Department of Economics and Finance

Chair of Law and Economics

SHAREHOLDERS' REMEDIES: THE DERIVATIVE ACTION IN THE UK, THE USA AND ITALY

SUPERVISOR

Prof. Sabrina Bruno

CANDIDATE

Elisa Greco

ID. 199221

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1 A GENERAL INTRODUCTION

Abstract- *Minority shareholders in corporations have few tools to protect themselves from negligent and harmful behavior by directors; furthermore, situations in which those tools can be used are very limited. Amongst shareholders' remedies is the derivative action, which is a claim brought by a shareholder on behalf of the company as a consequence of an actual or potential loss to the company caused by a director's action or inaction. However, many restrictions apply to this kind of claim, and many conditions must be met in order for a shareholder to bring a derivative suit. Those conditions differ across the UK, the USA and Italy; here, I analyze the derivative action under these three jurisdictions, highlighting the main differences and the main similarities in the procedure to bring it and its consequences.*

The matters I am going to discuss here arise after shareholders have exercised their right to elect directors and the board has initiated office. Each of the analyzed jurisdictions (i.e. UK jurisdiction, USA jurisdiction, and Italian jurisdiction) employs a mixture of rules and standards as safeguards against management incompetence and disloyalty. Each of the jurisdictions requires managers to act in accordance with the standard of due care ("duty of care") and loyally ("duty of loyalty"). A "standard of conduct" advises how a person should act or fulfil a task; on the other hand, a "rule" is something that the management (thus, directors) must do or not do. Directors are considered to be "fiduciaries" since they are appointed to manage assets that belong to the shareholders of the company, and not to themselves; therefore, they must act in good faith while pursuing the interests of the company, and they must subordinate their own interests to those of the company. Under the company laws of all our three jurisdictions, a director will breach his duty of loyalty if he causes the company to make a decision that damages it while benefiting himself. This standard leaves directors free to manage the company in the way they truly believe to be the best until they do something disloyal, which generally occurs when the director has some personal interest in the transaction that is going to be executed. Thus, the focus of the discussion regarding derivative suits should not be on negligent misbehaviour by officers, directors and controlling stockholders, but rather on self-dealing and intentional misconduct.

In fact, in the analysis of the cases I am going to introduce in this work, I will focus on situations in which directors tend to pursue personal interests rather than those of the company. These situations usually include conflicts of interests and are very similar in all the three jurisdictions, and can be classified as follows:

1. A director has a personal interest in a transaction that the company enters into (self-dealing), which can take the form of:

(a) A director actually being the contractual counterparty in the transaction, such as in the case of executive compensation, a loan or a sale of property; and

(b) A director receiving compensation for the transaction's success or failure, such as a fee paid by a third party or being fired or promoted because of a merger.

2. A director competes with the company, which can take the form of:

(a) A director owning or managing a competing business, or

(b) A director taking a valuable opportunity from the company for personal use.[1]

Of course, pre-suit screening devices exist to prevent the abuse of the derivative action, especially under US corporate law. The most prevalent screening mechanism for maintaining a derivative suit is the Board of Directors (I will explain this mechanism later on)[2]; another screening tool is conditioning a suit to approval by a third party, for example a governmental agency. But there is yet another screening device, also employed in the Italian jurisdiction, which is the requirement that limits suits to shareholders holding a minimum (specified) amount of the company's shares.

My discussion here will be divided into three main chapters, one for each jurisdiction considered, and each chapter will be divided into two parts: a study of the derivative action and its applicability/implications under the jurisdiction examined, and an analysis of a legal case.

2 DERIVATIVE ACTION UNDER UK COMPANY LAW

2.1 Directors' duties

The Board of Directors in UK companies includes both de facto and "shadow" directors[3]; under the Companies Act 2006, these directors owe a series of duties "to the company"[4]. The codification provides that a director "must act…in good faith…to promote the success of the company for the benefit of its members as a whole, and in doing so" must "have regard…(amongst other matters) to" (a) long-term consequences, (b) the employees' interests, (c)

[1] Andreas Cahn, Comparative Company Law: Text and Cases on the Laws Governing Corporations in Germany, the UK and the USA, p.338 (2010)
[2] See e.g., Federal Rule of Civil Procedure 23.1; Del. Ch. Ct. R. 23.1
[3] Stephen Judge, Business Law, p.238 (2009)
[4] Sec. 170(1) CA 2006

relationships with suppliers, customers and others, (d) the impact on the community and the environment, (e) the company's ethical reputation, and (f) fair treatment of all members.[5] The codification also includes a monitoring mechanism, according to which all directors of listed companies must in their annual report set out the company's policies to promote the interests of employees, the environment and the community, and state whether those policies are effective.[6]

In particular, seven are the key duties codified (under the Companies Act 2006), which reflect common law and equitable principles.

1) *Duty to act within powers:*

"A director of a company must (a) act in accordance with the company's constitution, and (b) only exercise powers for the purposes for which they are conferred."[7];

2) *Duty to promote the success of the company:*

"(1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to— (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company; (2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes; (3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company."[8];

3) *Duty to exercise independent judgment:*

"(1) A director of a company must exercise independent judgment; (2) This duty is not infringed by his acting— (a) in accordance with an agreement duly entered into by the company that restricts the future exercise of discretion by its directors, or (b) in a way authorized by the company's constitution."[9];

4) *Duty to exercise reasonable care, skill and diligence:*

[5] Sec. 172(1) CA 2006
[6] Sec. 417(5)(b) CA 2006
[7] Sec. 171 CA 2006
[8] Sec. 172 CA 2006
[9] Sec. 173 CA 2006

"(1) A director of a company must exercise reasonable care, skill and diligence; (2) This means the care, skill and diligence that would be exercised by a reasonably diligent person with— (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company, and (b) the general knowledge, skill and experience that the director has.";[10]

5) *Duty to avoid conflicts of interest:*

"(1) A director of a company must avoid a situation in which he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the interests of the company; (2) This applies in particular to the exploitation of any property, information or opportunity (and it is immaterial whether the company could take advantage of the property, information or opportunity); (3) This duty does not apply to a conflict of interest arising in relation to a transaction or arrangement with the company; (4) This duty is not infringed— (a) if the situation cannot reasonably be regarded as likely to give rise to a conflict of interest; or (b) if the matter has been authorised by the directors; (5) Authorization may be given by the directors— (a) where the company is a private company and nothing in the company's constitution invalidates such authorization, by the matter being proposed to and authorised by the directors; or (b) where the company is a public company and its constitution includes provision enabling the directors to authorize the matter, by the matter being proposed to and authorised by them in accordance with the constitution; (6) The authorization is effective only if— (a) any requirement as to the quorum at the meeting at which the matter is considered is met without counting the director in question or any other interested director, and (b) the matter was agreed to without their voting or would have been agreed to if their votes had not been counted; (7) Any reference in this section to a conflict of interest includes a conflict of interest and duty and a conflict of duties.";[11]

6) *Duty not to accept benefits from third parties:*

"(1) A director of a company must not accept a benefit from a third party conferred by reason of— (a) his being a director, or (b) his doing (or not doing) anything as director; (2) A "third party" means a person other than the company, an associated body corporate or a person acting on behalf of the company or an associated body corporate; (3) Benefits received by a director from a person by whom his services (as a director or otherwise) are provided to the company are not regarded as conferred by a third party; (4) This duty is not infringed if the acceptance of the benefit cannot reasonably be regarded as likely to give rise to a conflict of interest; (5) Any reference in this section to a conflict of interest includes a conflict of interest and duty and a conflict of duties."[12]

7) *Duty to declare interest in proposed transaction or arrangement:*

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[10] Sec. 174 CA 2006
[11] Sec. 175 CA 2006
[12] Sec. 176 CA 2006

"(1) If a director of a company is in any way, directly or indirectly, interested in a proposed transaction or arrangement with the company, he must declare the nature and extent of that interest to the other directors; (2) The declaration may (but need not) be made— (a) at a meeting of the directors, or (b) by notice to the directors in accordance with— (i) section 184 (notice in writing), or (ii) section 185 (general notice); (3) If a declaration of interest under this section proves to be, or becomes, inaccurate or incomplete, a further declaration must be made; (4) Any declaration required by this section must be made before the company enters into the transaction or arrangement; (5) This section does not require a declaration of an interest of which the director is not aware or where the director is not aware of the transaction or arrangement in question. For this purpose a director is treated as being aware of matters of which he ought reasonably to be aware; (6) A director need not declare an interest— (a) if it cannot reasonably be regarded as likely to give rise to a conflict of interest; (b) if, or to the extent that, the other directors are already aware of it (and for this purpose the other directors are treated as aware of anything of which they ought reasonably to be aware); or (c) if, or to the extent that, it concerns terms of his service contract that have been or are to be considered— (i) by a meeting of the directors, or (ii) by a committee of the directors appointed for the purpose under the company's constitution."[13]

These duties may not be limited or waived, but companies can acquire insurance to protect directors from costs in case of breach. The remedies for duties' breaches have not been codified, but they follow common law and equity, and include compensation for losses, restitution of illegitimate gains and specific performance and injunctions.[14]

However, it is important to underline the fact that when the company is insolvent, the duty to promote company success is displaced. In fact, under Sec. 214 of the Insolvency Act 1986, the liability for "wrongful trading" rule states that the liquidator can demand directors to contribute to the funds available to creditors in an insolvent winding up, if the court believes it is proper, when they should have recognized that the company had no reasonable way to avoid insolvent liquidation and then failed to take all reasonable steps to minimize creditors' loss.

Lastly, Companies Act imposes a duty on directors to declare both the nature and extent of their interest in any transactions which have been proposed but have not yet been entered into by the company, as well as in any transactions which the company has already entered into. In case of a proposed transaction, the relevant director must do so before the transaction is entered into, rather than at the first meeting at which the transaction is examined. Directors do not need, however, to declare an interest if it cannot reasonably be regarded as likely to give rise to a conflict of interest. A failure by a director to declare his interest in an existing transaction will result in the director having committed a criminal offence. Upon conviction, the director will be liable to a fine.[15]

[13] Sec. 177 CA 2006
[14] https://en.wikipedia.org/wiki/Directors%27_duties_in_the_United_Kingdom
[15] Rajah & Tann, The Duties and Responsibilities of Directors of a Singapore Listed Company, p.6, (2005)

A director does not need to declare his interest whenever: (i) it cannot reasonably be regarded to give rise to a conflict of interest; (ii) the other directors are already aware of it; and (iii) it concerns the terms of his service contract which is either to be considered by a meeting of the directors or by a committee of directors appointed for that purpose under the company's constitution[16].

