Has the statutory derivative claim fulfilled its objectives? A prima facie case and the mandatory bar: Part 1

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Legislation: Companies Act 2006 Pt 11, s.263 (2)(a)

Cases: Fanmailuk.com Ltd v Cooper [2008] EWHC 2198 (Ch); [2008] B.C.C. 877 (Ch D)
Kiani v Cooper [2010] EWHC 577 (Ch); [2010] B.C.C. 463 (Ch D)
Iesini v Westrip Holdings Ltd [2009] EWHC 2526 (Ch); [2010] B.C.C. 420 (Ch D (Companies Ct))
Mission Capital Plc v Sinclair [2008] EWHC 1339 (Ch); [2008] B.C.C. 866 (Ch D)
Franbar Holdings Ltd v Patel [2008] EWHC 1534 (Ch); [2008] B.C.C. 885 (Ch D)

*Comp. Law. 41* Since the introduction of the new derivative claim there have been six derivative proceedings in England. This article looks at the new two-stage derivative claim under these cases on issues relating to the assessment of s.263(3)(b) of the Companies Act 2006, whether there is a need to establish a prima facie case and issues relating to corporate social responsibility in derivative claims.

Introduction: the new derivative claim

In 1997 the Law Commission published a report on shareholders’ remedies and concluded that the rule in *Foss v Harbottle* was complicated and unwieldy; certain terms were not clear such as “wrongdoer control”; and that having members try to establish standing easily resulted in a mini-trial which increased the length and cost of such cases. The Commission concluded that derivative claims needed reform to reflect more “modern flexible and accessible criteria for determining whether a shareholder can pursue an action”, with the aim of allowing cases to continue in appropriate circumstances.

Derivative claims now come under Pt 11 of the Companies Act 2006. The scope for a claim was extended to include negligence and any breach of duty committed by a director. Previously one would have to show fraud on the minority or acts which were ultra vires, which has now gone. Further problems included ratification and wrongdoer control, which the Government was keen to remove. The old rule in *Foss* was seen as restrictive and the lack of a personal remedy meant derivative claims were rare and shareholders tended to opt for an unfairly prejudicial claim.

From parliamentary discussions it was clear directors were concerned that the increased scope, the introduction of the new directors’ duties and the reduced possibility of ratification would lead to increased shareholder litigation. Lord Goldsmith demonstrated that the new derivative claim would be a delicate balancing act, stating that directors should be able to take business decisions in good faith but also allow shareholders to bring meritorious claims against directors but have unmeritorious claims dismissed at the earliest possible stage. Hannigan reiterated the point, saying that there must be a balance between promoting higher standards and not deterring people from accepting directorships. The fear was that if directors became subject to frivolous claims, people would be unwilling to accept directorships. Bainbridge argues in a US context that “the system of corporate governance is designed to function largely without shareholder input”, which is echoed in the Law Commission’s guiding principle that there should be a freedom from shareholder interference. There is also the concept of “the business judgment rule”; although not a strict legal rule, it is the idea that judges are not there to second-guess business decisions and by allowing more derivative claims it was feared that courts would be more prone to do so. Although the Government believed there were already sufficient safeguards in place to protect from frivolous claims, they felt the need to respond to these concerns, and the end result was a two-stage test for claimants to pass in a derivative claim.

This two-stage process will be the point focus of discussion, drawing on key recent cases. The first
stage involves the claimant establishing a prima facie case, e.g. the case is one of breach of duty, whether there is some evidence to support it, etc. Hannigan believes that a derivative claim is unlikely to be stopped at the first stage:

*Comp. Law. 42* “Faced with a new procedure designed to make derivative actions more accessible … the courts may be reluctant to throw out a remotely plausible case at the first threshold.”

The second stage contains a non-exhaustive list of factors the judge must consider and goes beyond establishing a prima facie case. There are also mandatory bars to claims which may become apparent during the assessment, which include the court refusing the claim if a person acting in accordance with s.172 would not seek to continue the claim or if the act or omission has been authorised or ratified.

