International Corporate Rescue

Published by:
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

www.chasecambria.com

Annual Subscriptions:
Subscription prices 2017 (6 issues)
Print or electronic access:
EUR 730.00 / USD 890.00 / GBP 520.00
VAT will be charged on online subscriptions.
For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 207 014 3061 / +44 (0) 7977 003627 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

Derivative Claims and Insolvent Companies: Getting to the Core of the Issue

Paul Wright, Barrister, 9 Stone Buildings, London, UK

Synopsis

This article considers whether derivative actions can be brought on behalf of a companies once they have entered into liquidation or some other insolvency process in light of recent decisions of the High Court (in particular, in *Montgold Capital LLP v Ilska* [2018] EWHC 2982 (Ch) and *Core VCT Plc (in Liquidation), Re* [2019] EWHC 540 (Ch)).

The rule in *Foss v Harbottle*

The proper claimant for a wrong suffered by a company is the company itself and not its individual members. It is usually the board of directors that decides whether or not to commence litigation on behalf of the company as the board is commonly vested with the power to manage the company's business and affairs. The company's members (by majority vote) can ratify any action taken by the board. These principles are commonly referred to as the rule in *Foss v Harbottle* (1843) 2 Hare 461.

If applied strictly, this rule would permit unfair results in certain circumstances. For example, a director (who is also a majority shareholder) could sell a company's assets to himself for an undervalue, ratify his own wrongdoing and rely on the rule in *Foss v Harbottle* to stifle any investigation by the minority members.

To temper this potential for unfairness, the common law developed a series of limited exceptions to the rule in *Foss v Harbottle* where there had been a 'fraud on the minority'. Where there had been such fraud, the court would permit a wronged member to bring a claim against the wrongdoer on behalf of the company – a derivative action.

Consideration of insolvency at common law

The leading authority on the common law approach to the question of whether a claim can be brought on behalf of an insolvent company is the High Court's decision in *Fargro v Godfroy* [1986] 1 WLR 1134. In that case, a minority member sought the court's leave to bring a derivative claim as the company was otherwise deadlocked. Before that application could be heard, the company entered into liquidation. Walton J held that:

> 'once the company goes into liquidation the situation is completely changed, because one no longer has a board, or indeed a shareholders' meeting, which is in any sense in control of the activities of the company of any description, let alone litigation. Here, what has happened is that the liquidator is now the person in who that right is vested.'[1]

Though Walton J placed significant reliance on the fact that the liquidator intended to bring the claim on behalf of the company in any event, subsequent cases established that the same result would follow even if the office holder's views were unknown.[2]

The subsequent cases established that the court would not grant leave to bring a derivative claim on behalf of a company that had entered into liquidation or some other insolvency process.

Statutory scheme

Legal commentators noted that the piecemeal nature of the common law's development of the rule in *Foss v Harbottle* 'generated a complex, unclear and highly restrictive set of rules governing the bringing of derivative claims'.[3] For this reason, the Law Commission recommended that the common law rules be replaced by a 'new derivative procedure with more modern, flexible and accessible criteria for determining whether a shareholder can pursue an action'.[4]

Notes

1 *Fargro v Godfroy* [1986] 1 WLR 1134 at 1136.
2 *Barrett v Duckett* at 369.
3 *Palmer's Company Law* (loose-leaf edn, Sweet & Maxwell) at para. 8.3704.1.
4 Law Com No 246.

Parliament put the Law Commission's recommendation into effect by the enactment of Part 11 of the Companies Act 2006 (the 'Act'). As set out in the explanatory notes, Parliamentary intention was not to replace the substance of the rule in *Foss v Harbottle* but merely to provide a new procedural code.[5] That said, the Act clearly does make some substantive changes to the law. For example, the factors to be considered by the court are now enumerated by section 263.

Following the Act coming into force, all proceedings to bring a derivative claim are now comprehensively governed by the statutory scheme (other than the so-called 'double derivative' action which is outside the scope of this article).

Consideration of Insolvency under the statutory scheme

As the statutory scheme makes no express reference to the solvency of the relevant company, it was unclear whether the court would follow the common law approach when considering applications by members of insolvent companies brought under the Act.[6]

This question has now been considered in three decisions of the High Court:

(i) *Cinematic Finance Ltd v Ryder* [2010] EWHC 3387 (Ch);

(ii) *Montgold Capital LLP v Ilska* [2018] EWHC 2982 (Ch); and

(iii) *Core VCT Plc (in Liquidation), Re* [2019] EWHC 540 (Ch).

