COMPANIES
AND
SECURITIES
LAW REVIEW COMMITTEE

ENFORCEMENT OF THE DUTIES OF DIRECTORS AND OFFICERS OF A COMPANY BY MEANS OF A STATUTORY DERIVATIVE ACTION

REPORT NO. 12

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REPORT OF THE COMPANIES AND SECURITIES LAW REVIEW COMMITTEE ON ENFORCEMENT OF THE DUTIES OF DIRECTORS AND OFFICERS OF A COMPANY BY MEANS OF A STATUTORY DERIVATIVE ACTION

TO: The Ministerial Council for Companies and Securities

INTRODUCTION

Previous Reports of the Committee

The CSLRC presents to the Ministerial council its Report on the enforcement of the duties of directors and officers of a company by means of a statutory derivative action. This is the Twelfth Report of the Committee, the others

* Report on the Take-over Threshold (November 1984)

* Report on Partial Take-over Bids (August 1985)

* Report on Forms of Legal Organisation for Small Business Enterprises (September 1985)

* Report on the Civil Liability of Company Auditors (September 1986)

* Report on the Issue of Shares for Non-Cash Consideration and Treatment of Share Premiums (September 1986)

* Report on a Company's Purchase of its own Shares (September 1987)

* Report on Prescribed Interests (May 1988)

* Report on Nominee Directors and Alternate Directors (March 1989)

* Report on Director's Statutory Duty to Disclose Interest and Loans to Directors (November 1989)

* Report on Indemnification, Relief and Insurance in relation to Directors and Officers (May 1990)

* Report on Shares of No Par Value and Partly-Paid Shares (November 1990)

Term of Reference

The Ministerial Council for Companies and Securities referred to the Committee "for inquiry and review the directors and officers of companies:

(a) standards relating to their conduct and performance...

(b) .....; and

(c) any related matters."

Background: Discussion Paper No. 11

In July 1990 the Committee published Discussion Paper No. 11:" Enforcement of the Duties of Directors and Officers of a Company by means of a Statutory Derivative Action".

A list of respondents to the Discussion Paper is in Appendix 1. The Committee wishes to acknowledge the assistance provided by those respondents in the preparation of this Report.

Final Report of the Committee

In its Report No. 10 on indemnification, relief and insurance in relation to directors and officers the Committee noted that, subject to time being available, it intended to produce a report in relation to the methods of enforcement of the duties of directors and officers which are available to mere s of a company and others. The uncertainty there noted as to the future of the Committee is no longer evident; CSLRC is due to cease operating on 31 December 1990. This is, therefore, the final Report of the Committee.

Professor H A J Ford

The members of the Committee wish to acknowledge publicly the outstanding and major contribution made to the work of the Committee by its Chairman, Professor Harold Ford. Professor Ford has throughout the seven years of the life of the Committee by his industry and intellectual leadership been the driving force in the achievements of the Committee. It is a fitting testament to the Chairman that the Committee has rightly become known as "the Ford Committee".

CONTROL OVER INITIATION OF PROCEEDINGS BY COMPANIES

[1] In the majority of companies, the powers of management are expressly vested in the board of directors by the constituent documents of the company.[1] By subscribing for shares or otherwise becoming a member (in the case of a company not limited by shares), a member is taken to have agreed[2] that, with a number of exceptions concerning matters that are the exclusive province of the company in general meeting,[3] the conduct of the company's affairs ordinarily will be at the discretion of the board of directors or, through delegation by the board, at the discretion of the executive officers of the company.

[2] The discretion reposed in both directors and officers is subject to an overriding requirement that in all cases they act in the best interests of the company. That requirement has influenced the formulation of the recognized duties that directors and officers owe to a company. Those duties, which in many instances involve onerous standards of loyalty and fidelity, are imposed by statute, established by the general law or arise out of the terms of contracts of employment with a company.

[3] Directors and officers who breach sane duty owed to a company are in theory as vulnerable to have proceedings taken against them in relation to that breach as are outsiders who have caused loss to the company through failure to observe the terms of some contract with the company or by way of tortious act or omission.

[4] The power to initiate, prosecute, settle or otherwise deal with legal proceedings by any ordinarily resides in the board of directors as the primary organ of management. Apart from any power of review or direction which my be expressly reserved to the general meeting or which my be made necessary by the circumstances of the case,[4] a member of a company has little control over the initiation or conduct of litigation which is founded on a cause of action which belongs exclusively to the company, whether that cause of action involves breach of duty by any corporate insider or is one which can be pursued against a third party.

1. For example, Regulation 66 of Table A, 3rd Schedule to Companies Act 1981 (Cwlth). The Act is referred to hereafter as "Companies Act".

2. The constituent documents of a company being afforded contractual status by virtue of section 78 Companies Act.

3. For example alteration of, or addition to, the articles of association of a company under section 76 Companies Act.

4. As, for example, where directors are seeking absolution from the general meeting for their breach of duty; see below paras. [109] to [119].

INADEQUACY OF THE PRESENT LAW CONCERNING ENFORCEMENT WHERE A COMPANY FAILS OR REFUSES TO ENFORCE A CAUSE OF ACTION

[5] There is likely to be little criticism of that part of the rule in **Foss v Harbottle**,[5] which states that a company is the only proper plaintiff in respect of wrongs done to the company, in a case where there is a readiness on the part of the company to pursue causes of action that belong to it, regardless of the identity of the party or parties against whom proceedings are contemplated.

[6] The proposition upon which Discussion Paper No. 11 was based is that, due to the application of that rule and notwithstanding the recognition of a number of exceptions,[6] 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.

[7] The need for a change to the law has been evident for a considerable time. That need does not result from adverse economic or financial circumstances; all that corporate collapse and attendant financial loss of the kind now being experienced in Australia achieve is to bring that need into greater prominence. The Committee noted in para. [2] of Discussion Paper No. 11 that legislative amendment to facilitate action by, at least, a member of a company could also be useful in the general scheme of corporate regulation as an aid to protecting the interests of investors and creditors.

[8] There are, of course, statutory provisions designed to provide remedies against maladministration of companies; the more important ones, and the uncertainties as to their proper ambit, were outlined in Discussion Paper No. 11.[7]

PROPOSED LEGISLATIVE CHANGE

[9] In Discussion Paper No. 11 the Committee set out the terms of the sections of the Ontario Business Corporations Act, 1982 which provide for derivative proceedings. There was broad support amongst respondents for the introduction into Australian law of a similar provision.

[10] The Ontario provision was selected as a model for discussion because it is considered that it addresses those matters which the Committee believes should be incorporated into local legislation.

5. (1843) 2 Hare 461, 67 ER 189; the rule is in reality an amalgam of aspects of the judgments in that case and ***Mozley v Alston*** *(1847) 1 Ph 790, 41 ER 833.*

6. Which were summarised at paras. [11] and [12] of Discussion Paper NO. 11.

7. Although the Committee's conclusions as to one provision, namely section 320 Companies Act, were not entirely concurred in by one respondent, Mr G Stapledon; see further below at paras [238] to [240].

[11] The introduction of the derivative action will no doubt be seen by some as an innovative measure. There may be apprehension that the provision will encourage valueless claims and provide an opportunity for parties whose interests are antithetical to those of a particular company to harass the management of that company. One of the primary reasons why the Ontario provisions were chosen by the Committee as a model for consideration is that those provisions contain safeguards which the Committee believes are important in order to minimize the potential for abuse of the derivative procedure.

[12] The Ontario legislation is not the only example of derivative action provision available for examination. The concept of a stockholder's derivative suit has been recognised in the United States for well over a century.[8] The statutes of many American jurisdictions expressly provide for derivative suits and lay down procedural guidelines and restraints in relation to their conduct.

[13] Generally, the Committee views the terms of the Ontario legislation as more amenable to adaptation to the Australian scene than the criteria which are understood to apply in the United States. For example, see the discussion of the American Law Institute's recommendations concerning approval for termination of derivative actions at paras. [174] to [206] below.

[14] Other features of United States law which the Committee considers could not readily be applied for Australian purposes would include the considerable significance there attached to any requirement for, and the sufficiency of, any demand by a stockholder to a corporation that the matters complained of be remedied[9] and any requirement that a member of a corporation who is an applicant to take derivative action have held shares at the time of the breach of duty complained of: see below at para. [24].

[15] By recommending legislation along the lines of that which applies in Ontario, the Committee intends that the fundamental determinants of access to the Courts to pursue a cause of action belonging to a company be the merits of the application for leave and the suitability of an applicant to prosecute the consequent litigation.

[16] The Committee does not intend that any question as to the status of the relationship that an applicant has to a company be used as a bar to access. The specific granting of standing to apply for leave under the proposed legislation to certain parties such as members, directors and officers and creditors should not be viewed as a means of delimiting the range of persons who could apply. Rather, it is an attempt to ensure that access is not denied to those categories of persons because the nature of their relationship to a coup is not yet seen as requiring the recognition

8. See Cary and Eisenberg "Corporations : Cases and Materials" (1988, Foundation Press) at pp. 928 - 935 for a discussion of the history and competing policy considerations of the derivative action in that country.

9. see generally American Law Institute "Principles of Corporate Governance", Tentative Draft No. 6 (1986), Part 7.03.

of some distinct duty on the part of directors and officers of a company towards them.

