



DERIVATIVE LITIGATION | Recent High Court decision indicates continued significance of the common law derivative action

As COVID-19 continues to have far reaching implications for businesses – and their directors – in the UK, we consider an area of company law of which directors should be ever-mindful when navigating the challenging decisions ahead; namely derivative actions brought by shareholders to enforce the rights of the company.

While the statutory derivative action, enshrined in the Companies Act 2006, is more prevalent, its narrower common law counterpart still has teeth.

In a recent decision the High Court – for the first time – granted conditional permission for claimants to pursue a common law derivative action, notwithstanding their present lack of standing to do so. We consider the potential implications of this decision against the backdrop of an environment in which multiple stakeholders – not just direct shareholders – will be looking to ensure the interests of companies are sufficiently protected.

What are derivative actions and what purpose do they serve?

When a company is injured as a result of wrongful conduct, any cause of action vests in the company itself; the company is a separate legal person distinct from its shareholders, and is the proper claimant in proceedings. The company, acting through its directors, may decide not to pursue a claim, perhaps because the claim arises from a breach of duty, owed to the company, by those same directors.

Derivative actions are a means by which the company's shareholders can seek redress against the company's directors and officers (or third parties implicated in any breach of duty) for wrongs committed against the company. The claim is "derivative" because, again, the cause of action lies with the company; shareholders are able to bring the claim in their own name on behalf of the company.

Such claims can be brought either under the statutory mechanism or under the common law; both require permission to be obtained from the court before being allowed to proceed¹.

Statutory derivative claims

Most derivative actions are brought under Part 11 of the Companies Act 2006, which has largely – but not entirely – replaced the common law jurisdiction for such actions.

These claims, commonly brought by shareholders against the company's directors on the basis of alleged breaches of the directors' duties, will be limited to causes of action arising from actual or proposed acts or omissions involving any negligence, default, breach of duty or breach of trust by a current, former or shadow director of the company². The right to bring a derivative action on behalf of a company is confined to the members of that company³.

Common Law derivative claims

Prior to the Companies Act 2006, the circumstances in which a derivative action could be brought were limited by the ruling in *Foss v Harbottle*⁴, the nineteenth century authority for the proposition that, where harm is done to a company, the proper claimant is the company itself. As a result of the difficulty identified above, i.e. where the alleged wrongdoers are members of the board and, as is commonplace, the power to initiate litigation lies with them, the narrow common law derivative action developed as a limited exception to the rule in *Foss v Harbottle*. Actions under this exception required the necessary ingredients of both "fraud" and "wrongdoer control" to proceed⁵.

Despite being replaced by what is generally considered a wider statutory mechanism⁶, the fact that a statutory derivative action is only available to members⁷ means that the common law principles still govern "multiple" derivative claims⁸. These may emerge where a shareholder of a parent company wants to pursue a cause of action vested in a subsidiary of that parent company; so-called double derivative claims (or, indeed, subsidiaries of the subsidiary; so-called triple derivative claims). It was in this context that the High Court recently addressed the bounds of the common law jurisdiction, and the range of potential claimants.

Recent development in respect of common law derivative claims

In *Boston Trust Company Ltd v Szerelmey Ltd (No 2)*⁹ the issue to be considered by the High Court was whether, in certain circumstances, the court has the power – and, if so, when and how, if at all, it should exercise such power – to grant conditional permission for a claimant to pursue a multiple derivative action at common law.

The case, which is ongoing, involves a group of companies – the Szerelmey group – which are arranged in a complex corporate and trust structure. The ultimate parent company of the Szerelmey companies was a company called Tellisford Limited ("Tellisford"), in which the Erutuf Trust was a shareholder. The Claimants, acting in their capacity as trustees of the Erutuf Trust, sought permission to bring a multiple derivative action in respect of losses caused to the group by the allegedly fraudulent conduct of one of the owners of the group. Recognising their lack of standing to bring a claim as a shareholder on a derivative basis, the Claimants had issued separate proceedings seeking rectification of Tellisford's register of members to include its interest.

