1. The derivative claim is a procedural device designed by the common law to enable justice to be done where the wrongdoer is in control of the entity in which the relevant cause of action is vested.

2. Despite both jurisdictions now having provided for a statutory derivative action – in the UK in section 260 of the Companies Act 2006 (“CA 2006”) and in Hong Kong in sections 731 to 738 Companies Ordinance (“CAP 622”) - it is now recognised in Hong Kong and the UK that the common law is a flexible tool which does not distinguish between so-called “ordinary”, “multiple” or “double” derivative actions.

3. In the words of Briggs J. as he then was, in Universal Project Management Ltd v Fort Gillicker Ltd [2013] Ch 551 at [26]:
   “the common law procedural device called the derivative action was ... clearly sufficiently flexible to accommodate as the legal champion or representative of a company in wrongdoer control a would-be claimant who was either (and usually) a member of that company or (exceptionally) a member of its parent company where that parent company was in the same wrongdoer control. I would not describe that flexibility in terms of separate derivative action, whether headed “ordinary”, “multiple” or “double”. Rather it was a single piece of procedural ingenuity designed to serve the interests of justice in appropriate cases calling for the identification of an exception to the rule in Foss v Harbottle”.

4. The rule in Foss v Harbottle (1843) 2 Hare 461 is the rule of law by which only the company against whom a wrong is said to have been committed can bring proceedings in respect of that wrong and an individual member of the company concerned cannot normally do so. There are four so-called exceptions to the rule: first, that a shareholder can sue in respect of some attack on his individual rights as a shareholder; secondly, a shareholder can sue if the company, for example, if purporting to do by ordinary resolution that which its own
constitution requires to be done by special resolution; thirdly, if the company has done or proposes to do something which is ultra vires and fourth, and most important in practice, is that a shareholder is entitled to bring a claim where there is fraud which the minority is unable to remedy because of the protection given to the fraudulent shareholders or directors by virtue of their majority (“the fraud exception”).

5. Briggs J. held that although section 206 CA 2006 had replaced the ordinary derivative action by a member of the allegedly wronged company, the Act had not abolished the whole of the common law derivative actions and had left other aspects untouched, including the multiple or double derivative action. He relied, amongst other things, on the seminal review of the law of Lord Millett sitting in the Hong Kong Court of Final Appeal in *Waddington Ltd v Chan Chun Hoo and others* (2008) 11 HKCFAR 370, [2009] 2 BCLC 82.

6. Accordingly, it remains relevant to understand the relevant common law rules. This paper is concerned with a recent case in the UK Court of Appeal (in which I appeared for the successful parties) which considered the scope of the remedy and the important question of what is the proper meaning of “fraud” when seeking to bring the claim within the fourth exception.

**Harris v Microfusion 2013-2-LLP and others [2016] EWCA Civ 1212**

7. Brian Harris was a member of a limited liability partnership Micro Fusion 2013-2-LLP (“the LLP”). He wished to bring a derivative claim on behalf of the LLP against Future Films (Management Services) Limited and Future Films (Partnership Services) Limited, the Designated Members of the LLP (“Designated Members”), in respect of alleged breaches of duty committed by them in their day to day management of the LLP. He claimed to be entitled to damages or equitable compensation, in excess of £5m, from the Designated Members.

8. The background context was a film financing scheme. Wealthy individuals such as Mr Harris had been induced to invest in the British film industry to obtain certain taxation advantages. In common with similar schemes (which have generated substantial volumes of litigation in the UK), the investment was to enable the production, distribution and marketing of a specific film (the working title of which was “Untitled Many Moore Project 2/27/343” and which was ultimately called “Chasing Liberty”).