2.2 Rule in Foss v Harbottle

It has been suggested that historically the UK position toward minority protection and derivative lawsuits represents a dour attitude.[17] A major advance in the law in regard to minority shareholders was marked by the decision in Foss v Harbottle which transformed the old partnership rule into one of the leading principles of modern company law.[18]

It is a general principle of company law that an individual shareholder cannot sue for wrongs done to a company or complain of any internal irregularities.[19] In any action in which a wrong is alleged to have been done to a company, the proper claimant is the company itself. This principle is commonly known as the rule in Foss v Harbottle, and, since this rule leaves the minority in an unprotected position, several important exceptions have been developed, which are usually defined as "exceptions to the rule in Foss v Harbottle".[20] Amongst these is the 'derivative action', which is a claim brought by a shareholder on behalf of the company as a consequence of an actual or potential loss to the company caused by a director's action or inaction; therefore, a derivative action is concerned with recovering damages, property or funds which belong to the company for wrongs done to the company itself. In most cases, this implies a serious breach of directors' duties, but the derivative form of action is only proper where recovery for the company will result from a positive judgement; if the remedy pursued is an injunction or declaration to prevent an abuse of power by directors, the action is not properly classified as derivative. It can be therefore inferred that the rule in Foss v Harbottle is the starting point for minority shareholder remedies.[21]

In Foss v Harbottle (1842), the two minority shareholders Richard Foss and Edward Starkie Turton commenced legal action against the promoters and directors of the "Victoria Park Company" alleging that they had misapplied company assets and had improperly mortgaged company property. They asked that the guilty parties be held accountable to the company and that a receiver be appointed. The defendants were the five company directors

[16] Slaughter and May, Companies Act 2006: Directors' duties, derivative actions and other miscellaneous provisions, p.6, (2007)

[17] James Kirkbride, Steve Letza, Clive Smallman. Minority shareholders and corporate governance: Reflections on the derivative action in the UK, the USA and in China, pp.206-219, (2009)

[18] A. J. Boyle, Minority shareholders' remedies, p.3, (2009).

[19] Albert Lam, Shareholders Rights-Part I- Common Law Derivative Action, (2012)

[20] Yohana Gadaffi and Miriam Tatu, Strathmore Law Journal, Derivative action under the Companies Act 2015: New jurisprudence or mere codication of common law principles?, p.75, (2016)

[21] A. J. Boyle, Minority shareholders' remedies, pp.2-5, (2009)

(Thomas Harbottle, Joseph Adshead, Henry Byrom, John Westhead, Richard Bealey) and the solicitors and architect (Joseph Denison, Thomas Bunting and Richard Lane); and also H Rotton, E Lloyd, T Peet, J Biggs and S Brooks, the several assignees of Byrom, Adshead and Westhead, who had become bankrupts. The Court rejected the two shareholders' claim and held that a breach of duty by the directors of the company was a wrong done to the company for which it alone could sue. In other words, the proper plaintiff in that case was the company and not the two individual shareholders.

This rule is derived from two general legal principles of company law. Firstly, a company is a legal entity separate from its shareholders. Secondly, the Court will not interfere with the internal management of companies acting within their powers. Where an ordinary majority of members can ratify the act, the Court will not interfere. This simply means, if the majority can ratify an act, the minority cannot sue.[22]

2.3 Derivative action under the UK Companies Act (2006)

Before talking about derivative action under the UK CA 2006, I want to make a clear distinction between the different types of actions that a shareholder can bring as a remedy against injuries. In particular, when someone is injured by the acts of someone else and asks a court to stop the wrongdoer from continuing the injurious action or asks it to force the wrongdoer to compensate for damages suffered, this is a direct or a personal action: the plaintiff directly defends his own rights. When, instead, someone begins such a suit on the basis of a claim derived from the injury suffered by another person who cannot or is not directly interested in defending himself, this is a derivative action, in which the plaintiff defends the rights derived from another person, such as a corporation whose management has not acted to adjust the wrong. To conclude this brief general introduction, when a person suffers an injury that is also suffered in a similar way by an entire class of persons – such as thousands of investors who have all purchased shares on the basis of a misleading prospectus – and he asks a court to order the wrongdoer to compensate him and the entire class he represents for such wrong, this is a class action, which implies that the plaintiff suffered the same wrong as the others in the class and acts in court to represent that class of injured persons. Of course, in the case of a derivative action, in which an individual speaks on behalf of others (mainly of the company itself) who instead do not speak, there are many more procedural safeguards than in a direct action, in which a person speaks personally for himself, to protect his own rights.

After this general introduction to shareholders' remedies in all the three jurisdictions (UK-USA-Italy), I want to analyze derivative action in depth under UK Company Law.

As already stated, it has been long established in Foss v Harbottle that the proper plaintiff in an action for a wrong done to a company is the company itself, and this is strictly linked to the fundamental concept of separate legal

[22] Albert Lam, Shareholders Rights-Part I- Common Law Derivative Action, (2012)

personality[23]. The decision whether to sue or not is usually made by the board of directors acting in accordance with their "standard" management power; however, the problem arises when the people harming the company are its own directors, a situation in which it seems unsafe to let the directors themselves decide. Thus, under special circumstances when the company is not willing to defend its own right, individual shareholders may be allowed to bring a derivative claim. The two basic requirements under common law for a derivative action to be accepted by the court are:

1) that the alleged wrong or breach of duty is one that is incapable of being ratified by a simple majority of the members; and
2) that the alleged wrongdoers are in control of the company, so that the company, which is the proper claimant, cannot claim by itself.[24]

These two conditions imply that the individual can only enforce the company's claim if the breach of duty is a 'fraud against the minority' and the 'wrongdoers are in control of the company' and will not allow the company to sue.[25]

> "[. . .] apart from the benefit to themselves at the companies' expense, the essence of the matter seems to be an abuse on issues of power. Fraud in the phrase ''fraud in the minority'' seems to be used as comprising not only fraud at common law but also fraud in the wider equitable sense of that term, as in the equitable concept of a fraud on a power."[26]

An example to further clarify when a derivative action can be allowed is when a director causes the company to sell assets to himself at an undervalue, or when he leads the company to purchase worthless assets.

A derivative claim under common law has always been regarded as complicated and unsatisfactory; as a consequence, it has been brought far less frequently than other shareholder remedies.[27] This is linked to the fact that UK courts, as well as US courts, prefer leaving corporate issues to corporations, without interfering in their internal affairs, unless it is strictly necessary. This is why it is quite complicated to bring a derivative suit before the court, and obtain permission to continue it, in both jurisdictions.

The new statutory provision enlarges the basis for bringing a derivative claim by including cause of action in respect of 'an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company'.[28] It is now no longer necessary for the claimant to show that the alleged act is a

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[23] See Salomon v A. Salomon & Co. Ltd (1897)
[24] Dov Ohrenstein, New Law Journal, Derivative action, The New Derivative Claim, (2007)
[25] Albert Lam, Shareholders Rights-Part I- Common Law Derivative Action, (2012)
[26] Estmanco (Kilner House) Ltd v. Greater London Council (1982)

[27] LawTeacher, The new derivative claim: Where does the pendulum swing? ,(2013)
[28] LawTeacher, The new derivative claim: Where does the pendulum swing? ,(2013)

‘fraud on the minority’, and this means that a claim can be brought against pure negligence without the request to demonstrate that the defendant director has gained personally.[29] In addition, the requirement of proving ‘wrongdoer in control’ ceases to be a decisive factor for the court to consider. This makes it possible for a derivative claim to be brought in a public company where shares are widely dispersed, which is another point in favor of minority shareholders.

Despite the general expansion of the cause of action, a two-step procedure was adopted in the CA 2006 as a safeguard to protect against the risk of a torrent of troublesome or groundless claims against the management.[30] At stage one the applicant must make a prima facie case for the claim, providing evidence to support this claim. If no prima facie case is proven at this point, then the court must dismiss the application. The Court can also, through dismissing the application, make any consequential order that it considers appropriate, such as a cost order or civil restraint order against the application. If the application is not dismissed, the Court, on hearing the application, may grant permission, refuse permission and dismiss the claim, or adjourn the proceedings and give such directions as it thinks fit. If the evidence submitted by the claimant is forthcoming, the court will then proceed to the second stage and order the parties to prepare for a full hearing of the shareholder's application.[31]

In the second phase, the Court is required to consider a number of factors when deciding whether to give permission to continue and it may refuse permission according to other factors set out in legislation.[32] By sec. 263(2) of CA 2006, the court must deny permission if a hypothetical person acting in accordance with the duty to promote the success of the company would not seek to continue the claim.[33] Notice that the reference to sec. 172 twice, under sec. 263(2)(a) and sec. 263(3)(b) stresses its importance.[34]

In addition to commencing a derivative claim by himself, a shareholder may, in certain circumstances, continue as a derivative claim a claim brought by the company or continue a derivative claim brought by another shareholder. The court’s approval is required in either case and the two-stage procedure referred to above still applies. A shareholder may ask for permission to continue a claim brought by the company or by another shareholder if:

- the way in which the company or the other shareholder has initiated or continued the claim represents an abuse of the process according to the court;

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[29] LawTeacher, The new derivative claim: Where does the pendulum swing? ,(2013)
[30] LawTeacher, The new derivative claim: Where does the pendulum swing? ,(2013)
[31] Saleem Sheikh, A guide to the Companies Act 2006, p.1045, (2013)
[32] James Kirkbride, Steve Letza, Clive Smallman. Minority shareholders and corporate governance: Reflections on the derivative action in the UK, the USA and in China, pp.206-219, (2009)
[33] Law Explorer, Minority shareholder protection, (2016)
[34] Julia Tang, Shareholder remedies: Demise of the derivative claim?, p.186, (2012)

- the company or the other shareholder has failed to prosecute the claim diligently; <u>and</u>
- it is proper for the shareholder to continue the claim as a derivative claim (for example, if the other shareholder has fallen ill).[35]

The bar to a derivative claim proceeding is imposed where the matter complained of was authorized in advance or ratified since it occurred. In particular, the key provision 260(3) of CA 2006 states the following:

"(3) A derivative claim under this Chapter may be brought only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company.",
where 'director' refers to both shadow directors and former directors.

This process, as I have just stated, is followed to ensure that the claimant is serious about pursuing the claim and has sufficient grounds to do so.
Moreover, Section 263(2) establishes three situations in which permission for a derivative claim must be refused:
"(2) Permission (or leave) must be refused if the court is satisfied-

(a) that a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue a claim, or
(b) where the cause of action arises from an act or omission that is yet to occur, that the act or omission has been authorized by the company, or
(c) where the cause of action arises from an act or omission that has already occurred, that the act or omission-
  (i) was authorized by the company before it occurred, or
  (ii) has been ratified by the company since it occurred."[36]

If an application overcomes the hurdles in CA 2006, sec. 263(2), the court will then take into account the discretionary factors established in sec. 263(3) which states:
"(3) In considering whether to give permission (or leave) the court must take into account, in particular-

(a) whether the member is acting in good faith in seeking to continue the claim;
(b) the importance that a person acting in accordance with section 172 (duty to promote the success of the company) would attach to continuing it;
(c) whether the cause of action results from an act or omission that is yes to occur, whether the act or omission could be, and in the circumstances, would be likely to be-
  (i) authorized by the company before it occurs, or
  (ii) ratified by the company after it occurs;

[35] Slaughter and May, Companies Act 2006: Directors' duties, derivative actions and other miscellaneous provisions, pp.9-10, (2007)

[36] Dov Ohrenstein, The Commercial Litigation Journal, Through the looking glass, p.22, (2011)

(d) where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances, would be likely to be, ratified by the company;

(e) whether the company has decided not to pursue the claim;

(f) whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company."[37]

Another important provision is sec. 263(4) which declares:

"(4) In considering whether to give permission (or leave) the court shall have particular regard to any evidence before it as to the views of members of the company who have no personal interest, direct or indirect, in the matter."[38]

Moreover, pursuant to sec. 264, one member can apply to take over the derivative action of another member, e.g. where a derivative claim has been brought but not pursued diligently.

