Company law briefing

Derivative claims in the US and the UK

The story so far

Since February 2007, a large number of credit crisis related actions have been filed in the US (more than 150 at last count), of which a substantial number involve derivative claims. Derivative claims are brought by shareholders in the name of the company, typically against the company's current or former directors. The companies involved in these actions are primarily financial institutions, but also include insurance companies, construction companies and real estate investment trusts, all of which are at the front line of the crisis.

There have been numerous predictions that a similar volume of derivative claims will be brought in the UK as a result of the current financial conditions. In an economic downturn, derivative claims typically focus on the financial harm suffered by the company as a result of the directors' alleged failures in monitoring the company's operations and exposing it to imprudent risks. The shareholders behind these claims will have seen the value of their investment fall substantially. Their hope is that a derivative claim will restore some value to the company and (perhaps coupled with a change of management or strategy) help repair some of the damage to its reputation *(see box "Why bring a derivative claim in the UK?")*.

Why bring a derivative claim in the UK?

The factors that are likely to make shareholders consider looking to directors of UK companies for redress include where:

- The relevant acts/omissions are attributable to the company directors (and the corporate structure does not shield the directors from external shareholders).
- The company has failed significantly to achieve the objectives in its annual business review.
- Directors' remuneration outstrips the company's performance (a particularly sore point for shareholders in underperforming companies).
- The company's performance and/or prevailing market conditions have reduced returns for investors, leading to an increased focus on the performance of senior management.
- The company faces significant negative publicity (which often goes hand in hand with shareholder discontent).
- The company is dealing with issues that have an actual or perceived negative effect on employees, the environment or the wider community and that might attract the attention of shareholder activists looking to disrupt implementation of its strategy.

Most (if not all) of these factors are currently facing many companies. Recent events have created the conditions under which disaffected shareholders are likely to examine their available legal remedies.

However, despite the economic climate, a rise in shareholder activism and the widening of the derivative claims regime in the UK, these predictions have not yet been fulfilled.

The US experience

The Delaware court has recently addressed the issue of whether directors are liable in circumstances where subprime lending (directly and via structured investment vehicles) left a company exposed to massive losses (*In re Citigroup Inc. Shareholder Derivative Litigation Civil Action No. 3338-CC (24 February 2009)*).

While the court dismissed the bulk of the complaint on, essentially, procedural grounds (because, under Delaware law, the shareholder must either first ask the company's directors to bring an action on behalf of the company or establish that it would have been futile to do so), when dealing with the motion to dismiss, the court took the opportunity to tackle for the first time the issue of director liability for subprime losses.

The requirement to demand that the directors bring an action will be excused as futile if the shareholders are able to show that the directors' conduct is so

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egregious that the board cannot exercise independent and disinterested business judgment in responding to the demand because there is a substantial likelihood of director liability.

The issue at the heart of the case was, therefore, whether the directors could be held personally liable to the company for allegedly failing to oversee and manage its subprime exposure; in essence, for making business decisions that turned out badly. The court focused on the decision-making process rather than the merits of the decisions, recognising that it is almost impossible for the court to evaluate whether directors made a good or bad commercial judgment but that the court can assess whether the directors acted in bad faith and whether they undertook appropriate due diligence before exercising their judgment.

The court emphasised that claimants must show that a decision was taken in bad faith; they cannot work back from the bad outcome and assume that there was a breach of duty. It also recognised that imposing liability was unattractive on policy grounds: if directors were to face liability, the resulting fear would impair their ability to generate profits by taking legitimate business risks.

The one complaint that was not dismissed focused on the $68 million package awarded to the outgoing chief executive officer, which survived because the pleaded facts gave rise to a reasonable doubt as to whether the directors' approval of the package was the product of a valid exercise of business judgment.

Claiming in the UK

Despite predictions of a large increase in claims against UK directors, fuelled by the growth of shareholder activism (*see feature article "Shareholder activism: there's a lot of it about", www.practicallaw.com/7-381-9645*) and current economic conditions, there continue to be real obstacles to bringing a derivative action in the UK, particularly the need to obtain the court's permission to continue the claim.

The introduction in October 2007 of a new derivative claims regime has significantly broadened the range of circumstances in which shareholders can, in principle, bring claims (*www.practicallaw.com/3-376-3928*). Shareholders can now bring a derivative claim in the UK in respect of a cause of action involving negligence, so derivative claims are no longer limited to allegations of breach of fiduciary duty or breach of trust by a director.

The new regime also replaces the old (common law) procedural bars to derivative claims with a more flexible and qualitative analysis of whether the court should give the shareholder(s) permission to continue. Once the shareholder has shown a prima facie case for permission, the court will decide, on evidence from the shareholder and the company, whether the case should proceed.

In the two reported decisions so far in the UK, permission to continue was refused and the claim did not proceed to a full hearing on the directors' alleged breaches of duty (*Mission Capital plc v Sinclair and another [2008] All ER (D) 225; Franbar Holdings Ltd v Patel and others [2008] All ER (D) 14*). Although these cases did not arise out of the credit crisis, they provide some insight into how the courts will approach derivative claims.