[17] It seems to the Committee that any argument against granting Standing for this type of action based on the nonexistence of any of duty on the part of directors and officers towards anyone other than the company of which they are directors and officers would be a spurious one, as it is the interests of the company which are intended to be protected by means of the derivative action. If the successful prosecution of that cause of action also incidentally promotes the interests of the applicant or any person other than the company, then so be it.

AMENDMENT AND AMALGAMATION OF EXISTING LEGISLATION

[18] The Committee considers that the recommendation for the introduction of the provision for derivative proceedings results in a need to consider whether a number of present statutory provisions, particularly section 320 and other provisions of the Companies Act, should be amended in order that the legislation more clearly delineate the causes of action that may arise through the operation of a company and the parties to whom those causes of action might accrue.

[19] The Committee also recommends later in this Report[10] that a number of the major remedial and enforcement provisions of the Companies Act be placed in a separate division of the Act, a change which it is intended will provide further clarification of the means of redress available.

[20] This Report has been drafted on the basis of the legislation applying under the Co-operative Scheme for the regulation of company and securities laws. The legislation, including the Corporations Act, 1989 (Cwlth), which it is proposed will be administered by the Australian Securities Commission from 1 January 1991, is generally in similar terms.

REPORT FORMAT

[21] The approach adopted is firstly to set out the full text of the recommended derivative action provision followed by an examination of the different aspects of that provision. The last section of the Report contains recommendations concerning other relevant provisions.

[22] The proposed provision makes specific reference to the terms and conditions that the Committee considers should apply in relation to some aspects of the recommended procedure (including orders as to Withdrawal of a costs order in favour of an applicant or controller of derivative proceedings and directions as to who could be the recipients of any part of an amount ordered to be paid on successful prosecution of those proceedings) but leaves most other matters to be determined solely at the discretion of the Court. This approach has resulted from an intention on the part of the Committee to make it clear that the Court will have the power to make orders of a kind which, in the absence of specific provision, my be thought not to be justified on the basis of particular precedent and a recognition that any detailed prescription in relation to a number of the aspects of the proposed procedure my prove inadequate to deal with the variety of circumstances to

10. At para. [276].

which the provision will need to be applied. It should be noted that the Committee does not purport to set out the final form of the recommended legislation but rather to provide a possible approach to drafting. The text is indicative only.

PROPOSED LEGISLATIVE PROVISION FOR DERIVATIVE PROCEDURE

[23] The Committee recommends enactment in the Companies Act after section 320 of that Act of a provision the substance of which accords with the following draft:

"DERIVATIVE PROCEEDINGS ON BEHALF OF A COMPANY"

320A. (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 my 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 re~ 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 my 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 proceeds 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 persons;

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 totters for which the indemnity was granted or order made was such as to constitute an 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)."

COMMENTS ON PROVISIONS OF PROPOSED SECTION 320A

Sub-section (1): Standing to apply for leave:

"320A. (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 bolder 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."

[24] **Standing to apply for leave; present and former members.** It has been held in a number of United States jurisdictions where derivative actions are possible that an applicant to take derivative proceedings must be a member of the company at the time of the application and during the pendency of the derivative action.[11] Some statutory provisions require that the applicant should have been a shareholder at the time of the impugned transaction, or for at least part of that transaction.[12]

[25] Because one of the aims of the proposed provision is to ensure that proper corporate standards are enforced, it seems to the Committee unduly restrictive to require contemporaneous ownership for the purposes of standing to apply to take derivative proceedings. It would appear to be irrelevant for the purposes of standing to apply for leave whether the applicant became a member after the occurrence of the matters complained of or terminated his or her membership prior to such occurrence. As noted by Baxter,[13] it is the appropriateness of the applicant to take proceedings to enforce the right of action of the company which should be a primary consideration. The current status of the applicant in relation to the company may well be a matter which the Court could take into account on a successful application when deciding whether the applicant should have carriage of the subsequent derivative proceedings.

[26] **Standing to apply for leave; directors and officers.** In Discussion Paper No. 11 (at paras [87] to [89]) the Committee addressed the question whether directors and officers who are not also members should be granted express standing under the proposed legislation, or whether a discretionary provision would be sufficient.

[27] There was general agreement amongst respondents that specific standing should be provided.

[28] It is only logical to expect that when proper administrative standards are observed directors and officers would have more information concerning the running of a ~'s affairs than would members or outsiders. Even in a situation where those standards are not adhered to in a case such as a deliberate campaign on the part of a number of directors and officers to restrict the supply of important information to one or other of their colleagues, suspicions should be aroused on the part of the campaign's target.

11. See Cary and Eisenberg "Corporations : Cases and Materials" (1988, Foundation Press) at p. 936.

12 .For example s. 800(1) California Corporation Law quoted in Ballantine and Sterling "California Corporations Laws" (1987, Parker & Sons) at p. 60.

13. "The Derivative Action under the Ontario Business Corporations Act : A Review of Section 97" Vol. 27 (1982) McGill Law Journal 453 at p. 465.

[29] Presently, there are limited options open to any director of officer, particularly of a solvent company, who is in receipt of clear evidence, or suspects, that a board of directors is in breach of its duty to the in not pursuing a cause of action. The director or officer unable to sway the board may resign, convene a general meeting of the company, circularize members, alert the Commission or directly approach the Court.

[30] Resignation by itself would achieve nothing in the way of remedial action. Without the protection afforded by the giving of evidence before a Court, the director or officer after resigning may be reluctant to make public the matters complained of for fear of proceedings for defamation by the allegedly culpable directors or officers.

[31] A director may have power, under the constituent documents of the company,[14] to cause a general meeting of the company to be held. Assuming the director is willing to divulge the information relating to the breach of duty of the other directors or officers without the protection afforded by the conduct of litigation (discussed above) and provided the meeting votes impartially, that method of redress could be a valuable one. A resolution for the removal of any director of a public company could be put; see section 225 Companies Act. However, the procedure necessary for a meeting to be properly convened may be too time-consuming where the circumstances require urgent action. For example, on any resolution to remove a director of a public company, 28 days notice must be given to the company and 14 days notice to all those entitled to notice - section 249 Companies Act.

[32] The Commission, if approached for assistance by any director or officer, may be unable or unwilling to respond. The director or officer would have no standing to take proceedings in the nature of personal or representative action, even if the facts justified the taking of such action by any member of the company. Nor would the director or officer be able to take proceedings under section 320 Companies Act, standing under that provision only being accorded to a member or the Commission.

[33] The director or officer would not have ding to pursue an application for the winding up of the company under section 364 Companies Act (assuming the grounds for such an order were made out) and would need to have authorization from the Commission before he or she could approach the Court under section 574 of the same Act for orders against the other directors or officers who were in breach.[15]

[34] The possibility of obtaining an injunction under section 574 Companies Act may provide the most important means of enforcement available to a director or officer in these circumstances, although there is no certainty of standing to apply being granted.

14. Regulation 40 of Table A to the 3rd Schedule of the Companies Act provides for any director to convene a meeting "whenever he thinks fit".

15. Doubts concerning the applicability of this provision to solvent companies were outlined in para. [30] of Discussion Paper No. 11.

[35] The reach of section 574 was discussed at paras. [22] to [24] of the Discussion Paper. The scope of the provision may be wider than there posited by the Committee; certainly the decision of Hampel J of the Supreme Court of Victoria in **BHP v Bell Resources**[16] promotes a wide reading of the section:

"In my view the interests referred to in this section are interests of any person (which includes a corporation) which go beyond the mere interest of a member of the public. It is not necessary that personal rights of a proprietary nature or rights analogous thereto are or may be affected nor need it be shown that any special injury arising from a breach of the Act [sc Code] has occurred."[17]

[36] It remains to be seen whether the approach taken by his Honour to the range of parties who should be able to utilize section 574 as a means of enforcing duties owed to a company is generally followed.

[37] In order to overcome any possible doubt, the Committee is of the opinion that directors and officers who are not also members of a company should expressly be granted standing to approach the Court for leave to take derivative action.

[38] **Standing to apply for leave; interest in a related corporation**. The Ontario derivative action provision contemplates action by a member of a holding company on behalf of a subsidiary, bat does not specifically permit proceedings by a member of a subsidiary on behalf of a holding company.

[39] The justification for granting ,standing to a member or former member of a company which is part of a group of companies and a director or officer, or former director or officer, of such a company may be most readily apparent where a group consists of a holding comp and a number of wholly-owned subsidiaries. In that situation the board of a wholly-owned subsidiary, the composition of which is controlled by the holding company, might expect to be subject to less scrutiny of its actions than would be expected in the case of a company having a more diverse membership and spread of control.

[40] Unless a member or former member of a holding company were to be granted standing to apply for leave to commence proceedings on behalf of a wholly-owned subsidiary, it may be impractical to expect that there will be action to enforce a cause of action belonging to the latter.[18] A refusal by the holding company to compel the subsidiary to itself take action would not constitute a breach of duty of which the holding company member could directly complain unless the refusal of the subsidiary resulted in

16. (1984) 8 ACLR 609.