(i) Cinematic Finance

In *Cinematic Finance*, the applicant wished to bring a derivative claim against two of the former directors and an associated company. In highly unusual circumstances, the applicant was the majority shareholder of the relevant companies. He could, therefore, have caused the companies themselves to bring the claims rather than relying on permission to bring a derivative action. At common law, this would have precluded the applicant from obtaining the relief sought. The applicant argued that those common law principles should be set aside following the enactment of Part 11 of the Companies Act 2006. Roth J disagreed and held:

> '… the Act is not seeking to change the basic rule that a claim that lies in a company can be pursued only by the company or to disturb the fundamental distinction between a company and its shareholders. There is nothing to suggest that the Act intended such a radical reversal of long-standing and fundamental principles.'[7]

Though such an application may be appropriate in exceptional circumstances, Roth J found it 'difficult to envisage what those exceptional circumstances might be.'[8]

As an additional reason to withhold relief, the judge found that the companies were, on the applicant's own evidence, insolvent (though not actually in an insolvency process). With reference to the commentary in Gore-Browne on Companies (and presumably by reference to the common law authorities cited by its editors), Roth J held: 'The controlling shareholder should not seek to circumvent the insolvency regime by starting a derivative claim.'[9]

The application for permission to bring a derivative action was refused.

(ii) Montgold Capital

In *Montgold Capital,* the relevant company had entered administration and effected a pre-pack sale of its business. A fifty per cent shareholder sought permission to bring a derivative action alleging that the sale was at an undervalue and that this had been achieved by a conspiracy involving the directors, other members and the appointed administrators. The application was considered at the first stage by Norris J (who recited in his order that the evidence appeared to make out a sustainable case) and at the second stage by HHJ Simon Barker QC (sitting as High Court judge).

The judge did not explicitly consider any of the previous authorities concerning such applications being made when the company was in an insolvency process. Instead, the judge considered that there was insufficient evidence to show the company was in fact insolvent and found, even if it was, 'that would not be a barrier of itself to a derivative claim'.[10] In so finding, the judge relied upon the decision of the Privy Council in *Gamlestaden Fastigheter AB v Baltic Partners Ltd* [2008] BCLC 468.

The court granted permission to bring a derivative action.

Notes

5 Explanatory Notes at paragraph 491.
6 A. Keay, 'Can derivative proceedings be commenced when a company is in liquidation?' (2008) 21(4) *Insolvency Intelligence* 49-55.
7 *Cinematic Finance Ltd v Ryder* [2010] EWHC 3387 (Ch) at [11].
8 Ibid. at [14].
9 Ibid. at [22].
10 *Montgold Capital LLP v Ilska* [2018] EWHC 2982 (Ch) at [30].

(iii) Core VCT

In *Core VCT*, three solvent companies had been placed into MVL and, following the sale of its assets by liquidators, were dissolved. A number of years later, some of the minority members sought to investigate the stewardship of the company both by its directors before liquidation and by the appointed liquidators thereafter.

Unlike in *Montgold Capital*, the minority members in *Core VCT* sought to bring those challenges not by way of derivative action but by restoring the companies to the register with an order appointing new liquidators to investigate the previous affairs of the companies. Such an order was granted by Fancourt J (in an unreported decision).

Subsequently, a former liquidator and the companies' manager applied to court seeking to set aside the restoration order, to remove the newly appointed liquidators or, alternatively, to direct a members' meeting.

The majority of the arguments made in *Core VCT* are beyond the scope of this article. However, Mr Curl (counsel for the applicants) submitted that the appropriate course of action for the minority members would have been to seek permission to bring about a derivative claim.

Mr Curl's argument was that such a course of action was not only available to the minority members but offered the significant advantage that, if monies were recovered, those recoveries would accrue to the members without incurring the fees, costs and expenses of a liquidator.

Mr Sutcliffe QC (counsel for the new liquidators) submitted that this would not be an available course of action where the new liquidators were appointed (with reference to the decision of Roth J in *Cinematic Finance*).

The judge in *Core VCT* considered the earlier common law decisions (including *Fargro Limited v Godfroy*) and the decision in *Cinematic Finance*, and concluded:

> '...the reasoning of Walton J in Fargro still holds good, at least until a general meeting has decided that the power to litigation may be exercised by the board under s91(2) which has not occurred, and I consider that this view is supported by the passage in the judgment of Roth J to which I have referred in the preceding paragraph.'[11]

Reference was also made to the Privy Council decision in *Gamlestaden Fastigheter* that was relied upon by the court in *Montgold Capital* (though no reference is made to the decision in *Montgold Capital* itself). The judge found this case was confined to the question of whether an unfair prejudice petition could be presented against an insolvent company and did not assist with the issue of whether a derivative claim could be brought in respect of a company in liquidation.[12]

On that basis, the Judge did not consider that an alternative course of action for the minority members would have been to bring a derivative action.

Comment

There are two questions which arise from the three cases considered above: (i) does the common law restriction on claims relating to insolvent companies apply to claims brought under the Act; and (ii) is there now conflicting authority on this issue from the High Court?

Does the common law restriction on insolvent companies apply to under the Act?

