

SHAREHOLDERS' DIRECT ACTIONS:

When can a company's shareholders and creditors make claims separately from the company?

Teresa Rosen Peacocke

Introduction

1. Shareholders or creditors of a company, as such, may seek to assert claims against
 - a. other shareholders;
 - b. company directors; or
 - c. third parties, especially professional advisers to the company, such as lawyers, accountants or valuers.
2. It is well known that the ability of minority shareholders to bring actions against directors or majority shareholders (or third parties dealing with companies) in England and Wales¹ is limited, and that the atmosphere for such litigants in the UK courts is stifling.
3. It has, further, long been recognized that a significant barrier to effective shareholder action, particularly in cases of wrongdoing by a company's own directors, is what is known as the rule in *Foss v Harbottle* (1843) 2 Hare 461.
4. In the US, it is the business judgment rule that reflects the reluctance of the courts to engage in substantive review of directors' actions involving the exercise of business judgment, unless some vitiating factor exists.²

¹ To speak of English law, or UK law, is in both cases sloppy and inaccurate, but I adopt the practice with the excuse that accuracy is too complicated. The United Kingdom and Great Britain are political units, with the United Kingdom (of Great Britain and Northern Ireland) comprising England and Wales, Scotland and Northern Ireland. But within the UK there are distinct legal jurisdictions for England and Wales, Scotland, Northern Ireland, Guernsey, Jersey and the Isle of Man. Scottish law is based on Roman law; the law of England and Wales is common law with statutory overlay, although statutes adopted by the UK Parliament often apply to Scotland as well as England and Wales.

² Separate rules, of course, restrict the circumstances in which individual shareholders in a corporation may litigate about breaches of directors' duties.

5. English courts are similarly reluctant to review directors' business decisions; but the rule which generally precludes such review in England is more closely related to a demand requirement: this is the rule in *Foss v Harbottle* (1843) 2 Hare 461.
6. The rule in *Foss v Harbottle* limits standing to bring an action on behalf of a company. The 'fraud on the minority' exception to the rule permits shareholders to maintain a derivative action in certain (highly restricted) circumstances. The exception is, conceptually, not far removed from the recognition, in cases such as *Aronson v Lewis*, 473 A.2d. 805 (1984), that a demand requirement ought not to be insisted upon where it would be futile.
7. In Britain, a shareholder who surmounts the barriers presented by the rule in *Foss v Harbottle* will not then face the additional barrier of a business judgment rule; but it is far more difficult to overcome the *Foss v Harbottle* obstacles in the first place.
8. In addition to their restricted recourse to derivative actions, a shareholder has the right not to be unfairly prejudiced, by section 459 of the Companies Act 1985, and may thus petition the court for relief.³ The usual remedy sought (and granted) is for the shareholder's holding (in relatively small, private companies) to be bought out by the other members.
9. It has, further, always been accepted that a shareholder (or creditor) may have a separate, direct cause of action against a company director, majority shareholder or third party, for a wrong committed against him/her, causing personal loss.
10. It is the shareholder/creditor's personal cause of action which is the principal focus of this presentation.
11. In particular, I will discuss a recent, and curious, development in English company law, relating to claims by shareholders and/or creditors for direct losses arising (*inter alia*) from wrongs committed against or dealings by the corporation.
12. By the application of what is called the 'no reflective loss' principle, a claimant in a direct action faces a preliminary challenge to his right to maintain his claim, on

³ The statutory remedy for oppression was introduced in Britain in 1948, by section 210 of the Companies Act 1948, but interpreted extremely restrictively. Oppression was upheld in only two cases in Britain. However, a number of close corporation statutes adopted remedies based on the 1948 statute: see the Model Statutory Close Corporation Supplement §40. The US remedy has been applied more liberally and expansively.

- the ground that the loss claimed merely reflects loss also suffered by the company, which would be extinguished if the company's loss were remedied in full, (whether or not any such prospect exists).
13. This vague debarring principle has become an issue in a surprisingly variety of cases, including claims by beneficiaries against their trustees for failing to act to preserve the value of the trust assets, or for an account of unlawful profits,⁴ creditors' claims, misappropriation of corporate opportunity cases, conspiracy claims and professional negligence claims.
 14. In what follows, I examine the (largely historical) basis for the English court's general hostility towards minority shareholder actions, and seek to explain how the court's unduly restrictive approach towards minority derivative actions has given rise to this further layer of scrutiny, which appears to be impractically vague, wholly unnecessary and unjustifiable procedurally or substantively.

The Rule in *Foss v Harbottle*

15. The rule in *Foss v Harbottle* (1843) 2 Hare 461 derives from the early nineteenth century English law of partnership, which also explains the general hostility towards shareholders' claims that pervades English company law.
16. Seventeenth and eighteenth century corporations in both England and the US were formed by charter and statute, but the incorporated business forms in the different jurisdictions arose from different models.⁵ The English company is derived from the partnership form, whilst the American corporation grew from the legal form for municipalities, created to address public needs, relating principally to transportation and financial infrastructure.⁶
17. By the eighteenth century it had been firmly established in the English courts that the Chancellor would never interfere in the internal disputes of a partnership,

⁴ See *Walker v Stones* [2000] 4All ER 412; *Shaker v Al- Bedrawi* [2003] 2 WLR 922.

⁵ See A J Boyle, "Minority Shareholders' Remedies", *Modern Law Review* Jan 2002.