17. At p. 613.

18. Such "pass-through" of rights has been recognized for a variety of purposes in the United States; see Eisenberg, "The Structure of the Corporation" (1976, Little, Brown and Company) at pp. 288 and 289.

consequential loss to the parent company. Even then the cause of action belonging to the subsidiary would remain unlitigated.

[41] There could conceivably be situations where a member of a partly-owned subsidiary would be motivated to remedy a failure of the holding company to pursue a cause of action belonging exclusively to the holding company. The Court might well take into consideration the nature of the relationship between the respective companies and the interest of the applicant in determining who is the most appropriate party to have conduct of the derivative proceedings taken after a successful application under sub-section (2).[19]

[42] Due to the evident variety of group structures and the range of transactions which may take place between the component companies of such groups, the Committee does not see merit in confining the terms of the proposed provision to the taking of action on behalf of any subsidiary company by a person having an interest in the relevant holding company. A party interested in a subsidiary should be able to take action on behalf of that subsidiary's holding company.

[43] It may be more unusual to find action by anyone connected with a subsidiary in respect of a cause of action belonging to a holding company. Similarly, there may be fewer proceedings in which a party connected with a subsidiary attempts to enforce a cause of action belonging to a which is another subsidiary of the same holding company.

[44] In any action involving a partly-owned subsidiary, the Court my need to take into account the attitude towards the contemplated proceedings of the member, or remaining members, of that subsidiary. That step could be a more involved procedure than the determination of any response of a holding company in a case involving a wholly-owned subsidiary.

[45] The Committee does not see the necessity for the procedure in any given case to take account of the nature of the relationship between the various parties who could be involved as justifying restriction of standing to those connected to a company which is related in a particular My to another company.

[46] Doubtless there could be cases where someone outside the specified carries could be motivated to take action in respect of the affairs of a company. Such a situation should fall within the general discretionary of the Court set out in the proposed section 320A(1)(f), assuming the other criteria recommended in this Report are satisfied.

[47] **Standing to apply for leave; creditors and option-holders**. There may be an argument that the motivation for creditors to seek leave to take derivative action would be purely that of self-interest, action being taken merely to protect the stake of those creditors in the assets of the company.

19. At paras. [142] to [145] of this Report the Committee addresses the question whether an order for costs in favour of an applicant for leave, or person having the conduct of subsequent derivative proceedings, should be able to be made against a corporation related to the company for the benefit of which action is taken.

Derivative proceedings might be viewed as a means of preserving the interests of the creditors where the actions of the company are not such as to justify recourse to the contractual arrangements, if any, by which the interests of the creditors are secured. The American Law Institute has commented that disallowance of standing to creditors:

"..protects corporate officials from exposure to litigation brought by creditors who would rationally have a far different and more sceptical attitude toward business risks than shareholders, and it is also justified by the greater availability to creditors of contractual mechanisms by which to establish and enforce their rights."[20]

[48] It seems to the Committee that that argument misses the point; it is not the interests of the creditor which are intended to be protected through the mechanism of the derivative action, but those of the company. Nor is it obvious why creditors should necessarily be more sceptical company business risks; recent Australian experience would not tend to support that view.

[49] The degree of self-interest involved would not appear to be a sound basis for differentiation. Although there may not yet be explicit recognition of a right of redress to members for action resulting in diminution of the value of their investment in a company where the wrong is recognized as being primarily to the company[21], it can hardly be supposed that ~s seeking to take derivative proceedings would in the majority of cases be motivated by altruistic considerations.

[50] If it is accepted that one of the main criteria in determining who should be granted standing should be the appropriateness of the applicant to take action to enforce duties owed to a company, it can be asserted that creditors might well in many situations be in receipt of better relevant information than that available to other "outsiders". Another argument would be that creditors do stand in a different relationship to a member than other non-members.

[51] If there are insufficient grounds for action on behalf of a company, any creditor who abuses the derivative procedure would run the risk of bearing the costs of the application, including those of the respondents. The requirement to seek leave should minimize the potential for what in North America would be termed "strike-suits" by creditors; see below at paras. [86] and [87].

[52] For the above reasons the Committee sees justification in expressly granting creditors (whether secured or unsecured, contingent or prospective)[22] standing under the proposed legislation to apply for leave.

20. "Principles of Corporate Governance" Tentative Draft No. 6 (1986) at p. 40.

21. See Sterling, "The Theory and Policy of Shareholder Actions in Tort", Vol. 50 No. 4 Modern Law Review (July, 1987) p. 468.

22. Cf. description of those entitled to apply for a winding up of a company under section 363 (1) Companies Act 1981 (Cwlth). See McPherson "The Law of Company Liquidation" 3rd Edition Ed.

[53] In practice sane creditors may be restricted to obtaining injunctive relief, either because the granting of an injunction may result in rectification of the matters complained of (as could occur in the case of any other applicant) or because the Court considers it more appropriate that another person have control of the subsequent derivative action. However, if the threshold for taking action is proof that a cause of action belonging to the company is improperly being neglected and that an applicant, as a surrogate for the company, is able to enforce that cause of action, there should not in principle be any assumption that the range of action available to a creditor applicant should necessarily be limited. There may well be cases where a creditor establishes to the satisfaction of the Court that the creditor should have unfettered carriage of the consequent derivative proceedings.

[54] Respondents to the Discussion Paper did not favour specifically restricting creditors to applying only in certain circumstances or only being able to seek limited relief such as an injunction.

[55] In Discussion Paper No. 11 the Committee also raised the question whether holders of convertible notes or options should be granted standing.

[56] Holders of convertible notes should qualify as creditors. Holders of options to take up unissued shares not attached to convertible notes have less claim to standing. They are only potential members and their financial interest in relation to the company is only prospective. However, they have a legitimate interest in the way the company's affairs are presently being administered.

[57] The Committee considered whether option-holders should be able to apply as creditors. Since there is some debate as to whether an option-holder would be a creditor if the company failed to allot shares on exercise of the option,[23] it is necessary to proceed on the assumption that option-holders would not be considered "creditors" for the purposes of the proposed measure.

[58] The Committee is of the view that the suggested legislation should confer standing on holders of options as such specifically. The Court will need to consider whether in the particular case an option-holder is the most appropriate person to conduct proceedings after the granting of leave.

[59] **Standing to apply for leave; the Commission.** Section 306(11) Companies Act has provided that the NCSC may cause proceedings to be ~ced in the name of a company to recover damages resulting from fraud, negligence, default, breach of trust, breach of duty or other misconduct committed in connection with the affairs of a company if the results of a special investigation under Part VII or the contents of a record of examination under that Part have led the Commission to the opinion that it is in the public interest that such proceedings be undertaken. On the same basis the Commission has also been able to seek recovery of the property of a

O'Donovan (1987, Law Book Company) at pp. 43-45 for definition of "contingent and prospective creditors".

23. ***Re BDC Investments Ltd.*** *(1987) 6 ACLC 85.*

company.[24]

[60] Thus, in the case of reports after special investigations, the Commission already has had stand~ to cause derivative proceedings to be commenced; a similar prerequisite has applied in the case of actions under section 320 of the Act. A question arises whether the proposed legislation should also accord specific standing to the Commission,[25] or whether it may be assumed that in appropriate circumstances the regulator could successfully argue that the Court should exercise its discretionary power[26] to afford standing to seek leave to take derivative action.

[61] Information concerning corporate operations is provided to regulators from a variety of sources; there may also of course be some variety in the accuracy of that information. However, in a number of instances it would be reasonable to expect that accurate information would be provided by a party who felt unable, notwithstanding the anticipated provisions regarding orders as to costs,[27] to initiate action to enforce a company's cause of action.

[62] Whether the Commission would be minded to take advantage of the statutory provision as to sing could well be a different matter. However, the Committee believes that to provide expressly for the Commission could have beneficial results, a consideration which outweighs any potential reluctance to initiate enforcement action, whether that reluctance stems from an inadequacy of resources or ~ting regulatory priorities.

[63] This measure would assist in the recognition of the Commission as a protector of the broader public interest in the orderly administration of the affairs of companies.[28]

[64] **Standing to apply for leave; any other person - the court's discretion**. It is difficult to predict the range of persons who could be granted standing under the proposed provision. Some may see the introduction of such a discretionary provision as leading to a large number of unmeritorious actions by parties with little or no connection to the running of a particular company.

24. Cf. section 50 Australian Securities Commission Act 1989 (Cwlth).

25. As is the case in the Canada Business Corporations Act, which contains provisions for a derivative action in very similar terms to that of the Ontario legislation; under the Canadian legislation the relevant regulatory authority has at least a number of the administrative and discretionary powers accorded to the NCSC/ASC. See generally CCH "Canada Corporations Law Reporter".

26. See below paras. [64] and [65].

27. See below at paras. [124] to [143].

28. A regulatory function recognized by the Supreme Court of Canada; ***Sparling v Royal Trustco Ltd.*** *November 6, 1986 (unreported)-noted in CCH "Canada Corporations law Reporter" at para 12,315.15.*

[65] However, the Committee considers that the control that the Court will be able to exercise should be adequate in this regard and that the Court should be in a position to "filter out" valueless claims or improper attempt to harass management.

Sub-sections (2) and (3): Leave to take derivative action:

"(2) An application my 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."