This article will analyse potential shortcomings of the new derivative claims and whether the new claim is meeting the objectives of the reform under three headings: prima facie case and a mandatory bar; the second stage—s.263(3); and corporate social responsibility (which will be covered in Pt 2 of this article appearing in the next issue of the journal). In determining whether the new claim is meeting the objectives of the reform it will be necessary to focus on the new case law. Cases such as Iesini, Franbar Holdings Ltd v Patel and Stimpson v Southern Landlords Association will be particularly scrutinised and there will also be particular mention of two other statutory derivative claims, those of Mission Capital Plc v Sinclair and Kiani v Cooper. It is important to remember that although certain aspects of a case may have been interpreted incorrectly that is not to mean the decision to allow/deny the derivative claim was incorrect since all the factors must be taken together.

**Establishing a prima facie case and the mandatory bar**

At the first stage the applicant must establish that there is a prima facie case, and the court must also look to see whether there is a mandatory bar. As Hannigan mentioned, the courts may be reluctant to throw out a claim at the first stage. This raises the point as to whether there is a need for establishing a prima facie case and how it has been operating in practice so far.

The intentions of Parliament were clear: they wished frivolous claims to be dismissed at the earliest possible stage, without involving the company, and arguably the underlying fundamental principle was “efficiency and cost effectiveness” as they wished to avoid hearings turning into mini-trials. To see whether the new statutory derivative claim is achieving these goals we must look at how the first stage has been functioning. The cases do offer some guidance as to how matters are developing and whether there appears to be any linear development. Roberts and Poole note that since derivative claims are based on leave and judicial control, “it seems to automatically follow that this mechanism is unlikely to result in reduced costs and time saving”. We shall first look at establishing a prima facie case.

**Prima facie case**

Keay and Loughrey wrote that before 2006 the concept “prima facie” was well known but the meaning remained elusive. It was suggested one would have to show that a substantial chance of success is likely in the final hearing, which suggested the inevitability of there being some consideration of the ultimate merits of the case that could result in a mini-trial. They go on to note, though, that these conclusions may be unwarranted.

The history of common law derivative claims illustrates that point and also that passing the first stage in terms of establishing a prima facie case may be a relatively low hurdle. Since no evidence is required by the other side and evidence from the applicant may be “very flimsy” or “rudimentary”, the courts may be understandably reluctant to throw out a case at the first stage. It is conceivable that the test of establishing a prima facie case is merely establishing more than a 0 per cent chance of success. This is the approach taken by the Australian *Comp. Law. 43* courts which is taken from the American Cyanamid Co v Ethicon Ltd case. In Australian Broadcasting Corp v Lenah Game Meat it was stated:

“… [i]t is inappropriate to consider in any detail the standard of probability of the plaintiff's case. It is enough at this stage that the issue is ‘triable’ or ‘arguable’.”

This assumption may be rebutted by the case of Smith v Croft (No.2), where permission was refused on the grounds that they had not established a prima facie case on a number of issues but
had on others. This was due to independent expert evidence from the auditors—courts have also thrown out cases in other instances on the evidence from independent experts.\(^\text{29}\)

The Law Commission was originally critical of the prima facie requirement. They were reluctant to have a case falling either side of an invisible line and being decided on its legal merits.\(^\text{30}\) Table 1 demonstrates that case law is developing in a way that suggests the need for a prima facie test is unfounded:

<table>
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<th>Table 1: Prima facie decisions</th>
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As Table 1 shows, it is clear that the test for establishing a prima facie case is still undeniably low. In *Stimpson* the judge believed it would be unduly elaborate to consider whether there was a prima facie case\(^\text{41}\) and in *Franbar* neither party attempted to establish or contest the issue.\(^\text{42}\) Keay and Loughrey in a later article argue that *Stimpson* sets the bar dangerously high in relation to a prima facie case, noting that the judge believed establishing a prima facie case required addressing the factors under s.263 of the Companies Act 2006.\(^\text{43}\) With respect, this is an unfounded argument. The relationship the court drew in its assessment was between s.263(2)(a) and s.263(3), rather than s.261 and s.263 as Keay and Loughrey suggest, and *Stimpson* clearly shows, is a low threshold for establishing a prima facie case. Only in *Iesini* and *Kiani* has prima facie really been mentioned and only in *Iesini* was any framework really laid out regarding what is required to establish a prima facie case.\(^\text{44}\)