9. In simplified form, Mr Harris made three allegations of breach of fiduciary duty:

9.1. An allegation that the Designated Members had caused the LLP to pay excessive fees to LM Investments Limited, a company controlled by the same persons who controlled the promotion of the film (“the LMI Fee Issue”);
9.2. An allegation that the Designated Members had caused the LLP to make payments to Alcon Entertainment LLC for marketing services when there was no good commercial reason to do so because it had already contracted for those services to be provided by another company (“the Alcon Fee Issue”);

9.3. An allegation that the Designated Members had caused the LLP to pay away a surplus of more than £1m due to it by way of a rebate of sums paid over the actual cost of production of the film when there was no good commercial reason to do so (“the Rebate of Minimum Guaranteed Amount Issue”).

10. Two matters were common ground before the Judge and in the Court of Appeal. First, it was common ground that Chapter 1 of Part 11 of the CA 2006 did not apply to limited liability partnerships. Secondly, it was accepted following Briggs J. in *Fort Gillicker*, that the common law derivative claim had survived the enactment of the statutory remedy.

11. At first instance [2015] EWHC 1116 (Ch), HHJ Pelling QC sitting as a Judge of the High Court, granted permission for Mr Harris to proceed with the Alcon Fee Issue and for the Rebate of Minimum Guaranteed Amount Issue but refused permission for the LMI Fee Claim. A crucial part of his reasoning was that the pleadings constituted allegations of “deliberate and dishonest breach of duty”.

12. Both sides appealed contending that the Judge had got it wrong. The Designated Members’ position was that although the Judge had properly directed himself as to the relevant test for the application of the fraud exception (whether the claim disclosed either actual fraud or an allegation of wrongdoing coupled with personal benefit to the wrongdoers) he had misapplied it to the relevant facts.

13. In the Court of Appeal, Leading Counsel for Mr Harris did not seek to uphold the Judge’s decision on the two permitted claims on the basis decided by the Judge, namely that there had been “deliberate and dishonest” breaches (ie. actual fraud). Instead, he argued that the ambit of the fraud exception to the rule in *Foss v Harbottle* had been formulated too narrowly in the recent cases on which the Judge had relied and that the requirement of fraud for the purpose of the exception was satisfied where the proposed claim involves an allegation of breach of fiduciary duty and/or an abuse or misuse of power. It was no part of the relevant legal test, he said, that the breach of duty (whether fiduciary or otherwise) would only amount to “fraud” if it was alleged that the person in breach had benefitted from it.
**The earlier case-law**

14. It was necessary to review the relevant authorities on which the competing arguments were based.

15. In *Daniels and others v Daniels* [1978] 1 Ch 406, Templeman J. had conducted a thorough review of the law since *Foss v Harbottle* itself. *Daniels* was a claim brought by minority shareholders against the two directors and majority shareholders alleging that the majority had sold land to one of the directors, the wife of the other, at a price that was known to constitute an undervalue. The directors’ summons to strike out the claim was dismissed on the basis that the fraud exception included cases where, although there was no fraud alleged, there was a breach of duty by directors and majority shareholders to the detriment of the company and the benefit of the shareholders. Note that Counsel for the Defendant there was David Richards (now David Richards L.J).

16. After conducting his review of the earlier authorities, Templeman J. concluded as follows (in a passage explicitly relied on by the Court of Appeal in *Harris*):

