Contents

Table of Cases	xxi	
Table of Legislation	XXV	
List of Tables		
Glossary of Terms		
A Bird's Eye View of the Functional and Focused Model (FFM)	xxxiii	
T	1	
Introduction	1	
1. Background 2. The Prime and Objectives of the Book		
2. The Primary Objectives of the Book3. The Derivative Action: A Unique Procedure?	5	
4. Public and Private Companies	2 5 7	
5. The New Proposed Framework Advanced by the Book	9	
6. An Overview of the Book	11	
o. Im e ver view er sint		
I. THEORY AND PRACTICE ANALYSIS		
1. Shareholder Litigation and Corporate Governance	17	
1.1 Introduction	17	
1.2 Shareholder Litigation and Corporate Governance	18	
1.2.1 Limitations of traditional view 18		
1.2.2 Derivative actions and agency costs 20		
1.3 Alternative Devices to Control Agency Costs	24	
1.3.1 Internal mechanisms 24		
1.3.1.1 The right to vote 25		
	28	
1.3.2 External mechanisms for reducing agency costs 31		
1.3.2.1 Public enforcement 31		
1.3.2.2 Non-executive directors 32		
1.4 Derivative Actions versus Market Forces	36	
1.4.1 The market in corporate control—an effective functional		
substitute for litigation? 37 1.4.2 Flaws in the operation of the market for corporate Control 41		
1.5 Conclusion	44	
1.) Conclusion		
2. The Choice of Rationales and the Social Meaning of		
Derivative Actions	46	
2.1 Introduction	46	
2.2 Merits and Demerits of Derivative Actions	47	

	2.3	The Choice of Rationales: Deterrence versus Compensation	54
		2.3.1 The primary purposes of derivative actions in the US 54	
		2.3.2 Compensation 56	
		2.3.2.1 The rationale and decision rule 56	
		2.3.2.2 Limitations 56	
		2.3.3 Deterrence 59	
		2.3.3.1 The rationale and decision rule 59	
		2.3.3.2 Limitations 62	
		2.3.3.3 How does deterrence operate? 64	"
	2.4	Understanding the Social Meaning of Derivative Actions	66
		2.4.1 Introduction 66	
		2.4.2 Construction and deconstruction 67	
		2.4.2.1 Ambiguity of the action's objective 68	
		2.4.2.2 Tying derivative actions to a failed objective 71	
		2.4.3 Applying the right inhibitions 72	
		2.4.4 Procedural requirements and settlements 73	_,
	2.5	Conclusion	74
			=(
3.	The	e Difficulties with Conferring Rights on Shareholders to Litigate	76
	3.1	Introduction	76
	3.2	The Nature of the Problem with Conferring Rights on	
		Shareholders to Litigate	77
		3.2.1 Introduction 77	
		3.2.2 The policy problem: can a shareholder adequately	
		represent the company? 80	
		3.2.2.1 Perverse incentives 84	
		3.2.3.2 Access to information 85	
		3.2.3.3 Expertise 87	
		3.2.3.4 Shareholders' long-term commitment to a policy of suit 87	
		3.2.3.5 Costs 88	
	3.3	The Common Law Response	88
		3.3.1 The 'majority rule' and 'proper plaintiff' principles 88	
		3.3.2 Fraud on the minority 90	
		3.3.2.1 Fraud and wrongdoer control 90	
		Fraud 90	
		Wrongdoer control 92	
		3.3.2.2 When fraud and control must be shown 94	
		3.3.3 Ultra vires transactions 94	
		3.3.4 Breaches of special resolution procedures 97	
		3.3.5 The 'interests of justice'? 99	
		3.3.6 Additional restrictions on members' ability to bring	
		actions on behalf of the company 100	
		3.3.6.1 'Independent organ' does not wish the action to proceed 10	0

