COMPANIES AND SECURITIES ADVISORY COMMITTEE

REPORT ON

A STATUTORY DERIVATIVE ACTION

JULY 1993

A. BACKGROUND

For many years there has been widespread discontent with the obstacles that confront shareholders in bringing litigation. These obstacles include the following:

- the rule in *Foss v Harbottle*;[1]
- the expense of litigation; and
- difficulties that shareholders frequently face in obtaining information from the company.

There are two aspects to the rule in *Foss v Harbottle*. These are identified in the well-known judgment of Jenkins L J in *Edwards v Halliwell*[2]:

> "First, the proper plaintiff in an action in respect of a wrong alleged to be done to a company or association of persons is prima facie the company or association of persons itself. Secondly, where the alleged wrong is a transaction which might be made binding on the company or association and on all its members by a simple majority of the members, no individual member of the company is allowed to maintain an action in respect of that matter for the simple reason that, if a mere majority of the members of the company or association is in favour of what has been done then *cadit quaestio*".

There are advantages to the rule in *Foss v Harbottle*. According to Farrar, it is more convenient that the company should sue rather than to have any number of suits commenced and discontinued by individual shareholders. The rule also eliminates vexatious litigation by troublesome minority shareholders.[3] However, the rule has been subject to extensive criticism. The main problem has been that where the directors are the wrongdoers, they may decide not to have the company commence litigation, and therefore avoid liability. Consequently, four exceptions to the rule have been developed. These are where the transaction:

- is ultra vires or illegal;
- requires the sanction of a special majority;
- infringes the personal rights of a shareholder; or

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1 (1843) 2 Hare 461, 67 ER 189.
2 [1950] 2 All ER 1064 at 1066.
3 Farrar et al, *Farrar's Company Law* (2nd ed 1988), p 383.

- amounts to a fraud on the minority.

It can be seen that some of these are not so much exceptions as instances where the rule does not apply.

Despite the existence of these exceptions there have been continued calls for reform of this area of law on the basis that the exceptions are too narrow and hinder shareholder litigation. Some indication of the widespread nature of the calls for reform can be seen from the following:

1. The CSLRC Report stated that:

> "The proposition upon which Discussion Paper No 11 was based is that, due to the application of [the rule in *Foss v Harbottle*] and notwithstanding the recognition of a number of exceptions, existing law is inadequate to provide a method of enforcement where a company improperly refuses or fails to pursue a cause of action. There was no dissent amongst respondents to the Discussion Paper as to the accuracy of that proposition".[4]

2. The Senate Standing Committee on Legal and Constitutional Affairs (the Senate Committee) stated in its Report *Company Directors' Duties* (1989) that:

> "Despite a recent tendency towards relaxation, the narrow rules of standing make it difficult for a shareholder to take legal action. Moreover, the cost of litigation is a formidable barrier to shareholders contemplating action".[5]

3. The Australian Securities Commission, in its submission to the inquiry by the House of Representatives Standing Committee on Legal and Constitutional Affairs into Corporate Practices and the Rights of Shareholders (the Lavarch Committee) stated that:

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4 CSLRC, *Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action*, Report No 12 (1990), para 6.

5 Senate Standing Committee on Legal and Constitutional Affairs, *Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors* (1989), para 11.29.

> "The possibility of taking defaulting directors and others to Court is vital if shareholders are to be seen as a force to be reckoned with".[6]

The Commission also stated:

> "The ASC strongly supports the Companies and Securities Law Review Committee's recommendations for a statutory derivative action to be widely available".[7]

4. The Companies Bill 1992, currently before the New Zealand Parliament will, if enacted, introduce a statutory derivative action.[8] Under the Bill, the court must take into account various factors in considering an application to bring a derivative action, being

- the likelihood of the proceedings succeeding
- the costs of the proceedings in relation to the likely relief
- any action already taken by the company or related company to obtain relief and
- the interests of the company or related company in the proceedings being commenced, continued, defended or discontinued.

5. The Legal Committee has also noted the recommendation of the Lavarch Committee supporting a statutory derivative action.[9]

6. In addition to the above views expressed in the CSLRC, Senate and Lavarch Committee Reports, there are many company law commentators who endorse the need for reform in this area of the law. For instance:

> "It has been extremely difficult, if not impossible, to bring an action against a miscreant director if the wrong complained of can be classified

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6 Australian Securities Commission, *Submission to the Inquiry by the House of Representatives Standing Committee on Legal and Constitutional Affairs into Corporate Practices and the Rights of Shareholders* (1990), p 122.

7 Ibid, p 128.

8 The *Companies Bill* (1992) (New Zealand) cl 139-142. This Bill is based on the New Zealand Law Commission Report No 9 *Company Law Reform and Restatement* (1989).

9 Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (1991), paras 6.3.1-6.3.33; Recommendation 26.

> as a wrong to the corporation instead of, or in addition to, a personal wrong to the shareholder".[10]
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> "Despite judicial innovations, under the present law there are just too many hurdles to jump before bringing derivative suits. You must identify the wrongdoers, gather sufficient information, show there is fraud, prove the alleged wrongdoers control the company, and discover whether or not the acts complained of are ratifiable by a majority at a general meeting. Then you must somehow fund the action. In the face of all this and more, genuine grievances go unremedied."[11]

B. THE GOALS OF LAW REFORM

A key objective of shareholder litigation is that of achieving managerial accountability.