[66] **Proceedings in the name and on behalf of a corporation.** It would appear that in the predecessor derivative action provision of the Ontario legislation, it was necessary that a shareholder bring an action in representative capacity for himself or herself and all the other shareholders of the corporation[29] with the alleged wrongdoers named as defendants and the company as nominal defendant, a procedure designed to ensure that all relevant parties, including the shareholders, are bound by the terms of any judgment obtained. The Courts of all Australian jurisdictions have rules governing the conduct of actions in such a representative capacity.[30]

[67] As noted by Stapledon,[31] the use of such a representative form[32] does not afford a true description of what is really occurring. The current Ontario legislation provides for proceedings to be brought in the name and on behalf of a company, a procedure which affords a more accurate indication that the applicant is acting for the benefit of the company.

29. See Baxter op. cit. at p. 459.

30. See, for example, New South Wales Supreme Court Rule 8.13.

31. "Locus standi of Shareholders" Company and Securities Law Journal August 1990 213 at p. 217.

32. "AB (a minority shareholder) on behalf of himself and all other shareholders of the company..".

[68] Opinion amongst respondents to Discussion Paper No. 11 was divided; while some[33] favoured action in the name of a company, one submission[34] argued that to do so would in itself be misleading and that, notwithstanding that the company is the beneficiary of the proceedings, these should be conducted in the name of the party who has effective control of the litigation, namely the applicant.

[69] It seems to the Committee that any procedure employed for the conduct of derivative actions should draw a distinction between this type of proceeding and litigation conducted in a personal or representative capacity. As in the case of the proposed statutory derivative procedure the action would be taken for the benefit of the company, it appears logical that proceedings be in the name of the company.

[70] **Action on behalf of a related corporation.** At paras [38] to [46] above, the committee addresses the need for an applicant to be able to take proceedings to protect the interests of a corporation related to the company in which he or she has an interest. As there noted, the Committee does not see merit in confining the reach of such a provision to the case only of wholly-owned subsidiaries nor in preventing action to enforce the rights of a holding company by anyone having an interest in any subsidiary of that

Sub-sections (4) and (5) : Notice to the corporation and criteria for granting leave:

"(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.

33. Mr M A Adams; Institute of Corporate Managers, Secretaries and Administrators Ltd.

34. Australian Society of Certified Practising Accountants/The Institute of Chartered Accountants in Australia - joint submission.

[71] **Requirement of notice to the corporation of proposed application.** As pointed out by The Australian Society of Certified Practising Accountants/ The Institute of Chartered Accountants in Australia,[35] a requirement that notice of intention to apply for leave to take derivative proceedings be given can serve two major purposes; it allows for remedial action to be taken, or at least commenced, which might satisfy the potential applicant and, in the absence of such remedial action being contemplated, it gives time for the directors and officers to prepare their response for the hearing of the application.

[72] Ordinarily, 14 days notice period would appear to be adequate; that period is consonant with other provisions of the Companies Act such as section 242 dealing with the convening of a meeting of a company. Service of the notice could be undertaken in accordance with the standard provisions for service on a company.[36]

[73] In Discussion Paper No. 11 the Committee raised the question whether an application for leave to take derivative proceedings should be able to be heard on an **ex parte** basis and, if so, what kind of orders the Court should be empowered to make in that situation.

[74] One respondent, Mr M A Adams, considered that **ex parte** applications should only be permitted if the company involved faced imminent insolvency or a likelihood of destruction of property. However, it seems to the Committee that that formulation places too high a threshold. There may be a number of circumstances deserving of remedial action where neither element of that formulation is necessarily made out, but there is clearly a threatened breach of duty. Again, this would be a matter for the Court to determine.

[75] Another respondent, the Institute of Corporate Managers, Secretaries and Administrators Ltd., thought that orders on such applications should be limited to the grant of interim injunctions.

[76] Although it is highly unlikely that the Court would be minded to make any type of order other than the grant of an interim or interlocutory injunction on an **ex parte** hearing, the Committee does not consider it appropriate to limit specifically the power of the Court to such temporary relief. Later in this Report the Committee considers whether there should be any specific provision concerning undertakings as to damages on the part of an applicant in these circumstances; see below at paras [211] to [218].

[77] Under the proposed provision the Court would have the power to amend the requirement as to notice as it sees fit in the circumstances.

[78] **Criteria for granting leave; the corporation or related corporation will not take action.** The terminology employed in the current Ontario legislation means that in theory an applicant for leave should not have to

35. In the joint submission to Discussion Paper No. 11.

36. For example, see section 15 of the Companies and Securities (Interpretation and Miscellaneous Provisions) Act 1980 (Cwlth) in relation to postal service.

show that any demand that action be taken has been made and rejected in the case where the alleged wrongdoers control the company to such an extent that any such demand would be futile.[37] For Australian purposes, the fact of control alone may not be enough to obviate the need for an applicant to demonstrate that some consideration of the matters in question has been undertaken or, alternatively, suppressed or otherwise improperly dealt with.

[79] The type of demand that will be required in cases other than those in which the applicant can show a stranglehold of the company by wrongdoers will vary according to the circumstances of each case. In many instances some kind of formal communication will be necessary; this should not be required to be in any particular format, but be such as to convey accurately the requirement of the applicant that action be undertaken.

[80] In other circumstances, the undisputed terms of an oral demand might be of such a nature that the Court will be satisfied that no reasonable board of directors could be under any misapprehension as to the attitude of the applicant or the nature of her or his request.

[81] As a generalization, it might be enough to say that the applicant should show that he or she has made reasonable efforts to have the company undertake action[38] and that what is reasonable will vary according to the circumstances of each matter.

[82] **Criteria for granting leave; the good faith of the applicant**. There are two aspects of the requirement that the applicant is acting in good faith to be considered. The first is the need to determine whether there is any complicity on the part of the applicant in the matters complied of. The second relates to whether the applicant is pursuing any interest other than that of the company in applying for leave to take derivative proceedings.

[83] In a number of United States decisions, an applicant for leave has been met by a successful "personal defense" that she or he should be disqualified because of the applicant's participation in the wrongs alleged; consent to or explicit ratification of the matters in question have been held to be sufficient. Even "acquiescence" made out by failure to object has been considered enough to disqualify a particular applicant.[39]

[84] It may well be that an applicant who has been guilty of complicity in the matters complained of could be found personally liable on the final adjudication of the derivative proceedings. This situation could more readily arise in the case of an application by a director or officer of the

37. See Baxter op. cit. at pp. 466-467 and CCH "Ontario Corporations Law Guide" at para. 16,100.

38. Such an approach has been given official recognition in the Rules of Court dealing with applications under section 245 of the Ontario Business Corporations Act; see Baxter op. cit. at p. 466.

39. See Cary and Eisenberg "Cases and Material on Corporations" (1988, Foundation Press) at pp. 937 and 938.

company. The question is whether that possibility, or any likelihood that the applicant is seeking to avoid such liability through taking up the cause of action belonging to the company, should result in a disentitlement in relation to the application to take derivative action.

[85] In the committee's view the primary consideration should be the appropriateness of the applicant to make the application to have action taken on behalf of the Committee. The lack of "clean hands" on the part of the applicant should not be seen as enough by itself to result in disqualification for this purpose. Any acts or omissions on the part of the applicant might be of relevance to the question of who should have carriage of the subsequent proceedings if the company is not to have the conduct of those proceedings. The Court my feel it unwise to entrust the proper conduct of the company's action to the applicant. This possibility would not detract from the need to grant an order for derivative proceedings to be taken where the circumstances justify that course. In a doubtful case the Court would be empowered in any event to appoint a person other than the applicant to have conduct of the consequent proceedings, with or without the consent of the applicant.[40]

[86] Even in the absence of any complicity on the part of the applicant in the relevant breach of duty, there could be an allegation that the application is in reality being made to further the interests of someone other than the company. In North America such an attempt would be referred to as a "strike suit".

[87] The motivation behind a strike suit could be to advance the interests of a proposed takeover offeror or of a general business competitor of the company, to further an industrial claim of the company's employees or for some other reason to de-stabilise the management of the company.

[88] The case of an application by a take-over offeror, or any party who proposes a take-Over, could be one in which there may be particular concern that the furtherance of extraneous interests is the predominant aim. If there are proceedings which should be taken on behalf of the company, the possibility that disclosure of the fact that there is an improper failure to pursue that cause of action might lead members of the company to be more favourably disposed towards accepting the take-over offer should not be a factor contrary to the success of the application.

[89] However, publicity concerning an unsubstantiated claim could depress the market price in the case of a listed company; the price offered by the offeror could thus be made more attractive to members. An offeror could see the costs incurred on an ultimately unsuccessful application as a small price to pay for the publicity generated.

[903 Generally the Committee does not favour non-public hearings and so does not propose any particular provision in relation to such a situation. The Court would already have the power to suppress the reporting of any matter considered sufficiently scandalous to justify such a restriction.

40. See further below at paras. [120] to [123].

[91] As to the effect that evidence of such an extraneous interest should have on the outcome of an application for leave, the Committee believes that the same considerations are relevant as where complicity is alleged on the part of the applicant in the matters being complained of. Unless the primary motivation of an applicant is such that the Court cannot be satisfied that he or she is an appropriate party to apply, leave should not be refused merely because of the likelihood that some interest other than that of the company may be promoted. The Court still has to be satisfied that, on balance, it appears to be in the best interests of a comp that proceedings be taken; see further below.