In *Mission Capital*, although the first stage was passed with relative ease, it was concluded on the basis of s.263(2)(a) and not on establishing a prima facie case. The court believed the relevant part of establishing a prima facie case was s.263(2)(a). They stated there would be a mandatory bar if the claim had been purely duplicative of the counterclaim. A prima facie case and s.263(2)(a) are two different considerations, as a mandatory bar may be used at any point in the second stage and also, its primary purpose is not to determine whether or not there is a prima facie case. It is possible for there to be a prima facie case even if there is still no director wishing to continue. However, it would not be possible for a case to continue where a director would want to continue but there was no prima facie case. If s.263(2)(a) was the relevant section to establishing a prima facie case, Keay and Loughrey would have been correct in their assessment of the first stage in relation to *Stimpson*; but as we have just seen, s.263(2)(a) may be used at any time.

With all this in mind it would be beneficial for all those involved to skip the first stage. Since most claims involve small private companies, the reduction of costs resulting from not having to go through establishing a prima facie case may encourage more people to bring meritorious claims; but with sufficient safeguards at the second stage this will sufficiently protect against frivolous claims. It would also not disadvantage anyone claiming in cases of public companies, since disgruntled minority shareholders would most likely sell their shares.\(^\text{45}\) Alternatively, if shareholders had the incentive to bring a claim, the company would have the option of attempting to produce independent evidence to refute what they are claiming. Cases such as *Stimpson, Franbar* and *Mission Capital* have already seen a move towards this approach.\(^\text{46}\)

\*Comp. Law. 44 The mandatory bar

Now we must look to the assessment under s.263(2)(a) of the Companies Act. It is important to remember that these are two separate considerations under Pt 11 although there may be some
overlap. It may be possible for the court to skip the prima facie case and start with s.263(2)(a) for a number of reasons, such as in the recent cases where the defendants concede there is a prima facie case, the judge considers it unduly elaborate, both parts are heard together or it is unopposed. This section serves as a new element to the second stage, and Keay and Loughrey demonstrate it could result in a claim ultimately being decided on its merits. This was not favoured by the Law Commission as it feared the leave stage would develop into a detailed investigation.

Whether this section actually requires anything more than what is covered under establishing a prima facie case is now being revealed under the new cases. In *Iesini* the court stated that:

"S263(2)(a) will apply only where the court is satisfied that no director acting in accordance with section 172 would seek to continue the claim".

It will also be important to establish how this test should be assessed. It is arguable that when considering s.263(2)(a), although establishing a prima facie case may only require more than 0 per cent chance of success, it would be a struggle to satisfy this section if there was only a 1 per cent chance of success. It is likely no director would seek to pursue a claim with such low probability of success, which we can see from Table 2.

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<th>Table 2: Mandatory bars</th>
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<td><strong>Mandatory bar</strong></td>
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<td><strong>Case</strong></td>
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<td>Fanmailuk</td>
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<tr>
<td>Franbar</td>
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<tr>
<td>Iesini</td>
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<td>Kiani</td>
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<td>Mission Capital</td>
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<td>Stimpson</td>
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This ultimately leads this section to be decided on its merits, which Parliament was keen to avoid since they did not want cases falling either side of an invisible line. *Stimpson* illustrates this point well. Here, the judge threw out the case under s.263(2)(a), noting that there were chances of success in areas and some money might be recoverable, but on a balancing of the facts the court still ruled that no director acting in accordance with s.172 would seek to continue. Here we can see that although there was clearly a prima facie case, no director would seek to continue the claim, marking the notable difference between a prima facie case and s.263(2)(a). Table 2 and *Stimpson* demonstrate the ability of s.263(2)(a) to filter out frivolous claims at a better rate than the requirements for a prima facie case.