At the beginning, when the new procedure was introduced, it was thought that the introduction of the 2006 Act would result in an increased use of the derivative action provisions by activist shareholders. However, this did not happen as there have been very few reported cases of derivative action since the 2006 Act has come into force; moreover, two of the reported cases have failed at an early stage, and these are Mission Capital Plc v Sinclair & another and Franbar Holdings Ltd v Patel & others. [39]

Now I am going to talk about the first of the two cases just quoted, i.e. Mission Capital Plc v Sinclair & another. Before doing that, however, I think it proper to introduce the concept of specific performance, which together with the derivative claim concept, has a crucial role in the above (legal) case. In particular, "specific performance" is an order by a court which requires a party to perform a specific act, usually what is stated in a contract. It is an alternative to awarding damages and is classed as an equitable remedy commonly used in the form of injunctive relief concerning confidential information or real property. Orders of specific performance are granted when damages are not an adequate remedy and in some specific cases, such as land sales. Such orders are discretionary, as with all equitable remedies, so the availability of this remedy depends on whether it is appropriate in the circumstances of the case.[40]

2.3.1 Mission Capital PLC v Sinclair & another (2008)

Ronald Sinclair and his daughter Emma ("the Sinclairs") were the two executive directors of Mission Capital Plc ("the Company"), and they were in a minority on the board of the company; three non-executive directors, Robert

[37] Dov Ohrenstein, The Commercial Litigation Journal, Through the looking glass, pp.22-23, (2011)
[38] Dov Ohrenstein, The Commercial Litigation Journal, Through the looking glass, p.23, (2011)
[39] Mayer Brown, Corporate Legal Alert, p.2, (2009)
[40] https://en.wikipedia.org/wiki/Specific_performance

Burrough, Giuseppe Chani and Michael Guthrie, ("the non-executives") were in the majority. The contracts under which the Sinclairs were employed allowed the board to terminate their employment with immediate effect if he or she "engages in a conduct which in the reasonable opinion of the board is unacceptable or continues to perform his/her employment duties after being given a written warning in a manner which in the reasonable opinion of the board is unacceptable". Furthermore, clause 18 of the contract stated:

"An executive whose employment was terminated must resign all directorships forthwith".

Applying these mechanisms, the board decided to remove the Sinclairs from their employment and consequently as directors of the company, with immediate effect; moreover, Mr Christopher Phillips was appointed as a new executive director. The unacceptable conduct consisted of a failure to submit important financial information to the Company and failure to meet financial forecasts. For these reasons, the Company commenced an action ("the Company action") seeking injunctive relief to exclude the Sinclairs from the Company's premises and for the delivery of certain documents. Tracy J. granted an injection over the telephone, granting interim relief to that effect. However, the Sinclairs challenged the validity of the action taken. In particular, they claimed that:

(1) there was neither a basis for terminating their employment and neither had any unacceptable conduct occurred; as a result, the termination of their employment contracts was a wrongful repudiation of those contracts by the Company, which the Sinclairs did not accept. They affirmed that consequently, the provision in their contract causing them to lose their directorship was not triggered;

(2) the action taken by the board was null as the purpose of the non-executives in taking that action was the improper one of seeking to advance and protect the interests of other commercial ventures in which Mr Burrough was involved; they alleged that this was all in breach of their fiduciary duties to the Company.

As a result of these claims, the Sinclairs decided to counterclaim the Company's action; furthermore, they sought leave to continue a derivative action under the CA 2006 against the non-executives, Mr Phillips and the Company. It is possible to summarize the main applications before the court into:

I. whether permission should be granted under sec. 261 of the Companies Act to continue the derivative action;

II. whether there should be specific performance of the Sinclairs' employment contracts and directorship.

However, if one wants to know more in detail what the list of the main applications was, a summary follows hereunder:

1. in the Company's action, an application by the Court for continuation of the relief granted by Tracy J, restraining the Sinclairs from entering the premises;
2. also in the Company's action, an application by the Sinclairs to add the non-executives and Christopher Phillips as defendants to the counterclaim;
3. also in both the Company's and the derivative action, an application by the Sinclairs for interim injunctive relief:

a. to restrain the Company and the non-executives and Mr Phillips from enforcing or relying on the board resolution terminating the Sinclairs' employment and consequent resignation of their directorship;
b. requiring the board to re-employ the Sinclairs and restore them to the board.

4. In the derivative action, an application by the Sinclairs to be indemnified in respect of their costs out of the Company's assets.

The judge, Mr Justice Floyd, had to determine whether the injustice to the Sinclairs if he refused the injunction sufficiently outweighed the injustice to the Company and its directors if he granted it. In his evaluation, he also took into consideration the claim made by the Sinclairs according to which the Company would have suffered if the non-executive had continued to run the Company without the Sinclairs' interference. On the other hand, Mr Justice needed to consider the Company's position, which claimed that there had been a total breakdown of mutual trust between the existing board and the Sinclairs, for which the effect of restoring them to executive positions would be highly detrimental to the Company itself.

On the basis of all these observations, Mr Justice Floyd had no hesitation in finding that the balance of justice was plainly in favour of refusing injunctive relief. Firstly, he believed that restoring the Sinclairs to their executive positions under the control of a board of directors with whom they were locked in litigation was a perfect recipe for strife in the workplace; secondly, the concern felt by the Sinclairs about the future of the company was surely genuine, but on the other hand, it was by no means certain that the Company would not manage satisfactorily without them. Last but not least, courts were reluctant to grant specific performance in relation to orders requiring a company to allow a director to continue to act in that capacity. The Company had offered to provide an undertaking not to sell the business or its assets and not to wind up the company without giving notice to the Sinclairs, and the judge of course took that into account when considering the balance of justice. To restore the Sinclairs to form a minority group on the board would not give them power to prevent impropriety, although it would give them advance notice of it. Therefore, although the Sinclairs' case was arguable, the balance of justice was against the grant of an injunction to restore them to their directorships.

As regards the derivative action, when considering whether to grant permission for a party to continue with it, it is necessary to apply the two-step process set out in Companies Act 2006 sec.261 and sec.262, while sec.263(2) is mandatory in character. If it is established that a notional director would not seek to continue the claim, the court has to refuse leave.

The Sinclairs' derivative action might have succeeded where the counterclaim failed and the company would have been able to claim damages against the directors for damage suffered by the company as a result of the Sinclairs' wrongful dismissal. Damages of that kind would not have been available to the Sinclairs as shareholders. The Sinclairs therefore passed the first step of the test and it was necessary to consider the discretionary factors in sec.263(3): the Sinclairs had brought the action in good faith. However, while a notional director might have continued the claim, he would have not attached much importance to it, especially as the damage that the Company would suffer from the Sinclairs' wrongful dismissal was speculative. It was more likely that the Company would replace the Sinclairs than take action against those responsible for the damage caused by their wrongful dismissal. Furthermore, the Sinclairs could have recovered what they sought by means of an unfair prejudice petition under sec.994.

For all these reasons, Mr. Justice Floyd refused the Sinclairs' application for permission to continue with the derivative claim. As a consequence of this choice, the question of a costs indemnity did not arise.

"I am not satisfied that there is anything that the Sinclairs are seeking which could not be recovered by means of a section 994 unfair prejudice petition[41] […] Taking into account all those factors rehearsed in section 263(3) and all the other circumstances of this case, I have come to the conclusion that I should refuse permission to continue the derivative claim. It follows that the question of a costs indemnity does not arise. In the result, I dismiss the applications for injunctive relief. I refuse the application for leave to continue the derivative actions, but I allow joinder of the non-executives and Mr Phillips to the counterclaim in the Company's action. I will hear counsel as to the form of order and the ancillary matters I referred to earlier."[42]

3 DERIVATIVE ACTION UNDER US CORPORATE LAW

3.1 Directors' duties

Given that the majority of corporations in the United States are incorporated under Delaware State, I will focus on directors' duties there. Under Delaware law, directors owe fiduciary duties to a corporation's shareholders.[43] A director's fiduciary duties include both a duty of care and a duty of loyalty. The duty of care requires a fiduciary to be informed of all material information reasonably available before making a business decision.[44] In particular, according to the duty of care, a director or officer has a duty to the corporation to perform the director's or officer's functions:

(1) in good faith;

(2) in a manner that he or she reasonably believes to be in the best interests of the corporation, and

[41] See Sec. 994 CA 2006

[42] Mission Capital PLC v. Sinclair & another, Mr justice Floyd, 2008

[43] *Harris v. Carter*, 582 A.2d 222, 234 (Del. Ch. 1990)

[44] *Smith v. Van Gorkom,* 488 A.2d 858, 872 (Del. 1985)

(3) with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.[45]

In evaluating a director's actions under the duty of care standard, courts apply the "business judgement rule"[46], which is a standard of review, not a separate standard of conduct.

Instead, as regards the duty of loyalty, it prohibits self-dealing by directors and requires that directors act in good faith and in the way they reasonably believe to be in the best interests of the corporation and its stockholders.[47] This duty implies that directors should put their own financial and other self-interests after those of the corporation when making a decision on its behalf. While some US courts characterize good faith as a separate duty, the courts in Delaware generally treat it as part of the duty of loyalty.[48]

3.2 The business judgement rule

There is a difference between a director's decision which fails to achieve success and serious mismanagement. In Delaware, this distinction is explained by the "business judgment rule," which is formulated as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company"[49]. If a plaintiff challenging a business decision can disprove any of the presumed elements, then the director must respond by showing that the decision was a good one, i.e. that it was, in substance, fair to the company. If the presumption stands, the decision will not allow the bringing of a legal action, unless the director was grossly negligent.[50] Thus, under the business judgement rule, courts focus on the board's process in making a decision, rather than the outcome of the decision.[51]

3.3 The derivative action under US jurisdiction

Since, as a general rule, directors owe their duties to the corporation and not to specific shareholders or stakeholders, the right to sue for breaches of directors' duty rests by default with the corporation itself. This creates a difficulty because almost always, the right to litigate falls under the general powers of directors to manage the

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[45] Melvin A. Eisenberg, e Duty of Care of Corporate Directors and Officers, p.967-968, (1989)

[46] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)

[47] *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1345 (Del. 1987)

[48] Gilbert J. Bradshaw, The Bradshadow Law Group, Duty of care and duty of loyalty owed by directors in Delaware, (2015)

[49] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)

[50] Thomas A. Uebler, Shareholder policy power: shareholders' ability to hold directors accountable for intentional violations of law, p.214, (2008)

[51] Gilbert J. Bradshaw, Duty of care and duty of loyalty owed by directors in Delaware, (2015)

corporation day by day.[52] Actually, the derivative action originated in the UK as an exception to the proper plaintiff principle, that is the Rule in Foss v Harbottle, which means that an action brought because of wrongdoings to the company should be pursued by the company itself and damages should also be awarded to the company. Derivative actions enable (certain) shareholders to redress the company's losses on behalf of the company in the event that the company (which is the proper plaintiff) is not able to bring a suit by itself.[53] And because of the nature of the derivative action as an exception to the general principle, it can only be applied in limited situations.[54] Its nature explains also the fact that, if the action is for damages, any award will be paid to the company, and not to the shareholder who brought the action before the court, on behalf of the company.[55]

In the US, the law regulating derivative actions is incorporated in both state law and federal law, and even if rules regulating this kind of action vary from state to state, several principles exist that are generally accepted. One could ask himself/herself why the American version of the Foss v Harbottle rule is somewhat imprecisely denominated 'the requirement of demand', and the answer is that prior to launching a derivative suit, and so before a derivative action is commenced, the shareholder plaintiff should request the board of directors to correct the alleged wrongdoings; this principle is established under the Model Business Company Act.[56]

In particular, as the American rule developed, it required two conditions to be met by a minority shareholder: there had to be a 'demand', first, upon the board of directors to take proceedings on behalf of the corporation, followed by another similar 'demand' addressed to the general body of shareholders (where the board rejected the demand made upon them). Here, the majority's power to ratify aimed to explain the need for a 'demand' on the shareholders; whereas the principle that the corporation was the proper plaintiff in any action to enforce its rights was held to require a separate 'demand' upon the board of directors.