3.3.6.2 Ratification 1003.3.6.3 Inequitable conduct of the minority shareholder 1013.3.6.4 Availability of other adequate remedies 101	
3.3.6.5 Companies in liquidation 102	
3.3.7 Conclusion 102	
3.4 Policy Evaluation: Old Myths and New Realities	103
3.4.1 Policy response number one: reallocating the responsibility	
to determine the merits of the action 103	
3.4.1.1 Committee of independent directors 104	
3.4.1.2 Independent organ 107	
(a) Conceptual problems 108	
(b) Policy issues 109	
3.4.1.3 Judicial oversight 109 3.4.2 Policy response number two: formulating proper	
screening mechanism 111	
3.4.2.1 Current screening mechanisms 111	
3.4.2.2 Issues relevant to the grant of leave 112	
3.4.2.3 Rationales 114	
3.4.2.4 Applicant's good faith 115	
3.4.2.5 Interests of the company 117	
3.5 Conclusion	121
II. MAKING DERIVATIVE ACTIONS WORK	
The Way to Reform and a New Statutory Derivative Action:	
Much Ado About Nothing?	125
4.1 Introduction	125
4.2 Deficiencies in the Present Law and the Approach to Reform	126
4.2.1 Introduction 126	
4.2.2 Problems in the common law derivative action 126	
4.2.3 Guiding principles for resolving the problems identified 127	
4.2.4 The Law Commission's recommendations 129	
4.2.5 The Company Law Review Steering Group 131	
4.3 The Derivative Action Under the Companies Act 2006	132
4.3.1 Introduction 132	
4.3.2 General principles 134	
4.3.3 Scope of application 135	
4.3.3.1 The three key elements 135	
4.3.3.2 Extending the types of breaches under which a derivative claim may be brought 135	
4.3.3.3 Derivative claims against third parties 138	
4.3.3.4 Can the applicant bring a derivative claim in respect of	
wrongs committed prior to his becoming a member? 139	

4.

		4.3.3.5 Derivative claims against a former director and a shadow director 142	
		4.3.4 Procedural requirements 143	
		4.3.4.1 General principles 143	
		4.3.4.2 Permission to continue claim as a derivative claim 144	
		4.3.4.3 An assessment 145	
		4.3.5 Criteria for the grant of leave 146	
		4.3.5.1 Background 146	
		4.3.5.2 The new framework 148	
		4.3.5.3 The specific criteria 150	
		4.3.5.4 Matters that the court must take into account when considering an application for permission to proceed with a derivative claim 155	
		4.3.5.5 What is <i>not</i> there? 158	
	4.4	An assessment of the likely impact of the new regime	159
	4.5	Conclusion	165
5.	ΑP	roposed Model for Derivative Actions: the Functional and	
Focused Model (FFM)		cused Model (FFM)	167
A.	The	e Foundations	167
	5.1	Introduction	167
	5.2	The Role of Derivative Actions in a Changing	
		Menu of Governance	168
		5.2.1 Introduction 168	
		5.2.2 Enhanced protection of minority shareholders 170	
		5.2.3 Historical perspective 173	
		5.2.4 Policy shift 175	
	5.3	The Derivative Action as a Constraint on	
		Management Misconduct	178
		5.3.1 Public companies—constraints and limitations of	
		other mechanisms 178	
		5.3.2 Policing management in closely held corporations 183	
	5.4	Synthesis—the Functional and Focused Model	183
		5.4.1 Introduction 183	
		5.4.1.1 Aims of the model 183	
		5.4.1.2 Outline of the model 184	
		5.4.1.3 Policy premises 185	
		5.4.2 The value of deterrence against corporate misconduct 187	
		5.4.2.1 Introduction 187	
		5.4.2.2 The deterrence rationale in company law 187	
		8 /	89
		5.4.2.4 Infrequency of proceedings 191	
		5.4.2.5 A note on insurance and indemnity 193	

	5.4.3 Enhancing the social meaning of the derivative action 195 5.4.3.1 Reorienting the judiciary's focus—confirming the public nature of derivative actions 195 5.4.3.2 Providing adequate incentives to shareholders 197	
D		197
В.	Procedural and Substantive Aspects 5.4.4 Introduction 197	177
	5.4.4.1 Nature of cases arising under the derivative action 198	
	(a) Type of conduct 198	
	(b) Multiple derivative actions 202	
	(c) Types of companies 203	
	5.4.4.2 Who may be qualified to bring a derivative action? 204	
	5.4.4.3 Formulating an expeditious screening mechanism 206	
	(a) The proposed rule: identifying those actions that	
	appear likely to increase corporate value 206	
	(b) How will the inquiry operate? 207	
	(c) What should be the relationship between the	
	compensation and deterrence rationales? 211	
	(d) An illustration of the proposed inquiry 212	112
	(e) An assessment of the benefits of the proposed inquiry	12
	(f) Shareholder standing 215	
	(g) Access to information 216(h) Notice to the company 219	
	5.4.4.4 Funding derivative actions: a re-examination of costs	
	and fees as incentives to commence litigation 220	
	5.4.4.5 Maintaining doctrinal consistency 220	
	5.5 Conclusion	221
),) Conclusion	
6.	Funding Derivative Actions: Costs and Fees as	
0.	Incentives to Commence Litigation	222
	6.1 Introduction	222
	6.2 The Economics of Derivative Action Litigation	223
	6.2.1 Introduction 223	
	6.2.2 The US rules on derivative action fees 226	
		28
	6.3 A Re-examination of Indemnity Costs Orders	229
	6.3.1 Introduction 229	
	6.3.2 The common law recognition of the problems of the	
	impecunious shareholder 229	
	6.3.3 Fundamental flaws in the operation of indemnity costs orders 232	
	6.3.3.1 Lack of incentives 232	
	6.3.3.2 The problematic interrelationship between the application for	or
	an indemnity and the application for leave to proceed 234	
	(a) Procedure may result in a costly mini trial	
	to astablish antitlament /4/	

