Griggs & Lowry, *supra* note 67, at 480 (while highlighting differences between the demand requirement and the wrongdoer control requirement, Griggs and Lowry allude to certain similarities between the United Kingdom derivative procedure requiring that the alleged wrongdoers be in control of the board and the United States procedure that allows excusal from making a demand when it is futile). Essentially, both procedures concede director control of the litigation as a general rule. *See infra* Part I.C.

[79] *Compare* Wilson v. Inverness Retail & Bus. Park, [2003] S.L.T. 301, ¶ 11 *with* Sternberg v. O'Neil, 550 A.2d 1105, 1124 (Del. 1988).

Accordingly, both the United States and United Kingdom case law offer some analysis concerning when a personal action is preferable to a derivative action and vice-versa.[80] Theoretically, a successful shareholder derivative action will benefit the shareholders by allowing the corporation to recoup the amount of damages done to the corporation by a director, thereby potentially increasing the value of the shares in the corporation.[81]

Second, there is a presumption that the board of directors manages the operations of the corporation.[82] It is within the board of directors' authority to decide whether to initiate a lawsuit in order to recover damages sustained by the corporation.[83] Judges give great deference to a board's decision not to pursue litigation.[84] This principle explains why shareholder derivative litigation may proceed without management's approval in only limited circumstances.[85]

Third, there is a presumption that the board of directors operates in the best interests of the corporation.[86] Generally, the board has discretion when deciding what is or is not in the best interests of the corporation.[87] If the board of directors decides that a lawsuit to recover damages is not in the best interests of the corporation, notwithstanding possible director conflicts or wrongdoing, a court is unlikely to usurp the board's active management powers by making a contrary finding.[88]

Fourth, there is a presumption that the corporation is the proper plaintiff in a lawsuit initiated to recover for injuries to the corporation.[89]

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[80] *Compare In re* First Interstate Consol. Bancorp Litig., 729 A.2d 851, 860-66 (Del. Ch. 1998) *with* Edwards v. Halliwell, (1950) 2 All E.R. 1064, 1066-69.

[81] 19 AM. JUR. 2D *Corporations* § 2140 (2004). In both the United States and the United Kingdom, the corporation is the primary beneficiary, while the shareholders are nominal beneficiaries. *Id.*; *See* CONSULTATION PAPER 142, *supra* note 1, paras. 4.3-4.6.

[82] SIR FRANCIS BEAUFORT PALMER, PALMER'S COMPANY LAW § 8.2101 (Geoffrey Morse ed., Sweet & Maxwell 2008) (1976) [hereinafter PALMER'S]; *see also* DEL. CODE ANN. tit. 8, §141(a).

[83] Airey v. Cordell, [2006] EWHC (Ch) 2728, Bus. L.R. 391, 399 (Eng.).

[84] *See* Keay & Loughrey, *supra* note 60, at 475-77; *Legal Liability Part 2, supra* note 11, at 29.

[85] *See* FERRARA, *supra* note 32, § 3.01 (reinforcing the board's discretion by describing the derivative action as an inherent encroachment "on the board of directors' power to manage and control the corporation").

[86] *In re* Walt Disney Derivative Litig., 906 A.2d 27, 52-53 (Del. 2006). *See* Regentcrest Plc v. Cohen, [2001] B.C.C. 494.

[87] Arndt Stengel, *Directors' Powers and Shareholders: A Comparison of Systems*, 9 INT'L CO. & COM. L. REV. 49, 55 (1998) (stating that directors must "avoid situations where there is an actual or potential conflict between his [or her] own and the company's interests").

[88] PALMER'S, *supra* note 82, § 8.2608.

[89] 19 AM. JUR. 2D *Corporations* § 1949. *See* Foss v. Harbottle, (1843) 67 Eng. Rep. 189, 202; *see also* Brown v. Tenney, 532 N.E.2d 230, 232-33 (Ill. 1988) (describing the derivative suit in the

Presumably, since the corporation is the harmed party, it has standing to proceed with a claim. Shareholder derivative procedure has struggled with this concept since directors often disapprove of the lawsuit, which could result in an injustice to the corporation.[90]

Lastly, shareholder derivative procedure is inimitable and involves several complexities not found in other areas of corporate law.[91] The very nature of shareholder derivative litigation is unique in that shareholders compel the corporation to initiate a lawsuit against one of its directors. Furthermore, some of the rules governing corporate law, as explained above,[92] may not operate as neatly as they otherwise would during shareholder derivative litigation.[93] As a result, shareholder derivative litigation has generally remained a lesser-used tool by shareholders to recoup damages inflicted by a director as compared to other remedies.[94]

### D. CONCERNS AND CRITICISMS OF THE DEMAND REQUIREMENT AND SHAREHOLDER DERIVATIVE PROCEDURE

The complexities found in shareholder derivative procedure can have a preclusive effect on legitimate derivative claims. In the United States, use of shareholder derivative litigation has declined over the last half century.[95] Likewise, in the United Kingdom the common-law rule derived from *Foss v. Harbottle* has "generated a complex, unclear and highly restrictive set of rules governing the bringing of derivative claims,"[96] which has made it difficult for shareholders to initiate derivative litigation.[97] As stated by the Law Commission in reviewing the shareholder derivative procedure in the United Kingdom, the inflexible rule in *Foss v. Harbottle* is restricted from developing "in a principled way to cover new situations."[98] Furthermore, to understand the United

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United States as "two causes of action: one against the directors for failing to sue; the second based upon the right belonging to the corporation").

90 *See Legal Liability Part 2, supra* note 11, at 29.