Stephen Houseman QC (sitting as a Deputy Judge of the High Court), ruled that the High Court had jurisdiction to grant conditional permission to the Claimants, despite the fact that they currently lacked standing, to pursue a derivative action at common law, and that it was just and appropriate for the court to do so, provided there was a sufficiently robust and proximate prospect of the Claimants acquiring standing in due course (i.e. in the present case, through rectification of the share register) which, the court found, there was.

Permission to appeal Mr Houseman QC's decision has been granted, so the ultimate significance of this development is yet to be determined; nonetheless, there are potentially noteworthy implications of the finding. If the decision stands, it would mean that putative claimants, able to present a viable prima facie case that they would be able to establish standing within a "tolerable timeframe", may be

able to avail themselves of the common law derivative claim framework where they might otherwise have been prevented from doing so on the basis of lack of standing. While such a development would not necessarily lead to a flood of litigation by such claimants, particularly in the context of complex corporate structures, there would be scope for a significantly wider class of claimants, including those without direct shareholdings in the injured company, to seek redress.

Derivative actions and COVID-19

COVID-19 may be the source of much litigation in the months and years ahead; derivative actions by shareholders, arising from enhanced scrutiny of decisions and actions taken by directors in a challenging business environment, are likely to be an area of significant activity, particularly if the class of potential claimants is increased.

The pandemic is generating a host of risks for all organisations – including those arising from the business's response to the pandemic, business interruption, cyber breaches, health and safety, regulatory compliance, and ultimately for many, the risk of insolvency. Such risks inevitably result in high stakes actions, and decisions, being taken by directors; in a turbulent market, those actions and decisions will be under the spotlight. Shareholders will want to see that directors are acting in accordance with their codified duties¹⁰, in particular the duty to promote the success of the company (s.172) and the duty to exercise reasonable care, skill and diligence (s.174). If any losses suffered by the company can be attributed to such decisions and actions, disgruntled stakeholders may see the derivative action as a viable means of protecting the company's interests, enforcing the company's rights and, ultimately, seeking redress.

In the current circumstances companies might consider whether any contentious decisions can be authorised before or ratified after the event by the shareholders, in order to mitigate the risk of a derivative claim. In addition, understanding D&O insurance policies will also be key to assessing the extent of exposure in respect of any litigation.

Conclusion

The requirement to obtain the court's permission to proceed with a derivative action, whether under the Companies Act, or under the common law jurisdiction, provides a necessary and welcome procedural filter that aims to protect against spurious derivative claims. The decision in *Boston Trust Company Ltd v Szerelmey Ltd (No 2)* is an interesting development that could incrementally widen that filter so that conditional permission can be given to claimants who in ordinary circumstances would be denied permission due to an irregularity which deprives them of standing. Whether or not there is an appetite amongst putative claimants to pursue such actions, it will be interesting to track the ramifications of this decision – if it stands – at a time when shareholders and stakeholders will be closely examining the decision making of company directors.

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¹ CPR 19.9(4); s. 261 and s. 263 Companies Act 2006

² s.260(3) Companies Act 2006

³ s.260(1) Companies Act 2006. Note however s.265(5) "...a member of a company include[s] a person who is not a member but to whom shares in the company have been transferred or transmitted by operation of law."

⁴ *Foss v Harbottle* 67 E.R. 189 (1843) 2 Hare 461

⁵ *Prudential Assurance Co. Ltd. v Newman Industries Ltd. and Others (No. 2)* [1982] Ch. 204

⁶ For example, a statutory derivative action can be brought for breach of directors' duties arising from negligence.

⁷ or non-members to whom shares have been transferred or transmitted by operation of law. See s.265(5).

⁸ [*Universal Project Management Services Limited v Fort Gilkicker Limited and others*](#) [2013] 3 WLR 164

⁹ *Boston Trust Company Ltd (in their capacities as trustees of Erutuf Trust) (suing on behalf of Erutuf Trust and all other shareholders in Tellisford Ltd other than VOC Trustee Ltd) v Szerelmey Ltd* [2020] EWHC 1352 (Ch)

¹⁰ See s.171-177 Companies Act 2006