> "Shareholders derivative suits are a vital support to .... the free enterprise economy. .... Derivative suits are the major policemen of managerial integrity, ".[12]

Consequently, shareholder litigation can be seen as a mechanism for maintaining investor confidence.

Another advantage of shareholder litigation is that, in many respects, private enforcement accomplished via shareholder litigation may be preferable to public enforcement. Thus, the ASC has stated that it believes that the implementation of a statutory derivative action "would add greatly to the depth of enforcement action in the area of directors' duties and corporate practices".[13] The ASC may also assist private litigants by providing them with relevant information acquired during Commission investigations.[14] In addition, the American Law Institute has examined the role that statutory derivative actions play in the United States and has stated that "the substitution of public enforcement through state-initiated actions for a private

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10 M. A. Maloney, "Whither the Statutory Derivative Action?" (1986) 64 *Canadian Bar Review* 309 at 311.

11 J Corkery, *Directors' Powers and Duties* (1987) at 172.

12 A. F. Conard, quoted in Maloney, supra note 10 at 315.

13 ASC, supra note 6, at 128.

14 ASC Act ss 25, 37(4), (7); ASC Policy Statement 17.

action would both be very costly and probably logistically non-feasible".[15] The Institute has also referred to the fact that:

> "... when the legal system assigns a substantial enforcement role to private litigation, there is less need to rely on public agencies, and in turn the tendency of such public agencies to expand their jurisdiction is less likely to produce excessive bureaucratic regulation of private enterprise. In addition, absent private enforcement, the state holds a monopoly on the access to remedies, and it can determine, sometimes arbitrarily or for political reasons, not to enforce rights or duties it had previously guarded. Thus, private enforcement serves a fail-safe function and ensures greater stability in the application of law."[16]

At the same time however it is clear that management needs to be protected against vexatious and hostile minority shareholders who, when commencing litigation, are not acting in the interests of the company. Therefore, any proposal for law reform in this area must contain mechanisms which operate to prevent needless and harmful shareholder litigation.

C. SHORTCOMINGS OF EXISTING SHAREHOLDER REMEDIES

The need for any statutory derivative action proposal must be assessed in light of existing remedial laws.

Common law derivative actions

A derivative action, whereby one or more shareholders sue in the name of the company, is one method of private enforcement where a company improperly refuses or fails to pursue a cause of action. Often the need arises where a board declines to pursue an action against directors for breach of their common law or statutory fiduciary or other duties. Australian law recognises the right of shareholders to undertake derivative actions on behalf of the company where appropriate:

> "For example where the directors are acting in abuse of their powers by knowingly or recklessly acting contrary to the general law, as a result of which

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15 American Law Institute, *Principles of Corporate Governance and Structure: Restatement and Recommendations*, Tentative Draft No 1 (1982) at 232.

16 Ibid, pp 220-221.

> the company sustains loss, this breach of the directors' fiduciary duty could well give rise to a derivative action. In such an action the individual shareholder would seek to bring the action the company has vested in it against the directors for the damages suffered to the company for breach of the fiduciary duty. ..... In such a case, the company is the proper party, and if the action is successful judgment is given in favour of the company": *Australian Agricultural Co v Oatmont Pty Ltd* (1992) 8 ACSR 255 at 266.[17]

Existing case law gives some comfort, at least to successful plaintiffs, that their costs will be paid, though comprehensive indemnity rules have not been developed.[18] Moreover, a derivative action is not available to an equitable owner of shares,[19] nor may it lie where there is mere negligence by the directors.[20]

Undoubtedly the greatest legal difficulty with the existing derivative remedy is the law of shareholder ratification. Shareholders may by lawful ratification preclude or terminate a derivative suit. however the distinction in law between ratifiable and non-ratifiable matters is unclear and uncertain.[21] A statutory derivative action may be one means of by-passing much of this attendant complexity and imprecision.

Oppression: s 260

Section 260 is undoubtedly a powerful remedial tool. In *Re Bodaibo Pty Ltd* (1992) 6 ACSR 509 at 515, Vincent J of the Victorian Supreme Court commented that

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17 See generally, Ford and Austin: *Ford's Principles of Corporations Law* 6th Edition (Butterworths) 1992, para [1727] ff. In *Shears v Chisholm* (1992) 9 ACSR 691 at 789-92, the court discussed the exceptions to the proper plaintiff rule in *Foss v Harbottle*, including the common law derivative remedy.

18 *Wallersteiner v Moir (No2)* [1975] QB 373; *Smith v Croft (No1)* [1986] 1 All ER 551; *Smith v Croft (No2)* [1988] Ch 114; *Watts v Midland Bank plc* [1986] BCLC 15.

19 *Fulloon v Radley* (1991) 9 ACLR 1434.

20 In *Pavlides v Jensen* [1956] Ch 565, the court held that mere negligence or incompetence on the part of controlling directors does not justify a derivative suit. It is necessary to show that the directors, or persons connected with them, have derived benefits from the negligence of directors: *Daniels v Daniels* [1978] 2 WLR 73.