The main issue to be determined in *Cinematic Finance* was whether a majority shareholder could bring a derivative action. Roth J found that the court's discretion under the Act must be 'exercised in accordance with established principles'.[13] Other than finding that the common law restriction on applications by majority members was 'one such principle', the judge did not set out which of those principles continued to apply.

It would be surprising if Roth J intended to import *all* common law principles to the exercise of the court's discretion under the Act. This would be inconsistent with Parliament's express intention to introduce modern, flexible and accessible criteria, and the decision of Lewison J in *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch) at [123].

It is arguable that, by referring to the commentary in Gore-Browne, Roth J indicated that the common law restriction on insolvent companies was another such principle that continued to apply under the Act. The court in *Core VCT* certainly appears to have operated on this assumption. This is, however, by no means clear on the face of the judgment in *Cinematic Finance*.

Is there now conflicting authority?

If the common law principles regarding insolvent companies do apply to applications brought under the rules, there would, at first glance, appear to be a conflict of authority. The judges in *Cinematic Finance* and *Core VCT* found that derivative claims were not available where the companies were either insolvent or in solvent liquidation. The judge in *Montgold Capital* did not consider

Notes

11 *Core VCT Plc (in Liquidation), Re* [2019] EWHC 540 (Ch) at [116].
12 Ibid. at [114].
13 *Cinematic Finance Ltd v Ryder* [2010] EWHC 3387 (Ch) at [14].

the fact that the relevant company was in administration was a sufficient impediment to a derivative claim.

However, it is submitted that, when one considers the proper theoretical basis for the common law's different treatment, these decisions are not in conflict. It was not the mere fact of insolvency that caused the courts at common law to refuse leave to bring a derivative claim. If that were the case, there would have been no reason to refuse permission in *Core VCT* (as it was accepted that all the relevant companies were solvent). Rather, it was the fact that, when a company enters into an insolvency process, an independent office holder is generally appointed in place of its board of directors.

Leave would only be granted at common law when the relevant company was under the control of someone who had committed or acquiesced in the wrongdoing.[14] When an office holder is appointed over a company, they are automatically vested with the day-to-day powers of management. Those powers include the power to cause the company to commence litigation. For this reason, the court assumes that, when a company enters into an insolvency process, it ceases to be under the control of the alleged wrongdoer. Rather than intermeddling in the decision as to whether litigation ought to be brought, the common law left this as a matter of the independent office holder's discretion.

Therefore, the focus in *Montgold Capital* on the question of whether there was sufficient evidence to establish that the relevant company was in fact insolvent was potentially misplaced. The proper question for consideration was whether the company continued to be under the control of someone who had committed or acquiesced in the alleged wrongdoing after the appointment of the administrator.

In *Montgold Capital*, it was alleged that the appointed administrators had facilitated the pre-pack sale at an undervalue. For this reason, even after the appointment of administrators, the company remained to be under the control of someone who had committed the alleged wrongdoing. On that basis, it could be said that the court in *Montgold Capital* came to the right decision, albeit for potentially the wrong reason.

In *Core VCT*, the office holders were also alleged to have been involved in the wrongdoing. However, at the time of the application, they had been replaced by new office holders. The allegedly wrongdoing liquidators in Core VCT were not, therefore, in control of the companies. Had the companies in *Core VCT* been restored with its original liquidators in place (as Mr Curl submitted ought to have occurred), it would presumably have been open to the aggrieved members to bring a derivative action.

When these decisions are viewed in this way, there is no conflict of authority. Rather, there is a refinement to the common law principle which may be restated as follows: a derivative action is not available where the relevant company has entered into an insolvency process unless the appointed insolvency practitioners are also alleged to have been part of that wrongdoing.

Though there is now a small body of precedent from the High Court considering these issues, this area is clearly ripe for clarification by the Court of Appeal at the next available opportunity. According to the case tracker for civil appeals provided by the Ministry of Justice, the court is currently considering an application for permission to appeal the decision in *Core VCT*. In the circumstances, such an opportunity may arise sooner rather than later.

Notes

14 V. Joffe QC, D. Drake, G. Richardson, D. Lightman QC, and T. Collingwood, *Minority Shareholders* (6th edn, OUP) at para. 2.168.

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

Alongside its regular features – Editorial, US Corner, Economists' Outlook and Case Review Section – each issue of *International Corporate Rescue* brings superbly authoritative articles on the most pertinent international business issues written by the leading experts in the field.

International Corporate Rescue has been relied on by practitioners and lawyers throughout the world and is designed to help:

- Better understanding of the practical implications of insolvency and business failure – and the risk of operating in certain markets.
- Keeping the reader up to date with relevant developments in international business and trade, legislation, regulation and litigation.
- Identify and assess potential problems and avoid costly mistakes.

For more information about *International Corporate Rescue*, please visit www.chasecambria.com