

legal update

YOUR UPDATE OF
RECENT CHANCERY &
COMMERCIAL LAW

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Derivative claims: who pays?

The issue of costs is probably the last issue taught at law schools, yet as every practitioner knows it is usually the most important issue in the practice of the law. Legal rights do not grow on trees, and enforcing them means paying professionals (and more and more paying for court usage). In our legal system, this involves the lawyers advising their clients about the liability that they may have for the costs incurred by the opposing party in the dispute. This can become a very complicated equation indeed, dwarfing the complexities involved in the legal dispute itself.

The costs equation can be at its most difficult in those arcane areas of the law where a party can say that it has a legitimate interest in seeking to enforce somebody else's rights, ie it should be allowed to bring proceedings for the benefit of some other person who for whatever reason cannot do so itself. In such situations, the potential liabilities for costs lie not just between the parties who are directly involved in the taking of the legal proceedings but also the party for whose benefit the proceedings are brought. Introducing another party into the equation also raises the question of the proper role of that party in the dispute: should it just watch from the side-lines or should it take an active (and expensive) part?

One such arcane area of the law is the right of a minority shareholder to bring proceedings on behalf of the company in question to remedy a wrong done to the company where the wrongdoer is in control: the "derivative claim". Such claims have

now been put on a statutory basis in Part 11 of the Companies Act 2006, but the new statutory code, while it says a lot about the circumstances in which the court may grant permission for such a claim to be brought, says little or nothing about costs. The courts will continue to look to cases decided under the previous common law for guidance as to the incidence of costs in such cases. There has fortunately been a recent unreported decision of the Court of Appeal, in *Carlisle & Cumbria United Supporters Society v Story* [2010] EWCA Civ 463, which provides much needed guidance in this area.

Shareholders' Rights – new 6th edition

The 6th edition of Robin Hollington's book *Shareholders' Rights*, published in December 2010, offers an in-depth explanation of the principles surrounding the roles of shareholders and the company law that applies to them. The rights of minority and majority shareholders are analysed, showing you where the power lies so that you can better advise companies and clients.

Under the previous law a practice developed, by analogy with the Chancery practice associated with *Re Beddoe* [1893] 1 Ch 557, whereby the claimant shareholder applied for an order that the company should both fund the costs of the proceedings and provide an indemnity in respect of any adverse costs orders. Such an order has become known as a *Wallersteiner* order, named after the famous decision of the Court of Appeal which endorsed it. It is obvious that such an order conferred a tactical advantage upon the claimant, so the courts did not hand them out like confetti. For example, in *Halle v Trax* [2000] BCC 1020, the court declined to grant a *Wallersteiner* order in a derivative claim brought in respect of the affairs of a deadlock, 50:50, company. Furthermore, the courts invariably keep *Wallersteiner* orders under frequent review:

Fraser v Oystertec plc [2005] BPIR 389. Under the current statutory regime, it is necessary to apply for a *Wallersteiner* order at an early stage of the proceedings: CPR r 19.9A(12); CPR PD 19, para 6.

In the *Carlisle* case, the proceedings never reached the stage of the court granting permission for them to be brought as derivative proceedings, or a *Wallersteiner* order, because they settled at the door of the court on substantive issues *other than costs*. In a nutshell, the company was a soccer club in which a government-sponsored supporters' society had invested and acquired a minority shareholding. (In fact, there was a parent/subsidiary structure, but nothing turns on this for present purposes.) The society alleged that the controlling shareholder and director, a local businessman, Mr Story, was threatening to sell off the club's land at an undervalue to the person from whom he had bought the club. The society commenced a derivative claim to stop the sale and its application for permission to continue with the claim and for a *Wallersteiner* order came before Peter Smith J.

In the weeks leading up to the hearing, there had been intense solicitors' correspondence in an attempt to settle the dispute, and the proceedings were eventually settled by a consent order in Tomlin form, whereby the land would still be sold but subject to the oversight of a chartered surveyor. It turned out that the company had been paying Mr Story's costs. But the parties could not agree on costs and the judge agreed to decide that issue for them. The society appealed his order to the Court of Appeal.

The Court of Appeal's ruling may be summarised as follows:

- > The starting-point was that, by having stopped the threatened sale, the claimant society was the successful party and was entitled to its costs.
- > However, the claimant was deprived of a proportion of its costs at various stages of the solicitors' correspondence to reflect the court's concern that a settlement could have been reached more expeditiously had a more co-operative approach been shown by the claimant.