21 See further S Fridman: *Ratification of Directors' Breaches* (1992) 10 C&SLJ 252; K Yeung: *Disentangling the Tangled Skein: The Ratification of Directors' Actions* (1992) 66 ALJ 343. The complexities of ratification are further exemplified in *Hannes v MJH Pty Ltd* (1992) 7 ACSR 8, where the court attempted to differentiate between breaches which could be ratified by the entire body of shareholders, those which could be ratified by a simple majority, and those which were incapable of ratification. Another limitation of shareholder ratification is that while, as a general principle, shareholders may vote in a self-interested manner at general meetings, a resolution may be ineffective if it constitutes minority oppression: *Nicron Resources Ltd v Catto* (1992) 8 ACSR 219 at 237, applying *Peters' American Delicacy Co Ltd v Heath* (1939) 61 CLR 457 at 504.

> "the provisions contained in s 260 have been drafted in wide form in order to accommodate the almost limitless varieties of oppressive behaviour possible and the need for the court to have an appropriately extensive discretionary power to effect justice in the particular circumstances of individual cases".

Other cases, including *Jenkins v Enterprise Gold Mines NL* (1992) 6 ACSR 539, reinforce the principle that the provision covers conduct which is unjustly detrimental to any member of the company whatever form it takes and whether it adversely affects all members alike or is discriminatory. Furthermore it is not necessary for a complainant to point to any actual irregularity or to the invasion of his legal rights or to a lack of probity or want of good faith towards him on the part of those in control of the company.[22] Also, an applicant may bring proceedings for conduct that occurred before he became a member. Current membership is enough to give standing.[23]

Section 260 provides for derivative proceedings. A member may seek relief where the affairs of the company are being conducted "in a manner that is contrary to the interests of the members as a whole". Where the court forms this opinion, it may make an order under s 260(2)(g) "directing the company to institute, prosecute, defend or discontinue specified proceedings, or authorising a member or members of the company to institute, prosecute, defend or discontinue specified proceedings in the name and on behalf of the company".

The CSLRC adopted a particularly conservative approach to the reach of s 260 generally and s 260(2)(g), concluding that "the Committee is unable to be confident that [s 260] could, even on a wide interpretation, provide for anyone other than a company to seek to pursue a cause of action belonging to it where the company itself improperly refuses or fails to take action".[24] One commentator has described this as "a surprisingly narrow view of the scope of the provisions for by-passing the rule in *Foss v Harbottle"*.[25] On the Committee's own admission: "If it [the ambit of s 260 and s 260(2)(g)] were otherwise, there would have not been a need for consideration of the introduction of an Ontario-type derivative action provision".[26] The short answer may be that, given the dearth of relevant case law on s 260(2)(g), nothing decisive can be said on the ambit and possible limitations of this provision.

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22 *Re Quest Exploration Pty Ltd* (1992) 6 ACSR 659.

23 *Re Spargos Mining NL* (1990) 3 ACSR 1.

24 CSLRC Report No 12 para [238] - [253]. The quotation comes from para [249].

25 J Hill "Protecting minority shareholders and reasonable expectations" (1992) 10 C&SLJ 86 at 102.

26 CSLRC Report No 12 para [249].

Section 260 has other shortcomings as a derivative remedy.

- Applicants are limited to registered shareholders and the ASC. Directors and officers (unless also shareholders) and beneficial shareholders lack standing to take oppression proceedings.[27] The ASC has proposed that the section be extended to include any person with a presently exercisable and unconditional right to registration as a member.[28]

- The meaning of the phrase "contrary to the interests of the members as a whole" is uncertain. It is not clear whether this term is wide enough to encompass all matters which could constitute damage or a breach of duty to, or a cause of action vesting in, the company. Some cases hold that the various tests of oppression laid down within the section should be viewed as a composite whole.[29] This interpretation might restrict the width of this phrase. The other, and it is suggested preferable, view is that the reference to conduct "contrary to the interests of the members of the company as a whole" is a discrete test which may broaden even further the ambit of the section.[30] However the matter is not settled.

- Section 260 does not deal explicitly with costs, possibly the greatest inhibitor to shareholder litigation.

- The standard of proof required of shareholders is onerous. The ASC has argued that to obtain the right to proceed under s 260(2)(g) the complainant shareholder must virtually prove his entire case.[31]

- Paragraph 260(2)(g) gives no indication of the proper role, in this context, of the general meeting.

More generally, s 260(2)(g) does not deal adequately with the issues arising from derivative actions and which, from overseas experience, may require legislative or judicial guidance including:

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27 *Niord Pty Ltd v Adelaide Petroleum NL* (1990) 2 ACSR 347; *Panfida Ltd v Hartogen Energy Ltd* (1988) 14 ACLR 601.

28 ASC supra, note 6, at 123.

29 *Morgan v 45 Flers Avenue Pty Ltd* (1986) 10 ACLR 692 at 704.

30 *Re Spargos Mining NL* (1990) 3 ACSR 1 at 42-44.

31 ASC supra, note 6, at 126, citing *Re Overton Holdings Pty Ltd* (1984) 9 ACLR 225.

- the appropriate demand and response procedure
- the status of shareholders' resolutions
- the powers of the court to distribute the proceeds of the action
- the principles governing liability to costs, and indemnification rights.