⁶ Professor James Willard Hurst, in *The Legitimacy of the Business Corporation in the Law of the United States, 1780-1970* (1970), reports, at page 17 that two thirds of the 317 separate-enterprise special charters between 1780 to 1801 were for transportation enterprises (inland navigation, turnpikes, toll bridges), one fifth were for banks or insurance companies, one tenth for local public services (mostly water companies) and less than 4 per cent were general business bodies.

- except with a view to dissolution. Harmony between partners was not to be had by decree, and equity would not act in vain.
18. By the early nineteenth century the Chancellors had relented somewhat, and refashioned the old partnership rule, principally to suit the needs of the growing number of unincorporated joint stock companies. These companies had a large and fluctuating membership, in which ownership was already considerably divorced from management. Shares were, in practice, freely transferable, and internal procedures for remedying grievances were frequently provided.
 19. Under the modified rule, it was only in the case of ‘matters of internal regulation’ that the Chancellor would refuse to act.⁷
 20. For private partnerships, however, it was never expected that an aggrieved partner, even a minority partner, should first seek a remedy within the partnership. Thus, the Chancellors simply refused to intervene in ‘partnership squabbles’ or ‘mere passing improprieties’: see, e.g., *Marshall v Colman* (1820) 2 J & W 266.
 21. By 1841, however, the Chancellor’s approach to private partnership disputes had also been refined, so as to afford relief (without insisting on a dissolution) where to refuse would advantage the wrongdoer: *Smith v Jeyes* (1841) 4 Beav 503.
 22. The rule established by Wigram V-C in *Foss v Harbottle*, then, represented a major advance in the law relating to minority shareholders in corporations, by a transformation of the old partnership rule. The case actually concerned a statutory company created by private Act, but the decision came just before Gladstone’s Act of 1844 extended the right to incorporate to ordinary trading companies by simply registering their deed of settlement. The courts thus found themselves applying a partnership rule in a corporate context.
 23. In his judgment in *Foss v Harbottle*, Wigram V-C followed the older cases on unincorporated companies, by insisting that the minority must be able to show that they had exhausted any prospect of internal redress within the company.⁸ (To

⁷ This rule, and the rule in *Foss v Harbottle* that developed from it, were entirely the creations of the Chancellor, who had acquired nearly exclusive jurisdiction over internal disputes in partnerships and companies. As for companies, this jurisdiction was founded upon the trust created by the deed of settlement and, later, upon the remedies sought and the fiduciary duties of directors.

⁸ Proof of the exhaustion of internal corporate remedies remains a prerequisite of an American derivative action, under Fed R Civ P 23.1 and Cal Corp Code §800(b)(2).

- their credit, the Chancery courts soon afterwards abandoned any positive requirement that the minority's complaint first be referred to the general meeting.⁹)
24. Although earlier partnership decisions had not expressly relied upon the majority's power to ratify company acts, Wigram V-C held that, as a matter of principle, the court would not intervene where a majority of the shareholders could ratify irregular conduct.¹⁰
25. Wigram V-C's decision in *Foss v Harbottle* also established another, entirely new, basis to support the majority rule principle. The independent legal character of the company provided a separate ground for restricting minority actions: since an incorporated body was the 'proper plaintiff' in an action concerning its rights or constitution, it could only be very exceptionally, in the case of grave abuse, that a minority would be allowed to sue in its own name by joining the company as defendant.
26. Thus there were established the two elements to the rule in *Foss v Harbottle*, described by Jenkins LJ in the leading modern case of *Edwards v Halliwell* [1950] 2 All ER 1064 as follows¹¹:
- “First, the proper plaintiff in an action in respect of a wrong alleged to be done to a company or association of persons is prima facie the company or the association of persons itself. Secondly, where the alleged wrong is a transaction which might be made binding on the company or association and on all its members by a simple majority of the members, no individual member of the company is allowed to maintain an action in respect of that matter for the simple reason that, if a mere majority of the members of the company or association is in favour of what has been done, then *cadit quaestio*.”
27. Notwithstanding these strictures, it was implicit in Wigram V-C's judgment that where it was futile to hope for action by the general meeting, a suit may be

⁹ *Lord c Cooper Miners* (1848) 2 Ph 740.

¹⁰ Which is itself a somewhat circular proposition.

¹¹ [1950] 2 All ER 1064 at 1066.

brought by the minority, even for matters that could be ratified by the majority. He said¹²:

“If a case should arise of injury to a corporation by some of its members, for which no adequate remedy remained, except that of a suit by individual incorporators in their private characters, and asking in such character the protection of those rights to which in their corporate character they were entitled, I cannot but think that the principle so forcibly laid down by Lord Cottenham in *Wallworth v Holt* (1841) 4 My & Cr 619 at 635 and other cases, would apply, and the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue.”

28. This, then, constituted the legal basis in equity for the modern derivative action.
29. The ‘majority rule’ element of the *Foss v Harbottle* decision was, in the atmosphere of hostility by the court towards minority partners and shareholders, interpreted restrictively, by debarring a minority action whenever the misconduct was, in law, capable of ratification, whether or not an independent majority would ever in fact be given an opportunity to consider the matter.¹³
30. Interestingly, early cases following *Foss v Harbottle* suggested that it was not necessary that the claimant in a derivative action was a member of the company at the time of the alleged wrong: *Seaton v Grant* (1867) LR 2 Ch App 459. There is nothing which appears to reverse this position in the (relatively) new rules of court relating to derivative actions, in Part 19.9 of the Civil Procedure Rules 1998.
31. In 1902 Lord Davey, in *Burland v Earle* [1902] AC 83, explained reasoning behind the rule in *Foss v Harbottle*, by saying that the right of shareholders to bring an action in their own names is a mere matter of procedure in order to give a remedy for a wrong which would otherwise escape redress. He went on to say that:

“... it is obvious that in such an action the plaintiffs cannot have a larger right to relief than the company itself would have if it were plaintiff, and cannot

¹² At pages 490-492.