[92] As has been noted at para. [85] above, the Court would not be obliged to permit any applicant to have conduct of the subsequent proceed/rigs. If there were no obvious party to replace the applicant for this purpose, the Court might consider the Commission to be a suitable alternative.

[93] **Criteria for granting leave; furtherance of the corporation's interests/ The applicable standard of proof.** The inactivity on the part of a board of directors with which this Report is concerned would be made out by a failure of the directors of a comp to initiate proceedings in respect of a breach of duty on the part of another director or officer of the company, to pursue an arguable cause of action arising from a breach of contract, tortious act or omission etc. of a third party or to resist any proceedings initiated against the company where the company had at least an arguable defence, counter claim or set-off etc.[41]

[94] In some instances it may be a relatively straight-forward matter to establish such an improper refusal or failure. The clearest case might be that of a board of directors declining without legitimate reason to resolve that the ~y proceed directly against the directors for loss occasioned by a breach of duty. In that situation, the attitude of the ~ in general meeting towards granting absolution to the directors will be of considerable importance; see further below at paras. [109] to [119]. In other cases the issues may not be at all clear-cut. A refusal of the board to pursue action may be dictated by what are perceived in the exercise of a business just to be sound commercial imperatives, for example, the possibility that a long-standing and otherwise lucrative relationship with a customer might be terminated by the institution of proceedings. The board may consider that the amount which may be recovered by the company is outweighed by the costs which may be expended on the action, especially in cases of uncertain outcome. The board's attitude may have resulted from the terms of legal or other specialist advice.

[95] What kind of evidence should satisfy the Court hearing the application to take derivative action that such action would be in the interests of the relevant company?

41. While satisfaction on the part of the Court as to the existence of an arguable cause of action or defence etc is not listed as one of the criteria for the granting of leave, it is implicit in the requirement as to the corporation's interests, as it could hardly be to the benefit of a corporation to pursue a worthless claim or to resist proceedings in the absence of at least an arguable defence.

[96] In Discussion Paper No. 11 the Committee sought responses regarding the standard of proof which should apply in order to establish a breach of duty but did not specifically raise the question of the furtherance of the company's interests. Howe, as noted, the requirement relating to the interests of the company resumes the necessity to show unjustifiable inactivity in not pursuing a cause of action belonging to the company.

[97] Same respondents to the Discussion Paper[42] considered that it should be necessary to show a breach of duty on the balance of probabilities. In its response the Law Society of Western Australia suggested that:

"The degree of proof required to satisfy existence of a breach of duty should be on the balance of probabilities but the court must have regard to a balance of hardship and the court must be satisfied of a compelling and cogent reason for the making of the application."

However, proof on a balance of probabilities would seem to the Committee to be an appropriate standard for determination of the subsequent derivative proceedings in which there would be, subject to the possibility of an appeal, adjudication of the merits of the matter **inter partes**.

[98] An application to commence derivative proceedings would be interlocutory in nature, as there would be no final disposition of the rights of the parties.[43] Affidavit material submitted in support of an application could be drawn on the basis of information and belief, a factor which would assist in applications by minority shareholders or others who may not be in possession of information of the kind to which management should have access.

[99] While the interlocutory nature of an application may not necessarily be conclusive as to the standard of proof to be applied, there is authority for the proposition that in relation to a similar type of action, a petition requesting leave to take proceedings in the name of a company under section 320 Companies Act, the relevant matters need only be established **prima facie**

"In my view the facts already found by me establish a prima facie case .... It seems to me that it is not necessary nor desirable to discuss in detail the merits of the actions proposed by the petitioner in the name of the company. It is I believe sufficient to state that the facts disclosed indicate that in the absence of an explanation there is a cause of action established against each of [the defendants]."44

42. Institute of Corporate Managers, Secretaries and Administrators Ltd; The Law Society of Western Australia (Corporate Lawyers Committee).

43. For a discussion of the distinction between interlocutory and final orders see "Ritchie's Supreme Court Procedure - New South Wales" Ed. Taylor (1984, Butterworths) paras. 101.1 to 101.4.

*44. Rowland J in **Re Overton Holdings Pty Ltd** (1984) 2 ACLC 777 at 782.*

[100] A similar approach has been taken in respect of the Ontario provision about applications for leave:

"It is not my function to decide whether such contemplated action will succeed at trial, but simply to decide whether there is prima facie merit to it ..... It is obvious that a Judge hearing an application for leave to commence an action, cannot try the action. I believe it is my function to deny the application if it appears that the intended action is frivolous or vexatious or is bound to be unsuccessful. Where the applicant is acting in good faith and otherwise has the status to commence the action, and where the intended action does not appear frivolous or vexatious and could reasonably succeed; and where such action is in the interests of the shareholders, then leave to bring the action should be given...I am not to deny leave to bring an action simply because on a weighing of the evidence I should decide it is unlikely that the action will be successful." (O'Leary J in **Re Marc-Jay Investments Inc and Levy** (1974) 5 CR (2nd) 235 at 236-7).

[101] As noted by Baxter,[45] notwithstanding the use of the phrase "could reasonably succeed", O'Leary J should probably not to be taken as requiring an applicant to demonstrate that the intended action has a reasonable chance of success; such a stipulation would in effect prompt something of a trial of the issues.

[102] In **Re Overton Holdings Pty Ltd** (supra) the defendants chose not to give evidence which might have contradicted the claims of the petitioner. In such a situation it may be easier for the Court hearing the matter to conclude that a **prima facie** case has been made out.[46]

[103] Where the respondents to an application elect not to give evidence, the approach taken in the **Marc-Jay Investments** case may provide suitable criteria. The Court would still have considerable discretion; amongst other possible grounds, the application might be rejected if the evidence failed to disclose a cause of action,[47] if an essential ingredient of a cause of action is absent or if the application is otherwise an abuse of the Court's process.

45. Ibid.

*46. One formulation of proof to a **prima facie** standard involves production of evidence of such weight that no reasonable person, in the absence of further evidence, would find against the proponent of the relevant issue : see "Cross on Evidence" 3rd Australian Edition Ed. Byrne and Heydon (1986, Butterworths) at para. 1.117*

47. But, at least in Ontario, not necessarily if the cause of action pried is a novel one; see Baxter op. cit. at p. 463.

[104] Any formulation adopted by the Court may well be influenced by whether or not there is resistance to an application for leave. Different fact situations may result in the adoption of various approaches as to the matters which must be established.

[105] The Court might feel compelled in a doubtful case to adjourn the hearing if it is felt that the production of further evidence is necessary in order to meet the applicable standard of proof.

[106] It seems to the Committee that, 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 purpose for which the provision of a means to undertake derivative action is contemplated.

[107] Once leave had been granted the Court would be able to control the continuation of unmeritorious actions. Later in this Report[48] the Committee addresses the withdrawal or variation of any indemnity or other order for costs which has been granted in favour of an applicant or other party having the conduct of the derivative proceedings.

[108] The power of the Court to withdraw such an indemnity or vary such other order prospectively should act as a significant disincentive to the continued prosecution of dubious actions.[49]

Sub-section (6): Consideration by general meeting of the totters complied of:

"(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."

[109] **Criteria for granting leave; any action by the general meeting.** In Discussion Paper No. 11 the Committee noted[50] the often critical importance attributed to the attitude of the company in general meeting towards the matters complied of in relation to cases dealing with the recognised exceptions to the rule in **Foss v Harbortie,**[51] notably that dealing with an alleged fraud on the minority of shareholders.

48. At paras. [137] to [141].

49. It is proposed that retrospective withdrawal of an indemnity only be available to the Court in limited circumstances; see paras. [137] to [139] below.

50. At paras. [45] to [53].

51. (1843) 2 Hare 461, 67 ER 189.

[110] As there noted, in its Report No. 10 on indemnification, relief and insurance in relation to company directors and officers, this Committee recommended (in para [58]) that there should be legislative recognition of the ability of a ~ in general meeting to give advance authority for specific conduct of a director or officer of the company in relation to a specific transaction, other than conduct which involves an intent to deceive or defraud.

[111] In para. [106] of the same Report the Committee further recommended that there be legislation giving recognition to a similar right of the company in general meeting in relation to release after the occurrence of a breach of duty.

[112] Such advance authority or **ex post** facto release in the terms envisaged by the Committee would relieve a director or officer from any civil liability to pay damages or compensation to the company, but not from the possibility of being enjoined or being subjected to any other kind of relief. The general meeting would not be specifically empowered to reimburse the director or officer for the amount or any other amount by my of damages or compensation or for the amount of any penalty that the director or officer may be ordered to pay following a conviction for a criminal offence. Under the Committee's recommendations the sum of a penalty imposed for breach of certain sections of the companies legislation would not be able to be reimbursed; see paras. [143] to [147] of Report No. 10.

[113] Report No. 10 also set out the conditions the Committee considered should apply in order to determine the validity of such advance or **ex post** facto action on the part of the general meeting. These included the provision of adequate information to the general meeting and the absence of any participation in the vote by interested directors, their associates or relatives.