In order to prevent the abuse of derivative actions, during the mid-1970s a new strategy was introduced, according to which a special litigation committee consisting of disinterested directors could investigate a plaintiff's claim and recommend whether the litigation should be brought.[57] It should be noticed that those disinterested directors should not be the defendants of the lawsuit. If all the directors were named as defendants, the board might appoint outside directors who had no personal financial interest in the challenged transactions to the committee. Today, the 'special litigation committee' approach is still being used by many US courts, at state level as well as at federal level.

[52] Ian M Ramsey, Corporate governance and the duties of company directors, pp.11-12, (1997)
[53] Wenjing Chen, A Comparative Study of Funding Shareholder Litigation, p.17, (2017)
[54] Wenjing Chen, A Comparative Study of Funding Shareholder Litigation, p.18, (2017)
[55] Wenjing Chen, A Comparative Study of Funding Shareholder Litigation, p.18, (2017)
[56] The Model Business Company Act (MBCA) is a model set of law prepared by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association and is followed by twenty-four states. It was created due to variation in how states defined companies after World War II in 1950. The variation and uncertainty resulted in many lawsuits in which a promoter was sued personally for obligations ostensibly incurred in the name of the nascent company. The widespread adoption of the MBCA brought some clarity to such confusion and other corporate law issues. Most states are now guided by the Revised Model Business Company Act (RMBCA), a revised version of the MBCA.

[57] Wenjing Chen, A Comparative Study of Funding Shareholder Litigation, p.43, (2017)

A very important aspect of the derivative action, which comes even before the procedural requirements to bring that action before the court and to obtain the leave to continue it, is the difference between that kind of action and a direct action.[58] To distinguish between them (which is not always that easy), one should ask himself/herself two questions: who suffered the alleged injury (the company as a whole or the suing shareholder individually?); and, who would receive the remedies?[59] But there are cases in which the answers to these two questions are not sufficient, as both the company and the individual shareholder suffer the injury at the same time. In such circumstances, an additional question should be asked: to whom does the defendant owe the duties?[60] When the wrongdoers are directors or senior managers of the company, it is particularly important to identify the party to whom the wrongdoers owe the relevant duties since they owe duties to both the company as an entity and each shareholder individually. Considering that, if the directors or managers violate such kind of duty, the shareholders may bring a direct action to redress their own injuries, and they can also commence a derivative action on behalf of the company to seek recoveries.[61]

As well as under UK company law, also under US corporate law there are substantial limitations on the filing of a derivative action, among which the first one is represented by the business judgement rule. Even if the statutory rules do not explicitly indicate that the business judgment rule should be employed as an exception to the cause of a derivative action, the courts, in fact, hold it as a basic doctrine to avoid judicial interference in the business issues within a company.[62] If a director or a senior officer, performing in good faith and in the company's best interests, still causes losses to the company by his/her business judgments, he/she should be exempted from being charged.

I would like to talk more in detail about something I have just cited above, which is the procedural requirements on plaintiffs to commence a derivative action. But before introducing these requirements, I would like to list them and introduce them in general terms before explaining each requirement individually:

(1) The contemporaneous ownership rule
(2) The continuous ownership rule
(3) Demand on the board requirement
    a) Demand refused cases
    b) Demand accepted cases

[58] Dov Ohrenstein, New Law Journal, Derivative action, Shareholders now have a statutory right to sue directors in derivative actions. Will they use it?, (2007)

[59] Andreas Cahn, Comparative company law: text and cases on the laws governing corporations in German, the UK and the USA, pp.601-602, (2010)

[60] Wenjing Chen, A Comparative Study of Funding Shareholder Litigation, p.28, (2017)

[61] Wenjing Chen, A Comparative Study of Funding Shareholder Litigation, pp.28-29, (2017)

[62] For example, in Aronson v. Lewis, the Delaware court stated that 'it is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company'. Aronson v. Lewis, 473 A.2d 805, at 812 (Delaware 1984); The same rule can also be found in Smith v. Van Gorkom, 488 a.2d 858, at 872 (Delaware 1985)

c) Demand excused cases

(4) Settlements

As regards 'standing to sue', shareholders have to adhere to the 'contemporaneous ownership rule' and to the 'continuous ownership rule' at the same time, which implies that shareholders entitled to commence a derivative action should still hold shares at that time and they should continue to hold such shares until judgement is reached. Demand requirements before a derivative action is brought to the court are also important procedural rules that potential shareholders have to adhere to.

Let us now analyse each requirement and what it provides for.

(1) The contemporaneous ownership rule

The contemporaneous ownership rule requires that the shareholder plaintiff in a derivative action should be holding shares when the complained transaction is happening, or that shareholders entitled to launch a derivative lawsuit should be the ones whose shares had been devolved by operation of law (for instance, through succession).[63] This rule is designed to prevent abuse of derivative actions and in particular to avoid the purchasing of shares just in order to continue a derivative action attacking a transaction that had occurred prior to the purchase of the share.[64]

(2) The continuous ownership rule

The continuous ownership rule requires the shareholder plaintiff to hold shares in the corporation continuously till the delivery of judgment.[65] Once the plaintiff, for whatever reason, ceases to be a shareholder, he will lose the standing to continue a derivative action.[66] This rule is designed to avoid speculative suits and to ensure that the derivative action is brought with merits. However, it may cause problems in certain circumstances such as mergers and acquisitions. Thus, several states have developed exceptions to this rule. For instance, under Delaware law there are two exceptions to the continuous ownership rule. First, if a merger is conducted merely to deprive shareholders of standing to bring a derivative action. Second, if the merger is in reality merely a reorganization which does not affect the plaintiff's ownership in the company.[67]

(3) Demand on the board requirement [68]

[63] Sec.327 of Delaware General Corporation Law.

[64] See Lewis v. Anderson (Delaware, 1984)

[65] Wenjing Chen, A Comparative Study of Funding Shareholder Litigation, p.31, (2017)

[66] See Lewis v. Anderson (Delaware, 1984)

[67] Richard Burt, Shareholder Loses Standing to Maintain Derivative Action After Merger, (2012)

[68] Wenjing Chen, A Comparative Study of Funding Shareholder Litigation, pp.46-50, (2017)

The demand on the board requirement implies that a shareholder does not have the right to commence a derivative action without making a demand on the board of directors first, unless he can show that such a demand is futile. The demand requirement grants the board an opportunity to consider disputes before the shareholders bring them to court. The reason behind this requirement is largely based on the fundamental principle of company law for which the power to manage corporate business, including the power to make a litigation decision, is granted to the board of directors rather than to individual shareholders. After receiving a demand, the board of the company may react in three different ways: the board can (1) refuse the demand; (2) accept the demand and allow the litigation to proceed; (3) resolve the matter internally without judicial interference.

a) Demand refused case

In a demand refused case, the board usually affirms that the law was not violated and the cause of the derivative action could not be established on tenable grounds; for instance, the exception of business judgment rule. In many cases, shareholders may allege that the board which made the decision to refuse the action is 'personally involved or interested in the alleged wrongdoing in a way calculated to impair their exercise of business judgement on behalf of the company, or that their refusal to sue reflects bad faith or breach of trust in some other way'.[69] Since whether or not to pursue a claim could also be considered as the board's business judgment, it can only be challenged before a court on the ground that it is irrational. The problem here is that the interpretation of 'irrational' is greatly subject to the discretion of the court itself, which implies that the court will apply its own standard to decide whether the challenge is rational or not. If the shareholder's challenge is successful, the derivative action will then be allowed to proceed. It is important to underline that, in the challenge, the burden of proof belongs to the shareholder plaintiffs. Generally, the shareholder plaintiffs should prove that the directors who made the refusal decision were not independent or disinterested, which is definitely something not easy to prove.

b) Demand accepted case

When a demand is accepted by the board, there will be two possible outcomes. The first one is that the board accepts the demand and prosecutes the action. The second one, instead, is that the board intends to solve the issue internally without going before the court. In the former case, the board would notify the shareholders that it plans to take some measures on the demand. Usually, investigations on complained issues may be conducted by the company itself thereafter; then, the company may either go ahead with the lawsuit or make a settlement. It should be noted that the parties who attempt to make a settlement must comply with the judicial approval requirement

[69] Wenjing Chen, A Comparative Study of Funding Shareholder Litigation, p.46, (2017)

listed in the FRCP 23.1[70] (*Federal Rules of Civil Procedure*) or its relevant state counterparts. In the latter case, the company resolves the complained issues through a settlement, and the judicial approval requirement in the FRCP 23.1 does not apply.

c) Demand excused cases

In some cases, shareholders could initiate a derivative action without making a demand on the board. A typical example is when the demand is excused as futile, the shareholder could then initiate a derivative claim directly. But when can a demand be excused as futile? The answer is that, if the shareholder plaintiff supposes that a fair hearing by the board of the company would not be given upon the demand, then the demand could be futile. In state law, a widely-accepted doctrine is the Delaware Supreme Court's opinion in Aronson v. Lewis, stating that, in deciding whether a demand on the board is futile, two issues should be considered: whether the directors were disinterested and independent, and whether the challenged transaction was a product of a valid exercise of business judgment. Particularly, a litigation decision made by the company or by the special litigation committee is considered as business judgement which can be exempted from judicial review. This aspect creates a problem in that it is argued that the decision made by the special litigation committee should not have a binding effect due to the 'structural bias' problem, that is the members of a special litigation committee are normally appointed by the board and have a close relationship with the directors, which makes it hard for the committee to maintain independence in their litigation decisions. This 'structural bias' problem is confirmed by the fact that a large number of decisions made by the special litigation committee are not to initiate a derivative action; to deal with this, there are generally three approaches employed by state courts: the first approach, adopted by the New York Court of Appeals in Auerbach v. Bannet[71], totally adheres to the business judgement rule, for which only minimal review by the court of the committee's decision is allowed; in particular, only if the plaintiff can show that the committee members were not truly independent and disinterested or that they did not act in good faith or in the

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[70] Rule 23.1. Derivative Actions

(a) Prerequisites. This rule applies when one or more shareholders or members of a corporation or an unincorporated association bring a derivative action to enforce a right that the corporation or association may properly assert but has failed to enforce. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association.

(b) Pleading Requirements. The complaint must be verified and must: (1) allege that the plaintiff was a shareholder or member at the time of the transaction complained of, or that the plaintiff's share or membership later devolved on it by operation of law; (2) allege that the action is not a collusive one to confer jurisdiction that the court would otherwise lack; and (3) state with particularity: (A) any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and (B) the reasons for not obtaining the action or not making the effort.

