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Derivative Actions Do Not Always Play an Important Role in Corporate Governance in the U.S and the U.K

Haodian Hu[1]

[1] Law School, The University of Sheffield, Sheffield, UK

Correspondence: Haodian Hu, Law School, The University of Sheffield, Sheffield, UK.

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Abstract

Derivative actions have garnered significant attention in contemporary corporate law circles as a means of recourse for shareholders. As a result, research on derivative actions is expanding in several countries, including the United Kingdom and the United States. However, despite their shared significance in the evolution of derivative actions, these two countries exhibit distinct perspectives on the matter. This scholarly article aims to examine and compare the procedural and substantive variances pertaining to derivative actions in the United Kingdom and the United States. Additionally, this article aims to demonstrate the divergent functions that derivative actions serve in addressing shareholder grievances in these two nations.

Keywords: derivative actions, role

1. Introduction

Although the United Kingdom and the United States are both common law countries, they have adopted different attitudes and different legal provisions in dealing with the issue of shareholder derivative actions. However, the relatively dull stance on minority shareholder protection that it has displayed since Foss v Harbottle has not fundamentally changed. Compared to the US derivative action rules, it is procedurally more difficult to initiate a shareholder derivative action in the UK, and the UK shareholder derivative action is not a regular shareholder redress mechanism, it is more of an exceptional means of last resort, the UK corporate governance prefers alternative mechanisms to resolve disputes and protect shareholders' rights than derivative actions, and the UK corporate governance system has consistently adhered to the theory of shareholder representation, and shareholder derivative actions happen to be the opposite of this theory. In contrast, the US has taken a more inclusive and open approach to shareholder derivative actions, viewing them as an important means of safeguarding shareholders' rights and strengthening corporate oversight. As a result, derivative actions, which play an important role in US corporate governance, are not as important in UK corporate governance.

2. Derivative Action in the UK and US: Brief History and Meaning

The concept of the derivative action is a model that has evolved over time and is one of the legal dispute resolution processes open to individual minority shareholders in the United Kingdom and the United States.

In England, the derivative action evolved from Foss v. Harbottle's exception to the rule to the notion that a company is a legitimate plaintiff withstanding to appear for the wrong it has committed. [1]The rule depended on the fact that the company had a distinct legal personality and that most shareholders, not individual shareholders, decided company-related issues. [2]The exceptions to the rule that at the time constituted a cause of action for derivation were wrongs that could not be ratified by a majority of shareholders. [3]However, there was a loophole in the common law derivative regime that protected directors at the expense of shareholders because it did not include wrongs in which the controller had no personal interest. [4]The regime ended on October 1, and in 2007 the UK Companies Act 2006 went into effect, closing the gap in the common law derivative action.[5] This is the current derivative action law in the United Kingdom.

As was the case under English common law, the US legal system employs the necessary party rule, which requires all parties to the action to be parties to the action. [6]Therefore, the rule prohibits a shareholder from representing a corporation when the corporation is not a party to the action. State and federal governments recognized the right of a shareholder to sue on behalf of other shareholders for wrongs committed by the corporation in 1829 and 1855, respectively.[7] It was deemed an exception to the necessary party rule, with the requirement being identical to the exception in Foss v. Harbottle, except that the shareholder was required to demonstrate that he had endeavored to have the corporation itself rectify the wrong. [8]In the United States, the concept of a derivative action was an action brought on behalf of a shareholder in response to a wrong committed by the company for several years prior to 1946, when it was considered to be an action brought on behalf of the company.[9]

A derivative action is an action initiated by a shareholder on behalf of a company to redress a wrong committed against the company under current UK and US company law. [10]Therefore, the wrong sought to be redressed must impact the company itself rather than the individual shareholders or a subset of them; if this is the case, then individual or direct action should be pursued. [11]In both jurisdictions, the company is named as a nominal defendant to circumvent the rule that non-parties to an action are not bound by judgements. [12]This is because bringing a derivative action implies that the board of directors making decisions on behalf of the company did not consent to such conduct in some capacity; and because he is deemed to have done something through someone else,[13] this invariably means that the plaintiff shareholder lacked consent. The only method to make such a derivative action judgement enforceable against the company is to make it a ‘fictitious’ defendant.

