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**Empirical analysis of the statutory derivative claim: De facto application and the sine quibus non**

Dr David Gibbs and Dr Chidiebere Ogbonnaya

*School of Law, University of East Anglia, Norwich, United Kingdom*

*School of Business and Management, University of Sussex, Brighton, United Kingdom*

Corresponding Author: Dr David Gibbs, School of Law, University of East Anglia, Norwich, NR4 7TJ, [david.gibbs@uea.ac.uk](mailto:david.gibbs@uea.ac.uk)

Funding: This work was supported by the British Academy, under Award Number SQ140006

Data availability statement: This data from this study is stored with the UK Data Archive, D Gibbs and C Ogbonnaya (2018) *Derivative Claims Quantitative Analysis 1874-2017*. [Data Collection]. Colchester, Essex: UK Data Archive. *forthcoming*

Acknowledgements: Our thanks go to Prof. Mathias Siems, Arad Reisberg, Rob Heywood, Tarcisio Gazzini, and Ms Polly Morgan for their constructive and useful feedback on earlier drafts of this article.

## **Empirical analysis of the statutory derivative claim: De facto application and the sine quibus non**

This article empirically investigates how the statutory derivative procedure is being applied *de facto* in comparison with the equitable procedure. Agency theory supposes that the corporate purpose is to maximise the value of the company by approximating the “efficient contract” between the shareholders and directors. The derivative claim is one such way of doing so. However, an intractable tension exists between too much and too little litigation where there are inadequate private incentives relative to the corporate purpose. The equitable procedure did not incentivise litigation. The concern of the statutory reform was that an accessible procedure would create inadequate private incentives for shareholders to litigate. We do not find evidence that the statutory procedure is more accessible. We observed what we call the *sine quibus non* for permission. Shareholders are unlikely to meet these, creating little incentive to litigate and directors will continue to be incentivised to deter litigation.

Key words: Derivative Claims; Shareholder Rights; Directors’ Duties; Shareholders; Directors

## A. Introduction

The “normative consensus” of corporate law is that companies should be run for the collective interest of shareholders, which is to maximise the value of the company.<sup>1</sup> However where ownership and control are separated, directors may act opportunistically against that consensus by shirking responsibility or engaging in disloyal transactions.<sup>2</sup> This is the agency problem. The goal of agency theory is to explain how the disparate interests of directors and shareholders can be aligned to achieve the corporate purpose. This is done by approximating the “efficient contract”, which is one that minimises the agency costs the shareholders must incur in aligning the directors’ interests with their own to maximise their aggregate welfare.<sup>3</sup> Private enforcement through the derivative claim is one method for achieving this. However, an intractable tension exists. A derivative procedure can be efficiency reducing where private incentives are inadequate relative to the corporate purpose.<sup>4</sup> On one hand, incentives to litigate may result in opportunistic and over enforcement to extract private benefits for individual shareholders, rather than creating efficiencies. Conversely, a lack of incentives can create under enforcement, failing to deter managerial opportunism where other mechanisms fall short.

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<sup>1</sup> It is not the purpose of this paper to criticise this normative consensus and consider different theoretical models on organisational theory, and for the sake of this paper such consensus is therefore assumed to be correct; but for discussion see, for example, H Hansmann and R Kraakman, ‘The End of History for Corporate Law’ (2000-2001) 89(2) *Georgetown Law Journal* 439

<sup>2</sup> R Sitkoff, ‘The Economic Structure of Fiduciary Law’ (2011) 91 *Boston University Law Review* 1039, 1042

<sup>3</sup> R Posner, *Economic Analysis of Law*, (Wolters Kluwer 8<sup>th</sup> ed, 2011) 17-19; R Kraakman *et al*, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 2<sup>nd</sup> ed, 2009) 37; K Eisenhardt, ‘Agency Theory: An Assessment and Review’ (1989) 14(1) *Academy of Management Review* 57; M Jensen and J Meckling, ‘Theory of the Firm: Managerial behaviour, agency costs and ownership structure’ (1976) 3 *Journal of Financial Economics* 305, 308; R Coase, ‘The Nature of the Firm’ (1937) 4(16) *Economica* 386

<sup>4</sup> That is, the derivative procedure is not used in circumstances that would approximate efficient agency costs

The UK reformed its derivative procedure via the Companies Act 2006, Part 11. A principal aim was to make it accessible in appropriate circumstances by granting discretion to the court.<sup>5</sup> Others have considered the effect this reform will have, with some fearful that increased accessibility will produce inadequate private incentives for shareholders to litigate.<sup>6</sup> However, these conclusions are drawn from the law as enacted *de jure*. “One should always aim at measuring the institution as formally specified in legislation (*de jure*) and as factually implemented (*de facto*).”<sup>7</sup> This article statistically tests how the statutory procedure is being applied *de facto* in comparison with the procedure in equity.<sup>8</sup> That is claims heard in exception to the rule in *Foss v Harbottle* and in reference to the Civil Procedure Rules.<sup>9</sup>

The basic proposition with our hypotheses is that the equitable procedure was not accessible, creating little incentive to litigate. Directors, sensing this lesser incentive, could deter derivative claims by rationally exploiting their advantageous position over shareholders.<sup>10</sup> If we observe the statutory procedure is more accessible than the equitable procedure we can infer it will increase private incentives for shareholders to litigate. This does not tell us whether those incentives are inefficient relative to the

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<sup>5</sup> Law Commission, Shareholder Remedies (Law Com No 246) (Cm 3769, 1997), paras 6.8-6.15; *cf.* para 6.4 (hereinafter Law Commission Report)

<sup>6</sup> For discussion see, for example, M Siems, 'Private Enforcement of Directors' Duties: Derivative Actions as a Global Phenomenon', in S Wrba, S Van Uytsel and M Siems (eds), *Collective Actions: Enhancing Access to Justice and Reconciling Multilayer Interests?*, (Cambridge: Cambridge University Press, 2012); A Keay and J Loughrey, 'Derivative proceedings in a brave new world for company management and shareholders' (2010) 3 *Journal of Business Law* 151; J Armour *et al.*, 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States' (2009) 6(4) *Journal of Empirical Legal Studies* 687, 688-9; A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) *passim*; P Roberts and J Poole, 'Shareholder remedies – corporate wrongs and the derivative action' (1999) *Journal of Business Law* 9

<sup>7</sup> S Voigt, 'How (Not) to measure institutions' (2013) 9(1) *Journal of Institutional Economics* 1, 2

<sup>8</sup> Hereinafter the equitable procedure

<sup>9</sup> *Foss v Harbottle* (1843) Hare 461; Civil Procedure Rules 19.9

<sup>10</sup> L Bebchuk, 'The Debate on Contractual Freedom in Corporate Law' (1989) 89 *Columbia Law Review* 1395

corporate purpose. Accessibility can indicate how the incentives are biased between the relevant actors<sup>11</sup> but robust conclusions about approximating efficient agency costs cannot be drawn only from how many claims have been brought or are successful.<sup>12</sup> Under the assumption that they are relative to the corporate purpose, by comparing the change between the *quality* and *type* of claims the two procedures are accessible to we aim to draw some inferences about the effect the statutory procedure might have on approximating the efficient contract.

Our findings do not suggest that the statutory procedure is more accessible to shareholders. The data identified what we call ‘*sine quibus non*’ for courts to grant permission and high standards to meet these. The inference drawn from these essential conditions is that *de facto* application of the statutory procedure will not create greater incentives to litigate than under the equitable procedure. Instead, they might continue to incentivise directors to deter litigation because they will rationally seek to exploit their advantageous position over shareholders. While other mechanisms can and do control managerial opportunism, where they fail the lack of an effective deterrent may reduce efficiencies in achieving the corporate purpose.

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<sup>11</sup> J Coffee, ‘Understanding the Plaintiff’s Attorney: The implications of economic theory for private enforcement of law through class and derivative actions’ (1986) 86(4) *Columbia Law Review* 668-71, 700-1

<sup>12</sup> M Gelter, ‘Why do Shareholder Derivative Suits Remain Rare in Continental Europe?’ (2012) 37(3) *Brooklyn Journal of International Law* 844, 881; A Reisberg, ‘Shadows of the Past and Back to the Future: Part 11 of the UK Companies Act 2006 (in)action’ (2009) 6(3) *European Company and Financial Law Review* 219, 229-30; J Coffee, ‘Understanding the Plaintiff’s Attorney: The implications of economic theory for private enforcement of law through class and derivative actions’ (1986) 86(4) *Columbia Law Review* 669, 701

## B. Agency Costs

### 1. *Derivative Suits*

A legal system can reduce the agency problem by making directors accountable to shareholders.<sup>13</sup> This can be done through mechanisms such as the market, contracts, governance mechanisms, and legal liability rules. These do not operate at zero cost but mechanisms that incur lower, or more efficient, agency costs are more likely to be utilised and survive.<sup>14</sup> In certain circumstances a derivative procedure may approximate efficient agency costs but it should only be used where lower cost options have failed to control managerial opportunism.<sup>15</sup> A brief summary can explain this.

Derivative suits are a high cost solution to the agency problem that can reduce efficiencies. Reasons for this are said to include: 1) the cost and difficulty in structuring and defining directors' duties; 2) the threat to an otherwise valuable relationship; 3) efficient markets in disciplining managers; 4) rational risk shifting on to shareholders; 5) less costly methods for ensuring performance; and 6) certain principles of corporate law.<sup>16</sup> The primary concern of enforcement is that liability can inefficiently shift risk on to the directors who would subsequently undertake less risky projects to the

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<sup>13</sup> H Hansmann and R Kraakman, 'The End of History for Corporate Law' (2000-2001) 89(2) *Georgetown Law Journal* 439, 441

<sup>14</sup> M Jensen and J Meckling, 'Theory of the Firm: Managerial behaviour, agency costs and ownership structure' (1976) 3 *Journal of Financial Economics* 305, 308; see also, E Fama, 'Agency Problems and the Theory of the Firm' (1980) 88(2) *Journal of Political Economy* 288, 294; H Demsetz, 'Rationality, Evolution and Acquisitiveness' (1996) 34(3) *Economic Enquiry* 484, 489; A Alchian, 'Specificity, Specialization and Coalitions' (1984) 140(1) *Journal of Institutional and Theoretical Economics* 34, 47

<sup>15</sup> D Fischel and M Bradley, 'The Role of Liability Rules and the Derivative Suit in Corporate Law: A theoretical and empirical analysis' (1986) 71(2) *Cornell Law Review* 261

<sup>16</sup> D Fischel and M Bradley, 'The Role of Liability Rules and the Derivative Suit in Corporate Law: A theoretical and empirical analysis' (1986) 71(2) *Cornell Law Review* 261, 286-7; see also R Kraakman *et al*, 'When Are Shareholder Suits in Shareholder Interests' (1994) 82 *Georgetown Law Journal* 1733, 1736; and J Coffee, 'Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis' (1984) 52 *Geo Wash Law Rev* 789, 812-3 – who note other implications of increased liability may include higher remuneration for directors in the form of a "risk premium" and higher insurance costs

detriment of the shareholders.<sup>17</sup> It also rarely makes sense for shareholders to second-guess decisions of directors given the latter's "superior awareness and understanding of complex factors".<sup>18</sup> Because of these high agency costs, company law places limits on when shareholders can sue derivatively.<sup>19</sup>

Yet, where other mechanisms have failed to align the directors' interests, the function of enforcement is to deter managerial opportunism.<sup>20</sup> For example, governance mechanisms, including director removal, are designed to align the director's interests with maximising the wealth of the firm but they may only work insofar as the incentive to do so outweighs any incentive from acting opportunistically.<sup>21</sup> Other legal liability rules that can remedy breaches of duty by directors also have their limitations. The unfair prejudice petition is a personal remedy that is generally only utilised by small