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... the successful claimant in a derivative claim should get costs from the real defendant ...

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- > Mr Story, as the unsuccessful defendant, should pay the claimant's remaining costs on the standard basis.
- > The company, as the party for whose benefit the proceedings had been brought, should also pay the claimant's remaining costs, on the indemnity basis (but subject of course to Mr Story's contribution).
- > Mr Story should pay back to the company the legal costs that it had paid on his behalf in his defence of the proceedings.

The main lessons to be learned from this case are as follows:

- > The Court of Appeal endorsed the general principle that the successful claimant in a derivative claim should get its costs from the real defendant on the standard basis and from the company itself on the indemnity basis.
- > In determining costs issues and the issue of success, the court was entitled to look only at the terms of the Tomlin order: it was not required to determine the underlying merits of the claim.
- > A claimant should apply at the earliest opportunity for a *Wallersteiner* order so as to secure its right of indemnity from the company. Otherwise it will be at greater risk as to costs, even if it is ultimately successful, if the court thereafter takes the view that it should have been more co-operative in the course of the proceedings and costs have been increased as a result.
- > The general principle remains that the company should not take an active part in the proceedings where the real defendant is the majority shareholder. If company funds are used in the defence of the proceedings, they must be reimbursed.

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Claire Staddon

Derivative claims: how far can you go?

There have been many reported cases about derivative claims in the company law context since 1 October 2007, when the new provisions for derivative claims in the Companies Act 2006 (ss 260-264 in Part 11, Chapter 1) came into force, but none has yet expressly addressed the question that has been live since that date: has the new statutory regime extinguished the whole of the common law on derivative claims or do common-law derivative claims survive to the extent that they are not covered by the new code?

The classic examples of claims outside the 2006 Act which may survive are:

- > members' derivative claims based on causes of action vested in *foreign* companies, as in *Konamaneni v Rolls Royce Industrial Power (India) Ltd* [2002] 1 WLR 1269 at [43] and [44]; and
- > cases where the claimant is not a member of the company which has the cause of action in question but is a member of its parent or more remote holding company – double, or multiple, derivative claims; see, eg, *Airey v Cordell* [2007] BCC 785.

Opinions remain divided, but one view is that the definition of a “*derivative claim*” in subsection 260(1) as “*proceedings ... by a member of a company – (a) in respect of a cause of action vested in the company, and (b) seeking relief on behalf of the company*” has had the effect of

altering the substantive law to restrict the kind of derivative claims that it is now possible to bring, because the statutory definition:

- > does not apply to claims for the benefit of foreign companies (since the definition of “*company*” in s 1(1) of the 2006 Act excludes foreign companies), unless the context of Chapter 1 can be said to require otherwise; and
- > does not apply to multiple derivative claims.

By s 260(2) a derivative claim (as so defined) may only be brought (i) under Chapter 1 or (ii) pursuant to a court order made in unfair prejudice proceedings (ie an order made under s 996(1), (2)). It is therefore clear that a common-law derivative claim which does not qualify under the above definition may not be brought under Chapter 1. Section 260(3) further limits the kind of derivative claim that may be brought under Chapter 1 to a claim in respect of a company's cause of action arising from a director's negligence, default or breach of duty or trust.

The Law Commission had taken the view (Report: *Shareholder Remedies* No. 246, 1997 at [1.11], [1.13], [6.18], [6.51]-[6.55]) that the new derivative claims procedure that it was proposing ought to replace the common-law derivative action entirely, even if that meant that certain kinds of common-law derivative claim would not survive. But even the Law Commission thought (at [6.110]) that multiple derivative claims would remain a possibility *outside* Chapter 1: rather than dealing with them expressly within the new provisions, the question of multiple derivative claims would be “*best left to the courts to resolve, if necessary using the power under [the unfair prejudice provisions] to bring a derivative action.*”

In *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch), important for its detailed consideration of the new provisions, Lewison J said, at para. [73] (and see too paras. [75] and [81]), “*I should begin by saying a little about derivative claims generally. In the first place the new code has replaced the common law derivative action. A derivative claim may “only” be brought under the Act*”. At para. [75] he drew attention to the differences between the type of derivative claims

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... plenty of scope ... to decide just how far the substantive law of derivative claims has been changed