[114] It was the Committee's view that the granting of either advance authority or later release should be subject to the provisions of section 320 Companies Act, so that such a resolution to the general meeting would not be valid if its effect was such as to cause the oppressive, unfairly prejudicial or unfairly discriminatory results addressed in that section. Furthermore, retrospective release should be able to be negated by order of the Court if the company went into insolvent liquidation within 12 months after the granting of the release.

[115] If the recommendations in Report No. 10 are adopted, the result of any valid resolution of these kinds on the part of a general meeting would be to afford a complete defence to a director or officer to any action by the company. Advance authority would ensure that the relevant actions could not constitute a breach of duty, whereas retrospective release would provide protection against liability even if it did not result in a change in the characterization of the acts or omissions in question.

[116] Uncontradicted evidence of a valid resolution of the company in general meeting held under the conditions referred to in Report No. 10 should also act as a bar to the granting of an application to take derivative proceedings, either because there would be no cause of action which the company could enforce or because there would be an overwhelming

probability that the action could not succeed. In either case the Court hearing the application could not be satisfied that the interests of the company would be served by the institution of proceedings.

[117] In Discussion Paper No. 11 the Committee also addressed the situation where the general meeting had not been given an opportunity to consider the matters complained of prior to the hearing of the application for leave to take derivative proceedings. The view there expressed was that in practice, in all but the most urgent cases, the Court might require that a meeting be convened,[52] the application being adjourned pending the decision of that meeting. Provided the criteria set out above in respect of advance authority or retrospective release were satisfied, the attitude of the general meeting, if accepted as valid by the Court, should be conclusive as to the fate of the application.

[118] In a case of deadlock of a validly convened and adequately informed general meeting, the outcome of the application would then fall to be determined solely on the basis of any other evidence before the Court.

[119] During the course of the derivative proceedings any defendant could convene a general meeting in order to at~ to have the proceedings terminated; later in this Report it is recommended that the discontinuance or settlement of proceedings should only be possible with the leave of the Court.[53]

Sub-section (7): Consequential orders on the granting of leave:

"(7) In connection with an application made under sub-section (2) or proceedings taken pursuant to leave granted under sub-section (2), the Court my 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;

[120] **Consequential orders; conduct of the derivative proceedings.** These provisions are intended to provide the Court with the ability to ensure the proper carrying out of the proceedings for which leave has been granted. The suitability of an applicant to pursue the derivative action may not be in question at the time of the hearing of the application; later events may compromise or negate the ability of the applicant to prosecute the proceedings.

52. Under section 241 Companies Act.

53. See below at paras. [166] to [206].

[121] Alternatively, it my be the case that on the original hearing the Court is of the opinion that at some subsequent stage of proceedings, or on the occurrence of certain events, the conduct of the action should be handed over to another party. It my become necessary during the course of the action that a person be joined to the proceedings.

[122] One matter that the proposed provision makes specific reference to is a power in the Court to order that the corporation or related corporation undertake any action necessary for the proper facilitation of the conduct of the derivative p eels. It may be necessary that meeting of the board of directors or the company be ordered, or be directed to be carried out in a particular way. The Court might think that members of a company should be given certain information pertaining to the conduct of proceedings or that the operation of parts of the constituent documents of a company be suspended, at least during the course of the hearing of the proceedings.

[123] Generally, the possible circumstances are so various that the Committee considers it appropriate that the Court be granted a wide discretionary power in this regard and that there should be no attempt in the legislation to define the relevant circumstances.

(7) [consequential Orders] continued:

"(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 (c) and (d), including an order as to the withdrawal or application of such sum;"

.....

(8) No indemnity granted or order as to costs made under paragraph (c) or (d) of sub-section (7) shall be retrospectively rely 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."

[124] Consequential orders as to costs. As set out in Discussion Paper No. 11,[54] the need to consider introduction of a provision allowing the granting of an indemnity in favour of an applicant for leave or other order for costs in favour of the person having the conduct of the consequent derivative proceedings is prompted by two factors. The first involves the perceived need not to discourage a bona fide applicant and to provide protection for a controller of proceedings against liability for costs; the second centres on the use of such an order as a means of control by the Omar over unmeritorious or doubtful actions.

[125] Where the object of litigation is the protection of some personal right or interest, the possibility of an order for costs which is adverse to the proponent of the action is viewed as a risk which must be accepted. The potential litigant must weigh that risk in deciding whether to proceed to enforce the cause of action or not.

[126] However, as has been noted elsewhere in this Report, the object of an applicant to take derivative action should be the furtherance of the interests of the company in question, subject to some permissible degree of personal or other extraneous interest. The company will be the beneficiary if the derivative action succeeds.[55]

[1273 The judgments of the Court of Appeal in **Wallersteiner v Moir (No.2)**[56] demonstrate the significant disincentive constituted by the potential for an adverse order for costs against any party contemplating taking derivative action.

[128] Commercial totters, notwithstanding the adoption of specific Court procedures,[57] often involve lengthy hearings with the participation of senior members of the legal profession. The level of costs incurred can be very high indeed. The possibility of considerable financial detriment incurred through seeking to protect the direct interests of a person other than the applicant, such as the relevant company, could make the normal risk of an adverse costs order an unacceptable one.

[129] All the respondents to Discussion Paper No. 11 agreed that the proposed legislation should contain specific provision enabling the Court to make an order granting an indemnity or some other protection for the applicant or controller of the derivative proceedings against being improperly exposed to the risk of having to meet costs. There was a divergence of opinion concerning the proper terms and extent of such an order.

54. At paras. [57] to [59].

55. And, in a sense, the loser if the action ultimately fails, notwithstanding that the conduct of the action may by itself prompt improvements in, for example, the administrative and management structures of the company.

56. [1975] QB 373.

57. Such as the establishment of the Commercial List in the Supreme Court of Victoria and the procedures adopted for the expedited hearing of matters.

[130] One respondent[58] favoured restricting such protection to an indemnity to the application for leave itself; another[59] thought that an applicant should not have an order for costs in relation to that application, but only for the subsequent proceedings. Others considered that the duration and other terms of an indemnity should be at the discretion of the Court.

[131] Section 246 of the Ontario Business Corporations Act, 1982, which is reproduced in Appendix 2 to this Report, specifically provides for payment by the relevant corporation or subsidiary of legal costs and expenses to the complete (the applicant for leave) only in connection with the action for which leave is granted, not the application for leave itself. It may be that an order covering the application could be made under that specific provision as being "in connection" with the action, or could be made in any event under the broader discretionary power in relation to consequential orders contained in section 246.

[132] The question arises whether the proposed Australian derivative proceedings provision should make specific reference to the costs of the application for leave.

[133] There seems to be no good reason to disentitle the applicant from being indemnified for the costs of the application if leave to take derivative action is granted. In addition, as noted in the joint submission of The Australian Society of Certified Practising Accountants and The Institute of Chartered Accountants in Australia to Discussion Paper No. 11, an application for leave might ultimately fail because of intervening remedial action being undertaken by the respondents; in that situation as well, the applicant should not have to bear his or her own costs or those of the respondents.

[134] It seems to the Committee preferable to make specific provision for an indemnity in relation to the costs of an application as well as to provide for an order for payment of the costs of the subsequent proceedings in order to avoid possible doubt as to the intended reach of a broader discretionary power in the Court.

[135] In relation to the general terms which should apply concerning any order as to costs, the Committee's preferred approach, subject to a recognition of the importance of ensuring that meritorious claims are not discouraged by any procedure adopted, is to grant the relevant Court flexibility of application. There may be cases where the Court feels confident in granting an order which applies up to final adjudication, subject to variation or withdrawal if facts that emerge during the course of the proceedings substantially alter the prospects for success of those proceedings. In other cases the facts may mandate a restricted initial order, applicable to a particular step in the proceedings with any extension being at the discretion of the Court.

58. Mr M A Adams.

59. Institute of Corporate Managers, Secretaries and Administrators Ltd.

[136] Apart from the basic proposition that an indemnity in relation to the costs of an application should rest on the good faith of an applicant and the merits of an application, and not necessarily on the financial strength or weakness of a particular applicant, it appears difficult to lay down any detailed guidelines as to the approach which should be followed concerning this aspect of the provision.

[137] One particular matter which should be addressed is whether any withdrawal or variation of an indemnity or other order as to costs should be permitted to operate retrospectively or only prospectively.

[138] Having regard to the stated intention to facilitate the initiation of meritorious claims on behalf of companies by my of the derivative procedure, any retrospective withdrawal or variation of a costs indemnity or other order contrary to the interests of an applicant, or other person having the conduct of proceedings, should only be undertaken where it is shown that the applicant or person having conduct of proceedings has acted in a manner which to the Court requires censure.

[139] The formula adopted in this Report is that the conduct should be such as to constitute an abuse of the process of the Court. This would encompass any deceptive or fraudulent conduct. Having regard to the matters which must be shown before leave to take derivative proceedings may be granted, it should be more unusual to find that an indemnity or other order as to costs is withdrawn, set aside or varied retrospectively on a basis such as that the facts adduced have not disclosed a cause of action.