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<sup>17</sup> A Skyes, 'The Economics of Vicarious Liability' (1984) 93(7) *Yale Law Journal* 1231, 1233-9; F&B 270; H Markowitz, 'Portfolio Selection' (1952) 7(1) *Journal of Finance* 77; D Fischel and M Bradley, 'The Role of Liability Rules and the Derivative Suit in Corporate Law: A theoretical and empirical analysis' (1986) 71(2) *Cornell Law Review* 261, 270; B Black, B Cheffins, and M Klausner, 'Outside Director Liability' (2006) 58 *Stanford Law Review* 1055, 1059 *cf.* J Armour and J Gordon, 'Systemic Harms and Shareholder Value' (2014) 6 *Journal of Legal Analysis* 35, 39, 50-6

<sup>18</sup> M Moore, 'Private Ordering and Public Policy: The Paradoxical Foundations of Corporate Contractarianism' (2014) *Oxford Journal of Legal Studies* 1, 11

<sup>19</sup> D Fischel and M Bradley, 'The Role of Liability Rules and the Derivative Suit in Corporate Law: A theoretical and empirical analysis' (1986) 71(2) *Cornell Law Review* 261, 265-7; 70; see also, K Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14(1) *Academy of Management Review* 57, 60-2

<sup>20</sup> But deterrence may not always be in the company's best interests: For a discussion see, for example, R Kraakman *et al*, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (OUP 3<sup>rd</sup> ed, 2017) 42; A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) 187-219; R Kraakman *et al*, 'When Are Shareholder Suits in Shareholder Interests' (1994) 82 *Georgetown Law Journal* 1733, *passim*; D Schwartz, 'In Praise of Derivative Suits: A Commentary of the Paper of Professors Fischel and Bradley' (1986) 71(2) *Cornell Law Review* 322, 326; J Coffee and D Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform' (1981) 81 *Columbia Law Review* 261, *passim*

<sup>21</sup> See, for example, J Armour and J Gordon, 'Systemic Harms and Shareholder Value' (2014) 6 *Journal of Legal Analysis* 35, 48-9; Z Zhang 'Legal Deterrence: the foundation of corporate governance – evidence from China' (2007) 15(5) *Corporate Governance: An International Review* 741; D Schwartz, 'In Praise of Derivative Suits: A Commentary of the Paper of Professors Fischel and Bradley' (1986) 71(2) *Cornell Law Review* 322, 328, 342; E Fama, 'Agency Problems and the Theory of the Firm' (1980) 88(2) *Journal of Political Economy* 288, 293-4



private companies.<sup>22</sup> Shareholders of smaller companies will be utilising the remedy for personal gain, while directors would look to make a fair offer for the petitioner's shares if the benefit from managerial opportunism is greater. The legitimacy of the market for corporate control,<sup>23</sup> proxy fights,<sup>24</sup> and even public enforcement<sup>25</sup> are also doubted as being individually effective in curbing managerial opportunism. It would be unwise to abandon the derivative procedure altogether, as without it directors could act with impunity.<sup>26</sup> Therefore, some level of derivative enforcement should approximate efficient agency costs by deterring opportunistic behaviour.

## 2. Incentives

In litigation the incentives of the actors “may be excessive or insufficient, relative to the criterion of maximizing corporate value”.<sup>27</sup> On one hand, if too many limits are placed on litigation the deterrent function will not survive; but on the other “little will

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<sup>22</sup> See, for example, The Cohen Report, *The report of the committee on company law amendment*, (1945) Cmd 6659, para 60; *Re Astec (BSR) plc* [1999] BCC 59, 87; A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) Ch 8; cf. *Clark v Cutland* [2003] EWCA Civ 810 per Arden LJ

<sup>23</sup> See, for example, G Bittlingmayer, ‘The Market for Corporate Control (Including Takeovers)’, in B Bouckaert and G De Geest (eds), *Encyclopedia of Law & Economics*, (University of Ghent and Edward Elgar, 2000) 725-771

<sup>24</sup> See, for example, M Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups*, (Harvard University Press, 1965)

<sup>25</sup> See, for example, J Armour *et al*, ‘Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States’ (2009) 6(4) *Journal of Empirical Legal Studies* 687, 715-8; J Hay & A Shleifer, ‘Private Enforcement of Public Laws’ (1998) 88 *American Economic Review* 398; W Landes & R Posner, ‘The Private Enforcement of Law’ (1975) 4 *Journal of Legal Studies* 1; E Dodd, ‘Book Review: Report of the Committee on Company Law Amendment’ (1945) 58(8) *Harvard Law Review* 1258, 1262-4;

<sup>26</sup> R Sitkoff, ‘The Economic Structure of Fiduciary Law’ (2011) 91 *Boston University Law Review* 1039, 1043; D Schwartz, ‘In Praise of Derivative Suits: A Commentary of the Paper of Professors Fischel and Bradley’ (1986) 71(2) *Cornell Law Review* 322, 324; D Fischel and M Bradley, ‘The Role of Liability Rules and the Derivative Suit in Corporate Law: A theoretical and empirical analysis’ (1986) 71(2) *Cornell Law Review* 261, 262

<sup>27</sup> R Kraakman *et al*, ‘When Are Shareholder Suits in Shareholder Interests’ (1994) 82 *Georgetown Law Journal* 1733, 1736

more discourage” directors if developments deny them the freedom to make business decisions.<sup>28</sup>

This brings the UK statutory reform into context. If the way the court applies the statutory procedure makes it accessible to more claims in comparison to the equitable procedure it could increase the private incentives of the shareholders to use [the threat of] litigation for their own interests. These private incentives might not be aligned with maximising the wealth of the company. This is because shareholders and lawyers do not have the best incentives to maximise the wealth of the firm.<sup>29</sup> They do not need to consider the implications of enforcement on other investors. People do not become more selfless as they are given more powers, the opposite may very well be true.<sup>30</sup> Instead of considering the efficiency implications, shareholders may look to utilise an accessible procedure to extract a private benefit for their own interests.<sup>31</sup> Coffee takes the evidence from the introduction of special litigation committees in the US to demonstrate this. They were introduced in the US to reduce accessibility to litigation from frivolous suits but observed an increase in claims afterwards. The explanation for this is it did not consider the incentives of the actors. Since each side pays their own costs in the US,<sup>32</sup> lawyers could reach a collusive settlement at a lower rate than setting up a committee, incentivising litigation.<sup>33</sup> Another example is that shareholders will

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<sup>28</sup> J Coffee and D Schwartz, ‘The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform’ (1981) 81 *Columbia Law Review* 261, 287

<sup>29</sup> D Fischel and M Bradley, ‘The Role of Liability Rules and the Derivative Suit in Corporate Law: A theoretical and empirical analysis’ (1986) 71(2) *Cornell Law Review* 261, 271-4

<sup>30</sup> S Bainbridge, ‘The Case for Limited Shareholder Voting Rights’ (2006) 53(3) *UCLA Law Review* 601

<sup>31</sup> See, for example, W Landes & R Posner, ‘The Private Enforcement of Law’ (1975) 4 *Journal of Legal Studies* 1, 15

<sup>32</sup> Subject to fee shifting rules, US MCA, § 7.46; Del Code Ann tit 8 General Corporation Law, § 109(b), 144; Court of Chancery Rules, Rule 11; Fed. R. Civ. P. 11(b)(2); Del Super. Ct. Civ. R. 11(b)(2)

<sup>33</sup> J Coffee, ‘Understanding the Plaintiff’s Attorney: The implications of economic theory for private enforcement of law through class and derivative actions’ (1986) 86(4) *Columbia Law Review* 669, 721-3; see also R Romano, ‘The Shareholder Suit: Litigation without

look for the path of least resistance to advance their private interests. In Germany the requirements for establishing derivative liability are vague, creating uncertainty, making it considerably difficult for a shareholder to commence a claim. These difficulties mean recession suits are far more popular.<sup>34</sup> Vermeulen and Zetzche suggest that these recession suits were used in preference to other mechanisms because there was a private incentive to do so, despite potential inefficiencies.<sup>35</sup> Therefore, shareholders may use a derivative procedure to extract a private benefit regardless of whether it maximises the value of the company where there are inadequate incentives to litigate.<sup>36</sup> The law should look to incentivise the actors to act in a manner that “approximates the ... efficient outcome”.<sup>37</sup>

### C. Hypotheses

Whether the *de facto* application of the statutory procedure will incentivise shareholders to act in a manner that approximates the efficient outcome is the focus of

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Foundation? (1991) 7(1) *The Journal of Law, Economics, & Organisation* 55, 61, 68; J Coffee and D Schwartz, ‘The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform’ (1981) 81 *Columbia Law Review* 261, 318

<sup>34</sup> M Gelter, ‘Why do Shareholder Derivative Suits Remain Rare in Continental Europe?’ (2012) 37(3) *Brooklyn Journal of International Law* 844, 871

<sup>35</sup> E Vermeulen and D Zetzche, ‘The Use and Abuse of Investor Suits’ (2010) 7(1) *European Company and Financial Law Review* 1, 35-36

<sup>36</sup> Many others have recognised this phenomena: J Armour and J Gordon, ‘Systemic Harms and Shareholder Value’ (2014) 6 *Journal of Legal Analysis* 35, 60; M Siems, ‘Private Enforcement of Directors’ Duties: Derivative Actions as a Global Phenomenon’, in S Wrba, S Van Uytsel and M Siems (eds), *Collective Actions: Enhancing Access to Justice and Reconciling Multilayer Interests?*, (Cambridge: Cambridge University Press, 2012) 93, 97; B Black, B Cheffins, and M Klausner, ‘Outside Director Liability’ (2006) 58 *Stanford Law Review* 1055, 1061, 1076; R Kraakman *et al.*, ‘When Are Shareholder Suits in Shareholder Interests’ (1994) 82 *Georgetown Law Journal* 1733, 1741-3; R Romano, ‘The Shareholder Suit: Litigation without Foundation? (1991) 7(1) *The Journal of Law, Economics, & Organisation* 55, 57, 65; D Fischel and M Bradley, ‘The Role of Liability Rules and the Derivative Suit in Corporate Law: A theoretical and empirical analysis’ (1986) 71(2) *Cornell Law Review* 261, 270

<sup>37</sup> J Coffee, ‘Understanding the Plaintiff’s Attorney: The implications of economic theory for private enforcement of law through class and derivative actions’ (1986) 86(4) *Columbia Law Review* 669, 677

the hypotheses. The statutory procedure should be more accessible than its equitable predecessor. The greater access should positively correlate with the value of the procedure to shareholders, increasing their incentive to litigate.<sup>38</sup> Directors' incentives to deter claims will then be restricted principally because, with English rule on costs, as accessibility increases directors are more likely to incur and/or be liable for the costs.<sup>39</sup>

Greater accessibility alone may only tell us how the incentives are biased between the actors.<sup>40</sup> Whether greater accessibility in the statutory procedure incentivises claims that enhance or hinder company value is not an exact science,<sup>41</sup> but this paper considers two criteria for drawing inferences about efficiencies. Namely we compare the *quality*, rather than quantity, of claims,<sup>42</sup> and the *type* of claims the two procedures are accessible to.