¹³ See, for example, *Macougall v Gardiner* (1875) 1 Ch D 13, at page 25, to be contrasted with the wider view maintained by Jessell MR in *Russell v Wakefield Waterworks* (1875) LR 20 Eq 474 at page 482.

complain of acts which are valid if done with the approval of the majority of the shareholders or are capable of being confirmed by the majority.”¹⁴

32. Despite the characterization of the rule in *Foss v Harbottle* as purely procedural, it was as clear then as it is now to complaining shareholders that bringing a derivative action meant surmounting substantive hurdles of fact and law, about the details of the alleged wrong, its capacity to be ratified by the majority, and issues of corporate control.

33. In 1950, in *Edwards v Halliwell*, Jenkins LJ summarized the underlying principles of the rule in *Foss v Harbottle*, and its established exceptions, as follows:

- a. The proper plaintiff in an action on a wrong alleged to have been done to a corporation is, *prima facie*, the corporation;
- b. Where the alleged wrong is a transaction which might be made binding on the corporation and on all its members by a simple majority of the members, no individual member is allowed to maintain an action in respect of that matter;
- c. There is no room for the operation of the rule if the alleged wrong is *ultra vires* the corporation, because the majority of members cannot confirm the transaction;¹⁵
- d. There is, further, no room for the operation of the rule if the transaction complained of could be validly done or sanctioned only by a special resolution or the like, because a simple majority cannot confirm that which requires the concurrence of the greater majority;
- e. There is an exception to the rule where what has been done amounts to fraud and the wrongdoers are themselves in control of the company.

34. ‘Fraud’ in this context, is generally construed widely, to include not just deceit or illegality at common law, but also equitable fraud, such as abuse or misuse of power by directors.¹⁶

¹⁴ *Burland v Earle* [1902] AC 83 at 93.

¹⁵ Not an area of any real relevance today, in the US or the UK, the doctrine having effectively lapsed in the US before it was reduced in the UK by the new section 35(2) of the Companies Act 1985 (introduced by section 108 of the Companies Act 1989).

¹⁶ See *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 All ER 437 at 445, per Sir Robert Megarry, a case in which the ratifying majority shareholder (the Council) was also the wrongdoer.

35. Jenkins LJ also sought to explain the relationship between the two elements of the rule in *Foss v Harbottle* in this way: the will of the majority, *vis-à-vis* the complaining minority, is to be identified with that of the company; therefore, saying that the company is the proper plaintiff in actions concerning the company's affairs is just another way of saying that the majority, within the limits of their power to ratify, have the sole right to determine whether or not a dispute should be brought before the court.
36. This not unreasonable rationale has not, however, confined the court's application of the rule. For breaches of duty by directors, for instance, minority shareholders had to bring themselves within the 'fraud on a minority' exception to the rule in *Foss v Harbottle*¹⁷, which required them to establish not simply that the matter complained of was incapable of ratification by the majority, but also that the alleged wrongdoers remain in control of the company.¹⁸
37. In this way, the 'proper plaintiff' rule acquired a force of its own, independent of the rule relating to the majority's power to ratify. Even at this early stage, the rule had already become unnecessarily restrictive.

Summary

38. The propositions emerging from the rule in *Foss v Harbottle*, as developed over the years, are these:-
- a. Where a wrong is committed against a company, the proper plaintiff in any action in respect of that wrong is the company¹⁹;
 - b. Where the wrong has been committed by a third party, the directors in the exercise of their management powers (or the liquidator if the company is insolvent) will decide whether the company should sue to redress that wrong²⁰;
 - c. Where the wrong has been committed by the directors, it would be inappropriate to allow their control of the management of the company to

¹⁷ Declared by Jenkins LJ to be the only true exception to the rule.

¹⁸ See, for example, *Pavlides v Jensen* [1956] 1 Ch 565 at 575.

¹⁹ *Foss v Harbottle* (1843) 2 Hare 461.

²⁰ *Breckland Group Holdings Ltd v London and Suffolk Properties Ltd* [1989] BCLC 100.

prevent the company from seeking redress, and thus exceptionally the complaining shareholders can bring a derivative action in their own names and on behalf of the company;

- d. However, if the wrong or irregularity complained of is one which might lawfully be ratified by a simple majority of its members, no individual shareholder can maintain an action in respect of that matter²¹;
- e. Where an individual shareholder has suffered a personal wrong, whether perpetrated by the director(s), or the majority, or the company is threatening an *ultra vires* act, the proper form of action is a direct, personal claim by the shareholder, with the company as a true defendant (along with the directors where appropriate).²²
- f. If the wrong is one suffered by the shareholder in common with all members, or all members of a certain class, then a personal action may be brought, but also may a true representative action, under Part 19.6 of the Civil Procedure Rules (which is preferable, as binding all relevant parties).

39. In the US, the question whether a suit is derivative by nature or may be brought by a shareholder in his own right is governed by the law of incorporation.