91 *See* PALMER'S, *supra* note 82, § 8.3704.1.

92 *See supra* Parts I.A and I.B.

93 *See* BRODSKY & ADAMSKI, *supra* note 11, § 9.20.

94 *See* Kenneth B. Davis, Jr., *The Forgotten Derivative Suit*, 61 VAND. L. REV. 387, 388 (2008).

95 *See id*. at 389. Although reliance on the derivative suit in the United States is dwindling, it still plays a relevant role in certain areas of corporate law.

96 PALMER'S, *supra* note 82, § 8.3704.1.

97 CONSULTATION PAPER 142, *supra* note 1, paras. 1.4-.6.

98 *Id.* para. 4.35.

Kingdom's common-law procedure, "one needs to examine numerous reported cases decided over a period of 150 years, thus the law in this respect is virtually inaccessible, save to lawyers speciali[z]ing in the field."[99] These apparent inadequacies could have long-term effects on the usefulness of shareholder derivative litigation as a corporate governance tool.

Likewise, in the United States, a key concern is that shareholder derivative procedure may not be in step with the current corporate and political atmosphere calling for more transparency and greater shareholder protection from corporate wrongdoing.[100] The current state of shareholder derivative litigation seems to emanate from corporate law's generous deference to the board of directors' business judgment.[101] Accordingly, some argue that the shareholder derivative procedure unmistakably affirms a time-honored doctrine that protects the board of directors' ability to run the corporation, but lacks adequate protections for the corporation and minority shareholders' investments in the corporation.[102] This deference is due, in part, to a fear that shareholder derivative litigation could usurp the board's ability to manage the corporation.[103] Indeed, many "courts have generally characterized shareholder derivative suits as 'a remedy of last resort,' and . . . not favored by the law."[104]

At the heart of the criticisms against the demand requirement are questions concerning transparency, fairness, and justice. Shareholder derivative procedure debatably involves an inherent conflict of interest that could potentially allow the board of directors to block litigation against one of its members.[105] The effect of these management friendly rules "is to make individual access on behalf of the company to the courts extremely difficult."[106] A corollary of this is that there may be less

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[99] *Id.*

[100] *See* Priya P. Lele & Mathias M. Siems, *Shareholder Protection: A Leximetric Approach* (University of Cambridge Centre for Business Research, Working Paper No. 324, 2006), *available at* http://www.cbr.cam.ac.uk/pdf/WP324.pdf.

[101] Ryan, *supra* note 45, at 458.

[102] Victor Arnell DuBose, *Whose Corporation Is It, Anyway? Abolishing the Futility Exception in Derivative Litigation*, 12 MISS. C. L. REV. 197, 198 (1991). *But see* Am. Int'l Group v. Greenberg, 965 A.2d 763, 808 (Del. Ch. 2009) (explaining that the purpose of the demand requirement is not to benefit directors, rather, "[i]t exists to preserve the primacy of board decisionmaking regarding legal claims belonging to the corporation").

[103] 19 AM. JUR. 2D *Corporations* § 1949 (1962).

[104] *Id.*

[105] 18A AM. JUR. 2D *Corporations* § 225.

[106] *Statutory Derivative*, *supra* note 54, at 225.

litigation than the interests of companies require.[107] Thus, due to the obscure complexities and a lack of transparency, some argue that shareholder derivative procedure may effectively provide greater deference to the board of directors than it provides protection to the corporation and its shareholders.[108] Moreover, the business judgment rule in the United States may make it even less likely that the directors would voluntarily choose to prosecute a claim against one of their fellow board members, knowing that a court will defer to their judgment in many cases.[109]

In addition to the inherent problems of the demand requirement and board control, other complications arise in the shareholder derivative process. For instance, it is not always clear when an injury warrants shareholder derivative litigation as opposed to a direct suit.[110] Courts in both the United States and the United Kingdom have held that an injury that is personal to the shareholder gives rise to a direct action while a harm that affects the shareholders' investment in the corporation gives rise to a derivative action.[111] However, this differentiation can be less apparent in practice.[112] For instance, "Delaware courts have used several different tests to try to distinguish between direct and derivative claims, [but] the distinctions were not always clear."[113]

Aside from substantive and procedural hurdles specific to shareholder derivative procedure, basic civil procedural questions can arise. In the United States, strategic and jurisdictional issues can raise

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[107] *Id. But see* Kim, *supra* note 9, at 105-06 (suggesting that without these rules the derivative suit may become more prevalent as a "form of legalized extortion" to get corporations and insurers to settle meritless cases).

[108] *See* Ryan, *supra* note 45, at 459 (explaining the demand requirement, the demand-excused test, and the use of special litigation committees).

[109] *See* 3A FLETCHER CYC. CORP. § 1036 (2002). *But see In re* Citigroup, 964 A.2d at 139 (explaining that investors, in the wake of the subprime crisis, must differentiate "a desire to blame someone and a desire to force those responsible to account for their wrongdoing"). "Ultimately, the discretion granted directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses." *Id.*

[110] 12B FLETCHER CYC. CORP. § 5911 (2000). *See also* Lynden Griggs, *The Statutory Derivative Action: Lessons That May Be Learnt From Its Past!*, 6 U. W. SYDNEY L. REV. 64, § 4.2 (2002) (noting that plaintiff shareholders generally desire a personal action to evade procedural complexities).

[111] *See* CONSULTATION PAPER 142, *supra* note 1, paras. 4.1-4.6; *see also supra* note 79.

[112] DEMOTT, *supra* note 34, § 2:2.