- 1. Hypothesis 1: The number of successful derivative claims under the statutory procedure is higher and statistically different from the number of successful claims under the equitable procedure**
  
- 2. Hypothesis 2: The number of derivative claims that established a prima facie case under the statutory procedure is higher and statistically different from the number of claims that established a prima facie case under the equitable procedure**

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<sup>38</sup> M Gelter, 'Why do Shareholder Derivative Suits Remain Rare in Continental Europe?' (2012) 37(3) *Brooklyn Journal of International Law* 844, 863

<sup>39</sup> Civil Procedure Rules, 44.3(2)(a); see also, A Keay, 'Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006' (2015) 16(1) *Journal of Corporate Law Studies* 39, 57

<sup>40</sup> J Coffee, 'Understanding the Plaintiff's Attorney: The implications of economic theory for private enforcement of law through class and derivative actions' (1986) 86(4) *Columbia Law Review* 668-71, 700-1

<sup>41</sup> R Kraakman *et al*, 'When Are Shareholder Suits in Shareholder Interests' (1994) 82 *Georgetown Law Journal* 1733, 1737

<sup>42</sup> A Reisberg, 'Shadows of the Past and Back to the Future: Part 11 of the UK Companies Act 2006 (in)action' (2009) 6(3) *European Company and Financial Law Review* 219, 229-30

### **3. Hypothesis 3: Claims under the statutory procedure will spend less time in court than the equitable procedure**

First, we considered if the statutory procedure is more accessible than the equitable procedure to increase the incentives of shareholders to litigate. We relied on three variables to demonstrate this: establishing a prima facie case; successful claims; and time spent in court. Under the equitable procedure shareholders had the burden of disclosing a prima facie case. They had to demonstrate sufficient legal merit to a claim of fraud on the minority by wrongdoers in control of the company.<sup>43</sup> It was uncertain what amounted to this making the burden difficult to discharge.<sup>44</sup> This, *inter alia*, meant they had little incentive to litigate. The statutory procedure now provides clear grounds on who can bring a claim and when.<sup>45</sup> A simpler process to bring a claim should increase the accessibility and increase the incentive to litigate. For example, where there is little risk to the shareholder in submitting an *ex parte* application, perhaps because the individual is well capitalised, and a big risk of having to defend the claim to the company, such as loss of business and personal reputation and business resources deflected,<sup>46</sup> this may incentivise the company to ‘settle’ the dispute at a lower rate than defending the claim.<sup>47</sup>

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<sup>43</sup> *Edwards v Halliwell* [1950] 2 All E.R. 1064

<sup>44</sup> For examples see, *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 W.L.R. 2, 10-2; *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch. 204; Law Commission, Shareholder Remedies (Consultation Paper No 142 1996), para 4.14; A Keay and J Loughrey, ‘Derivative proceedings in a brave new world for company management and shareholders’ (2010) 3 *Journal of Business Law* 151, 162-5

<sup>45</sup> Companies Act 2006, pt 11; see also *Hansard* HL Vol 679, Official Report, 27/02/2006, col GC14; B Hannigan, *Company Law*, (2<sup>nd</sup> edn OUP, 2009) 451

<sup>46</sup> A Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (OUP, 2007) Ch 2.2; S Kalss, ‘Shareholder Suits: Common Problems, Different Solutions and First Steps towards a Possible Harmonisation by Means of A European Model Code’ (2009) *European Company and Financial Law Review* 324, 332

<sup>47</sup> Settling may not be financial but include “therapeutic” remedies that serve the interests of the shareholder. See, for example, *Mills v Elec Auto-Lite Co*, 396 US 375, 392 (1970); *Fletcher v AJ Industries Inc*, 266 Cal App 2d 313, 320 (1968); A Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (OUP, 2007) Ch 5.4.2.3

That incentive to litigate and to settle should be greater if there is increased likelihood that the claim will be successful. The rules in place to access corporate information can be ineffective,<sup>48</sup> so shareholders often lacked the preliminary knowledge and expertise to discover enough information to disclose a prima facie case. Directors who sensed this low incentive to litigate “will rationally be inclined to exploit informational and positional advantages vis-à-vis shareholders”<sup>49</sup> to deter claims. For example, they may engage in “dilatory tactics”<sup>50</sup> to increase the risk to shareholders of being unsuccessful.<sup>51</sup>

Even if sufficient legal merit could be demonstrated, there was further disincentive to litigate in the equitable procedure. Equitable principles meant the court had to be satisfied the claimant was the proper person to bring the litigation. The “proper person” test<sup>52</sup> prevented relief if the defendant could establish a principle why the claimant was not the proper person to bring the claim. If the company had not been improperly

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<sup>48</sup> The Companies (Model Articles) Regulations 2008 No 3229, Sch I, Art 50 (Ltd); Sch III, Art 83 (plc); Civil Procedure Rules, CPR 31.16; Companies Act 1985, Pt 14; *Arrow Trading and Investments v Edwardian Group Ltd* [2004] EWHC 1319; For discussion see, for example, C Paul, ‘Derivative Actions under English and German Corporate Law – Shareholder Participation between the Tension Filled Areas of Corporate Governance and Malicious Shareholder Interference’ (2010) *European Company and Financial Law Review* 81, 111-3; A Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (OUP, 2007) Ch 3 para 3.2.3.2; D Latella, ‘Shareholder Derivative Suits: A Comparative Analysis and the Implication of the European Shareholders’ (2009) *European Company and Financial Law Review* 307, 322; S Kalss, ‘Shareholder Suits: Common Problems, Different Solutions and First Steps towards a Possible Harmonisation by Means of A European Model Code’ (2009) *European Company and Financial Law Review* 324, 341

<sup>49</sup> M Moore, ‘Private Ordering and Public Policy: The Paradoxical Foundations of Corporate Contractarianism’ (2014) *Oxford Journal of Legal Studies* 1, 19; citing L Bebchuk, ‘The Debate on Contractual Freedom in Corporate Law’ (1989) 89 *Columbia Law Review* 1395; M Eisenberg, ‘The Structure of Corporation Law’ (1989) 89 *Columbia Law Review* 1461

<sup>50</sup> J Coffee, ‘Understanding the Plaintiff’s Attorney: The implications of economic theory for private enforcement of law through class and derivative actions’ (1986) 86(4) *Columbia Law Review* 669, 690; see also E Dodd, ‘Book Review: Report of the Committee on Company Law Amendment’ (1945) 58(8) *Harvard Law Review* 1258, 1263

<sup>51</sup> For examples of such conduct under the equitable procedure see, *Airey v Cordell* [2006] EWHC 2728 at [15]-[16]; *Wallersteiner v Moir (No 2)* [1975] QB 373, 389, 396

<sup>52</sup> *Airey v Cordell* [2006] EWHC 2728 (Ch); [2007] BCC 785 at [72]; citing J Gower, *Principles of Modern Company Law* (4th edn, Sweet & Maxwell 1997) 652; *Barrett v Duckett* [1995] 1 BCLC 243, 367; see also, *Nurcombe v Nurcombe* [1985] 1 WLR 370, 376

prevented from enforcing its rights;<sup>53</sup> improper motives;<sup>54</sup> and the availability of adequate alternative remedies<sup>55</sup> were all established principles to prevent permission being granted.<sup>56</sup> Directors only needed to invest in litigation to establish a reason why the shareholder was not the proper person to bring the claim. With the company's assets at their disposal, it was unlikely the directors could not establish a single reason to have the claim dismissed. These procedural requirements meant shareholders would most likely give up rather than commence litigation,<sup>57</sup> as shareholders had little incentive to commence derivative proceedings because "English rule of fee shifting would deter most plaintiffs".<sup>58</sup>

Rather than focusing on procedural requirements,<sup>59</sup> the statutory procedure hands substantive control over the litigation decision to the court. The court to consider all the circumstances of litigation to make its own substantive determination as to what the company "actually wants".<sup>60</sup> As Coffee and Schwartz noted "the court must have a

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<sup>53</sup> *Barrett v Duckett* [1995] 1 BCLC 243, 368-9; *Fargro Ltd v Godfroy* [1986] 1 WLR 1134, 2 BCC 99, 167

<sup>54</sup> *Barrett v Duckett* [1995] 1 BCLC 243, 367; *Smith v Croft (No 1)* [1986] 1 W.L.R. 580, 590

<sup>55</sup> *Barrett v Duckett* [1995] 1 BCLC 243, 367; cited by *Konamaneni v Rolls Royce* [2002] 1 WLR 1269, 1279

<sup>56</sup> Other reasons included: *Airey v Cordell* [2006] EWHC 2728 (Ch); [2007] BCC 785 at [53]; *Burland v Earle* [1902] AC 83, 93 - whether the conduct is capable of being ratified; *Airey v Cordell* [2006] EWHC 2728 (Ch); [2007] BCC 785 at [53]; *Smith v Croft (No 2)* [1988] Ch 114; *Smith v Croft (No 1)* [1986] 1 W.L.R. 580, 590; *Wallersteiner v Moir (No 2)* [1975] QB 373, 404 – independent views; *Harley Street Capital Ltd v Tchigirinsky (No.2)* [2005] EWHC 1897 (Ch) at [14]; *Nurcombe v Nurcombe* [1985] 1 WLR 370, 377; *Towers v African Tug Co* [1904] 1 Ch 558, 562 - if the plaintiff had wasted time or delayed in bringing proceedings; *Airey v Cordell* [2006] EWHC 2728 (Ch); [2007] BCC 785 at [72]; *Towers v African Tug Co* [1904] 1 Ch 558, 568 – if the shareholder participated in the wrong complained of; *Nurcombe v Nurcombe* [1985] 1 WLR 370, 378 - whether there were any equitable defences to the claim; and *Foss v Harbottle* (1843) 2 Hare 461 – where the company is the proper plaintiff no shareholder should be allowed to sue in the absence of wrongdoer control

<sup>57</sup> A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) 113

<sup>58</sup> J Coffee, 'Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis' (1984) 52 *Geo Wash Law Rev* 789, 812

<sup>59</sup> A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) 3

<sup>60</sup> *Hansard* HL, Vol 679, Official Report, 27/2/2006 Col GC26

measure of discretion if the deterrent role of the derivative action is to survive”.<sup>61</sup> Otherwise procedural requirements place an unrealistic demand on shareholders, as “occasions arise... in which a qualified plaintiff in a meritorious action may be unable to meet the verification requirement because of either lack of access to the relevant facts or financial naïveté”.<sup>62</sup> Discretion enables the court to be alert to the subtler problems that face shareholders in derivative litigation, such as lack of expertise, information asymmetry, or structural bias.<sup>63</sup> Courts can permit claims despite these limitations, reducing the shareholders’ burden. Conversely, the burden on directors will be greater. “A reviewing court would not accept the weak or disingenuous reasons proffered”<sup>64</sup> for why permission should not continue. The greater risk to directors will require them to invest more in litigation incentivising them to settle, as they will not be able to easily fall back on dilatory tactics to expose the shareholders naivety in meeting procedural requirements.<sup>65</sup> The prima facie case requirements and discretion should lead to an increase in successful claims, as predicted in hypotheses 1 and 2, increasing the incentive to litigate.

Discretion will also make the procedure more accessible by making the law more predictable and expedient. This will reduce the time spent in court and ultimately the cost of derivative claims. The potential liability for costs will act as less of a deterrent

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<sup>61</sup> J Coffee and D Schwartz, ‘The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform’ (1981) 81 *Columbia Law Review* 261, 287

<sup>62</sup> J Coffee and D Schwartz, ‘The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform’ (1981) 81 *Columbia Law Review* 261, 315

<sup>63</sup> J Coffee and D Schwartz, ‘The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform’ (1981) 81 *Columbia Law Review* 261, 301, 328

<sup>64</sup> J Coffee and D Schwartz, ‘The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform’ (1981) 81 *Columbia Law Review* 261, 287; see also, A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) 3.4.1.1

<sup>65</sup> See, for example, J Coffee and D Schwartz, ‘The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform’ (1981) 81 *Columbia Law Review* 261, 321-6 – on independent views; cf. A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) 3.4.1.1-2



in such circumstances. The law will be more predictable because, unlike the uncertainty of fraud on the minority and wrongdoer control, there is an established body of case law on directors' duties and courts will build up a body of subsidiary rules and principles to demonstrate when permission is likely to be given.<sup>66</sup> Appeals that would otherwise increase costs are also unlikely. Appellate courts do not second-guess lower courts' discretion unless the decision proceeded on some erroneous basis or it was obviously wrong.<sup>67</sup> The procedure will also lower costs through expedience. The court will apply its discretion to all the circumstances, rather than needing to be satisfied that the legal merits of the claim are sufficient and the claimant is the proper person. Hypothesis 3, therefore, predicts less time spent in court under the statutory procedure to demonstrate an increased incentive to litigate.