Section 1324

Under this section, any person "whose interests have been, are or would be affected" by a contravention (or associated behaviour) of the Corporations Law may seek an injunction and/or damages. Case law confirms that the test of eligibility to seek a remedy is substantially the same as the test of locus standi under the general law.[32] Nevertheless the section may not fully resolve the difficulties facing shareholders wishing to pursue remedies available to the company. The ASC, in its submission to the Lavarch Committee, was concerned that the section addresses so many different situations that a court might not discern a sufficient intention to abolish the limitations on standing arising from the rule in *Foss v Harbottle.*[33] Furthermore, the section applies only to Corporations Law contraventions; it would have no application, for instance, where shareholders sought a derivative action merely to enforce private contractual rights of the company. Also it is uncertain whether damages can be obtained unless an injunction is sought.[34] Finally there is no protection in the provision against costs, and an applicant other than the ASC may be required to give an undertaking as to damages.

ASC Derivative Actions

The ASC, during or in consequence of an investigation, may exercise its powers under the ASC Act s 50 to litigate on behalf of the company, with or without its consent, or make an application under s 260.[35] ASC-initiated civil proceedings may well complement, but are not intended to substitute for, private enforcement nor could they realistically do so. Also, to the extent that costs are borne by the ASC, the number of possible actions will be limited.

Class Actions

Representative class actions may be commenced in the Federal Court.[36] However this procedure is only available to persons who have proper standing to bring an action. It

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32 *Broken Hill Pty Co Ltd v Bell Resources Ltd* (1984) 8 ACLR 609; *QIW Retailers Ltd v Davids Holdings Pty Ltd* (1992) 8 ACSR 333.

33 ASC supra, note 6, at 125.

34 *Dempster v Biala Pty Ltd* (1989) 15 ACLR 191.

35 Refer ASC Policy Statement 4.

36 Federal Court of Australia Act (Cth) 1976 Part IVA; Federal Court Rules Order 73.

does not overcome the `proper plaintiff' problems arising from the rule in *Foss v Harbottle* which deny shareholders standing to act in the name of the company.

D. RECOMMENDATIONS OF THE CSLRC

The CSLRC Report made the following recommendations.

"Proposed Legislative Provision for Derivative Procedure

The Committee recommends enactment in the Companies Act after section 320 of that Act [section 260 of the Corporations Law] of a provision the substance of which accords with the following draft -

[260A]. (1) An application to the Court for an order under this section in relation to a corporation may be made by -

(a) any member, or former member, of the corporation or of a related corporation;
(b) any director or officer, or former director or officer, of the corporation or of a related corporation;
(c) any creditor of the corporation or of a related corporation;
(d) any holder of an option to take up unissued shares in the corporation or a related corporation;
(e) the Commission; or
(f) any other person who, in the opinion of the Court, is a proper person to make an application under this section.

(2) An application may be made to the Court for leave to take proceedings in the name and on behalf of a corporation.

(3) In this section "take proceedings" means -
(a) to initiate proceedings whether by way of issue of writ of summons or otherwise;
(b) to prosecute diligently any proceedings;
(c) to defend diligently any proceedings;
(d) to withdraw, discontinue or settle any proceedings;
(e) to intervene in any proceedings; or
(f) to control or influence the conduct of any proceedings.

(4) No application may be made under sub-section (2) unless the applicant has given 14 days notice to the corporation of the applicant's intention to apply to the Court or the applicant satisfies the Court that giving such notice is not practicable or expedient, in which case the Court may make any interim order it considers appropriate pending the giving of such notice to the corporation as the Court considers necessary.

(5) On an application under sub-section (2) the court shall not grant leave to take proceedings unless it is satisfied that -

(a) it is probable that the corporation will not take proceedings;

(b) the applicant is acting in good faith with a view to the best interests of the corporation; and

(c) it appears to be in the best interests of the corporation that proceedings be taken.

(6) In determining whether the requirements of sub-section (5) have been satisfied, the Court may have regard to any consideration by, or resolution of, any general meeting of the corporation or of a related corporation concerning the matters disclosed to the Court on the hearing of the application.

(7) In connection with an application made under sub-section (2) or proceedings taken pursuant to leave granted under sub-section (2), the Court may at any time and subject to any conditions it considers appropriate make -

(a) an order authorising the applicant or any other person to control the conduct of the proceedings;

(b) an order giving directions for the conduct of the proceedings including an order directing the corporation or a related corporation to do, or refrain from doing, anything in order that the proceedings are conducted properly;

(c) an order directing the corporation or a related corporation to indemnify the applicant for reasonable legal costs and disbursements incurred by the applicant in relation to the application whether or not the application is successful;

(d) an order directing the corporation or a related corporation to pay as directed by the applicant, or any other person for the time being having the conduct of the proceedings, the reasonable legal costs and disbursements incurred by the applicant or other person in relation to the proceedings;

(e) an order directing the corporation or a related corporation to deposit with the Court such sum as the Court considers necessary for the purposes of paragraphs (c) and (d), including an order as to the withdrawal or application of such sum;

(f) an order directing that any amount ordered to be paid to the corporation by any party to the proceedings be paid, in whole or in part, to -

(i) any member, or former member, of the corporation or of a related corporation;

(ii) any creditor, or former creditor, of the corporation or of a related corporation; or

(iii) any other person or class of person;

but before making any such order the Court shall consider the interests of the creditors of the corporation or of a related corporation; or

(g) any other order that the Court considers appropriate.