40. In general, where a corporation is injured by a wrongful act, but the board of directors refuses to seek relief, a shareholder can sue the wrongdoer on behalf of the corporation.²³ The cause of action is an asset of the corporation, which means that if the corporation is in bankruptcy, the suit is an asset of the bankrupt estate.²⁴

41. Most cases based upon breach of fiduciary duties of care and loyalty are derivative in nature. However, cases occasionally arise in which the corporation has sustained immediate injury, but the shareholder's action is nevertheless

²¹ See *Barrett v Duckett* [1995] 1 BCLC 243 at 249, CA.

²² In many cases, the shareholder does not benefit personally, the relief granted taking the form of an injunction or declaration.

²³ *Alabama By-Products Corp v Cede & Co*, 657 A.2d 254, 265 (Del. 1995); *Rales v Blasband*, 634 A. 2d 927, 932.

²⁴ 11 USC §541(a)(1); *Pepper v Litton*, 308 US 295, 306-7 (1939); *Koch Refining v Farmers Union Central Exchange Inc*, 831 F2d 1339, 1343-44 (7th Cir. 1987); *In re Ionosphere Clubs, Inc*, 17 F.3d 600, 604 (2d Cir. 1994).

- accepted to be a direct claim, because of some ‘special duty’ owed to the claimant shareholder.²⁵
42. In *General Rubber Cc v Benedict*, 215 N.Y. 18 (1915) a suit by a corporation-shareholder against one of its directors for looting the assets of the corporation’s subsidiary has been held to be a direct action. Even though the injury was to the subsidiary, there was a special fiduciary duty owed by the director to the corporation-shareholder.
43. In *Reifsnyder v Pittsburgh Outdoor Advertising Co*, 173 A.2d 319 (Pa. 1961) a corporation bought property owned by its majority shareholder, following approval of the transaction by the shareholders, including the seller. The minority shareholder objected to the price paid, and brought a direct claim to rescind the transaction. The claim was based not on unfair self-dealing – a derivative claim – but on infringement of the claimant’s voting rights, arguing that the seller majority shareholder ought to have abstained, and the proposal would have been defeated.
44. Common shareholders of a bankrupt corporation (who very much do not want to be in bankruptcy court), or others seeking to avoid the pre-requisites of a derivative action, will often seek to fit their cases into the framework of a suit by a minority against a majority shareholder. It is generally accepted that the latter owes the former a fiduciary duty.²⁶
45. The breach of that obligation is, so the argument goes, a wrong to the minority shareholder rather than to the corporation, since, *prima facie*, all it does is redistribute wealth from him to the majority shareholder; it does not reduce the value of the corporation. A derivative suit in such a situation would (paradoxically) benefit the majority.

²⁵ See *Citibank NA v Data Lease Financial Corp*, 828 F.2d 686 (11th Cir. 1987) where a shareholder/pledgor claimed directly against a director/pledge for dissipating corporate assets, by virtue of a ‘special duty’ arising from the pledge arrangements.

²⁶ *Kahn v Lynch Communication Systems, Inc*, 638 A.2d 1110, 1113-14 (Del. 1994); *In re MAXXAM, Inc*, 659 A.2d 760, 771 (Del. Ch. 1995); *Southern Pacific Co v Bogert*, 250 US 483, 487-88 (1919); *Pepper v Litton, supra*, 308 US at 306-07; *Rademeyer v Farris*, 284 F.3d 833, 837 (8th Cir. 2002).

Direct Actions by Shareholders: The *Prudential* Doctrine

46. It not very helpful to look at a direct action by a shareholder, for personal loss suffered independently of the loss caused to the company, as an exception to the rule in *Foss v Harbottle*. In principle, if a breach of a duty owed to the shareholder as such causes direct, personal loss, neither ratification by the majority of any corporate act or omission which precipitated the personal claim, nor the fact that the company may also have a cause of action for its own loss, should affect the validity of the shareholder's claim, or the standing of the claimant to sue.
47. But in 1982, confusion set in, with the decision of the Court of Appeal in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204. The case involved a combined derivative action and personal claim (or direct action) by a minority shareholder. The shareholder's claim was for damages for the diminution in the value of the minority shareholding, or loss of dividends, caused by the conspiracy of two directors, to provide a misleading circular to shareholders to induce them to approve a fraudulent, and commercial disastrous, purchase transaction by the company.
48. The court declared the personal claim to be no more than an attempt to circumvent the rule in *Foss v Harbottle* (as indeed it was), and held it to be misconceived (as indeed it was). It is important, however, to appreciate that the claim was misconceived irrespective of whether it was an attempt to circumvent the requirements for a derivative action.
49. It was accepted in *Prudential*, that fiduciary duties owed directly to the plaintiff as a shareholder had been breached by the directors, but found that the shareholder had not personally suffered the loss sought to be recovered.
50. The court held that although a shareholder could, in principle, bring a personal claim against those who had also committed a wrong against the company, "what he cannot do is to recover damages merely because the company in which he is interested has suffered damage. He cannot recover a sum equal to the diminution in the market value of his shares, or equal to the likely diminution in dividend, because such a 'loss' is merely a reflection of the loss

suffered by the company. The shareholder does not suffer any personal loss. His only 'loss' is through the company, in the diminution in the value of the net assets of the company ... the plaintiff's shares are merely a right of participation in the company on the terms of the articles of association. The shares themselves, his right of participation, are not directly affected by the wrongdoing. The plaintiff still holds all the shares as his own absolutely unincumbered property. The deceit practiced on the plaintiff does not affect the shares; it merely enables the defendant to rob the company."