**4. Hypothesis 4: The number of frivolous derivative claims brought under the statutory procedure is higher and statistically different from the number of frivolous claims under the equitable procedure**

**5. Hypothesis 5: The number of meritorious claims that are successful under the statutory procedure is higher and statistically different from the number of meritorious claims that are successful under the equitable procedure**

The next two hypotheses consider the quality of claims. By considering what the company actually wants, shareholders who bring claims with merit may not be hindered by the issues described in the equitable procedure. Claims that would not meet the requirements of the equitable procedure may now be able to continue once the court reviews the circumstances of why that is so. If the probability of a successful claim is higher, most directors will rationally seek to avoid unnecessary litigation expenditure

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<sup>66</sup> R Sitkoff, 'The Economic Structure of Fiduciary Law' (2011) 91 *Boston University Law Review* 1039, 1044; cf. A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) 114-5

<sup>67</sup> *Illot v The Blue Cross* [2017] UKSC 17 at [24]; *George Mitchell (Chesterhall) Ltd v Finney Lock Seeds Ltd* [1983] 2 AC 803, 816

and look for cheaper alternatives to resolve the matter.<sup>68</sup> From this, we can infer that the statutory procedure may produce some efficiencies. The increased risk of successful meritorious claims should deter director opportunism or encourage internal resolution.<sup>69</sup>

However, while costs fall on the loser to deter frivolous litigation,<sup>70</sup> greater accessibility may initially place the directors at greater risk than the shareholders because the statutory procedure rebalances the burden on the actors. Regardless of whether a claim lacks merit, circumstances may arise where the shareholder has little to risk while the burden on directors might incentivise them to settle for fear of loss of reputation, for example. We, therefore, predict that increased incentives in the statutory procedure may approximate some inefficiency by incentivising shareholders to bring more claims that are frivolous.

***6. Hypothesis 6: Where a discretionary factor is considered by the court under the statutory procedure it will significantly relate to permission***

The remaining hypotheses look at the type of claims when, with the exception of hypothesis 6, compared with the equitable procedure. For hypothesis 6, we would expect to disprove the alternative hypothesis and find no relationships between individual discretionary factors and permission.

Under the equitable procedure, a claim would be dismissed if a principle were established that demonstrated the shareholder was not the proper person to commence

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<sup>68</sup> J Coffee, 'Understanding the Plaintiff's Attorney: The implications of economic theory for private enforcement of law through class and derivative actions' (1986) 86(4) *Columbia Law Review* 669, 699

<sup>69</sup> J Coffee and D Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform' (1981) 81 *Columbia Law Review* 261, 287

<sup>70</sup> See, for example, Report of the Company Law (Jenkins) Committee (1962) Cmd 1749

litigation. Discretion allows the courts to form an “overall view” of the circumstances.<sup>71</sup> The court will balance the relevant factors to “determine what the company actually wants”<sup>72</sup> by taking “in to account all the factors set out ... and we expect the court to consider them together. It would not be a question of taking it step by step in a particular order”. Lord Goldsmith continued, “how important each factor is in any particular case would ... be for the court to determine on the facts of the case, having regard to all the circumstances and all the factors that are set out”.<sup>73</sup>

By considering all the circumstances we can infer that the statutory procedure should approximate efficiencies, as the court is considered best placed to determine whether derivative litigation is in the company’s interests.<sup>74</sup> For example, the directors may rely on independent views to show the claim is not in the company’s best interests.<sup>75</sup> Such views merit judicial scrutiny because they are subject to structural bias, incomplete information, and can be difficult for a shareholder to challenge.<sup>76</sup> Likewise, by forming an overall view, claims may continue even where there are reasons to dismiss it if, on review, it is what the company actually wants.<sup>77</sup>

***7. Hypothesis 7: The number of derivative claims brought for a fiduciary breach is more likely to be successful under the statutory procedure than the equitable procedure***

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<sup>71</sup> *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] BCC 134 at [29]

<sup>72</sup> *Hansard* HL, Vol 679, Official Report, 27/2/2006 Col GC26

<sup>73</sup> *Hansard* HL, Vol 679, Official Report, 27/2/2006 Col GC26

<sup>74</sup> A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) 117; J Coffee and D Schwartz, ‘The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform’ (1981) 81 *Columbia Law Review* 261, 280-3

<sup>75</sup> *Barrett v Duckett* [1995] 1 BCLC 243, 368-9; *Smith v Croft (No 2)* [1988] Ch 114; *Fargro Ltd v Godfroy* [1986] 1 WLR 1134, 2 BCC 99, 167

<sup>76</sup> J Coffee and D Schwartz, ‘The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform’ (1981) 81 *Columbia Law Review* 261, 280-4, 301; see also, A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) 3.4.1.1-3

<sup>77</sup> Which has been the case in the US. See, for example, *Meredith v Camp Hill Estates, Inc* 77 A.D.2d 649, 430 NYS.2d 383 (1980); cf. UK position, *Barrett v Duckett* [1995] 1 BCLC 243, 367; *Smith v Croft (No 1)* [1986] 1 W.L.R. 580, 590

**8. Hypothesis 7.1: The number of derivative claims brought for other types of conduct than fiduciary breach is higher under the statutory procedure and statistically different from the number of claims under the equitable procedure**

Next we looked at the type of conduct claims are brought for. Derivative enforcement is now available for breach of any of the director's duties. It is rarely efficient for shareholders to bring derivative litigation for matters relating to internal management or business judgment.<sup>78</sup> If accessibility increases the incentives of shareholders to litigate, we predict more claims will be brought for breaches of the duties of care and best interests providing evidence of efficiency reducing outcomes arising from the statutory procedure. The internal management rule should restrict inefficiency to claims brought rather than successfully so. If the claim has no more substance than questioning a business decision, shareholders will remain liable for costs and will not be incentivised to continue with the claim.

A more accessible procedure is likely to incentivise claims for a fiduciary breach of duty. The costs to shareholders for pursuing fiduciary breaches of duty are lower than ones of care, while costs are higher for directors.<sup>79</sup> Lawyers too will reserve their efforts for these clearer cases where they are more likely to recover their fees.<sup>80</sup> The court will also stick to what they "do best" by providing judicial oversight of transactions and

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<sup>78</sup> See, for example, *Scottish Insurance Corp v Wilson & Clyde Coal Co* 1948 S.C. 360, 377; citing *Thomas de la Rue & Co* (1894) 70 L. T. 870; *Welsbach Incandescent Gas Light Co* 1947 S.C. 651; *Mozley v Alston* (1847) 1 Ph 790, 799; 41 ER 833, 837; *Carlen v Drury* (1812) 1 Ves & Bea 154, 157; 35 ER 61, 62; M Moore, 'Private Ordering and Public Policy: The Paradoxical Foundations of Corporate Contractarianism' (2014) *Oxford Journal of Legal Studies* 1, 11

<sup>79</sup> *Keech v Sandford* (1726) Sel Cas Ch 61, 25 ER 223 – strict liability; *Ross River Ltd v Waveley Commercial Ltd* [2013] EWCA Civ 910 at [64], [95]; *Psycare Ltd v Mundy* [2013] EWHC 4573 at [30] – reverse burden of proof; and *Foskett v McKeown* [2001] 1 AC 102, 131; [2000] 2 WLR 1299, 1326 – favourable remedies

<sup>80</sup> D Schwartz, 'In Praise of Derivative Suits: A Commentary of the Paper of Professors Fischel and Bradley' (1986) 71(2) *Cornell Law Review* 322, 332

provide a remedy for the injured.<sup>81</sup> They should be willing to allow enforcement of a fiduciary breach of duty because they should “always need redress”.<sup>82</sup> We would, therefore, expect to see an increase in successful claims for fiduciary breaches of duty. Such a finding would be indicative of approximating efficiencies. Unless explicitly authorised, a rational principal would not negotiate away the protections afforded by fiduciary liability.<sup>83</sup> The increased prospect of success under the statutory procedure should increase the deterrent effect from engaging in managerial opportunism or incentivise directors to settle the matter internally.

***9. Hypothesis 8: The number of derivative claims brought by equal shareholders is higher under the statutory procedure and statistically different from the number of claims under the equitable procedure***

***10. Hypothesis 8.1: The number of derivative claims brought by equal shareholders is more likely to be successful under the statutory procedure than the equitable procedure***

These hypotheses look at the type of claimant. Any shareholder can now bring a claim. Wrongdoers do not have to be in control of the company. However where the company can still make a decision, allowing individual shareholders to litigate in the name of the company can reduce efficiencies, as they do not have the best incentive to maximise the wealth of the company.<sup>84</sup> It is unlikely many claims will involve majority shareholders as claimants or instances where a company does still have the ability to make a decision itself. Therefore, we look at equal shareholders to draw the relevant inferences.

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<sup>81</sup> D Schwartz, ‘In Praise of Derivative Suits: A Commentary of the Paper of Professors Fischel and Bradley’ (1986) 71(2) *Cornell Law Review* 322, 327-8

<sup>82</sup> D Schwartz, ‘In Praise of Derivative Suits: A Commentary of the Paper of Professors Fischel and Bradley’ (1986) 71(2) *Cornell Law Review* 322, 335

<sup>83</sup> R Sitkoff, ‘The Economic Structure of Fiduciary Law’ (2011) 91 *Boston University Law Review* 1039, 1047

<sup>84</sup> D Fischel and M Bradley, ‘The Role of Liability Rules and the Derivative Suit in Corporate Law: A theoretical and empirical analysis’ (1986) 71(2) *Cornell Law Review* 261, 271

Agency costs from derivative litigation between equal shareholders are high. Sunk costs into a valuable relationship of equals may make derivative enforcement inefficient<sup>85</sup> because it would be difficult to maintain an equal relationship where litigation is resorted to. In such situations the aggregate welfare of the parties is more likely advanced through alternative remedies. The unfair prejudice petition was a lower cost alternative under the equitable procedure because it offers a personal remedy for one shareholder to exit from the company without standing restrictions.<sup>86</sup>

However, derivative litigation may be the efficient cost for equal shareholders to incur in certain situations, particularly where the remedy they seek is unavailable through alternative means or would produce an inadequate result. Previously equal shareholders could have difficulty in establishing wrongdoer control, albeit not impossible.<sup>87</sup> If the claim is more accessible, equal shareholders will have a greater incentive to pursue derivative litigation where the alternative means is not adequate to their interests. It is predicted that equal shareholders will bring more claims and successfully so. Much like hypothesis 6, the problems that face equal shareholders in showing litigation is in the company's best interests merit judicial review. If the courts are willing to consider all the circumstances and permit claims of this type this can evidence efficiency in the statutory procedure.