(8) No indemnity granted or order as to costs made under paragraph (c) or (d) of sub-section (7) shall be retrospectively withdrawn or set aside or retrospectively varied in a manner contrary to the interests of the person in whose favour the indemnity was granted or order made unless

the Court is satisfied that the conduct of that person in relation to the matters for which the indemnity was granted or order made was such as to constitute an abuse of the process of the Court.

(9) Any proceedings taken pursuant to leave granted under sub-section (2) shall not be stayed, discontinued, settled or dismissed without the leave of the Court given on such terms as the Court considers appropriate and if the Court considers that the interests of any person may be substantially affected by an order for such stay, discontinuance, settlement or dismissal, the Court, before making that order, may order any party to the application or proceedings taken to give notice, in such terms as the Court considers appropriate, to any such person.

(10) An applicant is not required to give security for costs in relation to any application made under sub-section (2) or proceedings taken pursuant to leave granted under sub-section (2)."

The form of the statutory derivative action proposed by the CSLRC is based upon the Ontario Business Corporations Act, 1982.

E. ISSUES FOR CONSIDERATION

1. Adoption in Principle of the CSLRC Recommendations

The Legal Committee believes that, subject to some important modifications, the recommendations of the CSLRC should be adopted and a statutory derivative action introduced. The Legal Committee notes the statement in the CSLRC Report that "there was broad support amongst respondents for the introduction into Australian law of a similar provision".[37]

If a decision in principle is made to adopt a statutory derivative action there are a number of further issues that require consideration. Each of these is now identified. To the extent that some possible shortcomings in the draft statute of the CSLRC are identified, it should be noted that the CSLRC itself stated that it "does not purport to set out the final form of the recommended legislation but rather to provide a possible approach to drafting".[38]

2. The Interaction of the Proposed Statutory Derivative Action and the Common Law

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37 CSLRC Report No 12 para 9.

38 Ibid, para 22.

It is unclear from the CSLRC Report whether it is intended that the proposed statutory derivative action forms a code such that common law derivative rights are abolished. In other words, will it still be possible for a shareholder to bring a derivative action under one of the exceptions to the rule in *Foss v Harbottle* following the enactment of the statutory action? The Legal Committee believes that it is instructive to look at what has occurred in Canada in this respect. This issue was not addressed in the Canadian legislation. However, courts have subsequently held that although the legislation does not expressly prohibit the bringing of a common law derivative action under an exception to *Foss v Harbottle*, such an action is prohibited by necessary implication.[39] One commentator, writing prior to these Canadian decisions, stated:

> "On balance, however it ... seems clear that the section was intended to be a code for the expansion and control of the derivative suit. ... It would only lead to confusion to allow both common law and statutory actions. A more orderly development of the law would result from one point of access to a derivative action and would allow for a body of experience and precedent to be built up to guide shareholders." [40]

Under the New Zealand Bill, the common law derivative remedy is to be abolished.[41]

The Legal Committee therefore recommends that common law derivative rights be abolished. however the common law personal action exception to *Foss v Harbottle* should remain, as it is not based on the shareholder standing in the shoes of the company. The New Zealand Bill makes separate provision for actions by shareholders to enforce their personal rights.[42] Likewise the special majorities requirements in the Corporations Law would remain.

3. The Definition of Applicant

The CSLRC has recommended that a broad range of applicants be entitled to apply to the court for leave to commence a derivative action. These include any member or former member of the corporation or a related corporation, any current or former director or officer, any creditor, any holder of an option to take up unissued shares, and the Commission. In its submission to the Lavarch Committee, the ASC stated

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39 *Farnham v Fingold* (1973) 33 D.L.R. (3d) 156; *Shield Development Company Ltd v Snyder* (1976) 3 W.W.R. 44.

40 S. Beck, "The Shareholders' Derivative Action" (1974) 52 *Canadian Bar Review* 159, p 207.

41 Companies Bill (1992) (New Zealand) cl 139(6).

42 Companies Bill (1992) (New Zealand) cl 143ff.

that the definition of applicant should be broadened to include any person with a presently exercisable and unconditional right to registration as a shareholder. The ASC referred specifically to a purchaser of shares who is not yet on the register of members of the company. The ASC noted several cases which have held that such a person lacks standing to commence various proceedings and stated that, in its opinionh "It is not desirable that the availability of remedies should depend on whether or not the share registration process has been completed".[43] It is to be noted that the Canadian legislation includes a beneficial owner of a security in its equivalent definition. This is also common under the statutory derivative action provisions enacted by States in the United States.[44]

The Legal Committee is of the view that the definition of applicant should not be defined too broadly as this could lead to abuse. It particularly notes and supports the reservations expressed in the Lavarch Committee Report Dissent (p 216) concerning whether former shareholders and officers should have standing to bring a statutory derivative action. Consequently, the Legal Committee believes that the class of applicants should be limited to the Commission, current members, directors and other officers (as defined in s 232(1)) of the company itself, and persons presently entitled to be registered as members. Creditors, former corporate officers and members, option holders or current or former officers or creditors of related companies would be excluded. In this respect, the Legal Committee takes a more restrictive approach to the definition of applicant than the CSRLC or the Lavarch Committee Report (Recommendation 26).