(c) Settlement, Dismissal, and Compromise. A derivative action may be settled, voluntarily dismissed, or compromised only with the court's approval. Notice of a proposed settlement, voluntary dismissal, or compromise must be given to shareholders or members in the manner that the court orders.

[71] Auerbach v. Bennett, 47 N.Y.2d 619 (N.Y. 1979)

company's best interests, could the decision by the committee be reviewed. In contrast to the New York approach, the Iowa Supreme Court takes a rigid approach when it reviews a committee decision. In fact, in Miller v. Register & Tribune Syndicate, Inc.[72], the court stated that under no circumstances should the special litigation committee's decision not to sue be deferred to. In the court's point of view, where the majority of the board is incapable of making a litigation decision, it has no authority to delegate such power to a special litigation committee. Since both the New York and the Iowa approaches have been largely criticized for having imposed, respectively, too little and too much burden on the court with respect to the special litigation committee's decision, most states take a position in-between the two. For example, Delaware adopts a standard indicating that the committee's decision should be deferred to, to a certain degree, but judicial review should also be conducted when necessary. The Delaware standard is well illustrated by the *Zapata Corp. v. Maldonado* case, in which, in proceedings for judicial review of the exercise of business judgement, the Delaware Supreme Court applied a "two-step" test, according to which first, the court had to inquire into the independence and good faith of the litigation committee (or of the board where no committee was appointed), and had to review the reasonableness and good faith of its investigation; secondly, the court had to apply its own independent judgement to decide whether the motion to dismiss should be granted.

(4) Settlements [73]

The federal rule (FRCP 23.1) provides that derivative actions should not be dismissed or compromised without the approval of the court and that notice of a proposed settlement or dismissal must be given to the shareholders in the manner the court directs. Generally, the proponents of a settlement have the burden of convincing the court that the settlement is in the best interests of the company and its shareholders, when the court hearing is held. All of this means, in summary, that settlement agreements concluded by parties in a derivative claim should be approved by the court, in order to avoid suspect agreement and to protect the interests of the company.

3.3.1 Zapata Corp. v. Maldonado (1981)

In June 1975, William Maldonado, a stockholder of Zapata, brought a derivative action in the Court of Chancery on behalf of Zapata against ten officers and/or directors of the company, alleging essentially breaches of fiduciary duties. Maldonado did not first demand the board to bring this action, stating that it would have been a futile demand since all the directors were named as defendants and they had allegedly participated in the acts specified.[74]

[72] Miller v. Register & Tribune Syndicate, Inc. 336 N.W.2d 709 (Iowa 1983)

[73] Wenjing Chen, A Comparative Study of Funding Shareholder Litigation, p.51, (2017)

[74] Court of Chancery rule 23.1 states in part: "The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the

In June 1977, Maldonado started an action in the US District Court for the Southern District of New York against the same defendants, except one, alleging violations of federal security law as well as the same common law claims made previously in the Court of Chancery. Two years later, four of the defendant-directors were no longer on the board; the remaining directors appointed two new external directors to the board and then set up an "Independent Investigation Committee" (Committee), composed solely of these two, to investigate Maldonado's actions, and to determine whether the corporation should continue any or all of the litigation. The Committee's determination was stated to be "final ... not ... subject to review by the Board of Directors and ... in all respects ... binding upon the Corporation."

After an inquiry, in September 1979, the Committee stated that each action should "be dismissed forthwith as their continued maintenance is inimical to the Company's best interests ..." Accordingly, Zapata moved for dismissal or summary judgment in the derivative actions, and on January 24, 1980, the District Court for the Southern District of New York granted Zapata's motion for summary judgment, holding, according to its interpretation of Delaware law, that the Committee had the authority, under the "business judgment" rule, to require the termination of the derivative action.

Consequently, Maldonado appealed that decision to the Second Circuit Court of Appeals. On March 1980, the Court of Chancery denied Zapata's motion on the basis that the "business judgement rule" was not a grant of authority to dismiss derivative actions and that a stockholder had an individual right to maintain derivative actions in certain instances. In any case, the truth was that, as the Vice Chancellor noted, "it is the law of the State of incorporation which determines whether the directors have this power of dismissal…", and therefore the focus was on whether the Committee had the power to cause the action to be dismissed. However, even if the corporation's decision to move to dismiss or for summary judgement was a decision resulting from an exercise of the directors' (as delegated to the Committee) business judgement, the question of "business judgement" would not have become relevant until and unless the decision to seek termination of the derivative lawsuit were attacked as improper; but, in this case, the focus was on the power to speak for the corporation as to whether the lawsuit should be continued or terminated.

Therefore, the issue to be analysed and solved in this case contained three aspects: the conclusions of the Court concerning the continuing right of a stockholder to maintain a derivative action; the corporate power under Delaware law of an authorized board committee to cause dismissal of litigation instituted for the benefit of the corporation; and the role of the Court of Chancery in resolving conflicts between the stockholder and the committee.

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action he desires from the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort."

As regards the Court of Chancery's conclusions concerning the right of a plaintiff stockholder in a derivative action, the Supreme Court of Delaware found that the determination that a stockholder, once demand was made and refused, had an independent individual right to continue a derivative suit for breaches of fiduciary duty over objection by the corporation as an absolute rule, was erroneous. The Court of Chancery relied mainly upon Sohland v. Baker, Del.Supr., 141 A. (1927), for this statement of the Delaware rule. In Sohland, the complaining shareholder was allowed to file the derivative action in equity after making demand and after the board refused to bring the lawsuit. But the question in Zapata v. Maldonado was about the power of the corporation by motion to terminate a lawsuit properly commenced by a stockholder *without* prior demand. No Delaware statute or case cited up to that moment before the Court directly resolved that new question; furthermore, the Court did not believe that Sohland addressed the issue by implication.

In fact, the precise language in Sohland only supported the stockholder's right to initiate the lawsuit. It did not support an absolute right to continue to control it. Additionally, the issue and context in Sohland were simply different from this case.

Moreover, McKee v Roger stated "as a general rule" that "a stockholder cannot be permitted…to invade the discretionary field committed to the judgement of the directors and sue in the corporation's behalf when the managing body refuses. This rule is a well settled one."[75] Of course, the McKee rule should not be read so broadly that the board's refusal be decisive in every situation. Board members, owing fiduciary duties to the firm, were not allowed to cause a derivative action to be dismissed when it represented a breach of their fiduciary duties.

Essentially, from the McKee case, it derived that a demand, when required and refused (if not wrongful), terminated a stockholder's legal ability to initiate a derivative suit. But whenever demand was properly excused, the shareholder had the ability to initiate the action on behalf of the corporation.

These conclusions, however, did not answer the question in the case analyzed. The issue to be solved was when, if at all, an authorized board committee should be permitted to cause a litigation, properly commenced by a shareholder in his own right, to be dismissed.

Even when demand is excusable, situations may arise in which continuation of the litigation would not be in the best interests of the corporation. The Court's inquiry, in this case, was whether, under such circumstances, there was a permissible procedure by which a firm could rid itself of detrimental litigation. This concern was faced in Lewis v. Anderson: "To allow one shareholder to incapacitate an entire board of directors merely by levelling charges against them gives too much leverage to dissident shareholders." In fact, potentials for abuse had to be recognized, and this led the Court to deal with the second and the third aspects of the issue on appeal.

[75] See McKee v. Rogers, Del.Ch., 156 A. 191 (1931)

First of all, the Court clarified once more that an independent committee had the corporate power to seek the termination of a derivative suit.[76] The corporate power inquiry then focused on whether the board, tainted by the self-interest of a majority of its members, could legally delegate its authority to a committee of two disinterested directors. The Court clearly affirmed that it could.[77]

The Court did not believe that the self-interest taint of the board majority was per se a legal bar to the delegation of the board's power to an independent committee composed of disinterested board members; in actual fact, the committee could properly act for the corporation to move to dismiss derivative litigation that was believed to be detrimental to the best interests of the firm.
Later on, the concern of the court moved to the Court of Chancery, which was faced with a shareholder declaration that a derivative suit, properly instituted, should be continued for the benefit of the corporation and a corporate assertion, properly made by a board committee acting with board authority, that the same derivative suit should be dismissed as inimical to the corporation's best interests.

In particular, the Court wanted to find a balancing point where bona fide stockholder power to bring corporate causes of action could not be unfairly trampled on by the board of directors, but the corporation could rid itself of detrimental litigation.

The question had been defined, by other courts, as one of the "business judgment" of the board committee. If a "committee, composed of independent and disinterested directors, conducted a proper review of the matters before it, considered a variety of factors and reached, in good faith, a business judgment that [the] action was not in the

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[76] 8 Del.C. § 141(c) states: "The board of directors may, by resolution passed by a majority of the whole board, designate 1 or more committees, each committee to consist of 1 or more of the directors of the corporation. The board may designate 1 or more directors as alternative members of any committee, who may replace any absent or disqualified member at any meeting of the committee. The bylaws may provide that in the absence or disqualification of a member of a committee, the member or members present at any meeting and not disqualified from voting, whether or not he or they constitute a quorum, may unanimously appoint another member of the board of directors to act at the meeting in the place of any such absent or disqualified member. Any such committee, to the extent provided in the resolution of the board of directors, or in the bylaws of the corporation, shall have and may exercise all the powers and authority of the board of directors in the management of the business and affairs of the corporation, and may authorize the seal of the corporation to be affixed to all papers which may require it; but no such committee shall have the power or authority in reference to amending the certificate of incorporation, adopting an agreement of merger or consolidation, recommending to the stockholders the sale, lease or exchange of all or substantially all of the corporation's property and assets, recommending to the stockholders a dissolution of the corporation or a revocation of a dissolution, or amending the bylaws of the corporation; and, unless the resolution, bylaws, or certificate of incorporation expressly so provide, no such committee shall have the power or authority to declare a dividend or to authorize the issuance of stock."

[77] 8 Del.C. § 144 states: "§ 144. Interested directors; quorum. (a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if: (1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or (2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or (3) The contract or transaction is fair to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee, or the shareholders. (b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction."

best interest of [the corporation]", the action had to be dismissed.[78] The issues became solely independence, good faith, and reasonable investigation. The ultimate conclusion of the committee, under that view, was not subject to judicial review.

The Court, however, was not satisfied that acceptance of the "business judgment" rationale at this stage of derivative litigation was a proper balancing point.

The context in this case was a suit against directors where demand on the board was excused. As a consequence, the Court believed it was appropriate to pay attention to the fact that the lawsuit was properly initiated; thus, it was not a board refusal case. Moreover, the complaint was filed in June of 1975 and, while the parties undoubtedly would take differing views on the degree of litigation activity, the Court had to be concerned about the creation of an "Independent Investigation Committee" four years later, after the election of two new external directors.

Additionally, notwithstanding the Court's conviction that Delaware law entrusted corporate power to a properly authorized committee, the Court had to be mindful that directors were passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question that obviously arose was whether inquiry as to independence, good faith and reasonable investigation was a sufficient safeguard against abuse, possibly, subconscious abuse.