In both *Mission Capital* and *Franbar Holdings*, none of the circumstances where the court must refuse permission was present and the court therefore focused on the discretionary factors listed in section 263(3) of the Companies Act 2006 (the discretionary factors). It was particularly conscious that a derivative claim marks a departure from the normal position, where it is for the company's directors to decide what litigation should be pursued in the company's name. This echoes comments made by the Delaware court in *Citigroup*.

In both cases, the court found that a person acting in accordance with a director's duty to promote the success of the company (the hypothetical objective director) would not attach much importance to continuing the claims. The shareholders had separate remedies in their own right, which could be pursued instead of the derivative claim. Having reached that view, the court did not examine in detail the other discretionary factors so it did not grapple with the likelihood that the acts/omissions complained of would be ratified by the company. This suggests some reluctance to speculate on matters that are essentially commercial decisions, which should be taken by the shareholders in general meeting.

The manner in which the courts will apply the discretionary factors will, of course, depend on the facts of each case. The cases so far suggest a cautious approach will be taken, for reasons similar to the rationale underpinning the Delaware approach. We expect an English court to be reluctant to interfere with commercial decisions taken by directors in good faith where the shareholder's claim focuses on a matter of commercial judgment (rather than on alleged negligence in the decision-making process or on whether the directors considered all relevant information).

However, it is only a matter of time before a shareholder does successfully navigate the process. The credit crisis may well generate the type of claim for which it is appropriate to give permission, given the scale of the losses and in light of popular (although unproven) allegations that some risk taking may have been motivated by personal reward through, for example, company bonus schemes.

Key US/UK differences

Aside from the procedural obstacles, there are other disincentives for a shareholder contemplating a derivative claim in the UK. As the claim is brought on the company's behalf, it is the company that receives any damages award. By contrast, many of the US companies involved in subprime related derivative claims are also named in subprime related securities class actions, in which the shareholders can recover substantial damages. The growth of US securities litigation has been driven by substantial awards, which in turn have encouraged claimant lawyers (acting on a contingency fee basis) to challenge boardroom decisions.

Another key difference relates to the cost shifting rules that exist in the UK and the unavailability of contingency fee arrangements. A shareholder in the UK who decides to bring a derivative claim must not only fund the action (unless third party funding can be obtained or the court orders the company to indemnify the shareholder against liability for those costs) but also bears the risk of being ordered to pay the defendant directors' costs (subject to the possibility of obtaining an indemnity from the company). This is unlike the position in the US, where parties usually bear their own costs.

These factors, together with the difficulty of establishing liability, hardly encourage shareholders to embark on derivative actions. It seems more likely that shareholders will threaten a claim as a means to influence corporate strategy or prevent the implementation of decisions. There will often be better means for a shareholder activist to enhance accountability and influence management changes; litigation currently appears to be low down the list of preferred activist tools.

Nevertheless, the prospect of disaffected shareholders bringing damages claims against wealthy directors (including where the primary motive is to punish directors) remains very real, particularly given the broader range of circumstances in which shareholders can now bring claims in the UK. In addition to ensuring that appropriate directors' and officers' insurance cover is in place, there are a number of measures that directors can take to minimise this risk, as well as actions that can be taken once a claim has been threatened to prevent the company becoming dragged into expensive and time-consuming litigation (*see box "What can directors do?"*).

The credit crisis has already generated some high profile claims by shareholders (such as the application for judicial review by the shareholders of Northern Rock) and may lead to some derivative claims in the UK. However, the obstacles outlined above, coupled with anticipated judicial reluctance to second guess commercial decisions, make it unlikely that we will see an avalanche of derivative litigation.

Stuart Pickford is a partner and Rani Mina is a senior associate in the Commercial Litigation team at Mayer Brown International LLP.

What can directors do?

There are a number of practical steps that directors can take to reduce the risk of derivative litigation, including:

- Putting appropriate procedures in place, not only so that directors comply with their duties but also to create a paper trail to show that they have done so.
- Ensuring that board minutes address the directors' decision-making in depth. Detailed and accurate minutes should assist in defending a derivative claim (particularly at the permission stage) since, if the minutes are authenticated by the chairman, they will be prima facie evidence of the proceedings at the meeting. However, minutes should not just rehearse the directors' duties without conveying the substance of how they complied with them.
- Monitoring shareholder activity, that is, looking at the acquisition of shares by potential activists and also at whether existing shareholders are establishing action groups.
- Amending articles of association, for example, to bring them in line with the new conflict of interest provisions (*see Briefing "Situational conflicts of interest: a new regime", www.practicallaw.com/4-385-0958*) or to address how disputes are to be resolved.
- Seeking shareholder approval for actions that might be contentious, since authorisation or ratification by shareholders will stop a derivative claim.
- Considering whether the directors should receive refresher training on the new conflict of interest regime and, generally, on how to comply with their duties in current economic conditions.

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