[140] The ability of the Court to withdraw, set aside or vary an order prospectively is not intended to be so limited and should constitute an effective check on the continuation of proceedings which are in due course found to be of less substance than was originally accepted by the Court on the evidence then available to it.

[141] It is not proposed to make specific provision for prospective withdrawal; the powers that the Courts already possess in relation to revocation or variation of interlocutory orders[60] would appear to be wide enough for this purpose.

[142] The recommended provision permits the Court to make an order, either for an indemnity covering the costs of an application for leave or in relation to the costs of subsequent proceedings, against the company on behalf of which action is proposed or a corporation related to that company. Elsewhere in this Report[61] the Committee addresses the need to provide for a person connected with one company which is a component of a group of companies to be able to take proceedings to enforce a cause of action belonging to another company within that group.

60. For example, see Ritchie "Rules of the Supreme Court - New South Wales" paras. 40.9 to 40.9.18.

61. See paras. [38] to [46].

[143] In respect to costs, the Committee's view is that there could be circumstances where it is appropriate that an order be made against a related corporation. For example, a member of a holding company could be concerned that a liability may be imposed on that company because of a failure on the part of the holding company to direct a wholly-owned subsidiary to take action to enforce sane cause of action belonging to the subsidiary. The terms of financing arrangements within the relevant group of companies might be such that default on the part of subsidiary in meeting loan obligations to an outsider could trigger guarantees given by the holding company concerning the obligations of the subsidiary.

[144] In this situation any derivative proceedings taken by the member of the holding company would be directed against the management of the subsidiary, the immediate wrong being the failure of that management to protect the interests of the subsidiary. However, if the subsidiary were to be near-insolvent or at other substantial risk because of the failure to pursue the cause of action, the complacency of the holding company could found an argument that it should be the subject of orders as to the costs of the application for leave or subsequent derivative proceedings.

[145] Even in a less extreme example, the financial resources of a related corporation or recognition of a community of interests within a group of companies would be factors in favour of requiring a related corporation to assume an initial responsibility for a protective costs order in favour of the party seeking to take derivative action.

Sub-section (7) [Consequential orders] continued:

"(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 persons;

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

[146] **Consequential orders; recipients of the amounts of judgments.** It might appear inconsistent[62] to provide for the possibility of payment of any

62. As noted in the joint submission of The Australian Society of Certified Practising Accountants and The Institute of Chartered Accountants in Australia to Discussion Paper No. 11.

part of the amount of a judgment obtained on the successful prosecution of derivative proceedings to anyone other than the company for the benefit of which the litigation has been undertaken. However, it seems to the Committee that there may be circumstances in which such an approach would be warranted.

[147] The company might have been taken over after the relevant breach of duty had occurred. Although there might not yet be r cog ed some general duty on the part of directors and officers in relation to maintenance of a fair share price, the breach of which would be actionable at the suit of any member of the company,[63] if the breach of duty had caused such loss to the and concomitant fall in share price that the take-over offer had been unrealistically advanced, it would appear reasonable that there be a provision which would enable some part of a judgment to be paid to those members of the company who had accepted the take-over offer. The successful take-over offeror would not be disadvantaged as a present member of the company where it could be established that less than true value had been paid to acquire a controlling interest in the company.

[148] Another possibility could be that the company had undertaken a buy-back of a number of its own shares under Division 3A of Part IV of the Companies Act; this could be another example where those who had relinquished their shareholding should be compensated under the terms of a derivative action judgment.[54]

[149] Although it is difficult to envisage any persons other than members, former members, creditors and former creditors who might be thought deserving of a share of any judgment amount, the Committee considers that it is as well to provide a discretion as to potential recipients in addition to the specified classes.

[150] The wording of the recommended provision makes it clear that the interests of the creditors of a company or of a related corporation are to be taken into account in this regard, whether the intended recipients of any part of the amount of a just fall within the specific classes or are at the more general discretion of the Court.

[151] Whilst the Ontario legislation stipulates that any amount be ordered to be paid "directly" to any of the groups therein specified, the Committee is of the opinion that the mode of payment under the recommended provision should be at the discretion of the Court. There could be cases where it is appropriate that some intervening agency be involved.

63. See para. [49] above.

64. Recognition of such possible exceptions to the usual provision for payment exclusively to the relevant company could be seen as analogous to the statutory provision for partial re-ordering under section 450 Companies Act of payment priorities on a winding-up. That section gives preference to any creditor who has assisted a liquidator in recovery of property or who has contributed to the costs of a winding-up.

sub-section (7) [Consequential Orders] continued:

"(g) any other order that the ~ considers appropriate."

[152] **Consequential orders : the Court's general discretion.** At paras. [68] to [78] of Discussion Paper No. 11 the Committee raised the possibility of the proposed legislation concerning the taking of derivative proceedings providing specifically that the Court be empowered, on the hearing of an application for leave, to order the removal of all or some of the directors or officers of the company for the benefit of which derivative proceedings are contemplated.

[153] The Committee there noted that French law provides for the appointment by the Court of a temporary administrator who displaces the management of a company. That power of appointment, originally designed for cases of managerial deadlock or failure, has apparently been employed in cases where the Court has found some decision by directors to be deleterious to the overall commercial interests of a company.

[154] The Committee also mentioned the provisions of the Insolvency Act 1986 (United Kingdom) which allows for the appointment of an administrator for purposes which include the survival of a company as a going concern or a more advantageous realisation of the assets of a company than could be achieved on liquidation of the company.

[155] Discussion Paper No. 11 also addressed the situation where although displacement of the management might not be justified, nevertheless some greater control of the administration of a company might be necessary to protect properly the interests of that company. One possible solution mentioned was the appointment to the board of directors of a company of an "official observer" who could have at least some of the ordinary powers of a director and possibly possess a right of veto over matters touching the acts or omissions which had precipitated the application for leave to take derivative proceedings on behalf of the company.

[156] Respondents to Discussion Paper No. 11 did not enthusiastically embrace the notion of an administrator whose appointment would result in displacement of a company's management. The concept of the official observer attracted greater support, being viewed as not as interventionist a proposal and potentially less disruptive to the continued operations of a company.

[157] The Committee does not propose at this time to recommend that the legislation contain specific provision for the appointment in appropriate circumstances of either an administrator or official observer.

[158] It seems to the Committee that a far more detailed examination than the Committee is able to undertake at this time[65] would be necessary before such recommendations could be put forward with any confidence. Such an

65. It is anticipated that the Committee will cease to operate after 31 December 1990.

examination would need to address, amongst other totters, what qualifications should be possessed by anyone nominated for appointment, the method and scale of remuneration of an administrator or observer, whether such an appointee should have the status of an officer of the Court, whether an indemnity in relation to civil or criminal liability should be granted and whether the right of access to corporate information, and the use of such information, on the part of an administrator or observer should be unrestricted or subject to some limitation.

[159] There is also a need to consider the relationship that any provision for the appointment of an administrator or observer should bear to other legislative provisions, such as those governing liquidators and receivers and managers. The recent recommendations of The Australian Law Reform Commission on insolvency[66] might need to be taken into consideration. All of those totters are deserving of a more considered examination than can be undertaken by the Committee at this stage.

[160] However, some comments may be made concerning the types of orders which might be seen as appropriate to be made under the intended broad discretionary power.

[161] **Re Spargos Mining NL**, which is discussed elsewhere in this Report,[67] concerned an application under section 320 Companies Act. On finding that the grounds for intervention by the Court specified in that provision were clearly established, Murray J of the Supreme Court of Western Australia made orders which, in his Honour's words, "... would effectively replace the existing elected Board of Spargos with a Board of my own choosing"[68] under section 320(1)(d) which entitles the Court to make an order "for regulating the conduct of the affairs of the company in the future".

[162] Murray J also made orders, under the specific provisions of section 320, suspending the operation of various articles of association of the company and relied on a broader discretionary power to order that investigations be undertaken into the past activities of management and that reports as to the progress of those investigations be made periodically to the Court.

[163] Therefore, in at least one recent case, the Court was prepared to intervene substantially in the affairs of a comp for the purpose of ensuring the continuing viability of that company's operations.

[164] The Committee anticipates that the nature of any order made under the proposed section 320A(7)(g) will depend entirely on the facts of the particular case. In some circumstances, for example when a company faces the probability of imminent insolvency or other substantial and unacceptable detriment in the absence of corrective action, the Court my feel compelled to oust the entire management of a company and replace it with some kind of administrator who assumes all of the rights and obligations of the

66. In Report No. 45 "General Insolvency Inquiry" (1988, Australian Government Publishing Service).

67. See paras. [243] to [245] below.

68. At p. 113 of the reasons for judgment.

directors. In other cases, in the absence of such drastic probable consequences to a company, the replacement of specified directors may be seen as sufficient. Appointment to a board of an observer, with powers of control or veto over certain matters, may in another case be viewed as the most appropriate remedial action. It may be the case, as in **Spargos** (supra), that the Court considers it necessary to suspend or vary parts of the constituent documents of a company, or to mandate that certain administrative or financial procedures of a company are in future carried out in a particular way.

[165] It seems to the Committee that the terms and conditions of any such order should be at the discretion of the Court. It could be the case that the Courts in time conclude that more specific provision is needed concerning the proper ambit of the power to make broader consequential orders. Until that occurs, the Committee considers that to allow for a discretionary power of the kind set out in the proposed derivative action provision should be sufficient to permit in appropriate circumstances any necessary re-ordering of the affairs of companies.