“The authorities which deal with simple fraud on the one hand and gross negligence on the other do not cover the situation which arises where, without fraud, the directors and majority shareholders are guilty of a breach of duty which they owe to the company, and that breach of duty not only harms the company but benefits the directors. In that case it seems to me that different considerations apply. If minority shareholders can sue if there is fraud, I see no reason why they cannot sue where there the action of the majority and the directors, though without fraud, confers some benefit on those directors and majority shareholders themselves. It would seem to me quite monstrous – particularly as fraud is so hard to plead and difficult to prove – if the confines to the exception to *Foss v Harbottle*, 2 Hare 461, were drawn so narrowly that directors could make a profit out of their negligence. Lord Hatherley L.C. in *Turquand v Marshall*, L.R> 4 Ch. App 376, 386 opined that shareholders must put up with foolish or unwise directors. Danckwerts J. in *Pavlides v Jensen* [1956] 1 Ch. 565 accepted that the forbearance of shareholders extends to directors who are “an amiable set of lunatics”. Examples, ancient and modern, abound. To put up with foolish directors is one thing; to put up with directors who are so foolish that they make a profit of £115,000 odd at the expense of the company is something entirely different. The principle which may from *Alexander v Automatic Telephone Co.* [1900] 2 Ch 56 (directors benefiting themselves), from *Cook v Deeks* [1916] 1 AC 554 (directors diverting business in their own favour) and from dicta in *Pavlides v Jensen* [1956] 2 Ch.565 (directors appropriating assets of the company) is that a minority shareholder who has no other remedy may sue where directors use their powers, intentionally or
unintentionally, fraudulently or negligently, in a manner which benefits themselves at the expense of the company. This principle is not contrary to Turquand v Marshall, L.R. 4 Ch.App 376, because in that case the powers of the directors were effectively wielded not by the director who benefited but by the majority of independent directors who were acting bona fide and did not benefit. I need not consider the wider proposition for which Mr Blackburne against some formidable opposition from the authorities contends that any breach of duty may be made the subject of a minority shareholder’s action.”

17. The precise point in issue in Harris had been the subject of more recent analysis and decision by David Richards J (as he by then was) in Abouraya v Sigmund [2014] EWHC 277 (Ch) which Leading Counsel for the Designated Members placed heavy reliance upon and which HHJ Pelling QC had explicitly adopted as representing the law.

18. At [18] David Richards J. had said:

“The scope of ‘fraud’ for the purposes of this exception has been considered in many cases. In Daniels v Daniels [1978] Ch 406, Templeman J. reviewed the authorities to date on which subject. The nineteenth century authorities proceeded largely on the basis of what might be called actual fraud, that is to say deliberate and dishonest breaches of duty. The same is true of the celebrated passage in the advice of the Privy Council given by Lord Davey in Burland v Earle [1902] AC 83 at 93. However, derivative actions were permitted in Alexander v Automatic Telephone Co [1900] 2 Ch 56 and Cook v Deeks [1916] 1 AC 554, where allegations of fraud were rejected but the directors exercise their powers in a manner which conferred personal benefits on themselves at the expense of the company and the other shareholders”.

19. And later, at [24] he went on:

“It is therefore the case that all the authorities on direct derivative actions have taken as a requirement that the alleged wrongdoing should result in a loss to the company and. Hence, an indirect or reflective loss to the shareholders and also that the alleged wrongdoers should have personally gained from their breaches of duty”.

20. Finally, at [25] he concluded:

“It follows, on the authorities as they stand, that financial or other loss to the shareholders, albeit normally of a reflective character, is essential to give a claimant shareholder sufficient interest in the proceedings to make the shareholder an appropriate claimant on behalf of the company, whether he is a member of that company or of its holding company. Equally, the authorities require that, in the absence of actual fraud or an ultra vires act, the wrongdoers should themselves have benefitted from the wrongdoing. The significance of this requirement is that their breach of duty cannot be ratified by a majority vote which depends on the votes of
the wrongdoers. It is essential to the exception to the rule in Foss v Harbottle that the alleged wrongdoing it incapable of lawful ratification: see Smith v Croft (No 2) [1988] Ch 114.”

21. The case for Mr Harris was that David Richards J. was wrong and contrary to the decisions of Briggs J. in Fort Gillicker and the earlier decision of Megarry V-C in Estmanco (Kilner House) Ltd v Greater London Council [1982] 1 WLR 2. In Estmanco, the GLC owned a block of flats which were sold off on long leases. The shares in the management company, initially owned by the Council, were transferred to the respective purchasers. The company had entered into an agreement with the Council which provided that the Council would use its best endeavours to dispose of the remaining flats on long leases but, on the Council becoming Labour party controlled, it was opposed to the sale of Council owned properties. The directors of the management company brought proceedings against the Council to enforce the agreement but the Council convened a meeting of the company at which it used its majority power to require the directors to discontinue it. One of the purchasers applied to be substituted as claimant. Megarry V-C rejected that it was a suitable case to probe the intricacies of the rule in Foss v Harbottle and its exceptions but found that the fraud exception was wide enough to cover the case and permitted the substitution.