[113] Zachary D. Olson, *Direct or Derivative: Does It Matter After Gentile v. Rossette?*, 33 J. CORP. L. 595, 598 (2008). "The determination of whether a claim is direct or derivative is fact sensitive, which makes laying out a bright-line test difficult." *Id.* at 599.

concern about what procedure applies.[114] In many cases, directors want Delaware law to apply.[115] However, in some cases, different jurisdictions may have different derivative procedures.[116] Application of one procedure may set different requirements for the plaintiff and could preclude derivative litigation.[117] Delaware, for instance, has additional requirements that the individual must have held shares in the company at the time the harm occurred.[118]

Lastly, some opponents of shareholder derivative litigation believe that it is an unnecessary form of corporate governance because it disrupts the board's ability to operate the corporation.[119] Furthermore, there is concern that shareholder derivative litigation only results in an increase of meritless suits.[120] Although recovery goes to the corporation, rather than the shareholders individually, there are incentives to initiate shareholder derivative litigation in the United States notwithstanding the strength or weakness of the claim, such as the use of director insurance to cover liability and granting plaintiff's attorneys' fees.[121] This, critics argue, only benefits plaintiffs' attorneys by encouraging meritless claims in order to force large settlements.[122] However, completely abolishing shareholder derivative litigation from the already limited pool of shareholder remedies would seem rather harsh, ultimately leaving shareholders with one less remedy. The difficult task is to find a healthy medium where procedures do not burden shareholders' bona fide claims, while maintaining the board of directors' ability to manage the corporation.

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[114] *See* William S. Lerach, *Securities Class Actions & Derivative Litigation Involving Public Companies: One Plaintiff's Perspective*, *in* LITIG. & ADMIN. PRAC. COURSE HANDBOOK SER.: SECURITIES LITIGATION 65, 161-62 (Practising L. Inst., 1990) (highlighting circumstances involving California, Delaware, and Federal shareholder derivative procedure).

[115] *Id*. (explaining that directors often argue that Delaware law applies because it is "so incredibly favorable to defendants on the demand issue").

[116] *See* 19 AM. JUR. 2D *Corporations* § 2052 (2004). "The law of the state of incorporation determines the necessity of making a demand upon the shareholders prior to bringing the derivative action." *Id.*

[117] *See id.*

[118] DEL. CH. CT. R. 23.1(a).

[119] Kim, *supra* note 9, at 105-06.

[120] *See id*.

[121] *Legal Liability Part 2*, *supra* note 11, at 30-31.

[122] *See* Kim, *supra* note 9, at 127. Kim suggests that "the potential exists for settlements that lack merit" and, in fact, a "majority of settlements are judicially approved and rejections [of settlements] on the ground of inadequacy are comparatively rare." *Id*.

## II. THE COMPANIES ACT 2006

The United Kingdom is one of the first nations to establish uniformity in the operation of corporations.[123] In response to criticisms, the United Kingdom set out to revise its corporate law in an attempt to modernize the legal framework due to the evolving business environment.[124] In 1995, the Lord Chancellor and the President of the Board of Trade requested that the Law Commission "carry out a review of shareholder remedies," in particular, the principles espoused in *Foss v. Harbottle*.[125] Subsequently, the Department of Trade and Industry commissioned a fundamental review of company law, called the "Company Law Review" ("CLR").[126] The CLR presented its findings to the Secretary of State for Trade and Industry on July 26, 2001, which included recommendations from the Law Commission concerning changes to the shareholder derivative procedure.[127] Following the legislative process, on November 8, 2006, the Companies Act received Royal Assent.[128] On October 1, 2007, the newly enacted statutory derivative procedure went into effect.[129]

Aside from providing uniformity in corporate law, the Companies Act was the largest piece of legislation ever passed by Parliament.[130] The legislation completely replaced previous Companies Acts and codified much of the common law relating to companies.[131] The reforms intend to "preserve the substance of the existing law where it worked" and to implement improvements in areas that needed reform.[132] In other words, it is a proactive approach intended to ensure that the

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[123] EXPLANATORY NOTES, *supra* note 13, at 1.

[124] *Id.*

[125] CONSULTATION PAPER 142, *supra* note 1, at 1.

[126] *Id.*

[127] *See generally id.*

[128] DEP'T FOR BUS. ENTER. & REG. REFORM, COMPANIES ACT 2006, http://www.berr.gov.uk/whatwedo/businesslaw/co-act-2006/ (last visited Oct. 12, 2009).

[129] DEP'T FOR BUS. ENTER. & REG. REFORM, COMPANIES ACT 2006 – TABLE OF COMMENCEMENT DATES, http://www.berr.gov.uk/files/file48793.pdf (last visited Oct. 12, 2009).

[130] Philip Bovey, *A Damn Close Run Thing – The Companies Act 2006*, 29 STATUTE L. REV. 11, 11 (2008).

[131] John D. Vaughn & Stuart Borrie, *Legal Update – Corporate Law Changes in the UK*, 15 METRO. CORP. COUNS., May 2007; Bovey, *supra* note 130, at 11.