After an objective and exhaustive investigation of the derivative suit, the Court decided to apply a two-tiered test. Under the first tier, the Court had to inquire into the independence and good faith of the litigation committee (or of the Board, where no committee was appointed), and to review the reasonableness and good faith of its investigation. In the second step, instead, the Court had to apply its own independent judgement to decide whether the motion to dismiss should be granted. If the Court's independent business judgment was satisfied, the Court could proceed to grant the motion, subject, of course, to any equitable terms or conditions that the Court considered necessary or desirable.

3.3.2 Aronson v. Lewis (1984)

After Zapata Corp. v. Maldonado, Del.Supr., 430 A.2d 779 (1981) numerous derivative suits were filed without prior demand upon boards of directors. The complaints in such actions all alleged demand was excused because of board interest, approval or acquiescence in the wrongdoing. However, in this case the Court left a crucial issue unanswered: when is a shareholder's demand upon a board of directors, to redress an alleged wrong to the corporation, excused as futile prior to the filing of a derivative suit? The issues of demand futility were the core issues of the Aronson v. Lewis case. The plaintiff, Harry Lewis, was a stockholder of Meyers, while the defendants

[78] See, e. g., Maldonado v. Flynn

were Meyers and its ten directors, some of whom were also company officers. In 1979, Prudential Building Maintenance Corp. (Prudential) spun off its shares of Meyers to Prudential's stockholders. Prior thereto, Meyers had been a wholly owned subsidiary of Prudential. Meyers provided parking lot facilities and related services throughout the country and its stock was actively traded over-the-counter.

This suit challenged certain transactions between Meyers and one of its directors, Leo Fink, who possessed 47% of its outstanding stock. The plaintiff claimed that those transactions were approved only because Fink personally selected each director and officer of Meyers. [79]

Prior to January 1, 1981, Fink had had an employment agreement with Prudential which provided that upon retirement he was to become a consultant to that company for ten years. This provision became operable when Fink retired in April 1980. [80] Afterward, Meyers agreed with Prudential to share Fink's consulting services and reimburse Prudential for 25% of the fees paid to Fink. Under this arrangement, Meyers paid Prudential $48,332 in 1980 and $45,832 in 1981. Furthermore, the Meyers board approved and made interest-free loans to Fink for a total of $225,000.

The complaint affirmed that all those transactions had "no valid business purpose", and were a "waste of corporate assets" because the amounts to be paid were "grossly excessive", that Fink performed "no or little services", and because of his "advanced age" could not be "expected to perform any such services". The plaintiff also charged that the existence of the Prudential consulting agreement with Fink prevented him from providing his "best efforts" on Meyers' behalf. Lastly, it was alleged that the loans to Fink were in reality "additional compensation" without any "consideration" or "benefit" to Meyers.

The complaint alleged that no demand had been made on the Meyers board because such an attempt would have been futile for the following reasons: (a) all of the directors in office were named as defendants in the suit and they had participated in, expressly approved and/or acquiesced in, and were personally liable for, the wrongs complained of by the plaintiff; (b) defendant Fink, having selected each director, controlled every member of the Board and every officer of Meyers; (c) the institution of the action by those directors would have required the defendant-directors to sue themselves, so to place the conduct of the suit in hostile hands and to prevent its effective prosecution.

The relief sought included the cancellation of the Meyers-Fink employment contract and an accounting by the directors, including Fink, for all damage sustained by Meyers and for all profits derived by the directors and Fink.

[79] The Court of Chancery stated that Fink had been chief executive officer of Prudential prior to the spin-off and thereafter became chairman of Meyers' board. This was not alleged in the complaint. Lewis, 466 A.2d at 379

[80] The trial court stated that Fink "changed his status with Prudential building from employee to consultant". Lewis, 466 A.2d at 379

The defendants moved to dismiss for the plaintiff's failure to make demand on the Meyers board prior to the suit, or to allege with factual particularity why the demand is excused.[81] According to the Vice Chancellor, the test of futility was “whether a Board, at the time of the filing of the suit, could have impartially considered and acted upon the demand”. As part of this formulation, the trial judge stated that interestedness is one aspect affecting impartiality, and he affirmed that the business judgment rule is a potential defense to allegations of director interest, and hence, demand futility. However, the court observed that to establish demand futility, a plaintiff does not need to allege that the challenged transaction could ever be thought as a product of business judgment. Rather, the Vice Chancellor sustained that a plaintiff "must only allege facts which, if true, show that there is a reasonable inference that the business judgment rule is not applicable for purposes of considering a pre-suit demand pursuant to Rule 23.1". The court settled that this transaction permitted such an inference.
The Vice Chancellor then dealt with the plaintiff’s assertion that Fink, as a 47% shareholder of Meyers, dominated and controlled each director, thereby making demand futile. The Court of Chancery stated that a plaintiff, to properly allege domination of the Board, particularly domination based on ownership of less than a majority of the corporation's stock, in order to excuse a pre-suit demand, had to allege ownership plus other facts evidencing control to demonstrate that the Board could not have exercised its independent business judgment. Then, turning to the plaintiff's allegations of board approval, participation in, and/or acquiescence in the wrong, the Supreme Court of Delaware focused on the underlying transaction to determine whether the action of the board was wrongful and not protected by the business judgment rule. The Vice Chancellor specified that if the underlying transaction supported a reasonable inference that the business judgment rule did not apply, then the directors who approved the transaction were potentially liable for a breach of their fiduciary duty, and thus, could not impartially consider a stockholder's demand. The trial court then stated that board approval of the Meyers-Fink agreement, allowing Fink's consultant compensation to remain unaffected by his ability to perform any services, may have been a transaction wasteful on its face.[82] Accordingly, demand was excused as futile, as the Meyers' directors faced potential liability for waste and could not have impartially considered the demand.

The defendants made two arguments. First, they declared that the demand requirement comprises the policy that directors, rather than shareholders, manage the affairs of the corporation. They argued that this fundamental principle required the strict construction and enforcement of Chancery Rule 23.1. Second, the defendants pointed

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[81] Chancery Rule 23.1, similar to Fed.R.Civ.P. 23.1, provides in pertinent part: In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share of membership thereafter devolved on him by operation of law. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and the reasons for his failure to obtain the action or for not making the effort.

[82] Fidanque v. American Maracaibo Co., Del.Ch., 92 A.2d 311 (1952)

to four of the plaintiff's basic allegations and claimed that they lacked the factual particularity necessary to excuse demand. Concerning the assertion that Fink dominated and controlled the Meyers board, the defendants pointed to the absence of any facts explaining how he "selected each director". With respect to Fink's 47% stock interest, the defendants affirmed that, other facts being absent, this was insufficient to indicate domination and control. Regarding the statement of hostility to the plaintiff's suit, because defendants would have to sue themselves, the latter claimed that this bootstrap argument ignored the possibility that the directors had other alternatives, such as cancelling the challenged agreement. As for the allegation that directorial approval of the agreement excused demand, the defendants replied that such a claim was insufficient, because it would preclude the demand requirement in almost every case. The effect would be to subvert the managerial power of a board of directors. Finally, as to the provision guaranteeing Fink's compensation, even if he was unable to perform any services, the defendants contended that the trial court read this out of context. Based upon the foregoing, the defendants concluded that the plaintiff's allegations fell far short of the factual particularity required by Rule 23.1.

After a series of considerations, and relying also on section 141(a):

"The business and affairs of a corporation organized under this chapter shall be managed by or under the direction of a board of directors except as may be otherwise provided in this chapter or in its certificate of incorporation.", the Court arrived at the conclusion that the gap in Delaware law arose from the decision in Zapata Corp. v. Maldonado, in which the Court defined the limits of a board's managerial power granted by Sec. 141(a) and restricted the application of the business judgement rule in a factual context similar to that of Aronson v. Lewis. However, in this case the Court correctly recognized that demand futility is inextricably bound to issues of business judgement, but stated the test to be based on allegations of fact, which, if true, "show that there is a reasonable inference" that the business judgement rule was not applicable for purposes of a pre-suit demand.

The Delaware Court claimed that in determining demand futility, the Court of Chancery in the proper exercise of its discretion had to decide whether, under the particularized facts alleged, a reasonable doubt was created that: (1) the directors were disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. As a consequence, the Court of Chancery had to make two investigations, one into the independence and disinterestedness of the directors and the other into the substantive nature of the challenged transaction and the board's approval thereof. As to the latter inquiry, the Court did not assume that the transaction was a wrong to the corporation requiring corrective steps by the board; rather, the alleged wrong was substantively reviewed against the factual background alleged in the complaint. As to the former inquiry, instead, the Court reread the factual allegations to decide whether they raised a reasonable doubt, as a threshold matter, that the protections of the business judgment rule were available to the board. Clearly, if this was an "interested" director transaction, such that the business judgment rule was inapplicable to the board majority approving the transaction, then the inquiry ceased. In that event, futility of demand had been established by any objective or subjective standard.

It followed that the Court of Chancery in the exercise of its sound discretion had to be satisfied that a plaintiff asserted facts with particularity which, taken as true, supported a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment. Only in that context was demand excused.

After outlining the legal framework within which the issues were to be determined, the Court moved to the plaintiff's claims: Fink's domination and control of the directors, board approval of the Fink-Meyers employment agreement, and board hostility to the plaintiff's derivative action due to the directors' status as defendants.

The plaintiff's claim that Fink dominated and controlled the Meyers' board was based on: (1) Fink's 47% ownership of Meyers' outstanding stock, and (2) that he "personally selected" each Meyers director. The plaintiff also alleged that mere approval of the employment agreement showed Fink's domination and control of the board. In addition, the plaintiff argued on appeal that 47% stock ownership, though less than a majority, constituted control given the large number of shares outstanding, 1,245,745.

Such arguments did not support any claim under Delaware law that these directors lacked independence. In Kaplan v. Centex,[83] the Court of Chancery stated that "stock ownership alone, at least when it amounts to less than a majority, is not sufficient proof of domination or control". Furthermore, in the demand context, even proof of majority ownership of a company did not strip the directors of the presumptions of independence, and that their acts had been taken in good faith and in the best interests of the corporation. In particular, the Court relied on the meaning of independence, which is a director's decision based on the corporate merits of the subject before the board rather than extraneous considerations or influences. On the basis of this definition, the Court believed that it was not enough to charge that a director be nominated by or elected at the behest of those controlling the outcome of a corporate election, which is, moreover, the usual way a person becomes a corporate director. It was the care, attention and sense of individual responsibility to the performance of one's duties, not the method of election, that generally required independence.

Accordingly, the Court concluded that, in the demand-futile framework, a plaintiff charging domination and control of one or more directors had to assert particularized facts manifesting "a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling" (Kaplan, 284 A.2d at 123). Here, the plaintiff did not allege any facts sufficient to support a claim of control. The causal link between Fink's control and approval of the employment agreement was alluded to, but nowhere specified. The director's approval, alone, did not generate control, even in the face of Fink's 47% stock ownership.[84] The claim that Fink was unlikely to perform any services under the agreement, because of his age, and his conflicting consultant work with Prudential, added nothing to the control claim.[85] Thus, the Court stated

[83] Kaplan v. Centex Corp., Del.Ch., 284 A.2d 119 (1971)
[84] See Kaplan v. Centex Corp., 284 A.2d at 122, 123
[85] Plaintiff made no legal argument that the "best efforts" provision of the agreement prohibited dual consultant duties, thereby demonstrating that the contract's approval evidenced control or was otherwise wrongful.

that the complaint did not factually particularize any contexts of control and domination to overcome the presumption of board independence, and consequently, the demand could not be declared futile.