4. The Requirement of Notice

Proposed s 260A(4) provides that no application for leave may be made unless the applicant has given 14 days notice to the corporation of the applicant's intention to apply to the court or the applicant satisfies the court that giving such notice is not practicable or expedient, in which case the court may make any interim order it considers appropriate pending the giving of such notice to the corporation as the court considers necessary.

There are two issues that arise from this sub-section. First, it is clearly necessary for the court to have the power to hear an application without the required 14 days notice and sub-section (4) allows for this. It allows for an ex parte hearing where there is a

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43 ASC supra, note 6, at 123.

44 American Law Institute, supra, note 15, at 263.

need for urgent litigation. It is worth noting that this provision was not originally contained in the Canadian legislation but was subsequently inserted following the decision of a Canadian Court disallowing ex parte proceedings because of the requirement of 14 days notice by the applicant to the corporation.[45]

The second issue is whether the legislation should identify what is meant by "notice to the corporation of the applicant's intention to apply to the Court". There is the possibility that, as presently drafted, the first time the company may hear the specifics of a complaint would be at the hearing to determine the application for leave. This is because the section would appear to be satisfied by the applicant simply giving notice of his or her intention to apply to the court for leave, without necessarily identifying the complaint which forms the substance of the application.

If this occurs, it will not be satisfactory. The purpose of the 14 days notice is to allow the corporation to address the complaint or concerns of the applicant prior to the hearing date, should this be possible. In fact, because under the proposed statute the court cannot grant leave unless it is satisfied that, among other things, it is probable that the corporation will not take proceedings, clearly the corporation needs to have been informed of the complaint made by the applicant so that a response can be formed prior to the hearing date.

Consequently, the Legal Committee recommends that sub-section (4) provide that the applicant must give 14 days notice to the corporation not only of the applicant's intention to apply to the court for leave but also of the applicant's complaint.

5. The Criteria for the Court Granting Leave

Proposed s 260A(5) provides that on an application, the court shall not grant leave to take proceedings unless it is satisfied that:

- it is probable that the corporation will not take proceedings;
- the applicant is acting in good faith with a view to the best interests of the corporation; and
- it appears to be in the best interests of the corporation that proceedings be taken.

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45 T Hadden, R Forbes and R Simmonds, *Canadian Business Organization Law* (1984), p 270.

The Legal Committee recommends that a fourth criterion be added - the need to show a "serious question" to be tried.

In its Report, the CSLRC discussed what should be the appropriate standard of proof with respect to the criteria for granting leave. It believed that the appropriate standard should not exceed that of establishing a prima facie case.

> "It seems to the Committee, insofar as the application for leave is concerned, to require the establishment of anything greater than a prima facie case carries the risk that the hearing of an application could evolve into a trial of the issues, a result which it is considered would be contrary to the purposes for which the provisions of a means to undertake derivative action is contemplated." [46]

The issue for consideration is whether the legislation should provide more guidance to courts as to the appropriate criteria for granting leave. Otherwise the reference in sub-section (5) to the court being satisfied as to certain requirements may lead to a trial of the issues as stated by the CSLRC. More definite criteria would also prevent the evolution of a more rigorous standard of proof which would undercut the effectiveness of the proposed reform.

It has been said that to require the applicant to establish a prima facie case may in fact lead to a trial of the issues. In H*urley v BGH Nominees Pty Ltd*[47] King CJ stated that "In many cases a hearing to determine whether there was a prima facie case would be almost as long as a full trial and a good deal less satisfactory". One commentator[48] has stated that an applicant in a derivative action should not be required to demonstrate that it is more likely than not that he will succeed in the final trial and has suggested, relying on overseas cases,[49] that the applicant should only have to demonstrate that he has an arguable, or a reasonable, case.

The Legal Committee supports a "serious question to be tried" test rather than a prima facie case test. This `serious question' formula is a familiar and accepted test employed by the courts in the context of interim injunction applications. It could, without difficulty of interpretation, be applied to statutory derivative actions.

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46 CSLRC Report No 12 para 106.

47 (1982) 6 ACLR 791 at 794.

48 Corkery, supra note 11, at 170-171.

49 *Bellman, Bell-Irving v Western Approaches Ltd* (1981) 33 BCLC 45 and *Wallersteiner v Moir (No2)* [1975] 2 WLR 389.

6. The Applicant's Costs

The Legal Committee believes that the proposed legislation must contain some provision for the company to pay the applicant's costs. It therefore endorses the general approach adopted in proposed s 260A(7).

To avoid abuse of the procedure, the draft legislation should also contain a general discretionary provision empowering the court to direct an applicant to pay his or her own costs or to rescind or vary any prior order regarding the payment of an applicant's costs by the company.

7. The Defendant's Costs

The Legal Committee endorses the recommendation of the Lavarch Committee that:

> ".... any present or former director or officer who is the defendant in proceedings for which leave was granted shall be entitled to financial assistance from the company in defending such proceedings on the same basis as that provided by the company to the applicant. If no assistance is provided by the company to the applicant, then none would be provided to the defendant, officer or director. Any such assistance is to be regarded as an interest free unsecured loan (permission for which is to be recognised by an amendment to section 234)".[50]

Also, to protect a company against unmeritorious actions commenced on its behalf, the court should have a general discretionary power to require an applicant to meet all or some of the defendant's costs.