[132] Bovey, *supra* note 130, at 11.

corporate law connects with the modern business climate by sustaining efficiencies and restructuring inadequacies.[133]

### A. A MODERN SHAREHOLDER DERIVATIVE PROCEDURE IS BORN

The Companies Act, for the first time, provides statutorily based procedural rules for shareholder derivative litigation in the United Kingdom. The new-statutory procedure affects all claims filed on or after October 1, 2007.[134] In order to make shareholder derivative litigation more accessible to shareholders, the Companies Act expands the circumstances in which shareholders can bring a claim. A claim may be initiated in response to "an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company," notwithstanding 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."[135] This makes the derivative action available for directors' breach of the duty to exercise reasonable care, skill, and diligence, regardless of whether the director has benefited personally.[136] Furthermore, a shareholder is no longer required to show that the wrongdoing directors control the majority of the corporation's shares as a prerequisite to continuing the suit.[137]

Once a shareholder has initiated a shareholder derivative claim, the shareholder must then apply to the court for permission to continue the claim.[138] In general, the Companies Act provides a two-stage system

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[133] In order to adapt to changes in the business environment, the Secretary of State, in certain parts of the Companies Act, reserves the power to supplement the legislation by a series of regulations and commencement orders. Craig, *supra* note 53, at 361.

[134] DEP'T FOR BUS. ENTER. & REG. REFORM, FAQ COMPANIES ACT 2006 – DERIVATIVE CLAIMS, http://www.berr.gov.uk/whatwedo/businesslaw/co-act-2006/faq%20Act%202006/page41055.html (last visited Oct. 12, 2009).

[135] Companies Act, 2006, c. 46, § 260 (U.K.). The rule allowing claims that arise prior to becoming a shareholder, restates the common law based on the idea that the derivative action is a right of the company rather than the individual shareholders. *See* EXPLANATORY NOTES, *supra* note 13, at 75.

[136] EXPLANATORY NOTES, *supra* note 13, at 74-75. In addition, the Companies Act codifies several other duties owed by a director, such as the duty to promote the success of the company; the duty to exercise independent judgment; the duty to avoid conflicts of interest; the duty not to accept benefits from third parties; and, the duty to declare interest in proposed transactions with the company. *See* Craig, *supra* note 53, at 360.

[137] EXPLANATORY NOTES, *supra* note 13, at 74.

[138] Companies Act § 261(1). In addition, the Act also protects shareholders' rights when the corporation initiates a claim, which could otherwise be pursued by a shareholder, in a manner that amounts to an abuse of the process or failure to prosecute the claim diligently. *Id.* § 262(2).

for permission to proceed with a shareholder derivative claim.[139] First, the applicant must make a prima facie case for permission to continue the claim and the court considers the issue on the evidence filed by the applicant.[140] Second, after establishing a case, the court can require that the directors provide evidence opposing the request to continue the claim.[141] The court must dismiss the application "[i]f it appears to the court that the application and the evidence filed by the applicant in support of it do not disclose a prima facie case for giving permission (or leave)."[142] The court essentially plays the role of gatekeeper by separating the wasteful claims from valid claims. The board of directors may have to provide its own evidence only after the court has determined the evidence discloses a prima facie case to continue the derivative claim.[143] This allows "the courts to dismiss unmeritorious claims at an early stage without" involving the corporation or unnecessarily wasting corporate assets to defend frivolous claims.[144]

In deciding whether the evidence presents a prima facie case to continue the shareholder derivative claim, the Companies Act provides specific factors that the court must consider.[145] These particular factors include:

- Whether the shareholder is acting in good faith in seeking to continue the derivative action;
- The importance that a person acting in accordance with the duty to promote the success of the corporation would attach to continuing the action;
- Where the cause of action results from an act or omission that is yet to occur, could it be authorized by the corporation before it occurs, or ratified after it occurs;
- Where the cause of action arises from an act or omission that has already occurred, could it be ratified by the corporation;

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[139] EXPLANATORY NOTES, *supra* note 13, at 74.
[140] *Id.*
[141] *Id.*
[142] Companies Act § 261(2).
[143] *Id.* § 261(3).
[144] EXPLANATORY NOTES, *supra* note 13, at 75.
[145] Companies Act § 263(3). While the court must take into account these particular factors, it does not appear that the Act forecloses the court's ability to take into account additional factors at its discretion.

- Whether the corporation has decided not to pursue the claim; and

- Whether the shareholder could pursue a direct action.[146]

In its evaluation of these discretionary factors, the court must give greater weight to any evidence offered by individuals "who have no personal interest, direct or indirect, in the matter."[147]

After considering the evidence, the court must refuse permission to continue the shareholders' derivative claim if it concludes any of the following:

- That a person acting in accordance with their duty to promote the success of the company would not seek to continue the claim; or

- Where the cause of action arises from an act or omission that is yet to occur, that the act or omission has been authorized by the company; or

- Where the cause of action arises from an act or omission that has already occurred, that the company authorized the act or omission before it occurred, or has been ratified by the company since it occurred.[148]

If the court denies permission, the litigation will terminate and the court can order the shareholder to pay for costs of the litigation.[149]

## B. HOW WILL THIS AFFECT TRADITIONAL-CORPORATE PRINCIPLES AND SHAREHOLDERS' ABILITY TO CONTINUE SHAREHOLDER DERIVATIVE LITIGATION?

With the new statutory shareholder derivative procedure in place, it is important to recognize that many of the common-law principles that governed shareholder derivative litigation still exist within

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[146] *Id.*

[147] *Id.* § 263(4). The inverse assumption is that the court will give little weight to evidence presented by individuals with personal interests in the matter.

[148] *Id.* § 263(2).In addition, the Act provides shareholders with the ability to seek permission to continue a derivative claim when the current claimant has not made a good-faith effort or failed to prosecute the claim diligently. *Id.* § 264(2).