Contents

		 (b) The relationship between the indemnity procedure and the exceptions to the rule in Foss v Harbottle and its effect on the economics of litigation 236 (c) The court may more readily be persuaded against making an indemnity order 237 (d) Danger of under-settling the action 237 6.3.3.3 The problematic 'financial need test' 238 6.3.3.4 On what basis are indemnity costs orders awarded? 240 6.3.3.5 The shareholder may not be compensated if 	
		the company becomes insolvent 241	
	6.4 C	onclusion	242
7	Purci	ing the Resolution of the Funding Problem	244
۰			244
		lenu of Options: Solutions Involving the Company	
		nd the Shareholder	244
		2.1 Option One: a mandatory requirement for the company	
		to pay the costs of the action 244	
	7.	2.2 Option Two: rewarding the claimant with part of the	
		proceeds of litigation 246	
		7.2.2.1 Outline of proposal 246	
		7.2.2.2 Rationale explained 248 7.2.2.3 Rewarding the claimant and the 'reflective loss' rule 250	
	72 0		252
		olutions Involving the Claimant's Attorney 3.1 Option Three: conditional fee agreements 252	2,2
	/	7.3.1.1 How do conditional fee agreements work? 252	
		7.3.1.2 Conditional fee agreements and derivative actions 253	
	74 I	ntroducing Contingency Fees for Derivative Actions?	257
		4.1 Introduction 257	
		4.2 Argument One: a change in the climate 258	
		4.3 Argument Two: contingency fees versus conditional fees 259	
		7.4.3.1 The case for simplicity 259	
		7.4.3.2 Settling the case too low? 259	
		7.4.3.3 Charging excessive fees? 260	
		7.4.3.4 Increasing the costs? 261	
		4.4 Argument Three: the myth about contingency fees and ethics 261	
		4.5 Argument Four: the experience with contingent fees in US derivative action litigation 262	
	7	4.6 Argument Five: contingent fees are more compatible with derivative action 264	
		4.7 Argument Six: comparative perspective 266	
	7	4.8 The difficulties in introducing contingency fees into a system in which costs follow the event 267	ch

Con	+ nan	+0
1 /11/1		

			Contents		21.121
		7. 7. 7.4.9 F 7. 7.	4.8.1 The first objection 267 4.8.2 The second objection 267 4.8.3 The third objection 268 formulating proper safeguards 269 4.9.1 Regulation and methods to calculate fees 269 4.9.2 Approval of the court 270 4.9.3 Is there a need to reform attorneys' professional ethics? 4.9.4 Final adjustments 271 usion	271	272
0	The	Interr	elationship between the Derivative Action and the		
0.			judice Remedy		274
		Introd			274
	-		teraction between the Unfair Prejudice Remedy		
	0.2		e Derivative Action		276
		8.2.1 I	ntroduction 276		
		8.2.2	Towards amalgamation of the two remedies? 278		
	8.3		ase for Retaining Two Separate Remedies		280
			Leaving a gap in the enforcement mechanisms of		
		0227	corporate governance 280	283	
			The unfair prejudice remedy and breaches of fiduciary duties The Law Commission's arguments 284	203	
			The question of relief 288		
			The 'alternative remedy' argument revisited 288		
			Both remedies can operate together to ensure added		
		7	value for the aggrieved shareholder and the company 290		
			Comparative perspective 291		/
	8.4		/ay Forward—Practical Steps		294
			Redressing the balance—the case for duality 294		
			A new test for obtaining costs orders 295		200
	8.5	Concl	usion		298
9	Co	nclusio	on and Future Directions		299
,					299
			pproach of the Book roposed New Framework		300
			nd This Book: Future Directions		302
	9.5	Deyon	id This book. I deale brieddons		
A	bbeni	dix 1. (Companies Act 2006, Pt 11, Chap 1		307
Ā	ppeni	dix 2. 7	The Civil Procedure (Amendment) Rules 2007		
	_		07 (extracts only)		310
S			ography		314
17	ndex				331

Index