Berryman

Companies Act Update 2006

There are three main ways in which a company can take legal action against a director (or more usually, a former director) for default:

1. If the board of directors decide to commence proceedings
2. If the company goes into liquidation and the liquidator decides to commence proceedings pursuant to his powers in the insolvency legislation
3. Through an action (known as a derivative action) brought by one or more shareholders to enforce the company's right of action against the directors where the board has failed to act

Changes are being brought into force on 1 October 2007, which will expose directors to a greater risk of litigation by shareholders and liquidators.

These changes include:

- Making it easier for shareholders to bring derivative actions
- Making it more difficult for director/shareholders to ratify (approve) their own wrongdoing
- Preventing shareholders who are connected with directors from ratifying the director's wrongdoing
- Expanding the categories of persons who are connected with a director

Directors are advised to take immediate action to protect themselves against this increased risk of litigation.

Derivative actions

The general rule is that where a wrong is done to the company, then it is for the company itself to bring proceedings against the wrongdoers. However, if the directors or a majority of them committed the wrong, it is unlikely that the board will decide to pursue a claim. Unless the shareholders are able to force the board to bring a claim, either by passing an ordinary resolution to replace the existing directors with new appointees or by giving a direction to the board by means of a special resolution, the company and the shareholders will have no remedy in respect of any loss the company has suffered.

The law therefore permits one or more shareholders of the company to bring an action, in certain circumstances, on behalf of and for the benefit of the company of which they are shareholders, as an exception to this general rule. Such actions are called "derivative actions" because they enforce rights derived from the company.

Derivative actions are extremely rare. This is because:

1. If a wrong is capable of being ratified by the company's shareholders (normally, an ordinary resolution is required) and has been formally ratified, then this will be a complete bar to a derivative claim.
2. A derivative claim can only be brought at the discretion of the Court. If a wrong is capable of being ratified by the shareholders, then even if there has been no formal ratification, it may not be possible for a shareholder to bring a derivative claim.
3. Although a wrong done to the company is not ratifiable where this would constitute a "fraud on the minority", this is notoriously difficult to prove. In particular, the shareholder has to show that the directors have benefited personally from the default and that the directors who carried out the wrongdoing control the majority of the company's shares.

The Government sees derivative actions as an important mechanism by which the shareholders can hold directors to account for the proper exercise of their duties. Given the difficulties in bringing such actions, the Act will, on 1 October 2007, introduce a new statutory derivative action procedure, which will make it easier for shareholders to bring derivative actions.

Under the new procedure, one or more shareholders can bring a derivative action in respect of any act or omission involving negligence, default, breach of duty or breach of trust by a director (or former director) of the company. The shareholders no longer need to show that the director has benefited personally from the wrongdoing or that the defaulting director(s) control the majority of the company's shares. The circumstances in which a derivative action can be triggered have therefore widened significantly.

The Government has introduced a number of safeguards aimed at preventing abuse of the new procedure and in particular, to deter tactical or "fishing" litigation.

It remains to be seen how the Courts will use their powers and whether or not there will be a significant increase in derivative actions. Many shareholders will continue to be deterred from bringing derivative actions because any damages recovered will go to the company and not to the shareholders personally. However, this is unlikely to deter all shareholders.

Ratification

Under the new statutory derivative action procedure, the Court continues to be required to dismiss a derivative action if the default is capable of and has been ratified by the company's shareholders. Even if there has not been formal ratification, the Court continues to be required to consider whether the act is capable of and is likely to be ratified in considering whether or not to give permission to continue the claim.

On 1 October 2007, the Act will put the ability of shareholders to ratify director default on a statutory basis but subject to one significant change. That is that any decision to the default must be taken by the shareholders without reliance on the votes of the director in question or persons connected with him. This may make it more difficult for directors to achieve the necessary majority required for ratification, although the restriction on voting does not apply where all shareholders are in favour of ratification.

Shareholders continue to be unable to ratify director wrongdoing where they are prevented from doing so under the current law. For example where this would constitute a fraud on the minority, a fraud on the company's creditors or after the company has gone into liquidation.

Connected persons

Persons who are connected with a director cannot generally vote in favour of ratifying that director's default under the new statutory ratification procedures in the Act. The definition of connected persons is being extended under the Act from 1 October 2007 to include (in addition to those already covered under the Companies Act 1985):

- Civil partners
- Persons (whether of the same or a different sex) with whom the director "lives as partner in an enduring family relationship" unless the person is the director's grandparent, grandchild, sister, brother, aunt or uncle, nephew or nice
- The director's parents
- Children or step-children of the director who are over 18 years old (those under 18 are already covered); and
- Children or stepchildren of the director's unmarried partner (who are not children or step-children of the director) if they live with the director and are under 18 years old.

Directors: protecting yourself against this increased risk of litigation

In the light of the above changes, directors are advised to:

- Put in place/review the terms of their D & O insurance to ensure that the defence of derivative actions is covered and to ensure that the level of cover is appropriate.

- Where directors are also shareholders, review/put in place a shareholders' agreement providing that no shareholder may bring a derivative action without unanimous consent. This will not, however, protect a director against a misfeasance action by a liquidator.

- Negotiate an indemnity from the company

  Changes to companies' legislation in April 2005 make it possible for a company to indemnify a director against most liabilities to a person other than the company. These changes are carried forward in the Act.

  Although a company cannot indemnify a director in respect of any damages awarded to the company in any civil proceedings brought by the company (this will include any damages awarded against him in a derivative action), the company can indemnify the director in respect of the cost of such proceedings, where the director successfully defends them. An indemnity can also offer some protection to a director in respect of criminal and regulatory proceedings.

  Even where a company has already made changes to its Articles to allow it to indemnify its directors, directors may encounter difficulties in enforcing that provision. Directors are therefore advised to seek the added protection of a direct indemnity from the company.

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