[149] *Id.* § 261(2)(b). *See* Craig, *supra* note 53, at 364. Moreover, if future cases establish that judges will order shareholders to pay for costs of improper litigation, this could be a significant deterrent to shareholders filing meritless claims. *See infra* Part II.C.

the Companies Act.[150] Although the Act reforms some of the old procedure, the substantive rules remain, albeit in a less restrictive form.[151] To understand the significance of the Companies Act, it is essential to appreciate the differences and similarities between the old and new procedure.

### 1. NEW PROCEDURE RETAINS FUNDAMENTAL CORPORATE LAW PRINCIPLES

A key reason for reforming the shareholder derivative procedure was to broaden the scope of claims that would otherwise be restricted by the common law procedure.[152] The Law Commission's proposals for reform considered the basic approach to shareholder derivative litigation to be adequate but "complicated and unwieldy."[153] Likewise, while the Companies Act does not provide a substantive rule to replace the principles in *Foss v. Harbottle*, it does reflect recommendations that there "should be a new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue an action."[154] For instance, the Companies Act retains the idea that the corporation is the proper plaintiff to initiate litigation and the majority of shareholders control the decision to bring a shareholder derivative claim.[155] These underlying principles espoused in *Foss v. Harbottle*, however, are no longer bright-line rules. Now, they are merely a starting point in a judge's determination concerning whether to grant leave.[156]

Legislators anticipate that the new derivative procedure will provide shareholders "easier access to justice" by giving the court greater control.[157] Judicial discretion has supplemented the principles in *Foss v. Harbottle* and the limited exceptions to those restrictive common-law principles (such as the "fraud on the minority" exception) in an attempt

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[150] EXPLANATORY NOTES, *supra* note 13, at 76.

[151] *Id.* at 74.

[152] *Id.*

[153] LAW COMM'N, SHAREHOLDER REMEDIES, FINAL REPORT NO. 246 para. 6.4 (1997), *available at* http://www.lawcom.gov.uk/docs/lc246.pdf [hereinafter FINAL REPORT 246].

[154] EXPLANATORY NOTES, *supra* note 13, at 74.

[155] Craig, *supra* note 53, at 363.

[156] *See* Companies Act, 2006, c. 46, § 263 (U.K.).

[157] Lee, *supra* note 22, at 383.

to strengthen shareholder remedies.[158] In doing this, legislators hoped to enhance the position of shareholders and the protection of their interests in the company.[159]

The precise effect that these changes will have on the principles set forth in *Foss v. Harbottle* will depend on how the courts apply the factors contained in section 263 of the Companies Act. The court applies these factors against the totality of the evidence in its determination of whether to proceed with the claim.[160] However, since the promulgation of the new-statutory procedure on October 1, 2007, courts have yet to establish a firm approach when determining whether to grant permission to continue the shareholder derivative claim.[161] It is in the judge's discretion to allow the claim to continue, and some judges may apply the factors in a restrictive manner, much like the common-law principles.[162]

### 2. WHAT CAN SHAREHOLDERS EXPECT?

Since the new shareholder derivative procedure has only been in place since October 2007, it may be years before shareholders and corporations realize the true impact of the legislation. It is possible that the new shareholder derivative procedure will result in dispositions that are indistinguishable from the prior procedure since it retains the basic concepts that have prevailed for the last 150 years. However, this has yet to coalesce. Similar to understanding the ultimate effect the Companies Act will have on common-law principles, it is unclear how the new shareholder derivative procedure will ultimately affect shareholders because much will depend on how judges utilize the new procedure.

In early cases, courts that have applied the new procedure have not made it easy for shareholders to continue derivative litigation.[163] In *Mission Capital PLC v. Sinclair & Others*, the court refused the shareholders' application for leave to continue the derivative action using

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[158] *See* Keay & Loughrey, *supra* note 60, at 469 (suggesting that judicial discretion has replaced the limited exceptions in *Foss v. Harbottle*, such as the fraud on the minority and the wrongdoer control concept).

[159] Lee, *supra* note 22, at 378.

[160] Keay & Loughrey, *supra* note 60, at 470. *See also* Companies Act § 263.

[161] Keay & Loughrey, *supra* note 60, at 469-70.

[162] *Id.* at 470. Further stating that "[t]he availability of the derivative action, its utility as a shareholder remedy, and its potential for abuse, will depend on how courts assess whether a prima facie case exists, and on how [judges] exercise their discretion." *Id.*

[163] *See* Mayer Brown, *Corporate Legal Alert - Derivative Claims: A Case for Cautions Optimism*, Nov. 2008, at 1, 1, http://mayerbrown.com/publications/article.asp?id=5813&nid=6 (reporting that two shareholder derivative actions have failed "at an early stage").

the "discretionary factors" of the new derivative procedure.[164] Likewise, in *Franbar Holdings Ltd v. Patel & Others*, after taking into account all the circumstances via the "balancing exercise" provided in the new procedure, the court concluded that refusing permission to continue the suit was the best outcome.[165] In both cases, the court keenly focused on two of the "discretionary factors" in the new procedure: (1) whether, hypothetically speaking, a person acting in accordance with a director's duty to promote the success of the company would find it important to continue the claim; and, (2) whether the alleged wrongdoings gave rise to a personal cause of action.[166] In both cases, the court refused permission to continue the derivative claim, indicating that the new shareholder derivative procedure has not brought about a vast liberalization of procedural rules leading to an increase in litigation, as some opponents of the legislation argue.[167]

Initially, when deliberating changes to the shareholder derivative procedure, the Law Commission addressed three concerns on how the new shareholder derivative procedure may affect shareholders.[168] First, since shareholders rarely used the derivative action in the United Kingdom, many believed that the changes would have little to no consequence.[169] Although this may have been true, the purpose of the new shareholder derivative procedure was to provide a solution to the common-law procedure's lack of appeal, thereby promoting wider use of the remedy.[170] The intention of the reforms was to encourage parties to bring claims as derivative actions by modernizing the procedure.[171] In addition, expanding the availability of the action to circumstances that do not constitute a "fraud on the minority," such as negligence,

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[164] Mission Capital v. Sinclair, [2008] EWHC (Ch) 1339, [44]-[47]. *See also* Companies Act § 263(3).