Later on, the Court went back to the board's approval of the Meyers-Fink employment agreement, for which the plaintiff's argument was simple: all of the Meyers directors were named defendants, because they approved the wasteful agreement; if the plaintiff prevailed on the merits, all the directors would have been jointly and severally liable; therefore, the directors' interest in avoiding personal liability automatically and absolutely disqualified them from passing on a shareholder's demand.

Such allegations were conclusory at best. In Delaware, mere directorial approval of a transaction, absent particularized facts supporting a breach of fiduciary duty claim, or otherwise establishing the lack of independence or disinterestedness of a majority of the directors, was insufficient to excuse demand. Here, the plaintiff's suit was premised on the notion that the Meyers-Fink employment agreement was a waste of corporate assets. Thus, the argument could have held, thereby rendering futile any demand on them to bring suit; but, unfortunately, the plaintiff's claim fell in its initial premise: the complaint did not allege particularized facts indicating that the agreement was a waste of corporate assets. Furthermore, the basic assertion that Fink performed "little or no services" was the plaintiff's conclusion based only on Fink's age and on the existence of the Fink-Prudential employment agreement. As for Meyers' loans to Fink, beyond the bare allegation that they were made, the complaint did not allege facts indicating the wastefulness of such arrangements. Again, the mere existence of such loans, given the broad corporate powers conferred by Delaware law, did not even state a claim.[86]

In sustaining the plaintiff's claim of demand futility, the trial court relied on Fidanque v. American Maracaibo Co., Del. Ch., 92 A.2d 311, 321 (1952), which assumed that a contract providing for payment of consulting fees to a retired president and/or director was a waste of corporate assets. However, by contrasting the facts of Fidanque with the complaint in this case, it was clear to the Court that the plaintiff did not allege sufficient facts to render demand futile on a charge of corporate waste.

The plaintiff's final argument was the claim that demand was excused because the directors otherwise would have to sue themselves, thereby placing the conduct of the litigation in hostile hands and preventing its effective prosecution. This bootstrap argument had been made to and dismissed by other courts; in fact, its acceptance would have effectively revoked Rule 23.1 and weakened directors’ managerial power. Unless facts were alleged with particularity to overcome the presumptions of independence and a proper exercise of business judgment, in which case the directors could not be expected to sue themselves, a bare claim of this sort advanced no legally cognizable issue under Delaware corporate law.

[86] Plaintiff's allegation ignores 8 Del.C. § 143 which expressly authorizes interest-free loans to "any officer or employee of the corporation... whenever, in the judgment of the directors, such loan ... may reasonably be expected to benefit the corporation."

In summary, the Court concluded that the plaintiff had failed to allege facts with particularity indicating that the Meyers directors were tainted by interest, lacked independence, or took action contrary to Meyers' best interests in order to create a reasonable doubt as to the applicability of the business judgment rule. Only in the presence of such a reasonable doubt may a demand be deemed futile. Hence, the Supreme Court of Delaware reversed the Court of Chancery's denial of the motion to dismiss, and remanded with instructions that the plaintiff be granted leave to amend his complaint to bring it into compliance with Rule 23.1, based on the principles that the Court itself had announced following this case.

➢ *Observations*

In Zapata Corp. v. Maldonado, the Delaware Supreme Court established a 'two-step' test for the exercise of the courts' powers of judicial review, while in Aronson v. Lewis, the Court clarified, for the purpose of invoking the two-step approach, the circumstances in which demand would be excused. The *Aronson* decision consequently has strengthened the position of corporate boards of directors, making it highly unlikely that many derivative actions will proceed without their support.[87]

4 DERIVATIVE ACTION UNDER ITALIAN CORPORATE LAW

4.1 Directors' duties

According to the provisions of Article 2380*bis* (1) of the Italian Civil Code, a director is one who has the exclusive power to manage a company and acts as necessary to achieve the goals of the corporation. Furthermore, provisions of Article 2387 of the Italian Civil Code states that the company's bylaws can indicate a director be subject to specific requirements of honor, professionalism and independence.

Together with the definition of 'director' provided by the law, Italian case law provides for another type of director – the *'de facto'* or *'shadow'* director, who is an individual that carries out in practice the duties of a director in a company without being formally hired as a director and/or an individual who 'administers' the appointed directors. A de facto[88] director who acts with the approval of all shareholders, even if the approval has not been formally expressed, is subject to the same rules leading the exercise of the managing powers and civil responsibility as those which apply to an appointed director. However, in order to be qualified as a director, the management function of a de facto director must be systematic and not occasional or heterogeneous.[89]

[87] A. J. Boyle, Minority shareholder's remedies, p.42, (2009)

[88] Court of Milan, December 11 1997, in *Le società*, 1998, p 802

[89] *Corte di cassazione,* September 14 1999 n 9795, in *Le società*, 2001, p. 807

In both joint stock companies and limited liability companies, the Civil Code provides for the directors' duties, which are owed mainly to the company, shareholders, creditors and third parties.
These duties can be divided into[90]:

- *specific duties*, arising from the law or the company's articles of association; and
- *general dutie*s, to be fulfilled while dealing with all management activities.

In particular, amongst *specific duties* there are:

- a duty to convene a shareholders' meeting without delay in the event of losses[91];
- a duty to assess and note in the Companies Register, without delay, the occurrence of a cause for dissolution[92] and a duty subsequently to limit management activity only to the preservation of corporate property:[93]
- a duty to draft, and draft accurately, business-year balance sheets (case law);
- a duty to comply with accounting principles (case law); and
- a duty to comply with all fiscal, welfare and criminal laws (case law).

Instead, directors' general duties are:

- a duty of diligence/care[94];and
- a duty of loyalty – that is, a duty to pursue the interests of the corporation, avoiding conflicts of interest.[95]

Furthermore, the standard of care that directors of joint stock companies involved in management activities are required to exercise, is considered as a general principle established by specific provisions of the Civil Code. Thus, it needs to be elaborated by courts depending on the particular circumstances of the case at hand. However, even though there is no specific provision setting out the standard of care to be followed by directors of limited liability companies, according to the provisions of Article 2392(1) of the Civil Code, as amended by the Italian corporate law reform, "directors shall fulfil duties imposed by the law or by articles of association with the diligence required by the nature of their assignment and their specific competence". Furthermore, directors are required to act on informed basis[96] and to do whatever they can to eliminate or reduce harmful consequences, where they learn of facts which are detrimental to the company.[97]
As a result, directors are no longer subject to the 'reasonable man', but they must be evaluated while taking into account the professional nature of the activity that they carry out[98]; in fact, the activities carried out by a company's

[90] Serena Triboldi, Directors' liability, Pontecorvi Mannaerts & Triboldi, pp.286-287, (2012)
[91] Articles 2446 and 2447 of the Civil Code
[92] Article 2485(1) of the Civil Code
[93] Article 2486(1) of the Civil Code
[94] Articles 2392 and 2476 of the Civil Code
[95] Articles 2391 and 2475*ter* of the Civil Code
[96] Article 2381(6) of the Civil Code
[97] Article 2392(2) of the Civil Code
[98] Article 1176(2) of the Civil Code

director are considered as professional activities which require greater caution and attention than that attributed to the reasonable man.

Again, directors' obligation to act with the diligence required by their nature implies an evaluation of the diligence of each director with respect to his areas of competence; in particular, a director behaves negligently if he makes a management decision on an uninformed basis or without properly evaluating the related risks and advantages for the company. In any case, the standard of care required by law is a general clause to be applied with regard to the unique factual circumstances of each case.

Directors are also subject to a general obligation to pursue the best interest of the company, which does not necessarily mean to maximize company profits.[99] Actually, directors are not considered liable for the company's economic success, and liability for breach of the duty to act in the best interests of the company can emerge only from violation of a duty imposed by law or by the company's articles of association. In fact, the courts have generally applied the 'business judgement rule', stating that "a judge is not allowed to decide upon the opportuneness or appropriateness of directors' management decisions, which pertain to their discretionary powers and are not subject to an *ex-post* judgment; on the contrary, a judge can only check if a decision was made without conflicts of interest and with those preventive cautions, checks and information required by ordinary professional diligence"[100]. Like the duty of care, also the duty to pursue the best interests of the company must be described according to the factual circumstances. However, for joint stock companies, it may be indirectly deduced from Article 2391(1) of the Civil Code, under which a director must inform other members of the board of directors and the board of auditors of any interest he holds, on his own account or on account of third parties, in a specific company operation. In such situation, a managing director must also renounce to carry out the interested operation.[101]

In this case, a director is liable for any damage suffered by the company as a result of his act or omission. A director is also liable for any damage suffered by the company if he takes corporate opportunities.

A conflict of interest is alleged where a director:

- becomes a shareholder of a competing company with unlimited liability;
- carries out a competing business on his own account or that of a third party; or
- becomes director or general manager of a competing company (Article 2390 of the Civil Code).[102]

In the cases above, director who act without the authorization of the shareholders' meeting are responsible for any damage suffered by the company.

[99] Serena Triboldi, Directors' liability, Pontecorvi Mannaerts & Triboldi, p.288, (2012)
[100] Court of Cassation, Case 3652 of April 28 1997
[101] Serena Triboldi, Directors' liability, Pontecorvi Mannaerts & Triboldi, p.289, (2012)
[102] Serena Triboldi, Directors' liability, Pontecorvi Mannaerts & Triboldi, p.289, (2012)

4.2 The derivative action under Italian Civil Code (1942)

As in the US, under Italian company law the cause of action is solely vested in the company: the shareholder enforces the company's claim against its directors, seeking relief on behalf of the company itself.[103] Shareholders alleging directors must rely on the basic principles of Italian Tort Law, and resolution of this action must be approved by shareholders' meeting, which is of course influenced by controlling shareholders, who are in turn those who appoint directors, so that they will unlikely vote in fav or of such resolutions. Therefore, it is rare that directors are involved as defendants in liability suits.[104] Furthermore, not all shareholders are entitled to sue: initially, when starting a derivative action, plaintiff shareholders were required to possess at least 5% of the company's capital and to have been recorded in the shareholder book for at least six months prior to the beginning of the action. The request for a threshold to be respected derived from the fact that large shareholders have greater concerns about their company since they have more money invested in it, and so they would not indulge in strike-suits.[105] The six-month book registration as a condition for the action meant to prevent shareholders driven by a short-term investment perspective from interfering with the relationship between the company and its directors.[106] At the establishment, no derivative suit was brought against directors of any Italian listed company; as a consequence, in 2003, company law reform[107] reduced the threshold to 2.5% (for listed companies[108]) and removed the registration requirement, with the aim of giving life to this US imported weapon.[109]

Moreover, as I stated in the previous paragraph, directors' required diligence "does not mean that directors must necessarily be experts in accounting, finance and every field related to the management and administration of their company, but rather, simply, that their choices must be informed and well considered, based upon their respective knowledge, and that decisions must be made based on a calculated risk, rather than an irresponsible or negligent improvisation". Therefore, a director behaves negligently if he makes management decisions on an uninformed basis or without properly evaluating the attendant risks and advantages for the company.