51. This statement became the foundation of the "no reflective loss" principle.
52. But was such a principle necessary, and what does it achieve? It does, of course, explain why the rule in *Foss v Harbottle* operates to prevent a direct action by a shareholder to recover for losses which are indistinguishable from loss suffered by the company. But since
 - a. the specific common law and fiduciary duties owed by directors and third parties to a company are not owed to minority shareholders as well, and
 - b. the interests of the company and the shareholder, which may be adversely affected by a breach of duty, are not identicalit is unlikely, on general principles, that a breach of a duty owed specifically to a shareholder as such would give rise to a liability for loss which wholly reflects the loss caused to a company by breach of a different duty owed to it.
53. The simple fact is that the direct action in the *Prudential* case was bad because the loss claimed was not caused by the alleged breach.
54. The breach of duty in providing misleading information affected the shareholder's exercise of their voting rights; preserving the value of the shares was not within the scope of the duty.
55. In other words, there was no need for a special principle of company law to determine whether a shareholder's direct claim should be debarred because it reflects a claim vested in the company.
56. In the case of *Stein v Blake* [1998] 1 All ER 724, the matter got worse, for the introduction of the notion that one could test for reflective loss by asking whether

the claim would be extinguished by the (notional) restoration of the fortunes of the company.

57. In that case, the claimant and the first defendant each held 50% of the issued shares in various companies, and the first defendant acted as the sole director. The claimant asserted that the first defendant had transferred assets from one of these companies to others controlled by him in which the claimant had no interest, thereby depriving the claimant of the value of his interest in that company. He claimed damages based on the diminution in the value of his shareholding, arguing that in the unusual circumstances of the case, the first defendant owed him personally a fiduciary duty, the breach of which had caused him financial loss.

58. Millett LJ (as he then was) responded to this submission as follows:-

“But that is not the problem. The problem is that the only conduct relied upon as constituting a breach of that duty, however it is described and in whatever detail it is set out, is nevertheless the misappropriation of assets belonging to [the companies], so that the only loss suffered by the plaintiff consists of the diminution in the value of his shareholding by reason of the misappropriation of the assets of the companies in which those shares subsist. Such loss would be fully remedied by the restitution of the value of the misappropriated assets to the companies.”

59. The operation of the *Prudential* principle was affirmed and further explained by the House of Lords in *Johnson v Gore Wood & Co (a firm)* [2002] 2 AC 1. Lord Bingham summarized the position as follows²⁷:-

“...(1) Where a company suffers loss caused by a breach of duty owed to it, only the company may sue in respect of that loss. No action lies at the suit of a shareholder suing in that capacity and no other to make good a diminution in the value of the shareholder’s shareholding where that merely reflects the loss suffered by the company. A claim will not lie by a shareholder to make good a loss which would be made good if the company’s assets were replenished through action against the party responsible for the loss, even if the company,

²⁷ [2002] 2 AC 1 at 35-36.

acting through its constitutional organs, has declined or failed to make good that loss ... (2) Where a company suffers loss but has no cause of action to sue to recover that loss, the shareholder in the company may sue in respect of it (if the shareholder has a cause of action to do so), even though the loss is a diminution in the value of the shareholding ... (3) Where a company suffers loss caused by a breach of duty to it, and a shareholder suffers a loss separate and distinct from that suffered by the company caused by breach of a duty independently owed to the shareholder, each may sue to recover the loss caused to it by breach of the duty owed to it but neither may recover loss caused to the other by breach of the duty owed to that other ...”.

60. Lord Millett, in his own speech in *Johnson*, observed²⁸ that, where a company suffers loss caused by a breach of duty owed both to it and to the shareholder:-

“In such a case the shareholder’s loss, insofar as this is measured by the diminution in the value of his shareholding or the loss of dividends, merely reflects the loss suffered by the company in respect of which the company has its own cause of action. If the shareholder is allowed to recover in respect of such loss, then either there will be double recovery at the expense of the defendant or the shareholder will recover at the expense of the company and its creditors and other shareholders. Neither course can be permitted. This is a matter of principle; there is no discretion involved. Justice to the defendant requires the exclusion of one claim or the other; protection of the interests of the company’s creditors requires that it is the company which is allowed to recover to the exclusion of the shareholder.”

61. Lord Millett later discussed the scope of the ‘no reflective loss’ principle as follows²⁹:-

“Reflective loss extends beyond the diminution of value of the shares; it extends to the loss of dividends ... and all other payments which the shareholder might have obtained from the company if it had not been deprived of its funds. All transactions or putative transactions between the company

²⁸ ²⁸ [2002] 2 AC 1 at 62.

²⁹ ²⁹ [2002] 2 AC 1 at 66-67.

and its shareholders must be disregarded. Payment to the one diminishes the assets of the other. In economic terms, the shareholder has two pockets, and cannot hold the defendant liable for his inability to transfer money from one pocket to the other. In principle, the company and the shareholder cannot together recover more than the shareholder would have recovered if he had carried on business in his own name instead of through the medium of a company. On the other hand, he is entitled, (subject to the rules on remoteness of damage) to recover in respect of the loss which he has sustained by reason of his inability to have recourse to the company's funds and which the company would not have sustained itself.

The same applies to other payments which the company would have made if it had had the necessary funds even if the plaintiff would have received them *qua* employee and not *qua* shareholder and even if he would have had a legal claim to be paid. His loss is still an indirect and reflective loss which is included in the company's claim. The plaintiff's primary claim lies against the company and the existence of the liability must not increase the total recoverable by the company, for this already includes the amount necessary to enable the company to meet it."