[165] Franbar Holdings v. Patel, [2008] EWHC (Ch) 1534, [54].

[166] Mayer Brown, *supra* note 163, at 2.

[167] *See id.* at 4. Companies and directors will take comfort from the attitude the courts displayed in weighing the "discretionary factors" in *Mission* and *Franbar*. *See also* Stimpson v. Southern Landlords Assoc. [2009] EWHC 2072 (Ch) (also denying the right to continue the action due to the finding that a hypothetical director would not continue the claim).

[168] FINAL REPORT 246, *supra* note 153, para. 6.10.

[169] *Id.* para. 6.11.

[170] *See id.* paras. 6.11-.12 (suggesting that the new procedure may encourage some individuals to bring claims as derivative actions, rather than section 459 claims).

[171] *Id.*

automatically increases the prospective pool of claims, which could result in more shareholder derivative litigation.[172]

Second, concerns arose over the possibility that the changes would have adverse effects due to shareholder derivative litigation becoming available to a wider class of plaintiffs.[173] However, the Law Commission did not believe that the changes would have a significant impact on the availability of shareholder derivative litigation since the new procedure will subject all cases to "tight judicial control."[174]

Lastly, questions arose as to whether the new derivative procedure would be just as complicated as the previous procedure.[175] To the contrary, the Law Commission firmly believed that the reforms would "put the derivative action on a much clearer and more rational basis."[176] The goal is to "give courts the flexibility to allow cases to proceed in appropriate circumstances, while giving advisers and shareholders the necessary guidance" to determine whether the claim should proceed.[177]

A final way to assess how the reforms may affect shareholders is to look at other countries that have enacted similar procedures. In Canada, the majority of provinces have adopted the Canada Business Corporations Act ("CBCA"), which provides a statutory right to "apply to a court for leave to bring an action in the name and on behalf of a corporation."[178] The court may then grant leave if it is satisfied that the complainant gave adequate notice to the directors, the complainant is acting in good faith, and the litigation appears to be in the interests of the corporation."[179] The Canadian reforms to its shareholder derivative procedure have "expanded upon the availability of derivative action relief [in Canada] . . . and have introduced more precise procedural and substantive requirements that must be satisfied before such relief will

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[172] *See id.* paras. 6.38-.41 (also suggesting that while it may increase the availability of claims, "the risk of increased litigation . . . . is overstated"). *But see* Guy Pendell & Lindsey Davies, *United Kingdom: New Derivative Action May Lead to Increased Claims Against Directors*, MONDAQ, Oct. 2, 2007, http://www.mondaq.com/article.asp?articleid=52870 (detailing the increased risk for meritless claims).

[173] FINAL REPORT 246, *supra* note 153, paras. 6.10, 6.13.

[174] *Id.* para. 6.13. Furthermore, the Law Commission believed that "[i]n some respects, the availability may be slightly wider; in others it may be slightly narrower." *Id.*

[175] *Id.* paras. 6.10, 6.14.

[176] *Id.* para. 6.14.

[177] *Id.*

[178] Canada Business Corporations Act § 239(1) (1985).

[179] *Id.* § 239(2).

become available.[180] However, in many cases, courts are reluctant to grant leave where directors have decided, in good faith, that it is not in the best interests of the corporation to continue the claim.[181]

Another country to reevaluate its shareholder derivative procedure was Australia. Australia enacted a similar statutory regime in which shareholders may apply for leave to bring a shareholder derivative claim.[182] The procedure allows the court to sort out the unmeritorious claims by considering factors similar to those introduced in the Companies Act.[183] This resulted in an increase of shareholder derivative suits due to the enactment of the statutory procedure as compared to the previous common-law procedure.[184]

Although many shareholder derivative claims in the United Kingdom will still result in denial of the claim, based on the cases thus far, at the very least the procedural changes make for more transparency. Due to the uncertainty and limitations of the procedure in *Foss v. Harbottle*, the need for increased transparency in shareholder derivative procedure became apparent with the continuance of globalized investment and international interest in corporate governance.[185] This is precisely why the Law Commission recommended, "that there should be a new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue the action."[186] Again, the fundamental difference is that the court, rather than the board of directors, oversees the initial determination as to whether the claim can proceed. The outcome, if nothing else, may very well be that

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[180] CANADIAN ENCYCLOPEDIC DIGEST (ONTARIO): BUSINESS CORPORATIONS § 878 (3d ed., 1973).

[181] *Id.* § 882. This is particularly the case when independent directors have made the decision not to initiate litigation.

[182] Corporations Act, 2001, § 237 (Austl.). In Australia, the court must grant leave if it is probable that the company will not bring the proceedings; the applicant is acting in good faith; continuance is in the best interests of the company; there is a serious question to be tried; and, the applicant gave proper written notice to the company. *Id.* § 237(2). In addition, the Act sets forth specific criteria to determine whether the action is in the best interests of the company. *Id.* § 237(3).

[183] Hui Huang, *The Statutory Derivative Action in China: Critical Analysis and Recommendations for Reform*, 4 BERKELEY BUS. L.J. 227, 245-47 (2007).