The decision

22. As McCombe L.J. (with whom Christopher Clarke L.J and Jackson LJ agreed) observed in Harris, Estmanco was a “very unusual case”. However, he accepted the submission on behalf of the Designated Members that it was a case where the majority was seeking to use the alleged breach of duty to further its own ends and, in that sense, to gain a personal benefit, albeit political rather than financial and so was allegedly using its majority voting power to commit a fraud on the minority. In short, he was satisfied that it was on all fours with Daniels v Daniels.

23. So far as concerned the Fort Gillicker case, McCombe L.J. rejected the view that it provided Mr Harris with any material assistance. Briggs J. had there been examining the justification for the exceptions to the rule in Foss v Harbottle rather than its boundaries.

24. In short, the Court concluded that the exceptions could not be justified by simple touchstone of “justice” in the particular case and that the extent of the relevant exception to the rule was as stated by David Richards J in Abouraya. Leading Counsel for Mr Harris having accepted that in the case of the Alcon Fee Issue and the Rebate of Minimum Guaranteed Amount Issue that there was no allegation of personal benefit to the Designated Members meant that permission was refused for these claims. On the LMI Fee Issue, the Court found that there was no sufficient averment of benefit to the Designated Members such that the Judge’s
decision to refuse permission was correct. Mr Harris’s appeal was dismissed and the appeal of
the Designated Members was allowed.

**Hong Kong**

25. So far as concerns the position in Hong Kong:

25.1. In the context of a common law derivative action, fraud is not confined to actual fraud – it includes fraud in the wider equitable sense including breach of fiduciary duty - see *Anglo-Eastern (1985) Ltd and another v Karl Knutz and others* [1988] 1 HKLR 322;

25.2. In the recent decision in *Lsi Hsiao Cheng v Wong Shu Wai and others* [2015] HKCFI 1478 it was common ground that a plea that monies wrongly received by a company beneficially owned by the wrongdoer and his wife would be sufficient if personal benefit was required;

25.3. The same case considered *Daniels v Daniels, Abouraya v Sigmund* and other authorities including the critical observations of Joffe on *Abouraya* in *Minority Shareholders: Law, Practice and Procedure 5th ed.* At [2.15(a)] and concluded that it was arguable for the purpose of an application to strike out that, as a matter of Hong Kong law, receipt of personal benefits was not necessary;

25.4. In echo of the exchanges during argument in *Harris*, at [40] the Judge in *Cheng* noted the submission of Counsel that: “It is against common sense that a wrongdoer who is clever in hiding the whereabouts of the company’s property would be in a better position that one who is not so successful in such exercise”.

**Conclusion**

26. The decision in *Harris* provides welcome clarification as to the scope of the fraud exception to the rule in *Foss v Harbottle* and important guidance for those pleading the facts necessary to support a common law derivative claim. Absent actual fraud (“deliberate and dishonest breach of duty”), it is necessary to establish that the majority have acted in breach of duty (fiduciary or otherwise) in a manner which conferred personal benefits on themselves. It was acknowledged in argument before the Court of Appeal that the requirement of “benefit” can throw up “fine” distinctions depending on what precisely the wrongdoers are alleged to have done. Although decided in the different context of section 21(1)(b) Limitation Act 1980, the recent decision of the Court of Appeal in *Burden Holdings (UK) Ltd (In liquidation) v Fielding and Fielding* [2016] EWCA Civ 557 is of interest here. There, an alleged transfer of a share in
breach of fiduciary duty to a company directly or indirectly controlled by the wrongdoer
directors was held to be one to which no limitation period applied, by reason of s.21(1)(b).

27. However, it remains to be seen whether the Hong Kong courts adopt the same view.

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