62. Now of course the possibility cannot be excluded that a defendant may breach a duty owed in precisely the same terms to both a company and one of its shareholders, thereby giving rise to the possibility of two separate causes of action in respect of it. But if the only loss directly caused by the breach is loss to the company, then on ordinary principles, and without resort to any special rule of company law, it can be seen that the company and shareholder will not have separate, competing claims.
63. But this unusual case does not appear to be the focus of the 'no reflective loss' rule, as can be seen by the illustration of its operation provided by the Court of Appeal in the *Prudential* case itself:

"Suppose that the sole asset of a company is a cash box containing £100,000. The company has an issued share capital of 100 shares, of which 99 are held by the plaintiff. The plaintiff holds the key of the cash box. The defendant by

a fraudulent misrepresentation persuades the plaintiff to part with the key. The defendant then robs the company of all its money. The effect of the fraud and the subsequent robbery, assuming that the defendant successfully flees with his plunder, is (i) to denude the company of all its assets and (ii) to reduce the sale value of the plaintiff's shares from a figure approaching £100,000 to nil. There are two wrongs, the deceit practised on the plaintiff and the robbery of the company. But the deceit on the plaintiff causes the plaintiff no loss which is separate and distinct from the loss to the company. The deceit was merely a step in the robbery. The plaintiff obviously cannot recover personally some £100,000 damages in addition to the £100,000 damages recoverable by the company”.

64. It must be said that this analysis bears all the hallmarks of a basic illustration of the operation of ordinary common law principles of causation and remoteness of damage.
65. There is real danger in determining issues of recoverability by reference to criteria such as whether a claimed loss is a mere reflection of a less remote loss, or would be extinguished by the successful prosecution of a stronger claim, rather than by stepping back and considering more fundamental objections.
66. This is what has happened in cases following *Prudential* and *Johnson*, particularly in relation to actions by beneficiaries against their trustees³⁰, creditors' claims³¹, misappropriation of corporate opportunity cases³², conspiracy claims³³ and professional negligence claims³⁴ which are only tangentially connected with loss to company coffers.

Common Law: Loss Within the Scope of the Duty

67. In general, in order to establish what kind of loss is recoverable in respect of a breach of duty, it is necessary to determine what duty was owed to the claimant,

³⁰ For instance, in *Walker v Stones* [2000] 4 All ER 412; *Shaker v Al-Bedrawi* [2003] 2 WLR 922.

³¹ E.g., *Gardner v Parker* [2003] EWHC 1463 (Ch).

³² See, for instance, *Giles v Rhind* [2002] 2 WLR 237.

³³ As in *Humberclyde Finance Group Ltd v Hicks* [2001] 1 All ER (D) 202.

³⁴ As in *Day v Cook* [2001] EWCA Civ 592.

- and whether it was a duty in respect of the kind of loss which the claimant alleges to have suffered.
68. In *Caparo Industries plc v Dickman* [1990] accountants had negligently audited a public company's statutory accounts; but the House of Lords held that they were not liable for all the losses suffered by those who had relied upon the inaccurate accounts. They were not liable to an outside take-over bidder, because they owed such a person no duty of care. Further, they were not liable to shareholders in respect of additional shares purchased in reliance on the accounts, because although they did owe a duty of care to the shareholders, it was owed to them in their capacity as members of the company, and not in the capacity (which they shared with everyone else) of prospective buyers of the company's shares.
69. Lord Bridge of Harwich said³⁵
- “It is never sufficient to ask simply whether A owes B a duty of care. It is always necessary to determine the scope of the duty by reference to the kind of damage from which A must take care to save B harmless.”
70. In 1996 Lord Hoffman, in *South Australia Asset Management Corporation v York Montague Ltd, United Bank of Kuwait plc v Prudential Property Services Ltd, Nykredit Mortgage Bank plc v Edward Erdman Group Ltd* [1996] 3 All ER 365 provided a cogent analysis of the principles which determine the kind and extent of losses recoverable for breach of a duty of care (in contract, tort, or under statute).
71. What emerged from these seminal speeches in the House of Lords are the following basic principles of liability and recoverability for loss:-
- a. The question whether a claimant has suffered loss as a result of a breach of a duty owed to him is only the starting point of the analysis: the plaintiff must, of course, show that but for the breach of duty, he would not have sustained the harm (what we call the 'but for' test), but this only proves that some loss flowed from the breach, and begs the question whether such loss is recoverable from the defendant;

³⁵ At page 627.

- b. Recovery of loss for a breach of duty requires the claimant to prove both that a duty was owed to him, and that the loss claimed fell within the scope of that duty; in other words, that the duty owed to him was in respect of the kind of loss for which the claim is made;
- c. Where the duty is to take care to provide accurate information or advice, the court must compare the loss actually suffered by the claimant with what the position would have been if the claimant had not acted on the information/advice, and then ask what element of that loss is attributable to the information/advice being wrong; a defendant who provides false information in breach of duty is not liable for loss which would have been suffered even if that information had been correct.