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<sup>85</sup> D Fischel and M Bradley, 'The Role of Liability Rules and the Derivative Suit in Corporate Law: A theoretical and empirical analysis' (1986) 71(2) *Cornell Law Review* 261, 268-70

<sup>86</sup> See Companies Act 2006, pt 30

<sup>87</sup> *Mumbray v Lapper* [2005] EWHC 1152

## D. Methodology

The dataset was created using a sample of claims brought under the equitable procedure in exception to the rule in *Foss v Harbottle*<sup>88</sup> and all England and Wales claims heard under the statutory procedure.<sup>89</sup> We were looking for those claims regarding whether permission should be given to a shareholder to enforce the company's rights. Claims under the equitable procedure were identified using several methods to procure a sample. This included searching by keywords in Westlaw. We considered those with the topic as 'companies' with 'company law' or 'civil procedure' as the subject. We first searched for 'derivative claims'. We then searched for 'shareholders', 'minority shareholders', 'directors' and 'locus standi'. For these we used the "search within results" function by using keywords, 'derivative' or 'Foss', to reduce the number of cases. We also looked at a company law textbook written before the 2006 Act.<sup>90</sup> Finally, we looked at cases citing three main cases under the equitable procedure.<sup>91</sup> From this process we identified 44 cases from the equitable procedure. We limited the number of claims under the equitable procedure to 30 to avoid a large disparity of claims between the two procedures. These were selected at random. However, 3 of the claims selected were actions in the shareholder's own name, which standing restrictions did not apply, and were dismissed.<sup>92</sup> This left 48 derivative claims, 21 are statutory claims and 27 are equitable claims.

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<sup>88</sup> This means the data includes shareholder litigation on exceptions to the rule in *Foss v Harbottle*, as set out in *Edwards v Halliwell* [1950] 2 All E.R. 1064 *per* Jenkins LJ; including those in reference to the Civil Procedure Rules and those brought post-2006 as double derivative claims

<sup>89</sup> as reported on Westlaw by May 2017

<sup>90</sup> B Hannigan, *Company Law* (1<sup>st</sup> edn, OUP 2003)

<sup>91</sup> *Wallersteiner v Moir (No 2)* [1975] QB 373; *Edwards v Halliwell* [1950] 2 All E.R. 1064; *Foss v Harbottle* (1843) Hare 461

<sup>92</sup> *Isle of Wight v Tahourdin* (1883) 25 Ch D 320; *Sweny v Smith* (1868-69) LR. 7 Eq. 324; *Hoole v Great Western Railway Co* (1867-68) L.R. 3 Ch. App. 262

The key variable was 'procedure'. This variable was coded as binary: 1 represents claims brought under the statutory procedure and 0 represents claims brought under the equitable procedure. By measuring the change in successful claims between the procedures we can infer whether the procedure is more accessible, increasing the incentive to litigate. Successful claims were coded as 1 otherwise they were 0. To support this we look at increases in claims establishing a prima facie case and a reduction in time. Coding for time spent in court was determined by the number of hearing dates for each claim. There were 3 missing dates from claims heard under the equitable procedure.

To draw inferences about agency costs we looked at the quality and type of claims any increased accessibility would incentivise shareholders to bring. We coded: whether the claim was frivolous; individual discretionary factors; the strength of the claim; shareholding type; and the conduct complained of. These were all categorical/binary variables.

To draw those inferences we first looked at the change between procedures of the quality of claims i.e. whether they were frivolous or meritorious. Previous studies have drawn conclusions about the derivative claim by relying on descriptive figures of successful claims only.<sup>93</sup> Descriptive figures only show how the incentives are biased between the actors and not whether there are too few or too many claims. For example, a low success rate may not be the result of a lack of access to deter managerial opportunism but the derivative procedure incentivising frivolous claims that impose

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<sup>93</sup> Such as, A Keay, 'Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006' (2015) 16(1) *Journal of Corporate Law Studies* 39



inefficient costs.<sup>94</sup> Considering and isolating the quality of claims allows more robust conclusions to be drawn about efficiencies.

No taxonomy exists for quality of claims. What is frivolous or meritorious cannot be a term of art because it is claim specific.<sup>95</sup> We, therefore, recognise that categorisation can be subjective. We have taken the following steps in our methodology to ensure the results allow for fair and robust inferences from the quality of claims.

Our first step was to use comparable objective measures across the two procedures to identify frivolous and meritorious claims on the general assumption that those with low probability of success could fairly be considered frivolous. A claim was meritorious if it was not frivolous.<sup>96</sup> Frivolous claims were coded as 1 otherwise they were 0. Given the changes between procedures, it was not possible to use identical criteria for both procedures. For the equitable procedure, claims were frivolous where either the claim was not covered by the conduct complained of or if the court concluded no reasonable board would continue the claim. The latter criterion is a relatively low hurdle, justifying categorisation as frivolous.<sup>97</sup> It required the claimant to demonstrate the claim was not

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<sup>94</sup> See, J Coffee, 'Understanding the Plaintiff's Attorney: The implications of economic theory for private enforcement of law through class and derivative actions' (1986) 86(4) *Columbia Law Review* 669, 684-98

<sup>95</sup> We are not the first to highlight this issue. See, for example, E Vermeulen and D Zetzche, 'The Use and Abuse of Investor Suits' (2010) 7(1) *European Company and Financial Law Review* 1, 7; and D Schwartz, 'In Praise of Derivative Suits: A Commentary of the Paper of Professors Fischel and Bradley' (1986) 71(2) *Cornell Law Review* 322, 330

<sup>96</sup> Despite 13 claims being frivolous, 44 out of 48 claims were analysed as meritorious. This is because 5 statutory claims hypothetically considered the outcome of the claim if they had been wrong about the mandatory bar assessment, and in *Brannigan v Style* [2016] EWHC 512 (Ch) the court considered the claim frivolous against some directors but not others. Likewise the equity claims also considered a variety of other matters after having been considered frivolous

<sup>97</sup> *Wallesteiner v Moir* (No 2) [1975] Q.B. 373, 404; see also, *Airey v Cordell* [2006] EWHC 2728 (Ch); [2007] BCC 785 at [67]

one that no reasonable board would continue.<sup>98</sup> For the statutory procedure claims were frivolous if there was no prima facie case, the conduct was not covered by the claim, or it was dismissed for a mandatory bar. All of these are low thresholds for a claimant to overcome. For example, section 263(2)(a) is the same reasonable board test from the equitable procedure.<sup>99</sup> This categorisation does not include the considerations under section 263(3). This is the judicial discretion, where the requirements are higher than the mandatory bar thresholds.<sup>100</sup>

We measured the quality of meritorious claims in two ways. The first way was to exclude frivolous claims from the analysis, measuring only meritorious claims against permission to identify any change between the procedures. Looking at the change in successful meritorious claims only allows us to infer that the statutory procedure may create efficiencies through deterrence or promoting internal resolutions.

The second way was by developing a scale on meritorious claims to test hypothesis 5. Claims with merit may be stronger than others. Those with less merit may incur higher agency costs but are still predicted to be more likely to be successful. This is due to the increased accessibility under the statutory procedure that enables the court to consider all the circumstances, leading to efficiencies described in hypothesis 5. To account for this we coded the strength of meritorious claims as strong, middle, and weak based on the reasons for and against granting permission. Those with no reasons to dismiss the claim were considered ‘strong’, coded as 2; claims with reasons for and against dismissal were considered ‘middle’, coded as 1; and ‘weak’ claims were those with no

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<sup>98</sup> *Airey v Cordell* [2006] EWHC 2728 (Ch); [2007] BCC 785 at [67]; *Mumbray v Lapper* [2005] EWHC 1152 at [5]; *Harley Street Capital Ltd v Tchigirinsky* [2005] EWHC 1897 (Ch) at [143]

<sup>99</sup> *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] BCC 420 at [86]

<sup>100</sup> See, for example, *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 at [86]; *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] BCC 885 at [30]

reasons for permission, coded as 0. We only used 3 categories to reduce the analysis being biased by how many considerations a court considered in any individual claim.

To code the strength of meritorious claims, under the equitable procedure this included whether there was a prima facie case and any equitable principles considered by the court. For the statutory procedure this was based on how many discretionary reasons were cited by the court for and against permission. As the equitable principles are similar to the discretionary factors, the two procedures were comparable. To code these variables we used the list of discretionary factors in section 263(3) and (4) as well as a variable on 'wrongdoer control' and 'other'. If the court cited a reason in favour of permission it was coded as 1, otherwise it was 0. This required a careful reading of each claim to make this determination.

Our inferences from the quality claims may not be well supported if, for example, the coding concludes meritorious claims are those brought for breaches of the duty of care that inefficiently shift risk. Looking at the types of claims that are brought between the two procedures furthers the robustness of our inferences.

First, the types of statutory discretionary factors were tested individually against permission for hypothesis 6. Disproving the alternative hypothesis will help support the claim that discretion promotes efficiencies by allowing the court to consider all the circumstances on whether to grant permission, as it should lower the demand on shareholders but increase it for directors.

Second, we captured the type of conduct and the type of shareholder. The latter was coded by identifying the share ownership structure between the claimant and defendant. For 'conduct' the grounds were not directly comparable. Fraud on the minority was not

always a fiduciary breach of duty.<sup>101</sup> We categorised claims brought for breaches as directors' duties based on the duties coded in the Companies Act 2006. 'Fiduciary breach' for those claims brought under or what would have been brought under section 175-177; 'negligence' for section 174; 'other breaches of duty' under sections 171-173; and also 'multiple breaches of duty'. The equitable procedure also consisted of ultra vires claims as a final category. Finally, to interpret our findings and support our inferences about incentives and efficiencies, they are supported by the judicial dicta.

All hypothesised relationships except hypothesis 3 were examined by Cross-tabulation analysis (or Crosstab). Crosstab is a type of descriptive analysis for examining relationships between two or more categorical variables in tabular form. For example, we can use Crosstab to determine whether the number of successful derivative claims under the statutory procedure is statistically different from the number successful claims under the equitable procedure. We used the Chi-Square ( $X^2$ ) test in Crosstab analysis to determine the extent to which relationships are statistically different. Statistical significance was assessed against three levels of probability (i.e., p-values): 95% confidence level (p-value < .05), 97% confidence level (p-value < .01), and 99% confidence level (p-value < .001). If the Chi-Square p-value falls outside any of these confidence levels, we can infer no statistically significant relationship or difference between variables.

Hypothesis 3, which considers the assumptions that derivative claims brought under the statutory procedure will spend less time in court compared to the equitable procedure, was examined by one-way Analysis of Variance (ANOVA). ANOVA was used because hypothesis 3 contains a continuous variable (i.e., time) and therefore does not meet the

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<sup>101</sup> See, for example, *Daniels v Daniels* [1978] Ch 406, 413-4

precondition for Crosstab analysis. ANOVA is also a type of descriptive analysis. It examines whether the means of two or more continuous variables are significantly different across categories of a grouping variable. Statistical significance for the ANOVA test was assessed by the same three levels of probability as our Crosstab analysis.

Our preference for the above statistical procedures is justified by at least three factors. First, we needed to ensure that any observed differences or relationships between the two legal procedures were statistically significant. We used estimates of statistical significance (i.e., p-values) from our analytical procedures to ensure our results were not simply due to random chance. Secondly, a variety of analytical procedures might be useful for establishing statistical significance; however, they tend to be very sensitive to sample size. Crosstab and ANOVA tests do not have strict requirements for sample size and were therefore considered suitable for our relatively small sample size. Thirdly, Crosstab and ANOVA tests allowed us to analyse our mainly binary and categorical variables.

## **E. Results**

### ***1. Descriptive Results***

Overall 41.7% (20 out of 48) claims have been successful. 11 out of 27 (40.7%) claims were successful under the equitable procedure whereas 9 out of 21 (42.9%) were successful under statute. The amount of claims that have demonstrated a prima facie case has risen from 55.6% to 100% under statute. Overall the mean time spent in court is 3.80 days. Under the equitable procedure it was 5.35 days while the statutory procedure claims have a mean of 1.80 days. However, a large standard deviation (8.82)

for the old procedure suggests the presence of outliers, which was confirmed where two claims exceeded 15 days.<sup>102</sup> Excluding these from the analysis, the mean reduced to 3.17 from 24 claims. The maximum time spent in court also decreased from 8 days to 4.