3. Derivative Action Under UK Company Law

3.1 Directors' Duties

The Companies Act of 2006 recognises de facto and “shadow” directors on the board of directors of a British company. According to the Companies Act of 2006, these directors have a variety of obligations to the “company.” [14]The Code stipulates that directors “must act in good faith to promote the success of the company for the benefit of all of its members,” and in doing so, they must “have regard to, among other things,” (a) the long-term effects; (b) employee interests; (c) relationships with suppliers, consumers, and others; (d) the impact on the community and the environment; (e) the company’s ethical reputation; and (f) the fair treatment of all members. Under this regime, all directors of publicly traded companies are required to disclose in their annual reports the company’s policies for promoting the interests of its employees, the environment, and the community, as well as the effectiveness of these policies.

Seven duties in particular have been enshrined in law (under the Companies Act 2006), reflecting both common law and equitable principles. Companies can insure their directors against financial loss in the case of a breach of their duties, even if they are unconstrained or exempt. There is currently no codified body of law outlining remedies for breach of duty; nonetheless, damages, restitution of ill-gotten riches, specific performance, and injunctions are all available through the common law and equity.

Lastly, the Companies Act requires directors to disclose the nature and scope of their interest in a company.

Company that has been proposed but not yet executed, as well as any transaction executed by the company. In the case of a proposed transaction, the relevant director must do so prior to the transaction’s conclusion, not at the initial meeting where the transaction is Checked. On the other hand, if it is not reasonable to consider an interest to be one that is likely to result in a conflict of interest, then it cannot be considered to have such a likelihood. The failure of a director to disclose his or her interest in an existing transaction would constitute a criminal offence. The superintendent would be liable for a fine upon conviction.

A director is not required to declare his interest if (i) he cannot reasonably be expected to give rise to a conflict of interest; (ii) other directors are aware of it; and (iii) it pertains to the terms of his service contracts considered by a meeting of the Directors or a committee of the Directors appointed pursuant to the Articles of Association.[15]

3.2 Derivative Action Under the UK Companies Act (2006)

First, it is necessary to distinguish between the various shareholder-only actions that may be initiated. There are a variety of actions that a shareholder may pursue as a remedy for the damage he or she has suffered. This is a solely personal act if a shareholder brings a lawsuit for his or her benefit against an ongoing or ongoing violation. In contrast, a derivative action occurs when a shareholder brings an action against the company on behalf of the plaintiff’s entire group of interests based on rights acquired from the company.

In the case of Foss v. Harbottle, it has long been established who the proper plaintiff to sue for wrongdoing should be.

The corporation itself was the victim of the actions taken, which has implications for the concept of a company’s separate legal identity[16]. Under normal circumstances, the Board of Directors makes the call on whether or not to file suit.

In most cases, the board of directors decides whether or not to file suit based on its "standard" management powers. However, when the individual who has harmed the firm is one of the board members themselves, it seems risky to leave the choice to the directors. Accordingly, in unusual cases where the corporation does not want to pursue its rights, shareholders may be permitted to bring derivative claims on their own behalf. Under common law, a court will usually only accept a derivative action if both of the following conditions are met: 1) the alleged wrong or breach of duty cannot be approved by a simple majority of members; and 2) the alleged wrongdoer controls the company and is therefore not the proper claimant.

3.3 Procedural Hurdles for Derivative Actions in the UK

3.3.1 The Role of the Court

When the applicant complies with the law and requests permission to continue the derivative action, the court fulfils its duty at this stage. [17]The establishment of a prima facie case is the first prerequisite for the granting of permission. This requires proof of what constitutes a cause of action in order to demonstrate the existence of significant issues to be litigated and that the claims are well-grounded or, at the very least, not frivolous. Prima facie evidence.[18] The case is handled ex parte to prevent the company from being distracted by such matters until the court identifies a substantial cause of action.