72. About a month after the *South Australia* decision, the House of Lords, in *Bristol and West Building Society v Mothew* [1996] 4 All ER 698, performed a similar expository exercise for breach of fiduciary duty. Lord Millett's speech contained the following remarks:-

- a. The expression 'fiduciary duty' is properly confined to those duties which are peculiar to fiduciaries, the breach of which attracts legal consequences differing from those consequent upon the breach of other duties. Accordingly, not every breach of duty by a fiduciary is a breach of fiduciary duty;
- b. It is similarly inappropriate to use the expression to refer to the obligation of a trustee (or other fiduciary) to use proper skill and care in the discharge of his duties he common law and equity each developed the duty of care, but they did so independently of each other and the standard of care required is not always the same;
- c. The law and equity influenced each other, and today the substance of the obligations is more significant than their particular historical origins;
- d. As Lord Brown-Wilkinson said, in *Henderson v Merrett Syndicates Ltd*, *Hallam-Eames v Merrett Syndicates Ltd*, *Hughes v Merrett Syndicates Ltd*, *Arbuthnott v Feltrim Underwriting Agencies Ltd*, *Deeny v Gooda Walker Ltd (in liq.)* [1995] 2 AC 145 at 205:

“The liability of a fiduciary for the negligent transaction of his duties is not a separate head of liability but the paradigm of the general duty to act with care imposed by law on those who take it upon themselves to act for or advise others. Although the historical development of the rules of law and equity have, in the past, caused different labels to be stuck on different manifestations of the duty, in truth the duty of care on bailees, carriers, trustees, directors, agents, and others is the same duty: it arises from the circumstances in which the defendants were acting, not from their status or description. It is the fact that they have all assumed responsibility for the property or affairs of others which renders them liable for the careless performance of what they have undertaken to do, not the description of the trade or position which they hold;”

- e. Ipp J explained the position specifically relating to directors, in *Permanent Building Society (in liq) v Wheeler* (1994) 14 ACSR 109 at 157, as follows:

“The director’s duty to exercise care and skill has nothing to do with any position of disadvantage or vulnerability on the part of the company. It is not a duty that stems from the requirements of trust and confidence imposed upon a fiduciary ... that duty is not a fiduciary duty, although it is a duty actionable in the equitable jurisdiction of this court”;

- f. Although the remedy available in equity for breach of the equitable duty of care is equitable compensation, and not damages, this is a mere product of history, and now constitutes a distinction without a difference. The common law rules of causation, remoteness of damage and the measure of damages should be applied by analogy.

73. What follows from all this is, it is hoped, fairly simple. The duty owed by a director or majority shareholder (or a third party dealing with a company) to a minority shareholder is generally not such as to include a duty directly to preserve the value of his shareholding, the amount or frequency of his dividends, and

- certainly not (where the shareholder is also an employee) to ensure that the company pays his salary and provides him with employee benefits to which he is contractually entitled.
74. A shareholder in a company has rights of participation, in accordance with the company's Articles of Association, and the general law. Infringement of these rights and interests of the shareholder, as such, by a person or body who owes common law or fiduciary duties to the shareholder, would give rise to a claim for compensation for such loss as is within the scope of the duty owed to the shareholder and is attributable to the breach in respect of which redress is sought.
75. In other words, the sort of loss suffered by a shareholder, which the courts fear will be so closely connected with company losses as to be a mere reflection of them, would fall within the scope of the duties owed specifically and directly to shareholders in only the most exceptional circumstances.
76. Equally, the policy arguments advanced by the court in support of the rule can hardly be called compelling. Reference is most often made to the danger of a multiplicity of shareholder suits, double recovery against the wrongdoer, and prejudice to creditors.
77. But the courts of equity have always been able cope with this sort of problem procedurally, by exercising its powers to stay and consolidate proceedings, and substantively where necessary, for instance where a negligently drafted Will caused loss to a named beneficiary but also a diminution in the value of the testator's estate as a whole: *Carr-Glynn v Frearsons* [1999] Ch 326, Court of Appeal.

Recent Developments

78. In *Strougo v Bassini*, 282 F.3d 162, 171-72 n.6 (2d Cir. 2002) the court conjectured that Delaware may require that the harm to the plaintiff shareholders be different from the harm to the rest of the common shareholders (the 'undifferentiated harm' test) for a direct suit to lie, although apparently no Delaware case actually says this.

79. In any event, it may be that all that follows from the ‘undifferentiated harm’ test is that if all the common shareholders are harmed equally, the case is unlikely to fit the ‘majority oppressing the minority’ pattern allowing a direct suit to lie.
80. In a further twist in the UK came in the case of *Floyd v John Fairhurst & Co* [2004] EWCA Civ. 604, involving separate claims against accountants by a company and its shareholders for negligence tax advice. One of the complaints by the shareholders was that a bonus paid ought to have been paid as a dividend, so as to reduce the shareholders’ tax liability, even though the dividend would have caused an additional tax charge on the company.
81. The Court of Appeal held that the ‘no reflective loss’ principle applied by analogy, as the loss suffered by the shareholders was reflected in the tax saved by the company, for which the shareholders had to give the defendants credit, and only the balance of the claim could be recovered.

Jurisdictional Differences

82. Derivative actions by shareholders against corporate fiduciaries in publicly held companies are much less common in Britain than in the United States, as the Courts in the United Kingdom are unfriendly to such suits.³⁶
83. When coupled with British judges’ reluctance to interfere with market operations³⁷ the result is the almost total absence of contemporaneous litigation in Britain over takeovers. This contrasts sharply with the duty of care in the context of take-overs which has such powerful consequences in the United States, especially in Delaware.³⁸
84. By far the greatest legal difficulty with the existing derivative remedy is the law of shareholder ratification.
85. There are also differences in the duties imposed on corporate fiduciaries in the US and Britain. In both jurisdictions, company directors and other fiduciaries owe duties at common law and under statute, and English courts are increasingly

³⁶ See, e.g. *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, and *Re Blue Arrow plc* [1987] BCLC 585.

³⁷ See, e.g. *R v Panel on Takeovers and Mergers, ex parte Datafin* [1987] QB 815; *R v Panel on Takeovers and Mergers, ex parte Guinness* [1989] 2 WLR 863.