Frivolous claims increased from 6 claims (22.2%) to 7 claims (33.3%). Conversely the amount of meritorious claims considered strong increased from 40% to 42.9%. For the discretionary factors, Table 2 details the frequency of the discretionary factors considered from those claims where the courts have applied their discretion. Several claims considered more than one discretionary factor. Table 3 details the frequencies for the type of claims.

[insert Table 1 here]

[insert Table 2 here]

## **2. Statistical Results**

The number of derivative claims that were successful under the statutory procedure is not significantly different from those that were successful under the equitable procedure ( $\chi^2 = 0.02$ ,  $p > 0.05$ ). This indicates that the changes to legal rules between the statutory and equitable procedures may not have had a significant influence on whether derivative claims were granted permission. Thus, hypothesis 1 was not supported. We further examined whether this non-significant relationship remained true when frivolous claims were discounted from the analysis, leaving 14 claims under statute and 21 claims under the equitable procedure. The percentage increase was from 20% to 64.3% bringing the UK's success rate in line with other jurisdictions, such as Australia

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<sup>102</sup> *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204; and *Smith v Croft (No 2)* [1988] Ch 114

and New Zealand where success rates of 61% and 70% have been reported respectively.<sup>103</sup> The analysis, however, showed no statistically significant difference in the number of successful derivative claims between the statutory and equitable procedures ( $\chi^2 = .486$ ,  $p > 0.05$ ).

The number of derivative claims that established a prima facie case under the statutory procedure was found to be higher and statistically different from the number of claims that established a prima facie case under the equitable procedure ( $\chi^2 = 11.10$ ,  $p < 0.001$ ). Out of a total of 37 claims that established a prima facie case, 56.8% were brought under the statutory procedure and 43.2% under the equitable procedure. All of the eleven remaining claims that did not establish a prima facie case were brought under the equitable procedure. Thus, hypothesis 2 is fully supported by our analysis.

Our analysis of whether derivative claims will spend less time in court when brought under the statutory procedure than the equitable procedure showed no statistically significant relationship ( $p > 0.05$ ). However, once the outliers (i.e., the two claims where time spent in court amounted to 18 and 45 days, respectively) were discounted from the analysis, we found a statistical significant relationship ( $p < 0.05$ ).

Hypothesis 4 assessed whether the number of frivolous claims is higher under the statutory procedure and statistically different from the number of frivolous claims under the equitable procedure. Our analysis did not find this to be statistically significant ( $\chi^2 = .738$ ,  $p > 0.05$ ). Out of a total of thirteen frivolous claims in our data, 53.8% were brought under the statutory procedure and 46.2% were brought under the equitable

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<sup>103</sup> A Keay, 'Assessing and rethinking the statutory scheme for derivative actions under the Companies Act 2006' (2015) 16(1) *Journal of Corporate Law Studies* 39, 54; I Ramsay and B Saunders, 'Litigation by Shareholders and Directors: An Empirical Study of the Australian Statutory Derivative Action' (2006) 6(2) *Journal of Corporate Law Studies* 397, 424 – however these analyses considered all claims and did not discount those claims that were considered frivolous, so the data is not directly comparable

procedure. This indicates that the tendency for claims to be judged as frivolous was slightly greater under the statutory procedure compared to the equitable procedure. Hypothesis 4 is not supported.

The test for hypothesis 5 showed no statistically significant result ( $\chi^2 = 0.05$ ,  $p > 0.05$ ). The number of meritorious claims that were successful under the statutory procedure is not statistically different from the number of meritorious claims that were successful under the equitable procedure. However, a further analysis of the data showed that derivative claims were in general more likely to be granted permission if they had a strong claim ( $\chi^2 = 44.00$ ,  $p < 0.001$ ). The 20 (out of 44) meritorious claims that were granted permission were all considered to be strong claims (i.e., the claims had no reason to be dismissed). From this result we can infer that regardless of differences in legal rules between the statutory and equitable procedures, a derivative claim will be granted permission if it provides a strong claim but permission will not be granted where there is a reason to dismiss it.

Hypothesis 6 examined whether a derivative claim is likely to be successful under the statutory procedure if the court considers a discretionary factor. Three individual discretionary factors under the statute are significantly related to a claim being granted permission. These were, 'how much weight a hypothetical director acting in accordance with section 172 would attach to the claim' ( $\chi^2 = 17.00$ ,  $p < 0.001$ ); 'the availability of another remedy' ( $\chi^2 = 14.00$ ,  $p < 0.001$ ); and 'other' ( $\chi^2 = 8.00$ ,  $p < 0.05$ ). The first two factors showed a 100% chance of success when one of these factors was considered in the claimant's favour. Further, a perfect relationship was observed with the consideration of a hypothetical director and permission. No case has been successful without this factor considered in a claimant's favour. In addition to hypothesis 5 showing for a court to grant permission there must be no reason to dismiss it, hypothesis



6 also shows a court must consider that a hypothetical director would attach weight to the claim under section 263(3)(b).

The analysis of our test for hypothesis 7 showed no statistically significant result ( $\chi^2 = 0.09$ ,  $p > 0.05$ ), providing no evidence that the number of derivative claims brought for a fiduciary breach will be more successful under the statutory procedure. However, upon further examination, our analysis showed that derivative claims were in general more likely to be granted permission if they were brought for fiduciary breach ( $\chi^2 = 6.52$ ,  $p < 0.05$ ). For example, a total of 33 out of 47 claims were brought for fiduciary breach and 54.5% of these were granted permission. Although the percentage difference between successful and unsuccessful claims brought for fiduciary breach is quite marginal (9%), our result provides some evidence that changes to legal rules between the statutory and equitable procedures may not significantly influence the success of any claim brought for a fiduciary breach but such claims are generally successful. When we examined the hypothesis that the number of claims brought for other types of conduct than fiduciary breach is higher under the statutory procedure and statistically different from the equitable procedure, we found no statistically significant result (no support for hypothesis 7.1).

Hypothesis 8, which examined whether the number of claims brought by equal shareholders is higher under the statutory procedure and statistically different from the equitable procedure, showed a statistically significant result ( $\chi^2 = 4.66$ ,  $p < 0.05$ ). However, the test for whether the number of claims brought by equal shareholders is more likely to be successful under the statutory procedure than the equitable procedure (hypothesis 8.1) found no statistically significant result. We interpret these results to suggest that the likelihood for granting permission to claims brought by equal

shareholders may not necessarily be dependent on differences in legal rules between the statutory and equitable procedures.

#### **F. Analysis of Incentives and Agency Costs**

There is little to suggest that the statutory procedure is more accessible to increase the incentives of shareholders to litigate. While there appears to be greater predictability of when a claim will succeed, a reduction in time spent in court and an increase in claims establishing a prima facie case, we do not observe claims being more successful, neither generally, for meritorious claims, or for fiduciary breaches of duty. One might interpret these findings differently. The statutory procedure may be increasing the incentive to use the threat of litigation internally without the dispute ever reaching the court, therefore not resulting in an increase in observed litigation. We would reject such an interpretation. This is because our findings suggest that, instead of considering all the circumstances, there appears to be *sine quibus non* for the courts to grant permission. These require that the claim has sufficient legal merit and there is no reason to dismiss it, reminiscent of the equitable procedure. Shareholders will face difficulties in meeting the standards required of those conditions creating little incentive to litigate, as they are likely to be liable for costs. Directors sensing this will continually be able to deter litigation by exploiting their position. This will be particularly true in claims not previously caught by the equitable procedure. The inference drawn is that where other mechanisms have failed to control managerial opportunism, directors could reduce efficiencies by deterring enforcement.

### *1. Sine Quibus Non: The hypothetical director*

Consider the first condition for permission as an explanation for why there will not be an increase in the incentive to litigate and how it could reduce efficiencies. The court must be satisfied that a hypothetical director would attach weight to the claim. Rather than being satisfied of a procedural requirement that there was sufficient legal merit,<sup>104</sup> discretion can overcome the subtler problems shareholders face to determine what the company actually wants.

However, the court appears to continue to view litigation as a matter of business judgment; something that they consider themselves ill equipped to make except in a “clear case”.<sup>105</sup> Instead courts have assessed whether a director would attach weight to the claim by considering its legal merits.<sup>106</sup> For example, in *Franbar* the assessment under section 263(3)(b) proceeded on the legal merits that “there is sufficient material for the hypothetical director to conclude that the conduct of Medicentres’ business by those in control of it had given rise to actionable breaches of duty”<sup>107</sup> but could not yet be said to amount to “breaches of duty which ought to be pursued”.<sup>108</sup> Judicial discretion introduces a condition that the claim’s legal merits meet a threshold for permission through the back door.<sup>109</sup>

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<sup>104</sup> Law Commission Report, paras 6.4, 6.71-3; see also, *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] BCC 134 at [29]; *Hughes v Weiss* [2012] EWHC 2363 (Ch) at [33]; *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) LSG 19 at [40]

<sup>105</sup> *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] BCC 420 at [85] – what a clear case is was not expanded upon but might include situations such as *Stimpson v Southern Landlords Association* [2009] EWHC 2072 (Ch); [2010] BCC 387; see also D Schwartz, ‘In Praise of Derivative Suits: A Commentary of the Paper of Professors Fischel and Bradley’ (1986) 71(2) *Cornell Law Review* 322, 325, 327-8

<sup>106</sup> *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] BCC 420 at [85]-[88]

<sup>107</sup> *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] BCC 885 at [30]

<sup>108</sup> *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] BCC 885 at [37]

<sup>109</sup> For other examples of courts considering the legal merits under section 263(3)(b) see, for example, *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] BCC 420 at [85] – refusing to consider commercial matters; *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011]

To satisfy this condition for permission under section 263(3)(b) it is not enough that the claim relates to a breach of duty and the legal merits are not so weak that no director would continue the claim.<sup>110</sup> They must go further by showing the legal merits disclose a director would also attach weight to the claim:

Section 263(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. If some directors would, and others would not, seek to continue the claim the case is one for the application of section 236(3)(b).<sup>111</sup>

What amounts to sufficient merit to satisfy the court that a hypothetical director would attach weight to the claim appears to be considerable. In *Franbar*, one of the complaints was for a breach of fiduciary duty. The defendants had attempted to divert opportunities to another company.<sup>112</sup> Strict liability should have meant the defences offered would not alleviate a breach of fiduciary duty. Another complaint about the diversion of patients to another company would be a clear breach of fiduciary duty, even if the new company would offer a different type of medical services.<sup>113</sup> Further, the court conceded that the directors were likely to blame for the conduct complained of.<sup>114</sup> Yet, while the court was satisfied that a reasonable board would pursue the allegations, satisfying section 263(2)(a), the claims were not yet in a form that disclosed “obvious

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BCC 134 at [29]-[48] – stating the court will consider a “range of factors” but focused their decision on the possible unlawfulness of the loan

<sup>110</sup> Which are the standards under Companies Act 2006, ss 261 and 263 respectively

<sup>111</sup> *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch); [2010] BCC 420 at [86]

<sup>112</sup> *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] BCC 885 at [11]-[12]

<sup>113</sup> *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] BCC 885 at [13]

<sup>114</sup> *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] BCC 885 at [30]

breaches of duty”<sup>115</sup> that were worth pursuit and the claim was dismissed. In another claim it was said more than an “arguable case” was needed to satisfy the condition.<sup>116</sup>

The assessment of section 263(3)(b) in successful claims also reflects this high standard. In *Stainer*, despite obiter statements that claims with weak legal merit could still be successful,<sup>117</sup> the claim was said to be “well arguable”<sup>118</sup> where there was a “clear conflict of interest”.<sup>119</sup> In *Hughes v Weiss*, despite the court saying there was no merits test<sup>120</sup> the claim had “good prospects”<sup>121</sup> and a “strong case”.<sup>122</sup> *Parry v Bartlett* was said to be a case that would have been successful under the equitable procedure.<sup>123</sup> The merits of one successful claim were described as “so powerful” and “so sufficiently substantiated” permission should be granted.<sup>124</sup>