8. Security for Costs

The Legal Committee disagrees with proposed s 260A(10) which provides that an applicant is not required to give security for costs. The Legal Committee believes that, in order to provide appropriate controls against possible abuse, the present law for security for costs should apply to statutory derivative actions, with two significant amendments. First, the court should be empowered to make security for costs orders against the applicant and the company. Second, these orders may require that the

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50 Ibid.

party shall provide the security not merely that proceedings shall be stayed until the security is given, as provided under s 1335 of the Corporations Law. Without this additional power, a company might attempt to frustrate the litigation by failing to provide the security.

9. Payments

The Legal Committee disagrees with proposed s 260A(7)(f) that the court be empowered to order payment to a third party. While noting the reasoning in the CSLRC Report para [146] - [150], the Legal Committee believes that upon a derivative action, brought on behalf of the company, being successful, any compensation or damages should be paid to the company.

10. Case Management

The Legal Committee recommends that the court should be given the power to authorise an independent body, for example the company auditor, to investigate a complaint to see if it constitutes a good cause of action. This power would be in addition to s 319 of the Corporations Law.

The court appointed investigator would be asked to provide an independent analysis of the strength of the applicant's case. The court should have the power to make an order authorising a registered company auditor to inspect the books of the company and to report on any other matter pertaining to the financial affairs of the company, and report its findings to the court for the purposes of determining the merits of a proposed action. The company would be required to give all necessary information to the auditor to assist his or her investigation. This would contrast with s 319 as the auditor would be asked to form a judgment and report back to the court on the merits of commencing a proceeding.

As part of its case management the court should have an absolute discretion in respect of costs to be paid by the company, or an applicant, for example, an explicit power to award costs or an order against the applicant to give security for costs, at any time during the proceeding. The legislation might state that "nothing shall derogate from the court's absolute discretion to award costs" in these proceedings. This discretion would give the court the opportunity to regularly review the merits of the proceedings, the motives of the applicant, and the company's resources to meet these costs. The Legal Committee endorses the recommendation of the Lavarch Committee that:

> ".... in situations where the derivative action is being funded by the company, the Court shall be obliged to be active in case-management by requiring regular

reports on steps taken and funds expended on both sides so as to ensure that the shareholders' funds are being expended in a reasonable manner".[51]

11. The Role of the General Meeting

Proposed s 260A(6) provides that in determining whether the requirements of sub-section (5) have been satisfied, the court may have regard to any consideration by, or resolution of, any general meeting of the corporation or of a related corporation concerning the matters disclosed to the court on the hearing of the application.

If this provision (which is not in the Canadian legislation) results in a practice by courts of referring matters to the general meeting, this has the potential to completely negate the reforms being proposed. One of the elements of the rule in *Foss v Harbottle* is that an individual shareholder is not permitted to commence an action, say, breach of duty by a director, if a majority of the shareholders can ratify that breach. This has led to a host of difficulties which would undoubtedly continue if the practice of referring matters to the general meeting was adopted. A few of these difficulties can be mentioned.

1. A troubling aspect is the possibility that a wrongdoer director may be entitled to vote, as a shareholder, to ratify his or her own misconduct. One commentator has stated that in this area of the law, "ratification does not mean ratification by an independent majority".[52]

2. The law remains uncertain as to what breaches may be ratified by a majority of shareholders. Commentators have not been able to satisfactorily distinguish between cases such as *Regal (Hastings) Ltd v Gulliver*[53] (where it was suggested that shareholders could ratify the breach of duty by the directors) and *Cook v Deeks*[54] (the breach of duty by the directors was held not to be ratifiable). One commentator has referred to "the uncertain boundaries of majority rule" in this area of the law.[55]

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51 Supra, note 9, para 6.3.33.

52 Farrar, supra note 3, p 388, referring to *North-West Transportation Co Ltd and Beatty v Beatty* (1887) 12 App Cas 589.

53 [1942] 1 All E.R. 378.

54 [1916] A.C. 554 (PC).

55 Beck, supra note 40, at 199. See also supra, note 21.

3. There is also the question whether in all cases shareholders will have before them adequate information to accurately decide whether a breach of duty by directors should be ratified. In one case, the court stated:

> "Given that the board were deceived and, at least in part, as a result of that deception viewed [the dissentient director's] conduct in this hostile way, there was in my view no real possibility that the question whether proceedings should be commenced by the company would ever be put to the shareholders in a way which would enable them to exercise a proper judgment as to whether it was in the interests of the company that the litigation should be commenced." [56]

4. Courts have recognised that in some circumstances it is not appropriate for the majority of shareholders to ratify breaches of duty by directors. This is part of the exception to the rule in *Foss v Harbottle* known as "fraud on the minority". However, once again, the law is in an uncertain state in this area. For instance, while negligence on the part of directors is not sufficient to bring the transaction within the fraud on the minority exception,[57] negligence by which the directors profit in some manner may be sufficient to come within that exception.[58] Finally, before a shareholder can come within the fraud on the minority exception to the rule in *Foss v Harbottle*, it must be established that the alleged wrongdoers are in control of the company. It is unclear under the established cases whether courts will recognise de facto control or whether numerical control must be established.[59] Because in some circumstances control of a company can be established with well under 50% ownership of the issued shares, it is unsatisfactory for wrongdoer control to be limited to numerical control of more than 50% of the issued shares.