[184] Melissa Hofmann, *The Statutory Derivative Action in Australia: An Empirical Review of its Use and Effectiveness in Australia in Comparison to the United States, Canada and Singapore*, BOND U. CORP. GOVERNANCE EJOURNAL, May 2004, at 1, 14, http://epublications.bond.edu.au/cgi/viewcontent.cgi?article=1012&context=cgej (last visited May 11, 2010).

[185] FINAL REPORT 246, *supra* note 153, para. 6.9.

[186] *Id*. para. 6.15.

shareholders gain more faith in the procedure due to the court's impartial determination to continue the shareholder derivative claim.

### C. THE BENEFITS AND RISKS OF THE MODERN SHAREHOLDER DERIVATIVE PROCEDURE

While the statutory shareholder derivative procedure in the Companies Act seems to provide greater shareholder protections than that of the common-law procedure, there are still diverging views as to whether the benefits will outweigh the risks. Opponents suggest that the newly enacted statutory procedure is merely an attempt to erode the well-established principles that the corporation is the proper plaintiff to bring a claim and that the court will not interfere with the majority shareholders' decision to forego litigation.[187] Under the *Foss v. Harbottle* standard, courts were reluctant to usurp or appear to usurp internal management's decision-making process.[188] However, this was during a period when the corporation's autonomy was of paramount importance and judicial supervision was highly disfavored.[189] Proponents of the new procedure point to the trend of protecting shareholders from corporate wrongdoings by making the procedure more transparent.[190] Accordingly, providing greater judicial control over shareholder derivative litigation, as opposed to control by the board, is a more transparent process for determining whether the litigation can continue.[191]

The obvious risk, shared by many in the corporate community, is that the new procedure effectively substitutes a judge's personal judgment for corporate management's business judgment and experience. For instance, under the Companies Act, the court makes the initial determination of whether shareholder derivative litigation is in the interest of the corporation, rather than the board of directors.[192] However,

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[187] *See Statutory Derivative*, *supra* note 54, at 225 (describing the proper plaintiff rule and the courts' reluctance to interfere with the "internal management of the company"). *See also* Mayer Brown, *supra* note 163, at 4 (alluding to the concern that the new procedure may "override the rights of the company's directors to consider whether or not to take proceedings to enforce the company's rights").

[188] Griggs, *supra* note 110, § 1.3.

[189] *Id*. § 1.

[190] *See* FINAL REPORT 246, *supra* note 153, paras. 6.8-.9 (describing several international developments regarding the shareholder derivative action and a growing trend towards greater judicial involvement).

[191] *See id*. para. 6.13.

[192] Nicholas Plowman, *Shareholder Remedies – Past and Present*, 17 INT'L CO. & COM. L. REV. 242, 244 (2006).

the concern regarding a reduction of directors' power to control the corporation has yet to materialize due to the limited amount of shareholder derivative claims since the reforms took effect.[193] To the contrary, early cases suggest that judges have not strayed from the principles espoused in *Foss v. Harbottle*.[194] Ultimately, erosion of the long-held principle that the court should defer to management's business judgment, if any takes place, will depend on how judges utilize the new procedure.[195]

Another risk is that the new statutory procedure will eradicate the purposes of the common law procedure, creating fear that the revisions will overwhelm corporations and the judicial system. The expansion of allowable claims beyond the "fraud on the minority" limitation and the allowance of claims involving negligence without showing a personal benefit could increase the amount of shareholder derivative claims in the United Kingdom.[196] After all, the common law rules, in part, were to protect against an overflow of claims, oppressive litigation, and the erosion of internal management's ability to control its corporate destiny.[197] The fear is that the new procedure will lessen these corporate protections and force corporations to spend resources on meritless claims.[198] However, proponents of the revisions claim that the new legislation will actually save corporations from having to expend corporate resources to defend weak claims.[199] By allowing the judicial system to dismiss the weaker claims before involving the corporation and its directors, the new process saves corporate resources until the court is satisfied that the shareholder has established a prima facie case.[200] Moreover, the court has discretion to order that the shareholder pay for the costs of the litigation in the case of a frivolous suit.[201] In this context, the two-step process aids in efficiency and cost-savings by limiting

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[193] *See* Mayer Brown, *supra* note 163, at 2-3 (noting two cases initiated using the new statutory procedure, both of which were denied leave).

[194] *See id.*

[195] Pendell & Davies, *supra* note 172.

[196] *Id.*

[197] *See id.*

[198] *See id*. Pendell and Davies suggest that shareholders may use the new procedure for improper purposes, such as to object to management decisions; to highlight areas of individual concern; or to draw negative publicity on management. *Id*.

[199] *See* PALMER'S, *supra* note 82, § 8.3709. "The purpose of the initial stage of consideration . . . is to enable the court to weed out weak cases without the company having to incur the effort and expense of working out its view on the merits of the claim." *Id.*

[200] Companies Act, 2006, c. 46, § 261 (U.K.). *See also* EXPLANATORY NOTES, *supra* note 13, at 75.

[201] *See* Companies Act, § 261(2)(b). *See* Craig, *supra* note 53, at 364.

corporate resources until the court determines that the evidence presents a valid claim. Nonetheless, only time will tell whether the benefits of the new procedure fully materialize or whether the changes will rectify the traditional complexities of shareholder derivative procedure.