³⁸ E.g. *Smith v Van Gorkom*, 488 A.2d 858 (Del. 1985).

- prepared to recognize duties owed by directors to creditors when the company faces insolvency.³⁹ There is, though, no English equivalent of general corporate constituency statutes in the United States.
86. By contrast, the state takes an active role in Britain in the discipline of directors of insolvent companies, under the Company Directors (Disqualification) Act 1986. When a British company becomes insolvent, those who controlled the company may be liable for losses incurred in the period leading up to the insolvency.⁴⁰ Moreover, British enthusiasm for state involvement in corporate discipline is further reflected in the reforms of insolvency and competition law introduced by the Enterprise Act 2002.
87. The corporate opportunities doctrine is much less well developed and much less extensive in Britain than in the US.⁴¹
88. The ability of shareholders in the US to bring claims against, in particular, company directors has been highlighted in recent disputes involving Enron, World.com and Allfirst/AIB, where shareholder/derivative actions have been brought in the US naming directors outside the jurisdiction, especially those in the UK, as co-defendants.

Practical Impediments

89. It is generally considered that the two most significant barriers to successful shareholders' proceedings (especially derivative actions) are:
- a. The difficulty in obtaining, prior to and in contemplation of bringing an action, evidence to support the alleged wrongdoing; and
 - b. The difficulty of funding the litigation, particularly (in the case of derivative actions) without any real prospect of direct personal benefit.
90. In general, the courts have never been wholly consistent in determining the stage of the proceedings at which the *Foss v Harbottle* issue should be raised, or on

³⁹ See *West Mercia Safetywear v Dodd* [1988] BCLC 250, but also *Yukong Line Ltd of Korea v Rendsberg Investments Corporation of Liberia* [1998] 1 WLR 294, suggesting that no direct fiduciary duty is owed by a director to an individual creditor.

⁴⁰ See the Insolvency Act 1986 sections 212 (misfeasance), 213 (fraudulent trading) and 214 (wrongful trading)

⁴¹ *IDC v Cooley* [1972] 2 All ER 162, stressing the capacity in which the fiduciary learned of the opportunity

- what evidential basis the issue of *locus standi* should be resolved. Usually, the matter has been dealt with *in limine*, but in some cases the plaintiff was permitted a full hearing to determine the issue.
91. In the case of derivative actions, it is clear that a stricter approach is now taken. The Court of Appeal, in the leading case of *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, insisted that the *locus standi* point must be raised at any interlocutory stage without the admission of evidence. Of course, in almost every case, this will also mean before any process of discovery, resulting in the absence of evidence about the *prima facie* case against the wrongdoers, and a necessarily unsatisfactory, and largely theoretical, analysis of the allegations in the pleadings.
92. This practice is consistent with the court's treatment of the rule in *Foss v Harbottle* as a purely procedural matter. But as any American trial lawyer can confirm, issues of *locus standi* are a mixture of substance and procedure, requiring the determination of questions of both fact and law.
93. On the question of legal costs, it was held in *Wallersteiner v Moir (No 2)* [1975] QB 373 that in appropriate cases the court should order that the company should indemnify the plaintiff against the costs of the action, whether or not the action succeeds.⁴²
94. However, a subsequent case on the availability of an indemnity in such a situation suggested that it was a limited remedy, and that it is the plaintiff who must demonstrate that such an order is necessary: *Smith v Croft (No 1)* (1986) 2 BCC 99 at 100. Walton J in that case said that the test for an indemnity order should be whether an independent board would consider that it should bring the action.⁴³
95. This indemnity procedure is not available to a claimant complaining, in substance, of infringement of his rights as shareholder: *re a Company (No 005136 of 1986)* [1987] BCLC 82.

⁴² The specific provision for such an order is now contained in the Civil Procedure Rules 1998 Part 19.9(7).

⁴³ There is an interesting overlap of concepts between the notion of such an independent litigation board and the all too familiar special litigation committee in relation to US derivative actions.

96. Such an order will usually be considered at an interlocutory hearing, not usually before discovery. To date, comprehensive indemnity rules have not been developed.⁴⁴

The Current Climate

97. A recent survey of more than 100 partners in commercial law firms⁴⁵ found 75% of them expecting an increase in shareholder litigation in the UK. At the same time, 67% of the survey panel thought that it would represent a negative step if shareholder litigation were to take hold in the UK.

98. Guy Henderson, commercial litigation head at Allen & Overy London envisaged a "steady increase" in shareholder litigation but added that "until we adopt a [US-style] class action culture, there will be no explosion". He said: "Life is getting tougher for the boards of public companies. We are seeing a serious increase in focus on the governance of companies."

99. The Law Commission has produced a Consultation Paper (number 142) criticizing the existing system. The Commission has also produced a Report (Report Law Comm. No. 246) entitled "Shareholder Remedies". In summary, the Commission's recommendations amount to a tidying up of the derivative action procedure (and apparently putting it on a statutory basis), and of the shareholder's remedy for "unfair prejudice" under section 459 of the Companies Act 1985. The Commission also recommends the addition of winding up to the remedies available to the petitioner under section 459.

Teresa Rosen Peacocke
3 Stone Buildings New York
September 2004

⁴⁴ See *Smith v Croft (No 2)* [1988] Ch 114; *Watts v Midland Bank plc* [1986] BCLC 15.

⁴⁵ The *Legal Week*/E J Legal Big Question survey, published in *legal Week* on 15 July 2004.