EVERSHEDS SUTHERLAND

Finding balance

Derivative actions and what it entails

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Introduction

One of the cornerstones of Company Law is that the "will" of the majority (of shareholders) ought to prevail in respect of how the Company is managed, and to determine what contracts the Company enters into[1]. Our common law system provides a remedy whereby oppressed shareholders may seek legal remedies from the Court to challenge the rule of majority shareholders – this remedy is known as a "derivative action". In addition, s.212 of the Companies Acts 2014[2] provides a statutory remedy for minority shareholders to challenge a decision taken by the majority shareholders. The purpose of this article is to examine when a minority shareholder can sue in the name and on behalf of the Company, as an alternative to simply seeking to bring proceedings in their own name as an oppressed minority, by way of a derivative action, where compensation and relief is sought on behalf of the Company and not the individual minority shareholder.

Derivative actions

A derivative action permits a minority shareholder, as representative of all of the other shareholders, to institute proceedings on behalf of the Company in an attempt to redress a wrong perpetrated by the majority shareholders on the Company. Historically, derivative actions arose in large public Companies where the division of power between members and directors was a reality. However, as commerce has evolved this remedy has been called upon within all types of Companies, and not limited to public Companies. The basic rule of Company Law is that where a wrong is committed on the Company, whether by the directors or majority shareholders, the proper plaintiff is the Company itself.

The central question a Court will assess in deciding whether to permit a minority shareholder to bring a derivative action is whether a wrong committed against the Company would otherwise go unredressed if the derivative action was not brought. Ordinarily, the decision for the Company to litigate will be taken by the board of directors, who will usually have the power to do so pursuant to s.158(1) of the Companies Act 2014 or the Company's bespoke Constitutional provisions. The reason why a Company may not litigate if a wrong has been done to it and why a minority shareholder may wish to bring a derivative action arises in two particular scenarios:

1. where the directors are themselves responsible for the wrongdoing; or
2. the minority shareholders cannot muster sufficient voting power at a general meeting to compel the directors to institute proceedings.

Unfortunately, in practice it remains extremely difficult for a minority shareholder to secure the Court's permission to bring a derivative action – the reasoning for this is explored in greater detail below.

Overcoming practical hurdles

For a minority shareholder to succeed in being permitted to bring a derivative action, that minority shareholder must first be granted "Leave" (or permission) by the Court to do so. At the Leave application a minority shareholder must demonstrate that:

(i) a wrong has been done to the Company whilst under the control of the wrongdoers;

(ii) from which the wrongdoers have benefited;

(iii) there is no other way of remedying this state of affairs save for permitting the minority shareholder to bring the derivative action; and

(iv) the action is reasonable, prudent and in the interests of the Company, and there is a realistic prospect of the derivative action being successful at a full trial.

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1 In order for a minority shareholder to bring a claim on behalf of the Company it must fall within one of the exceptions to *Foss v Harbottle*. These exceptions are: (i) illegality act is perpetrated; (ii) infringement of a shareholder's personal rights; (iii) where more than a bare majority is required to ratify the "wrong" complained of; (4) justice of the case requires the minority to be permitted to institute proceedings; or (5) a fraud has been perpetrated on the minority by those in control, this is the most popular exception.

2 Section 212 of the Companies Act 2014 provides the statutory exception to the rule in *Foss v Harbottle*. In order to bring a s.212 application the shareholder must established he has *locus standi*, in other words, he a member of the company in question, and that the affairs of the company are being conducted, or that the powers of the company directors are being exercised in (i) an oppressive manner which is affecting the minority shareholder and/or any other member; or (ii) in disregard of the shareholders' interests.

However, even if a minority shareholder has established all of these eventualities, a Court may still refuse to permit the derivative action from proceeding. This would generally occur where the Court disapproves of the conduct of the minority shareholder, or if that minority shareholder has delayed in bringing the application, or if that minority shareholder previously approved the conduct against which he is now complaining. During the Leave application the Court will also want to ensure that the minority shareholder has exhausted all available remedies before granting permission to proceed with a derivative action. In particular, that the minority shareholder has fulfilled the necessary precondition of holding, or trying to hold, a shareholders' extraordinary meeting before he has sought the Leave of the Court. At this meeting, the minority shareholder will highlight the alleged fraudulent transaction/behaviour to the other shareholders so that they can vote on whether to set aside the impugned transaction or authorise the Company to institute the necessary proceedings.

Should a minority shareholder fail to take this step the Court will consider that the derivative action application is premature. Equally, where the minority shareholder does not muster sufficient strength to convene an extraordinary meeting, the Court may be minded to Order the calling of such an extraordinary meeting. The idea being that the Court will want to ensure that every reasonable step is taken by a minority shareholder before the Court will grant permission for a derivative action to be brought, which could result in the Company being involved in a lengthy and costly trial, and the claim may subsequently transpire to be baseless and unmeritorious. The Court will also want to ensure that the alleged wrongdoers were in control of the Company before it will allow a derivative action to go ahead[3].

Do derivative actions need to be placed on a legislative footing?

One notable absentee from the Irish Companies Act 2014 is derivative actions. In contrast, s.206 of the Companies Law (England) 2006 has placed derivative actions on a legislative footing. Here, s.206 provides that an applicant must outline the exact elements needed to sue on the Company's behalf and permits a minority shareholder to take an action for any instance of negligence, default, breach of duty or breach of trust by a director, where the Court is so satisfied it is appropriate. Although bringing a successful derivative action still remains the subject of many significant procedural hurdles, the English legislation has widened the grounds for taking an action to those currently available in Ireland.

Notwithstanding the apparent opening up to permitting the availability of derivative action claims, this UK statutory process has to date been ineffective in establishing a plethora of successful derivative actions. Indeed, the number of successful derivate actions instituted still remains very low.

As such, the procedural rules applied in both Ireland and England remain extremely demanding and restrictive when the Court is assessing a derivative action claim. It would seem that the rationale for this is that the Courts remain generally unwilling to get involved in the internal workings of Companies and they do not wish to become embroiled in corporate policy-making. Equally, allowing minority shareholders to take derivative actions is still seen as undermining the cardinal principle of majority rule, which is crucial to the effective governance of companies. Consequently, the Courts remain mindful of potential disruptions resulting from minority shareholders seeking to bring litigation on behalf of, and in a Company's name. Finally, if a minority shareholder's rights are being oppressed, or the majority is running the Company in disregard of the shareholder's interests, minority shareholders can still bring an application under s.212 of the Companies Act 2014 which will permit an exhaustive list of remedies, including compensation.

Practical implications

In practice, it is extremely difficult for a minority shareholder to successfully bring a derivative action. The main reason for this is to ensure the internal governance of Companies remains free from the possibility of regular actions being taken by minority shareholders on the Company's behalf.

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3 See Cooks v Deeks [1916] 1 AC 554.

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