The inference drawn from this is *de facto* application of the statutory procedure is it will create little incentive for shareholders to pursue derivative litigation because they have the burden of proof.<sup>125</sup> Meeting this high standard will be difficult due to information asymmetry. Unless the shareholder has actively monitored the company or has the relevant expertise, they may well be ignorant of what happened. A lack of preliminary knowledge may make applications for pre-action disclosure “close to a

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<sup>115</sup> *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] BCC 885 at [37]

<sup>116</sup> *Stimpson v Southern Landlords Association* [2009] EWHC 2072 (Ch); [2010] BCC 387 at [34]; see also *Bridge v Daley* [2015] EWHC 2121 at [19]

<sup>117</sup> *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] BCC 134 at [29]; see also *Hughes v Weiss* [2012] EWHC 2363 (Ch) at [33]

<sup>118</sup> *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] BCC 134 at [42], [46]

<sup>119</sup> *Stainer* at [42]

<sup>120</sup> *Hughes v Weiss* [2012] EWHC 2363 (Ch) at [33]

<sup>121</sup> *Hughes v Weiss* [2012] EWHC 2363 (Ch) at [34]

<sup>122</sup> *Hughes v Weiss* [2012] EWHC 2363 (Ch) at [37]-[38]

<sup>123</sup> *Parry v Bartlett* [2011] EWHC 3146 (Ch) at [81]

<sup>124</sup> *SDI Retail Services Ltd v King* [2017] EWHC 737 at [68]-[75]

<sup>125</sup> See, *Barrett v Duckett* [1995] 1 BCLC 243, 249; *Airey v Cordell* [2006] EWHC 2728 (Ch); [2007] BCC 785 at [59], [73]

fishing expedition, which the courts ... will be very slow to admit".<sup>126</sup> Shareholders also have to pay the cost of pre-action disclosures, meaning the absence of preliminary knowledge creates a big risk to shareholders in attempting to pursue derivative litigation, as there is no guarantee they will find sufficient evidence. In *Bridge*, for example, the shareholder had substantial difficulties in compiling evidence to substantiate his claim of market manipulation, which were dismissed since various factors can affect share valuation in a publicly listed company and a fall in share price did not mean the company had suffered a loss.<sup>127</sup>

Directors will continue to have a greater incentive to deter litigation. Knowing that a shareholder will be liable for costs if they cannot demonstrate sufficient legal merit to their claim, they may exploit their advantageous position. There is evidence of this in the claims. In *Franbar*, the claim could not be substantiated to the standard required under section 263(3)(b), partially due to the directors withholding financial information.<sup>128</sup> In *Stainer*, Mr Lee made several spurious submissions to try and defeat the claim. For example, claiming it had been agreed monies were to be lent interest free in the offer document when they had not<sup>129</sup> and refusing to discuss company accounts with individual shareholders.<sup>130</sup> In *Kiani*, the directors withheld information despite having six weeks to produce it.<sup>131</sup> While the latter two of these three claims were

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<sup>126</sup> C Paul, 'Derivative Actions under English and German Corporate Law – Shareholder Participation between the Tension Filled Areas of Corporate Governance and Malicious Shareholder Interference' (2010) *European Company and Financial Law Review* 81, 112-3

<sup>127</sup> *Bridge v Daley* [2015] EWHC 2121 at [40]-[45]

<sup>128</sup> *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] BCC 885 at [15], [22]

<sup>129</sup> *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] BCC 134 at [10]-[11]

<sup>130</sup> *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] BCC 134 at [13]

<sup>131</sup> *Kiani v Cooper* [2010] EWHC 577 (Ch); [2010] BCC 463 at [30]; for another example of deterrent tactics by directors see, *SRI Retail Services Ltd v King* [2017] EWHC 737 (Ch) (CHD) at [29]-[33]

permitted,<sup>132</sup> they may have been Pyrrhic victories. In *Stainer* a cap was applied to the indemnity,<sup>133</sup> while *Kiani* only achieved permission down to disclosure and was not granted an indemnity,<sup>134</sup> leaving shareholders at risk of additional monetary and nonmonetary costs.

While the courts will evidently not accept disingenuous reasons from directors about the merits of the claim, the directors are able to put costs onto the shareholders to deter even beneficial litigation by creating some doubt about the claim's prospects. This creates the prospect of inefficiencies manifesting where other mechanisms fail and litigation would otherwise be in the company's best interests.

## ***2. Sine Quibus Non: Discretion and the proper person***

Suppose a shareholder can demonstrate sufficient merit to their claim. The second condition requires there to be no reason to dismiss the claim. The court still appears to be guided by the proper person test and its principles. Roth J acknowledged that “permission ... is a discretion resting in the court”,<sup>135</sup> and “the discretion must, of course, be exercised in accordance with established principles”.<sup>136</sup>

Given the range of established principles under the proper person test, it seems unlikely controllers, with the company's assets at their disposal, would be unable to come up with a reason to have the claim dismissed.<sup>137</sup> Faced with the range of principles that

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<sup>132</sup> *Kiani v Cooper* [2010] EWHC 577 (Ch); [2010] BCC 463 at [30] – information withheld; *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] BCC 134 at [46] – authorisation for a transaction obtained illegitimately

<sup>133</sup> *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] BCC 134 at [56]

<sup>134</sup> *Kiani v Cooper* [2010] EWHC 577 (Ch); [2010] BCC 463 at [46]-[49]; see also *DPM Property Services Ltd v Kiani* [2012] EWHC 2056 (TCC)

<sup>135</sup> *Cinematic Finance Ltd v Ryder* [2010] EWHC 3387 (Ch) at [21]; [2012] BCC 797

<sup>136</sup> *Cinematic Finance Ltd v Ryder* [2010] EWHC 3387 (Ch) at [14]; [2012] BCC 797

<sup>137</sup> Echoing A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) 113 sentiments that a shareholder, faced with this prospect, might as well give up

can have a claim dismissed, *de facto* application suggests a shareholder will have little incentive to litigate under the statutory procedure.

Take two principles – independent views and adequate alternative remedies – as examples of how they can reduce the incentive to litigate.<sup>138</sup> The first principle is that the extant derivative claim is utilised in the absence of an *adequate* alternative remedy.<sup>139</sup>

It is the availability of an alternative remedy which may have some significance in the light of what I am about to say. ... If the court ... is satisfied that such a proposal affords adequate protection for the claimant, he should not, in my judgment, be allowed to proceed with his derivative claim.<sup>140</sup>

Regardless of what the company may actually want, if an adequate alternative remedy is available permission will be refused. Once it is appreciated that an adequate alternative will frequently be available to shareholders it will limit the utility of the derivative claim in deterring managerial opportunism.

An alternative remedy will frequently be available because the unfair prejudice petition covers most complaints also caught by a derivative claim.<sup>141</sup> This has become more so as the scope of the petition has expanded over the years.<sup>142</sup> It will also be adequate in

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<sup>138</sup> Other examples include *Re Singh Brothers Contractors (North West) Ltd* [2013] EWHC 2138 at [44]; see also *Rex v Kensington Income Tax Commissioners* [1917] 1 KB 486, 505; cited by *Smith v Croft (No 1)* [1986] 1 W.L.R. 580, 590 – principle of *uberrima fides* from the claimant; and *Cinematic Finance Ltd v Ryder* [2010] EWHC 3387 (Ch) at [21]; [2012] BCC 797 – wrongdoer control. This was “not a case where the company cannot or will not enforce its rights”; *Franbar Holdings Ltd v Patel* [2008] EWHC 1534 (Ch); [2008] BCC 885 at [39]-[48] – ratification

<sup>139</sup> *Barrett v Duckett* [1995] 1 BCLC 243, 367

<sup>140</sup> *Airey v Cordell* [2006] EWHC 2728 (Ch); [2007] BCC 785 at [74], [77]

<sup>141</sup> See, for example, *O'Neill v Phillips* [1999] 1 WLR 1092, HL; [1999] 2 BCLC 1; *Grace v Biagioli* [2006] 2 BCLC 70; *Re Little Olympian Each-Ways Ltd (No 3)* [1995] 1 BCLC 636; *cf. Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] 1 All ER 354

<sup>142</sup> The remedy was introduced under the Companies Act 1985, s 459; replaced by Companies Act 2006, s 994; between 1948-1985 there was the oppression remedy see, Companies Act



most circumstances. An adequate alternative is more than the theoretical availability of one.<sup>143</sup> The court considers the subjective intentions of the claimant in what they hope to achieve and then objectively assess whether there are alternate means that can adequately address the complaint.<sup>144</sup> For example, the courts considered the subjective intentions of the claimants in *Kleanthous* and *Stainer* who were and were “not seeking to be brought out”<sup>145</sup> respectively. The courts then objectively assess the adequate way to remedy the claim. In *Kleanthous*, the court agreed that the unfair prejudice petition was more appropriate since sums recovered from a derivative claim would be returned to the shareholders, 85% of which were owned by the defendant directors.<sup>146</sup>

The application of this principle may reduce efficiencies because regardless of whether the claim’s merit may enhance corporate value, it will often be in the interests of both actors to pursue the alternative remedy. Shareholders are likely to prefer the petition and complaints can frequently be resolved through this route.<sup>147</sup> Likewise, directors may go undeterred if they can make a fair offer to purchase the claimant’s shares at a lower rate than the benefits that accrue from the opportunism.

Now consider the principle of independent views. If independent views, either those of directors or shareholders, conclude litigation was not in the best interests of the company then litigation had been properly prevented and the claimant is not the proper

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1948, s 210; Companies Act 1980, s 75; for the restrictive approach see, for example, *Re a Company* [1983] Ch 178

<sup>143</sup> *Mumbray v Lapper* [2005] EWHC 1152 at [5]

<sup>144</sup> See, for example, *Hughes v Weiss* [2012] EWHC 2363 (Ch) at [66]

<sup>145</sup> *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) LSG 19 at [80]-[81]; *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] BCC 134 at [52]; see also, *Parry v Bartlett* [2011] EWHC 3146 (Ch) at [88]

<sup>146</sup> *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) LSG 19 at [77]; see also, *Bridge v Daley* [2015] EWHC 2121 (Ch) at [83]; *Phillips v Fryer* [2012] EWHC 1611 (Ch); *Franbar Holdings Ltd v Patel* [2008] EWHC 1534; [2008] BCC 885 at [37], [54]

<sup>147</sup> *cf. Parry v Bartlett* [2011] EWHC 3146 (Ch) at [88] – where there shares were worthless; for discussion see, A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) Ch 8

person to act for the company.<sup>148</sup> Short of actual bias or illegitimacy,<sup>149</sup> a court will not challenge the substance of that independent decision.<sup>150</sup> There is, of course, good reason for respecting these views. The majority of independent shareholders are best placed to maximise the wealth of the company, while independent directors will be better informed of the merits of any litigation.<sup>151</sup>

However, an unwillingness to challenge the independent view in the absence of exceptional circumstances will not create greater incentive to litigate leaving the risk of managerial opportunism going undeterred. Independent views are likely to support dismissal, as the US example of special litigation committees shows,<sup>152</sup> even though litigation may be beneficial. Psychological and sociological factors mean independent directors are likely to rally around their own,<sup>153</sup> while collective action problems mean independent shareholders are unlikely to support the action<sup>154</sup> or will favour other action, such as “therapeutic” remedies or director removal.<sup>155</sup> Likewise, claimant shareholders will have difficulty challenging independent views<sup>156</sup> and the independent views may be solicited after the claimant has incurred costs.<sup>157</sup> This creates a significant

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<sup>148</sup> *Smith v Croft (No 2)* [1988] Ch 114, 185

<sup>149</sup> See, for example, *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) LSG 19 at [75]; *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] BCC 134 at [46]

<sup>150</sup> *Bridge v Daley* [2015] EWHC 2121 at [56]; *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) LSG 19 at [75], [83]

<sup>151</sup> A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) Ch 3.4.1.1

<sup>152</sup> J Cox, ‘Searching For the Corporation’s Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project’ (1982) 6 *Duke Law Journal* 959, 963

<sup>153</sup> L Bebchuk and J Fried, *Pay Without Performance: The unfulfilled promise of executive compensation* (Harvard University Press, 2006) 31-4; J Coffee and D Schwartz, ‘The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform’ (1981) 81 *Columbia Law Review* 261, 283; M Klein, ‘Conduct of Directors When Litigation is Commenced Against Management’ (1976) 31(2) *Business Lawyer* 1355, 1359; R Buxbaum, ‘Conflicts of Interests Statutes and the Need for a Demand on Directors in Derivative Statutes’ (1980) 68(6) *California Law Review* 1122

<sup>154</sup> A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) Ch 3.2.3.4

<sup>155</sup> *Mills v Elec Auto-Lite Co*, 396 US 375, 392 (1970); *Fletcher v AJ Industries Inc*, 266 Cal App 2d 313, 320 (1968)

<sup>156</sup> A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) Ch 3.4.1.1-3

<sup>157</sup> Companies Act 2006, ss 261-4

risk for the shareholder. They may commence a claim and incur costs only for the directors to solicit independent views to have it dismissed.