However, in *Iesini* four days were spent deliberating over independent expert evidence and legal issues in the assessment of s.263(2)(a), which eventually led to the conclusion there was no breach of duty in question and it was impossible to say whether there was negligence. Although evidence showed there was clearly no chance of success, that assessment still developed into a mini-trial. The question arising seems to be whether it is worth having to establish a prima facie case owing to the time it adds to the claim or whether you should begin with s.263(2)(a). It is true that not all factors will take four days to assess, but this is argued to be an unavoidable factor in derivative proceedings as demonstrated by Roberts and Poole. Owing to the flexibility of the courts not all cases will now deteriorate into lengthy mini-trials, which can be seen from *Kiani* where the parties curtailed their arguments, although the proceedings still lasted a day; and also in *Franbar* the court merely mentioned that there was room for more than one view in its assessment of s.263(2)(a) before moving on to s.263(3). No case has yet to stretch to any length as seen pre-2006, but the statutory claim is still young.

*Comp. Law. 45* Reisberg also highlights that it is unlikely a case will be so poorly formulated that it will not survive the court's analysis in the first stage. This evidence points towards starting with
s.263(2)(a) rather than a seemingly redundant need to establish a prima facie case.

The actual assessment of s.263(2)(a) is not vastly different from that of the second stage in s.263(3)(b), and as mentioned earlier in Stimpson, the court saw a relationship between assessing this section and the second stage. To digress slightly, the key difference between s.263(2)(a) and s.263(3)(b) is not between these sections themselves, but the other subsections under s.263(3). We will see later that assessing s.263(2)(a) and s.263(3)(b) is mainly carried out on a basis of legal validity, except in a clear case where commercial considerations may be included. If the legal claim is very weak, as in Iesini, then s.263(2)(a) will apply. If the claim has some legal merit to it as in Franbar, the court will move on to the second stage and may attach weight to the claim based on the strength of the legal claim. In allowing the claim to proceed, all the other factors must be considered under s.263(3), such as the availability of another remedy, and the court must decide at its discretion whether to allow the claim based on all the considerations. Here we can see there is no great difference between s.263(2)(a) and establishing a prima facie case, other than there being evidence from the defendants. There is, however, a difference between a prima facie case and s.263(3), contrary to the views of Keay and Loughrey.

As a starting point Iesini stated that s.263(2)(a) will only apply where no director would seek to continue the claim. Iesini also noted that although there may be certain commercial considerations to take in to account, a court would be ill-equipped to consider them except in a clear case. Here the court preferred to stay within the confines of the law to determine whether no director would continue the claim demonstrating there was no breach of duty and where it was impossible to say whether there was negligence. What a clear case actually is may be difficult to determine but arguably, Stimpson is such as case. Since the company was limited by guarantee its objectives were easier to decide; however, that decision might have not been so easy had the company been limited by shares. Other issues such as the existence of independent evidence and whether the company has any money may also lead to mandatory bars. Each factor alone--or even coupled together--may not mean a mandatory bar; however, the existence of any factor, as we will see later, may lead a court still to decide that a director would attach little weight to continuing a claim because of it.

In summary, it would seem there is little need to establish a prima facie case, or as put in Stimpson “unduly elaborate”. There is no great difference between establishing a prima facie case and s.263(2)(a); and removing the need to establish a prima facie case will progress towards achieving the goals of Pt 11--cost effectiveness and efficiency--which would be especially beneficial to small private companies. It is argued that a more appropriate test as a means of achieving efficiency is to merely establish whether no director would continue the claim. If this is so, then permission should be denied. Even though this means a case is still decided on its merits, it is arguably more efficient than doing both (as demonstrated by the tables above) and also unavoidable, as reasoned by Roberts and Poole.