## III. WHAT THE UNITED STATES CAN LEARN FROM THE COMPANIES ACT 2006

In the United States, shareholder derivative litigation has protected shareholder rights dating back for more than a century and has become a recognized tool for corporate governance.[202] Likewise, utilization of the demand requirement in shareholder derivative litigation is a long-held practice in the United States.[203] However, the demand requirement may not be in step with the current trend and need to increase shareholder protections. The shareholder derivative procedure in the Companies Act provides suggestions to some of these concerns as an alternative to the United States' shareholder derivative procedure utilizing the demand requirement.

It is clear that the United Kingdom has moved away from a procedure largely controlled by corporate management in favor of a procedure operated through the judiciary.[204] While retaining fundamental principles of corporate law and shareholder derivative litigation, the United Kingdom has injected judicial discretion into the determination of whether to continue a shareholder derivative claim.[205] By doing this, the judge stands as an impartial decision maker, weighing the evidence and applying several factors, which include whether the directors decided not to pursue the claim.[206]

If the United States utilized more judicial discretion in its shareholder derivative procedure, it seems likely that conflict of interest concerns stemming from the demand requirement would be less prevalent.[207] Having an impartial-third party decide whether the claim is meritorious seems superior to having a possibly interested board of

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[202] DuBose, *supra* note 102, at 200.

[203] Hawes v. Oakland, 104 U.S. 450, 452 (1881).

[204] *See* FINAL REPORT 246, *supra* note 153, para. 6.13 (noting that the new procedure is subject to tight judicial control).

[205] *Statutory Derivative*, *supra* note 54, at 225. *See also* Companies Act, § 263(3).

[206] *Statutory Derivative*, *supra* note 54, at 227.

[207] *See* DuBose, *supra* note 102, at 225.

directors decide the same.[208] In terms of fairness and transparency, having a judicially guided shareholder derivative procedure also seems preferable as compared to requiring that shareholders demand that the board initiate the claim. By clarifying the procedural steps and making the procedure more accessible, the United States could reduce the complexities and inherent conflict of interest concerns that have lingered due in part to the demand requirement. Moreover, increasing judicial control will likely increase transparency. In restructuring its shareholder derivative procedure, the United Kingdom suggested that a more transparent process could improve the complexities of the common-law shareholder derivative procedure.[209] This is contrary to the demand requirement in the United States, where termination of a claim may occur, literally or figuratively, by the board of directors prior to any judicial involvement. Giving the judiciary a greater role in the determination to continue the derivative claim, thus making the proceedings more transparent, could enhance public perception of the process and provide shareholders with a greater understanding and faith in the procedure.

Eventually, the main question for every shareholder of a harmed corporation is, "when can shareholders bring an action to enforce their rights or the corporation's rights?"[210] The concern under the demand requirement standard in the United States is that an interested board of directors may deny shareholders' meritorious claims, resulting in an injustice to the corporation and its shareholders.[211] The new shareholder derivative procedure in the United Kingdom may diminish this concern. Although no system is impervious to some inequities, the goal is to reduce those inequities and inconsistencies as much as possible. Again, this may or may not result in more shareholder derivative claims or provide outcomes that are more favorable to shareholders,[212] but it does provide a more transparent process using objective criteria for determining whether shareholder derivative litigation can continue.[213]

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[208] *See id*. at 199 (suggesting that if demand futility were abolished, it may bring greater judicial review "rather than placing more reliance on the business judgment of the corporation's board").

[209] CONSULTATION PAPER 142, *supra* note 1, para 15.5. *See supra* text accompanying note 170 (explaining that transparency may encourage shareholders to bring derivative actions using the new procedure, rather than claims under section 459 for unfair prejudice).

[210] CONSULTATION PAPER 142, *supra* note 1, para. 1.1.

[211] *See* DuBose, *supra* note 102, at 226.

[212] Pendell & Davies, *supra* note 172.

[213] *See* FINAL REPORT 246, *supra* note 153, para. 6.15.

## IV. CONCLUSION

Shareholder derivative litigation is an important aspect of corporate law and has been a meaningful tool for shareholders to protect their interests in corporations for over 150 years.[214] However, the demand requirement utilized in the United States offers a set of complex procedural rules that may diminish a shareholder's chance to remedy bona fide harms inflicted upon the corporation by the board of directors.[215] This seems inapposite from the recent trend of increasing shareholder protections and transparency.[216]

The United Kingdom's shareholder derivative procedure, found in the Companies Act, offers a viable alternative to the demand requirement in the United States. By providing greater judicial control, clarity of rules, and transparency in the procedure, the United Kingdom endeavors to take shareholder derivative litigation into the 21st century. Likewise, within the past two decades, many other countries have made changes similar to those found in the Companies Act.[217] The United States should recognize this growing trend. The shareholder derivative procedure put forth in the Companies Act provides an alternative procedure to the United States' demand requirement. The Companies Act attempts to find a middle ground between director control and judicial control, assuring the protection of shareholders' interests while comforting directors by reaffirming their managerial powers.[218] It seems apparent that the same medium is just as desirable in the United States. Accordingly, the United States should recognize the statutory changes to the shareholder derivative procedure in the United Kingdom in an effort to improve shareholder protections and address shareholder concerns with the current demand requirement procedure.

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[214] Foss v. Harbottle, (1843) 67 Eng. Rep. 189.

[215] *See Legal Liability Part 2*, *supra* note 11, at 29 (describing the United States' concern with who should control the suit, through "extremely complex procedural rules").

[216] *See* FINAL REPORT 246, *supra* note 153, paras. 6.8-.9.

[217] *Id*. paras. 1.13, 6.8 (including countries such as Australia, Hong Kong, New Zealand, Canada, Japan, and South Africa).

[218] *See* discussion *supra* Parts I.D and III.