A court is “impotent when faced with [these] subtler problems of structural bias that inhere in a corporate structure”.<sup>158</sup> Therefore, managerial opportunism may go undeterred as long as independent views can be solicited regardless of other circumstances. As *Kleanthous* demonstrates, the courts have continually followed this principal, even going as far as refusing to agree with the submission that “seriously abusive behaviour” should defeat a genuine belief by independent members or directors that enforcement was not an appropriate course of action.<sup>159</sup> This was despite Mr Paphitis selecting the independent views from two selected business associates. Both were directors of the defendant company, though not at the time the conduct took place. One was previously an employee while the other had been a director of several companies associated with Mr Paphitis. The judge did not wish to challenge their determination, holding that they had received “legal advice on their duties”<sup>160</sup> and were therefore “better placed ... to assess where the companies' commercial interests lie”.<sup>161</sup>

Principles in derivative litigation continue to be biased towards directors. They need not invest more in litigation under the statutory procedure to have a claim dismissed. The court will continue to dismiss claims falling foul of a single principle rather than assessing what the company actually wants. The adherence to these principles means managerial opportunism may continue to go undeterred where other mechanisms fail, creating the risk of inefficiencies arising in the statutory procedure.

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<sup>158</sup> A Reisberg, *Derivative Actions and Corporate Governance* (OUP, 2007) Ch 3.4.1.2; J Coffee and D Schwartz, ‘The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform’ (1981) 81 *Columbia Law Review* 261, 301

<sup>159</sup> *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) LSG 19 at [75]

<sup>160</sup> *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) LSG 19 at [75]

<sup>161</sup> *Kleanthous v Paphitis* [2011] EWHC 2287 (Ch); (2011) 108(36) LSG 19 at [75]

### 3. *Sine Quibus Non: Claims on wider grounds*

Claims brought for different types of conduct, such as mala fides or negligence, and by different types of shareholders, such as equal shareholders, can produce inefficient agency costs, but they may have some positive effect in limited circumstances. However, the *sine quibus non* mean such claims are even less likely to be successful than those that would have been caught by the equitable procedure.

The condition of sufficient legal merit means claims for other breaches of duty will struggle to, to use the words in *Franbar*, demonstrate an “obvious breach of duty”. The non-interventionist imperative of the court means they will not second-guess commercial decisions taken in good faith.<sup>162</sup> A claimant would need to show the director has been negligent or acted in bad faith. To do so, they would either have to show the director did not believe what they were doing was in the best interests of the company<sup>163</sup> or had not provided proper oversight of the company’s affairs.<sup>164</sup> The information asymmetries in derivative litigation will mean shareholders will struggle to demonstrate sufficient legal merit to their claim to discharge this burden.

Even if sufficient merit could be established it less likely than claims for fiduciary breach of duty that the controllers would be unable to come up with a reason to dismiss the claim. Independent views, for example, would be unlikely to conclude that pursuing claims for negligence or bad faith would be worthwhile. In the one claim brought for

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<sup>162</sup> *Scottish Insurance Corp v Wilson & Clyde Coal Co* 1948 S.C. 360, 377; citing *Thomas de la Rue & Co* (1894) 70 L. T. 870; *Welsbach Incandescent Gas Light Co* 1947 S.C. 651

<sup>163</sup> Companies Act 2006, s 172

<sup>164</sup> *Equitable Life Assurance Society v Bowley* [2004] 1 BCLC 180 at [41]; for examples, see, *Lexi Holdings v Luqman* [2009] EWCA Civ 117; *Daniels v Anderson* (1995) 16 ACSR 607; *Dovey v Cory* [1901] AC 477 HL

negligence under the statutory procedure, none of the independent shareholders canvassed supported the claim.<sup>165</sup>

The conditions also demonstrate why other types of shareholders have not been more successful. We suggest the primary reason for this is the court's attitude to the existing principles of wrongdoer control and the availability of an adequate alternative remedy. While the claimant need not show wrongdoer control as a prima facie requirement, the courts still apply the proper plaintiff principle.<sup>166</sup> Roth J noted "a claim that lies in a company can be pursued only by the company".<sup>167</sup> An absence of wrongdoer control means the company may not be deprived of its rights of enforcement.<sup>168</sup> Therefore, shareholders outside the scope of the equitable procedure will still be prevented from accessing permission, so there will be little incentive to pursue it.

The significance of an adequate alternative remedy should also restrict claims brought by equal shareholders. A cordial business relationship is unlikely to be restored when it has resorted to legal proceedings. Objectively, the adequate way to resolve such disputes is for one party to exit the company under section 994, and it is well established that shareholders can do so for fiduciary breaches of duty<sup>169</sup> as well as care.<sup>170</sup> While several claims between equal shareholders have been successful under the statutory procedure these claims would have been successful under the equitable procedure. They

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<sup>165</sup> *Bridge v Daley* [2015] EWHC 2121 (Ch) at [55]-[57], [68]

<sup>166</sup> *Russell v Wakefield Waterworks Co* (1875) LR 20 Eq 474, 482

<sup>167</sup> *Cinematic Finance Ltd v Ryder* [2010] EWHC 3387 (Ch) at [11]; [2012] BCC 797

<sup>168</sup> *Cinematic Finance Ltd v Ryder* [2010] EWHC 3387 (Ch) at [21]; [2012] BCC 797; see also *Bridge v Daley* [2015] EWHC 2121 (Ch) at [55]-[57], [68]; cf. *Stainer v Lee* [2010] EWHC 1539 (Ch); [2011] BCC 134 at [16], [49]

<sup>169</sup> See, for example, *Grace v Biagioli* [2006] 2 BCLC 70; *Re Little Olympian Each-Ways Ltd (No 3)* [1995] 1 BCLC 636

<sup>170</sup> *Oak Investment Partners XII v Boughtwood* [2010] 2 BCLC 459; *Re Macro (Ipswich)* [1994] 2 BCLC 354

have tended to involve relationships or companies that had ended anyway<sup>171</sup> sometimes making the shares worthless.<sup>172</sup> In such situations the unfair prejudice petition would be inadequate, as a share purchase would be of no value, and where the relationship is ended the court does not have to be concerned about the likely effect on a continuing relationship.

While such claims may generally reduce efficiencies, they can have some benefit. The *sine quibus non* mean there is little incentive to utilise derivative litigation in these wider circumstances. This may create some inefficiency in those rare circumstances where such claims would otherwise enhance corporate value.

## **G. Conclusions**

The conclusions from this analysis should not be overstated. Other mechanisms can and do control managerial opportunism in the majority of companies. The point is that without an effective backstop, in those instances where directors do decide to act opportunistically, the *sine quibus non* for permission could minimise the deterrent function of derivative litigation.

The data demonstrates the way the courts are applying the statutory procedure in comparison with the equitable procedure is unlikely to increase the incentives of shareholders to use litigation once the *sine quibus non* are accounted for. They show the incentives in litigation are likely to be continually biased in favour of directors. Directors are unlikely to settle a complaint and they will exploit their advantageous position to deter litigation. A rational shareholder is unlikely to look to commence

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<sup>171</sup> *Hughes v Weiss* [2012] EWHC 2363 (Ch) at [4] – company dissolved; *Parry v Bartlett* [2011] EWHC 3146 (Ch) – company to be wound up

<sup>172</sup> *Parry v Bartlett* [2011] EWHC 3146 (Ch) at [88]

litigation and they will seek cheaper alternatives to remedy their complaint. The inference we draw from *de facto* application is that inefficiencies may arise from managerial opportunism going undeterred where other mechanisms fail to control it.

Widening the scope of the claim is unlikely to resolve this issue, as the court’s “engrained traditions do not disappear overnight; rather, they persist in ways that have low visibility.”<sup>173</sup> A practical solution may be to look to reduce information asymmetry to enable the litigant shareholder to meet the high standard set by the court in meeting the requirement of sufficient legal merit.<sup>174</sup> This is unlikely to lead to opportunistic or over enforcement as the conditions for permission will still restrict such claims from being successful and liability for costs will deter claims. However, those desirable claims, particularly for fiduciary breaches of duty, can continue in appropriate circumstances. Without further consideration a director will continue to have a strong incentive to deter litigation that could otherwise control their opportunism to maximise the value of the company.

Table 1: Discretionary Factors

<b>Discretionary Factor</b>	<b>Overall</b>	<b>Equity</b>	<b>Statute</b>
Good Faith	17	6	12
Section 172/Reasonable board	25	9	17
Ratified/Authorised	9	2	7
Company Decision	5	4	2

<sup>173</sup> J Coffee and D Schwartz, ‘The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform’ (1981) 81 *Columbia Law Review* 261, 329

<sup>174</sup> For discussion see, C Paul, ‘Derivative Actions under English and German Corporate Law – Shareholder Participation between the Tension Filled Areas of Corporate Governance and Malicious Shareholder Interference’ (2010) *European Company and Financial Law Review* 81, 111-3; A Reisberg, *Derivative Actions and Corporate Governance: Theory and Operation* (OUP, 2007) Ch 3 para 3.2.3.2

Alternative Remedy	19	6	14
Independent Views	7	4	3
Wrongdoer Control	5	0	5
Other	15	7	8

Table 2: Practical Variables Frequency

<b>Practical Consideration</b>	<b>Overall</b>	<b>Equity</b> (permission granted)	<b>Statute</b> (permission granted)
<b>Type of Company</b>			
Public	4	2(1)	2(0)
Private	36	19(7)	18(9)
Other	7	6(3)	1(0)
<b>Shareholding Type</b>			
Minority/Majority	17	12(7)	6(2)
Equal	15	5(2)	10(6)
Majority Claimant	2	1(0)	1(0)
Dispersed Minority <sup>175</sup>	9	7(2)	2(1)
Shareholder/Director	4	2(0)	2(0)
<b>Conduct Type</b>			
Other	5	3(1)	2(0)
Fiduciary	32	17(9)	16(9)
Negligence	2	1(0)	1(0)
Other breach of duty	0	0(0)	0(0)
Ultra Vires	3	3(1)	0(0)
Multiple Claims	4	3(0)	1(0)

<sup>175</sup> Where the claimant and wrongdoer do not collectively own all the allotted shares