How the courts will assess s.263(2)(a) is not entirely clear, but this does not lead to intolerable uncertainty as Stimpson and Iesini do offer guidance. If the legal claims are very weak or it is a clear case on commercial reasoning, it will be dismissed. Guidance can also be taken from issues relating to establishing a prima facie case such as where there is the existence of independent expert evidence or the state of finances of the company. This assessment would still allow frivolous claims to be stopped at the earliest possible stage, but the court would nevertheless retain the ability to strike a claim out at any time if it becomes apparent that no director acting in accordance with s.172 would seek to continue. This is also in conjunction with the fact that there are already natural safeguards to prevent from frivolous claims and thus it must be concluded that the need to establish a prima facie case is surplus to requirements. Removal of the prima facie requirements would also not require any greater involvement from the company at an earlier stage since the onus is on the applicant to show that directors would seek to continue the claim and independent evidence may be sought without the interference in the day-to-day business.

Comp. Law. 2011, 32(2), 41-45
7. Foss (1843) 2 Hare 461—the rule here was that where a wrong is done to a company the proper plaintiff is prima facie the company and where the alleged wrong may be ratified by a simple majority no individual member could bring aclaim in respect of it.
8. The availability of a personal remedy and not having to address issues of locus standi made these claims favourable.
9. Companies Act 2006 s.239—Directors no longer able to vote on their own wrongdoing.
16. Such as that any sums recovered would be returned to the company and if the claim is unsuccessful the claimant may incur substantial costs; see A. Reisberg, “Derivative actions and the funding problem: the way forward” [2008] J.B.L. 445.
18. (a) Whether the member is acting in good faith in seeking to continue the claim; (b) the importance that a director acting to promote the success of the company would attach to continuing it; (c) whether the act or omission (still to occur) would be likely to be authorised or ratified by the company or, (d) where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company; (e) whether the company has decided not to pursue the claim; (f) Whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member would pursue in his own right rather than on behalf of the company.
20. Companies Act 2006 s.263(2).
22. Franbar Holdings Ltd v Patel [2008] EWHC 1534 (Ch); [2008] B.C.C. 885 Ch D.
31. See, for example Halle v Trax BW Ltd [2000] B.C.C. 1020 Ch D; Knight v Frost [1999] 1 B.C.L.C. 364 Ch D; Bracken Partners Ltd v Guttridge [2003] EWHC 1064 (Ch); [2003] 2 B.C.L.C. 84—all allowed for similar reasons as in fnn.47-50 below.
32. Hansard, HL Vol.679, col.GC22 (February 27, 2006).
38. Smith v Crott (No.2) [1988] Ch. 114 Ch D.
39. Harley Street Capital Ltd v Tchigrinsky (No.2) [2005] EWHC 1897 (Ch); [2006] B.C.C. 209.
44. lesini [2009] EWHC 2526 (Ch); [2010] B.C.C. 420 at [78]. The Act now provides for a two-stage procedure where it is the member himself
who brings the proceedings. At the first stage, the applicant is required to make a prima facie case for permission to continue a derivative
claim, and the court considers the question on the basis of the evidence filed by the applicant only, without requiring evidence from the
defendant or the company. The court must dismiss the application if the applicant cannot establish a prima facie case.


47. If there is no prima facie case it is irrelevant whether a director would want to continue the claim or not, but if there is a prima facie case there may still be sufficient reason why no director acting in accordance with s.172 would want to pursue the claim.


52. Although this bar may be used at any point during the second stage if it becomes clear no director would continue the claim.


62. For example, a claim may be dismissed where there is a strong legal claim but the availability of another remedy, but it may be granted
where the legal claim is weaker but no option of an alternative remedy.

63. Keay and Loughrey, “Derivative proceedings in a brave new world for company management and shareholders” [2010] J.B.L. 151, 157--here, the authors believe that a prima facie case may be a tougher test than the second stage and there was no real difference
between the first and second stage.


65. Stimpson [2009] EWHC 2072 (Ch); [2010] B.C.C. 387 at [28] and [40]--reasons included the ability of the first defendant to provide more
extensive services at a lower annual fee or the ability to regain the members after litigation.


67. Watts v Midland Bank Plc [1986] B.C.L.C. 15--although to do with granting an indemnity order this still offers guidance as to the court's
approach with companies which are “hopelessly insolvent”.

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