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that could be brought under Chapter 1 and the wider type apparently permitted to be authorised by an unfair prejudice order. It is true that s 260(3) does not seek to restrict the type of derivative claim that an unfair prejudice order may authorise. Nor do s 996(1) and (2) themselves, the only express limitation being found in subsection (2)(c), to the effect that an order under that subsection may authorise a claim “to be brought in the name and on behalf of the company”. But that jurisdiction is expressly without prejudice to the generality of the court’s unrestricted power under s 996(1) to make “such order as it thinks fit for giving relief in respect of the matters complained of”. So it does appear that multiple derivative claims and derivative claims where the cause of action is vested in a foreign company could be brought pursuant to an unfair prejudice order where the facts are such as to trigger the unfair prejudice jurisdiction, though that is not going to be true of every such case.

It is fair to say that, in so far as they have considered the point at all, the other reported cases since the coming into force of Chapter 1 have also spoken in terms that suggest that the common-law derivative claim is dead:

- > *Mission Capital plc v Sinclair* [2008] EWHC 1339 (Ch) at para. [35]: “Part 11 of the Companies Act 2006 has introduced new provisions concerning derivative claims, i.e. claims brought by a member of the company in respect of a cause of action vested in the company. These provisions were enacted to as to give effect to the Law Commission’s recommendation that the exceptions to the rule in *[Foss v Harbottle]* should be codified. They go further and make changes to the law”.
- > *Stainer v Lee* [2010] EWHC 1539 (Ch) at para. [24]: “The jurisdiction governing derivative claims in England and Wales is now comprehensively governed by Chapter 1 of Part 11 of the Act: sections 260-264. Such claims may be brought only under the provisions in that chapter or pursuant to a court order in proceedings on an “unfair prejudice” petition ...”.

> *Cinematic Finance Ltd v Ryder* [2010] EWHC 3387 (Ch) at para. [11]: “I accept that proceedings for a derivative claim are now comprehensively governed by the Act”

But none of these recent cases was dealing with causes of action vested in foreign companies or multiple derivative claims and the question of the survival of parts of the common-law derivative claim not covered by the 2006 Act was not directly in issue.

Nor did these cases need to investigate the provisions of the Civil Procedure Rules which arguably on their face contemplate and make provision for the possibility of common-law derivative claims arising otherwise than pursuant to the Act. CPR rule 19.9 does not apply to derivative claims (undefined for the purposes of this rule) made pursuant to an unfair prejudice order but it does apply to derivative claims “whether under Chapter 1 of Part 11 of the Companies Act 2006 or otherwise”. Rule 19.9C applies to derivative claims where the cause of action is vested in a body corporate to which Chapter 1 does not apply and rule 19.9D(b) applies rule 19.9C to cases where a derivative claim other than pursuant to an unfair prejudice order or under Chapter 1 “arises in the course of other proceedings...”. Likewise, Practice Direction 19C PD applies to derivative claims (other than pursuant to an unfair prejudice order) “whether under Chapter 1 ... or otherwise”. There is clearly still plenty of scope for a case on the new provisions to decide just how far the substantive law of derivative claims has been changed.

As part of a general chancery litigation practice, Claire Staddon acts and advises in shareholders’ disputes, unfair prejudice claims and company and commercial work generally, including insolvency.

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Sebastian Prentis

Interpreting articles of association

Since 1856 Parliament has prescribed default articles of association for companies limited by shares. By s 18 of the Companies Act 2006 a company cannot be formed without articles, and by s 17 the articles are one element of a company’s ‘constitution’. Earlier Acts had not defined the word ‘constitution’. Neither had they explained fully the legal effect of the articles. So, even as late as the 1985 Act, the express statutory hypothesis in s 14(1) was that the articles would bind the company and members as if signed by each member and containing covenants on the part of each member to observe them: no mention there of the company covenanting, despite the earlier decision that the articles did constitute a contract between the company and its members: *Hickman v Kent or Romney Marsh Sheep-Breeders’ Association* [1915] 1 Ch 881. (Romney Marsh sheep-breeders still revel in the apparently old saying, reflecting their success in exporting to Australia, that *the sun never sets on Romney sheep*.) That defect has been remedied by s 33 of the 2006 Act, so that one can now be certain that the articles do constitute covenants both between company and members and between the members inter se.

Articles therefore perform a dual role: their very existence permits the company to exist; and they govern the relationships between the company and its members and, as to company matters, between the members as well. Following *O’Neill v Phillips* [1999] 1 WLR 1092, the starting-point

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for an investigation into whether a shareholder has suffered unfair prejudice is to ascertain *the terms on which he agreed that the affairs of the company should be conducted*, before going on to determine whether those terms have been breached and the effect of any breach.