However, the 2003 amendments did not solve one of the main problems regarding the derivative action, i.e. what happens to the suit if the plaintiff sells his shares (or part of them) during the court case, thereby dropping below the 2.5% threshold requirement. Most specialists believe that the plaintiff must keep at least 2.5% of ownership

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[103] Massimo Fabiani, L'azione di responsabilità dei soci di minoranza e la sostituzione processuale, pp.1-2, (1998)

[104] L. Stangellini, Corporate Governance in Italy: Strong Owners, Faithful Managers. An Assessment and a proposal for Reform, 6 Indiana International and Comparative Law review, pp.169-170, (1995)

[105] Elliott J. Weiss, 'The Lead Plaintiff Provisions of the PSLRA After a Decade, or "Look What's Happened to My Baby"', (2007)

[106] There is no contemporaneous ownership requirement under Italian law

[107] Guido Ferrarini, Paolo Giudici and Mario Stella Richter, 'Company Law Reform in Italy: Real Progress?', p.658, (2004)

[108] For non-listed companies the threshold is higher; i.e. 20%

[109] Italian law does not have anything like a "contemporaneous ownership requirement": the shareholder can start the action even though he was not a shareholder at the time of the act or omission contested

shares during the whole period of the unresolved litigation; if the shareholding goes below this threshold, the defendants could ask for the dismissal of the suit, on the basis of the fact that the standing condition is no longer in place.[110]

Besides the absence of 'contemporaneous ownership rule', differently from the US, the Italian law does not allow the board of directors to stop an action. Therefore, the shareholding threshold is the only barrier the plaintiff has to face in order to start the action; once the action has started, the board has no power to prevent it; only the shareholder meeting has the power to do it, but minority shareholders above the 2.5% threshold can veto any proposal aimed at ending the derivative action, thereby blocking a company's attempt to protect its directors.

Under the Italian company law, similarly to UK, as regards legal costs, it is up to the loser to pay the winners' expenses as decided by the court. However, according to the English law, minority shareholders do not have adequate incentives, given that if they win, the company and its directors reimburse their litigation costs as established by the court, but it is the company which takes the entire redress. Furthermore, the court's judgment cannot consider any private agreement between a minority shareholder and his lawyer: it is the court that decides the quantity of litigation expenses that the plaintiff can recuperate. In doing so, the court takes into account public prices established for lawyer job, and their final decision about the amount to be recovered by the minority shareholder is usually very ungenerous.

Aiming at lightening the cost problem, a special rule concerning derivative actions[111] permits to plaintiffs, in case of win, to recover not only litigation expenses, but also 'the costs incurred in the finding of facts'. Though, it is the court that, again, establishes the sum to be paid by the defendants, without taking into account the agreements between the plaintiff and his attorneys. All of this implies that the minority shareholder is entirely in the hands of the court, and even in the event of success, the risk of being out of money is still high.

There is also another problem for minority shareholders in a derivative action setting, that is the difficulty to access information, for which, in case of victory, they should be recovered: Italian law does not grant any inspection right to shareholders of public companies[112]; it is the statutory auditor athat can access relevant facts, and that is expected to use them for the benefits of minority shareholders. This implies that the latter cannot scrutinize the company and find relevant information outside the derivative action context. Furthermore, situations in which the plaintiff has the right to discover relevant facts are very limited. In theory, a court order is necessary to access the documents held by the other party; however, the court cannot grant any disclosure unless a document is specifically showed. If the party required to show it does not comply with the court's order, the judge can only

[110] Piergaetano Marchetti and Luigi Arturo Bianchi, La disciplina delle società quotate nel testo unico della finanza, pp. 988–989, (1999)

[111] Article 2393-*bis*, para5, Civil code

[112] Thomas, Randall S., Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information, p.311, (1996)

take this into consideration when deciding on the merits, but he cannot decide whether the undisclosed document was in favor of the plaintiff.[113]

4.2.1 Court of Milan, Judgement, 29-04-2016

Action promoted by T.B. as common representative (i.e. the plaintiff) of shareholders of Company I S.p.A., Against T.A., F.M.F. and P.G. (i.e. the directors).

B.T., the plaintiff, owning 23.81% of Company I S.p.A.'s shares, brought an action based on art. 2393 bis c.c. against T.A., F.M.F. and P.G. (the directors), these being members of the Board of Directors of the Company when the alleged facts occurred, and, together with them, also against Company I S.p.A. itself.

The plaintiff claimed that the directors did not comply with their duties, according to art. 2393 bis c.c. in the management of the society; in particular, the alleged facts were the following:

I. The stipulation of four leasing contracts for luxury goods in 2008; and, more precisely:
   a) A 2007 Ferrari F430 Coupè F1 ("Ferrari");
   b) A BRENTA 38 racing boat ("Boat");
   c) A BMW 335XL Coupè ("BMW");
   d) An Audi TT 2.0 ("Audi")

The plaintiff complained, firstly, that these luxury goods were outside the company's object, implying that the director and the President of Company T exercised exclusive use of those goods; secondly, he alleged false representation of costs balance sheet deriving from those goods, given that they were accounted for as production costs in favour of third parties, rather than as credits toward Company T. Therefore, he required directors to reimburse all the costs derived from the stipulation of the four leasing contracts.

II. Record in the balance sheet, dated 30.04.2009, of Production Costs/Services for € 336.550,00 and of Production Costs/Salaries for € 210.547,00, both amounts considered as being too high given that Company I did not have productive activities to manage.

III. An investment of more than € 400.000,00 in long-term equities in a Private Equity Fund, located in Luxembourg, a transaction that was well outside the scope of the business of Company I, without recording such operation in the financial statement dated 30.04.2009.

As regards the first alleged fact, three out of the four leasing contracts were accepted by the Milan Court; in particular, the demand regarding the leasing contract having the Audi as object, was rejected, since the object was justified as the company car of the Administrative Director (of the Company).

[113] See Article 116 Civil Procedure Code

The object of Company I was, in particular: A) Investing in other societies - technical and financial coordination of those societies; B) Acquiring and selling classic (vintage) cars.

This implied that contract I.a) fell outside the business objective, given that a Ferrari could not be considered as a classic car according to art. 60 of the Highway Code. Furthermore, that car could not be considered as a collectors' car; this last fact, however, was not relevant as even if the Ferrari had been a collectors' car, then it would have also fallen outside the scope of Company I. Directors, even if they had tried to, would have had nothing to say to justify all the above observations. Therefore, the Board of Directors was liable to reimburse the company for all the expenses (and for all the damages) that arose from the I.a) leasing contract.

The same conclusions were reached by the Court in relation to the I.b) contract, as the Boat was totally outside the object of the business, and it was exclusively used by T. for personal purposes, such as taking part in a regatta from 30 April to 3 May 2009. Therefore, the Boat represented another source of director liability toward Company I.

Finally, as regards the I.c) leasing contract, the BMW was available for business use to Luigi T., as part of the Company; however, he declared that his work contract, relative to his first work period in the Company, did not include the (personal) use of the car, but that this *was* included the second work period. Yet, with respect to the first work period contract, the use of the car had been agreed verbally. Naturally, this verbal agreement had not been confirmed by any written declaration nor by any record in the financial statement; furthermore, nor did the second work contract regarding the use of the car appear in the balance sheet of the company!

Moreover, the BMW continued to be used by the Company even in the period in which Luigi T. was not employed, implying that he continued to use it beyond the object of the business. Therefore, also the I.c) contract turned out to be the result of negligent and harmful behaviour by the Board of Directors.

On the basis of all the above considerations, the Court of Milan declared the three leasing contracts having as objects the Ferrari, the Boat and the BMW as being unlawful and prejudicial, and therefore representing a source of liability for the Board of Directors according to art. 2393 c.c.. In particular, the Directors were declared liable to reimburse Company I the amounts of € 214,563.32 for the "Ferrari contract", of € 260,514.04 for the "Boat contract" and of € 73,588.77 for the "BMW contract", for a total of € 548,666.13. All the damages suffered by Company I were charged to Alessandro T., who was the CEO at the time the contracts were stipulated.

With reference to II. "Production Costs/Services" and "Production Costs/Salaries", the alleged facts were not proved to be true, as they were correctly recorded in the balance sheet of Company I; therefore, the Directors were not liable for any damage derived from them. However, the Plaintiff claimed that those costs were disproportionate, given the absence of any managerial activity in Company I. The Court of Milan declared this accusation not valid, meaning that it did not represent a crime according to Italian law.

Finally, as regards the investment in the Private Equity Fund located in Luxembourg, the Plaintiff claimed its irrelevance to the scope of the business., and also the fact that the investment did not appear either in the balance

sheet or in any note to the financial statement. Furthermore, the Plaintiff emphasized the decrease in the investment realized, whose value fell by € 159,990.00. About the first allegation, i.e. irrelevance to the scope of the business, the Court declared that investing in other companies to control them (at least in part) was perfectly in line with Company I's object. As regards, instead, the second allegation, it was not formulated as it should have been and therefore, it too, was rejected.
To conclude, the Directors, and in particular T.A., F.M.F. and P.G. as representatives, had to reimburse Company I not only for their negligent behaviour and for all consequent damages, but they also had to repay all the legal expenses incurred in the course of the derivative action.

5 CONCLUSIONS

As shown so far in this work, bringing a derivative action against a company's directors by minority shareholders is a rare occurrence. Not only is it a complicated procedure, but due to the laws in the three jurisdictions discussed, there is little chance of it being successful. In particular, the two-step procedure in the UK, the 'requirement of demand' and the special litigation committee in the US, and the 'minimum specified amount' of company shares in Italy, represent the main reasons why it is quite difficult to bring a derivative suit before the court, and obtain permission to continue it.

In all the three jurisdictions, even if a minority shareholder is successful in bringing a derivative action, any damages awarded are to the company (as it is the proper plaintiff, according to the rule in Foss v Harbottle), and not to the shareholder who is only entitled to the legal costs incurred in the process. This is hardly an incentive to any minority shareholder who is considering this course of action. As is also the fact that, in the UK and in the US, the preliminary steps required before an action even goes to court are many and very complicated to overcome, while in Italy an action is in any case impossible unless a shareholder has a minimum of 2.5% shares in a company.

Nevertheless, on the one hand, the attitude of the three courts is after all understandable, given that majority shareholders have larger investments and interests in a company, and are therefore more exposed to risk than one or more minority shareholders; for this reason, the former need greater legal protection. On the other hand, however, this fact should not lead to an abuse of their rights, as majority shareholders are those who elect company directors, who in turn are those that manage the company and should make decisions in its best interests rather than in their personal interests (or in the interests of those by whom they have been elected), otherwise damaging minority shareholders. This is why, instead, the latter should be provided with efficient tools to protect their rights, and so their company's rights, from directors' abuses.

It is evident that in all the three jurisdictions, minority shareholders not only are in the hands of directors and/or of majority shareholders, but also and mainly in those of the courts, which have, moreover, the final say in case of a successful derivative action, especially in Italy, in establishing the amount of legal expenses minority shareholders are entitled to be reimbursed. These amounts are often very ungenerous, representing an additional disincentive for them to bring a derivative suit.

In my opinion, however, in spite of the tendency by courts to, firstly, avoid interfering in a company's internal affairs unless it is strictly necessary and, secondly, protect the rights of directors and majority shareholders, by widely resorting to the use of the 'business judgement rule' (in particular, in the UK and in US), Italian courts have demonstrated a greater propensity to take minority shareholders' needs into account, even if concrete results as yet have been few and far between.

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