

COVID-19: Derivative actions against directors

The economic damage resulting from the coronavirus-induced national lockdown has led to 'life or death' decision-making by directors. Nonetheless, directors' actions are still vulnerable to scrutiny by shareholders, and a significant risk in a legal dispute is the derivative action.

The statutory derivative action is enshrined in the UK Companies Act 2006, and while difficult to establish, offers a powerful tool that aggrieved shareholders can use against directors.

In addition to the statutory derivative action, recent developments in the Boston Trust case point to the possible use of the common law derivative action by shareholders where there is a prima facie case, albeit conditional on further events.

Companies should ensure adequate record-keeping is in place, to offer a rationale for director decision-making if a dispute materialises over prior emergency action to deal with the deteriorating trading environment. Shareholder ratification may also prove an effective obstacle against a claimant considering a derivative action. D&O insurance may provide meaningful protection on legal costs, depending on the terms of the policy.

Introduction

The coronavirus pandemic and resulting national lockdowns have caused a severe economic contraction with consequences for the UK and NI business environment. Company directors have had to take difficult decisions such as furloughing the workforce, raising additional capital and negotiating with creditors. The challenges of the virus-induced lockdown are unprecedented, but the emergency decisions taken by management during these difficult times may still be called into question by shareholders in legal action, either now or in the future.

One of the main risks to directors in legal disputes arises from derivative actions. This article will look at potential risks for directors and companies from derivative actions by shareholders in relation to alleged company mismanagement for actions or inactions taken during the coronavirus crisis.

Derivative actions

Where there is a prima facie case to be heard, shareholders may seek a derivative action under i) section 260 of the Companies Act, or ii) under the common law rules in *Foss v Harbottle*. The criteria for leave of court to bring a statutory derivative action against a director is strict and is often a last resort option. However, bringing a successful derivative action has the added benefit of usually making the company liable for legal costs of the action, an advantage for a shareholder with an arguable case who is reluctant or unable to fund an action out of their own pocket.

Where leave of the court is granted, a successful derivative action will allow minority shareholders to take action in the name of the company against individual directors, and other entities where there's been diversion of business etc. The company becomes responsible for bringing the action against the director, but control of the legal process remains with the minority shareholders. For this reason, a derivative action proves a useful course in some corporate disputes.

The reasons for bringing a statutory derivative action are wide-ranging, and include 'an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company'. A derivative action may be taken on the basis of director inaction, where the director is alleged to have not responded to given circumstances in the manner that a shareholder thought in-keeping with the best interests of the company.

Boston Trust Company Ltd v Szerelmey Ltd (No 2) [2020] EWHC 1352 (Ch)

Whilst it remains to be seen how the landscape for corporate disputes will be altered by the coronavirus and an increase in claims over alleged mismanagement by directors, an important recent case on derivative actions is Boston Trust. In this case, the claimants sought a common law derivative action to pursue the defendants using a cause of action vesting in a subsidiary company, a so-called 'multiple derivative action'. The claimants were the trustees of the shareholder and therefore had no immediate standing to bring a claim for a derivative action under the statutory procedure.

The English High Court found that it was 'just and appropriate' to grant the claimants 'conditional permission' to bring a common law derivative action, provided the claimants succeeded in a separate action they had brought to update the parent company's members' register to include the trustees' interest in the shares. On the facts, the prima facie requirement would not have been met until the crystallisation event of rectification of the shareholders' register. The judgment is not an end to the requirement of a prima facie case, allowed for conditional prima facie case.

Though permission has been given to appeal against the judgment, and the Deputy Judge described his decision as a 'procedural airlock' before a prima facie case had arisen, it appears to allow a common law derivative action to succeed where a statutory action would not have, as the claimants would not have had a valid claim

in statute until first succeeding in the separate action. Furthermore, the judgment appears to open the common law derivative action to further parties that do not have a direct shareholding i.e. the trustees.

The decision has added to the uncertainty around common law derivative actions, a concept in law that already lacks clear boundaries, and may not be desirable given the ongoing pandemic. Indeed, the Deputy Judge stated that he had been informed that 'if I were to make such an order it would set a bad precedent and create confusion in an area of law where stakeholders are entitled to expect certainty around the issue of title/standing. I disagree'.

Protection directors against derivative actions

It is predicted that the return to stability after the end of lockdown will result in an increase in corporate disputes from controversial measures taken by companies during the crisis, for which individual directors will have given sign-off. Potential claimants may be waiting until the legal system and the economy return to business as usual.

Companies and directors should be on guard against the possibility of a statutory or common law derivative action and are advised to ensure the detailed recording of important decisions taken during the crisis, especially with those decisions proving more controversial for shareholders, for example, the issuance of further shares to fund the business, but with the effect of diluting the holdings of existing shareholders. Of course directors should be mindful of their duties to the company, as set out in the 2006 Act, and the requirement for them to act in the best interests of the company.

Companies should examine the terms of their D&O liability insurance carefully, to understand what conduct by directors is covered in the event of a claim by shareholders.

Conclusion

Difficulties caused by the virus-induced lockdown have impacted the majority of businesses in NI and the UK. Where directors have had to make decisions quickly in response to market volatility, this has led to room for dispute with shareholders, who may not share the directors' views on the appropriateness of the actions or inactions, raising the issue of whether what was done or not done was in the best interests of the company.

Shareholders can bring the matter to court in a statutory or common law derivative action, and Boston Trust suggests the common law action has been widened to allow actions to proceed whereby the prima facie case is conditional, albeit the English Court of Appeal may yet intervene. This, combined with an expected increase in corporate disputes emanating from

the deteriorating economy, mean that companies and directors must be vigilant to the heightened prospect of legal action by shareholders.

Companies should act in the best interests of the company, keep accurate and detailed records of important decisions taken, ratify action or inaction of directors by shareholder resolution and consider the effectiveness of current D&O insurance arrangements.

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