The consequence of the *Romney Marsh* analysis is that, shorn of the regulatory function, articles are but a single contract, albeit one which governs a varying multitude of relationships. Since they are a contract, in interpreting articles the ordinary rules of contractual construction apply.

As with every other contract which falls to be construed, context is all. One may start with the statutory context, outlined above. It is most unlikely that the detached observer is going to conclude that a particular provision, copied exactly from Table A, is intended to mean something different from the meaning given by the case law on that provision. The same is true of the common variants. On the other hand, a significant difference in wording may point to the conclusion that the difference is deliberate.

Because articles are apt to govern multiple business relationships, they are the paradigm example of the rule of construction which says that contracts should be interpreted, so far as possible, in a way which renders them valid rather than invalid. In *Rayfield v Hands* [1960] Ch 1, 4 Vaisey J stated that articles ought not to be construed too meticulously, and specifically referred to the maxim *ut res magis valeat quam pereat*, which he usefully translated in the ringing phrase *validate if possible*.

Rayfield is a forceful example of the articles as contract. The company's article 11 provided that "Every member who intends to transfer shares shall inform the directors who will take the said shares equally between them at a fair value ...". The claimant gave notice to the directors that he wished to transfer his shares to them at fair value.

The directors contended that there was no obligation on them to buy. The court found that the word *will*, while distinct from *shall*, nevertheless imported a *resultant prospective eventuality* such that there was a personal obligation on the directors to purchase, the directors also being members and so bound by the articles. Notable too is that while the articles prescribed no mechanism for ascertaining the *fair value*, or the basis on which it should be calculated, the court granted the claimant an inquiry.

The principles enunciated in *Rayfield* were followed in the recent case of *Cream Holdings Ltd v Davenport* [2010] EWHC 3096 (Ch). There an outgoing shareholder, Mr Davenport, was deemed by the articles to have served a transfer notice in respect of his shares. The articles went on to provide a mechanism for the ascertaining of the fair value which Mr Davenport was to receive for them. The process included the appointment of a third party valuer and, in default of agreement on the choice of valuer, the appointment of such a valuer by the relevant president. It was Mr Davenport's position that because even that default process required the parties' agreement to the valuer's terms of engagement, he held an effective veto over the entire process, there being no express obligation on him to agree to any particular terms that the valuer might propose. The court held that as he was bound to interpret the articles in such a way that they should be validated, they must be read as subject to the implied term that Mr Davenport could not unreasonably refuse his consent to any terms proposed by the valuer. With permission of the Court of Appeal, Mr Davenport is appealing that decision.

Perhaps the most notorious example of the implication of terms into articles is the Equitable Life case, *Equitable Life Assurance Society v Hyman* [2002] 1 AC 408. Article 65 of Equitable Life's articles gave its directors a discretion to apportion surpluses by way of bonus among policyholders "on such principles, and by

such methods, as they may from time to time determine". The House of Lords, however, considered that that article should be read as subject to the implied term that the exercise of the discretion could not be exercised in such a way as to deprive guaranteed annual rate policyholders of the benefits of their guarantee. So it must always be remembered that the context in which articles are construed can include the company's own contracts or, to take the more usual case, any agreements between shareholders.

Finally, it is in the context of the construction of articles that Lord Hoffmann has delivered his second seminal speech on contractual construction. The mantra of the *factual matrix* derived from his speech in *Investors' Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896. In *Attorney General of Belize v Belize Telecom Ltd* [2009] 1 WLR 1988, delivering the judgment of the Privy Council, he builds on *ICS* by discarding traditional tests for the implication of terms (that they must *go without saying* or *provide business efficacy*, for example) in favour of the overarching doctrine that all the court is doing as a reasonable and objective observer, with the advantage of the background knowledge which a participant would have, is to discover and give expression to what the parties meant. In that sense, to imply a term is not to add anything to an instrument but instead to spell out what the instrument means, even if those particular words neither appear in it nor were in the minds of the parties when they executed it. While of general application, that is a conclusion which sits most comfortably in the context of company articles.

Sebastian Prentis's practice is concerned with shareholders' disputes and with insolvency, both corporate and personal. Led by Robin Hollington QC of these chambers, he appeared in *Cream Holdings Ltd v Davenport*.

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