Given this, it would clearly be unsatisfactory if courts adopted the practice of referring matters to the general meeting rather than granting leave for the applicant to commence legal proceedings. In some circumstances, it may be highly desirable for the majority shareholders to express their view on certain matters provided that the court itself is satisfied that the shareholders will be fully informed of all relevant

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56 *Prudential Assurance Co v Newman Industries Ltd* [1980] 3 W.L.R. 543 at 585-86, quoted in D. DeMott, "Shareholder Litigation in Australia and the United States: Common Problems, Uncommon Solutions" (1987) 11 *Sydney Law Review* 258, p 274.

57 *Pavlides v Jensen* [1956] Ch 565.

58 *Daniels v Daniels* [1978] Ch 406.

59 Farrar, supra note 3, at 389.

matters and that only the independent shareholders will vote. In other circumstances, it will be preferable for the applicant to be permitted to commence litigation. Clearly, this is the intention of the proposed provision. The proposed section, along with the statutory oppression remedy, is premised upon the fact that in some circumstances judicial action is preferable to action by the shareholders. As one commentator has said ... it would be misguided to consider that judicial non-interference will in all cases be in the interests of the company as a whole".[60] In fact, two other commentators have stated, with respect to the Canadian provision (which, as noted above, provides less scope for shareholder approval than the provision recommended by the CSLRC):

> "The section ... affects ... only derivative actions ... It may ... make proceedings more cumbersome and expensive if the courts adhere to the futility principle of *Foss v Harbottle*. "[61]

> "It can only be hoped that the courts will use the statutory scheme in an enlightened manner to free the minority from the tangles of the rule and not consider themselves constrained by the traditional exceptions. This was clearly the intent of the company law reform committees that recommended statutory solution to the *Foss v Harbottle* problem."[62]

No reason is given in the CSLRC Report why it did not adopt the Canadian provision. Given the problems referred to above, the Legal Committee considers that proposed s 260A(6) should be replaced by a provision (based upon the Canadian law with amendments) in the following terms:

> "An application shall not be stayed or dismissed by reason only that it is shown that an alleged breach of a right or duty owed to the corporation or its subsidiary has been or may be approved by the shareholders of that corporation, but evidence of approval by the shareholders may be taken into account by the Court in hearing an application where the Court is satisfied that such approval by shareholders has been undertaken by independent shareholders fully informed as to all relevant facts".

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60 B.A.K. Rider, "Amiable Lunatics and the Rule in Foss v Harbottle" (1978) 37 *Cambridge Law Journal* 270, p 271.

61 F.H. Buckley, "Ratification and the Derivative Action Under the Ontario Business Corporations Act" (1976) 22 *McGill Law Journal* 167, p 196.

62 Beck, supra note 40, at 198.

12. Corporate Disclosure of Litigation

Canadian law requires the disclosure in the management proxy sent to shareholders in conjunction with the annual meeting of the company, of any action brought or taken under the derivative suit section or the oppression section to which the company is a party.

This provision was not referred to in the CSLRC Report. The Legal Committee suggests that, because corporate funds may be used to pay the costs of an applicant, consideration should be given to its adoption in Australian law so that this information should be disclosed in the annual reports of companies.

13. Access to Company Records

Section 319 of the Corporations Law enables a member to apply to the court for an order authorising a registered company auditor or a duly qualified legal practitioner acting on behalf of the member to inspect the books of the company. The CSLRC has recommended that this section be widened to enable an application to be made not only by a member but also by any other person who, under the Committee's recommendations, would be able to apply for leave to bring a statutory derivative action. In its Report, the CSLRC states that respondents to the Discussion Paper generally agreed with the idea that the efficacy of a derivative action may be lessened if there is undue restriction on access to information.[63] The recommendations made by the CSRLC are as follows:

" (a) that section 319 of the Corporations Law be amended so that any of the persons who, under the Committee's recommendations, could apply for leave to bring derivative proceedings, would be eligible to apply under section 319 but any such persons, other than members, should be required to satisfy the Court that the predominant reason for the application is their reasonable apprehension that the company has a right of action which will not be vindicated unless they act on the company's behalf by applying to bring derivative proceedings;

(b) that section 319 be amended so that, in addition to registered company auditors and duly qualified legal practitioners, an inspection of the books of a company can also be made by any other person who in the opinion of the Court is a proper person to undertake the inspection in respect of which an application has been made;

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63 CSRLC Report No 12, para 224.

(c) that section 319 be amended so that it would expressly provide that the Court's discretion extends to authorising inspection of the records of boards of directors and of any person to whom the board delegates a function of the board; and

(d) that section 319 be amended so that it would expressly provide that the Court's discretion extends to authorising inspection of the records of any corporation which is related to the company in respect of which the applicant is a member, former member, director, officer, former director, former officer, creditor or option-holder."

The Legal Committee recommends a narrower amendment to s 319. Under (a) and (d) above, only those persons who are within the class of applicants entitled to bring derivative proceedings under the recommendations of the Legal Committee (see Part E: Issue 3: **The Definition of Applicant**) should also be eligible to apply under s 319.