In Hughes v. Weiss, a speck of evidence would have sufficed. [19]Thus, in Hughes v. Weiss, the court determined that a prima facie case of transfer of corporate opportunity was established, even though the evidence was insufficient; the decision was predicated on the existence of appropriate evidence to be presented at the merits stage. This is commendable because it affords the applicant the chance to be heard, as incomplete cases are more likely to proceed to trial than those at the merits stage.

It is preferable to go to trial with an incomplete case than to enable the wrongdoer's directors to avoid liability due to insufficient evidence to establish a prima facie case.

3.3.2 Participation of the Board

As the board is charged with administering the company's affairs,[20] it will be responsible for providing the court with justifications for granting or denying leave. Likewise, the alleged commission of wrongdoing against the company would be an appropriate reason for denying permission or leave.[21] Therefore, permission will be denied if the board or the putative wrongdoer provides evidence demonstrating the grounds for refusal.[22] As a result, the court allowed a derivative claim to proceed in Kiani v. Cooper, even though the director who was accused of breaching his duties had failed to rebut the allegations. Before denying permission or leave based on the board's arguments, the court considers the issues that will be discussed in the following section. These are concerns raised by the board that threaten the action's continuation.

4. Derivative Action Under US Company Law

4.1 Directors' Duties

Given that the majority of U.S. companies are incorporated in Delaware, I will focus on the responsibilities of directors. Under Delaware law, directors owe a fiduciary duty to a corporation's shareholders.[23]

The fiduciary duties of directors consist of the duties of care and loyalty. Before making business decisions, the trustees must be aware of all material information that is reasonably accessible.[24]

Under the duty of care, a director or officer owes a duty to the company to perform the director's or officer's Functions: (1) in good faith; (2) in a manner that he or she reasonably believes is in the corporation's best interests; and (3) with the care that a person reasonably expected to exercise in a position of ordinary care under similar circumstances.

4.2 The Business Judgement Rule

A differentiation can be made between a director's decision that did not yield the desired outcome and a case of severe mismanagement. The state of Delaware provides clarification on this differentiation through the implementation of the "business judgement rule." The decision-making process of a company's directors is predicated on trustworthy data and a genuine intention to act in the best interests of the organisation. The principle is commonly referred to as the business judgement rule, which posits that the board of directors of a corporation acted in good faith, with due diligence, and in the best interest of the corporation when making a business decision. If an individual who opposes a business decision is able to provide evidence.

If a plaintiff contests a commercial decision and successfully disproves any of the presumptive elements, the burden of proof shifts to the directors to establish the validity of the decision in question. Specifically, they must demonstrate that the decision was sound and substantively equitable for the company. Once the presumption is established, the decision effectively precludes legal recourse against the director, unless it can be demonstrated that the director acted with a degree of negligence that far exceeds what would be considered reasonable under the circumstances.

The business judgement rule dictates that the court's focus is on the decision-making process employed by the board, rather than the ultimate result of the decision.

4.3 Procedural Hurdles for Derivative Actions in the US

The United States' procedure for initiating derivative actions differs from the English system. The court will only intervene if the plaintiff challenges a board decision that prevents him from bringing an action, or if the board wishes to challenge the plaintiff's failure to consult the board prior to taking action. This paper argues, contrary to the opinion of one academic, that the procedural aspects of derivative proceedings action in the United States provide the same protection for individual minority shareholders as their counterparts in the United Kingdom. The minimum participation in U.S. courts may be founded on the recognition that the board of directors is the company's decision-making body. [25]The procedural aspects of U.S. derivative actions will be discussed to support this argument.

5. Conclusion

Although the UK derivative action and the US derivative action are both remedies to protect the interests of shareholders, the UK derivative action does not have the advantage of being procedural compared to the US, its formation is more demanding, the proceedings are more cumbersome and even successful judgments are often not always in favour of the plaintiff, resulting in the plaintiff having to bear greater litigation risk. In short, derivative actions in the UK play a much smaller role in corporate governance than in the US.

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