Sub-section (9)[69]: Requirement of the leave of the Court to discontinue derivative proceedings:

"(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 my be substantially affected by an order for such stay, discontinuance, settlement or distain, the Court, before making that order, my order any party to the application or proceedings taken to give notice, in such terms as the Court considers appropriate, to any such person."

[166] Respondents to Discussion Paper No. 11 were unanimous in their support for a provision that any derivative proceedings only be discontinued or settled with the leave of the Court.

[167] The mischief at which such a requirement would be aimed would be collusion between the person having conduct of the proceedings and the defendants where payment to, or some other arrangement with, the applicant or other person having the conduct of the derivative proceedings could result in abandonment of a valid claim on behalf of a company.

[168] There is also a need to ensure that any proposed settlement would be for the benefit of the company or others who it is anticipated will be the recipients of at least part of the amount of any judgment awarded against the defendants; see paras [146] to [151] above.

[169] In the United States it is recognized that in certain circumstances a decision of a board of directors or of a committee of the board can be effective, with the sanction of the Court, to prevent the institution of

69. For sub-section (8), see before para. [124].

derivative proceedings, or to cause proceedings already under way to be discontinued.[70]

[170] In that jurisdiction a board or committee decision to recommend termination is examined by the Court as whether it is one to which the protection afforded by the "business judgment rule" should be granted. That rule states, broadly, that the merits of a business decision are not reviewable in a court of law provided certain criteria, including the good faith and disinterestedness of the deciding board members and the validity of administrative and procedural requirements, are satisfied.[71]

[171] On a strict application of that formulation, as occurred in **Auerbach v Bennett,**[72] a decision to terminate a derivative action should be viewed no differently from any other decision as far as the application of the business judgment rule is concerned. Provided the criteria set out above are satisfied, there would be no place for a consideration of the merits of the proposed termination.

[172] In **Zapata Corp v Maldonado**[73] the Supreme Court of Delaware added a further requirement for the applicability of the business judgment rule in cases where derivative proceedings are sought to be discontinued. It was there held that the Court's examination should consist of two lines of entry. The first matter to be addressed should be the independence and good faith of the board or the committee and the bases supporting a decision to recommend discontinuance. If satisfied as to those aspects, the Court should then, applying its own "independent business judgment", determine whether the motion to dismiss the derivative action should be granted; in other words, to decide the merits of continuing the derivative action:

"The second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation s interest.[74]

70. See generally Cary and Eisenberg, "Corporations; Cases and Materials" (1988, Foundation Press) pp. 964-1007.

71. See generally Block, Barton and Radin "The Business Judgment Rule; Fiduciary Duties of Corporate Directors and Officers" (1987, Prentice Hall).

72. 47 NY 2d 619 (1979); extracted in Cary and Eisenberg op. cit. at pp. 972 - 981; decision of the New York Court of Appeals.

73. 430 A.2d 779 (1981); extracted in Cary and Eisenberg op. cit. at pp. 981 - 990.

74. Per Quillen J; Cary and Eisenberg at p. 989.

[173] This approach has not been wholly followed in at least one later decision[75] in which it was held that the Court has a discretion, rather than an obligation, to move to the "second step" outlined in the Zapata case. It would appear that the question as to the correct application of the business judgment rule in these circumstances has not yet been authoritatively settled by the united States Courts.

[174] The question is addressed in Tentative Draft No. 6 of the American Law Institute's "Principles of Corporate Governance" (1986). The Institute's recommendations differ according to the status of the defendant to the derivative suit and whether the decision to terminate is being taken by the board of directors, or a committee thereof, or the company in general meeting.

[175] Part 7.07 of the Tentative Draft contains a general statement as to termination in the case of actions against persons other than directors, senior executives, persons in control or associates of any of those parties. The Institute's recommendation is that the Court should dismiss such an action on a determination that the action is adverse to the interests of the corporation, provided that that determination satisfies the requirements of the business judgment rule or if the shareholders approve the termination in the manner provided for in a later recommendation (Part 7.09).

[176] In the case where the defendants are either directors or senior executives of the company, control the company or are associates of any of those parties, the American Law Institute is of the view that a Court should dismiss in response to a motion of the board of directors, or a properly delegated committee thereof, only if the Court is satisfied that;

(a) Specified procedures for the conduct of an internal investigation by the company and evaluation of the merits of the action contained in Part 7.10 of the Tentative Draft had been complied with, or there were material departures from the requirements that were justified by the circumstances;

(b) The board or committee made a written report, which must contain adequate particulars in relation to the matters set out in (c) below, to the Court in good faith; and

(c) After considering the report and any contrary evidence, one of the following facts, or a combination of them, justifies dismissal as being in the company's best interests:

(1) The likelihood of a judgment for the plaintiff is remote;

(2) The value of the potential relief, if discounted for the likelihood of success and determined with respect to each defendant separately, "does not clearly exceed the corporation's probable out-of-pocket costs if the action were to continue against the defendant";

*75. **Kaplan v Wyatt** 499 A. 2d 1184 (1985); Supreme Court of Delaware - see Cary and Eisenberg at pp. 1004 and 1005.*

(3) Before the action had been commenced the company had itself undertaken appropriate corrective or disciplinary action in respect of the matters complained of; or

(4) The "balance of corporate interests" warrants dismissal of the action, regardless of its merits.

[177] In relation to such an action against corporate insiders, the Institute recommends that the Court should be satisfied that dismissal would not frustate any legal rule that operates for the protection of shareholders and further that the dismissal would not allow a defendant to retain some improper benefit where the defendant controls the company, either alone or with others who have also received an improper benefit out of the same imp ed transaction, or that the improper benefit was obtained through misrepresentation or fraud through a transaction with the company, use of corporate information, insider trading or misuse of corporate property where there had been no valid authorization for the benefit by disinterested directors, or ratification by disinterested shareholders.

[178] Part 7.10 of the Tentative Draft details what procedures the Institute considers should be undertaken by a board of directors or committee thereof in arriving at a decision to recommend termination. The decision should be taken by disinterested directors who as a group are capable of an informed and objective judgment under the circumstances. As well, in the case of decision by a board committee, it should be necessary that the full authority of the company concerning the relevant proceedings had been delegated to the committee.

[179] The Tentative Draft further mandates that the board or committee have been assisted by independent counsel of its choice and any other agents deemed necessary by it and have presented to the Court a written report that complies with the requirements set out above at para [176].

[180] In Part 7.09 the Institute addresses a resolution to terminate made by a meeting of shareholders. The first requirement in this instance is that the resolution to recommend termination was adopted by the board or committee after an examination the procedure for which complied with the requirements set out in Part 7.10. The other criteria include whether disclosure of all material facts had been made to the meeting, whether only disinterested shareholders voted in favour of the resolution and whether dismissal of the action "would not in substance amount to waste of corporate assets .... or frustate any legal rule that operates for the protection of shareholders."

[181] Assuming that any decision of the corporation to recommend termination, whether made by the board or a committee of the board or by a meeting of shareholders, complies with the requirements set out above, the Institute recommends that the Court must still be satisfied that any settlement, discontinuance, compromise or voluntary dismissal is in the best interests of the company.

[182] In the absence of circumstances leading the Court to find that the interests of shareholders will not be substantially affected by the proposed termination, the American Law Institute considers that any such settlement etc should be preceded by individual notice to each shareholder who may be

so affected. The notice should contain details of the proposed termination and the hearing in relation to it. A dissentient shareholder should be able to request the Court for an adjournment, adduce evidence and cross-examine witnesses called by the proponents of the termination, obtain discovery and have a right of appeal against any approval of the termination if these standards have been ignored or an abuse of discretion on the part of the Court has occurred.

[183] Assuming that adequate action has been taken in relation to any such dissenting shareholders, the Institute recommends that the following approach be taken in order to determine whether the derivative action should be terminated:

"In evaluating a proposed settlement, the court should place primary emphasis on the present value of the best possible recovery and, if calculable, of the probable recovery at trial, discounted in each case by the risk to the corporation of an adverse judgment and the time value of money. In addition, the court should consider:

(1) the value of any corrective measures or non-pecuniary relief required by the settlement or undertaken as a result of the litigation;

(2) the deterrent impact of settlement with respect to the type of conduct in question;

(3) any diminution of the recovery that will result from attorneys' fees or indemnification payments to be made by the corporation;

(4) the solvency of the defendants; and

(5) the availability of other plaintiffs to intervene and prosecute the action, or a portion thereof, in a superior fashion."

[184] The detailed and extensive nature of the American Law Institute's recommendations set out in Tentative Draft No. 6 results from the fact that derivative actions have been a feature of United States jurisdictions for many years; in some cases the recommendations are an at~ to reconcile conflicting decisions, such as **Auerbach v Bennett** and **Zapata Corp v Maldonado** which are discussed above at paras. [171] and [172] respectively.

[185] Some aspects of a number of the recommendations relate to matters which would be inapplicable to Australia at the present time, such as the effect on litigation of contingency fees payable to attorneys and the absence in the United States of a general presumption as to the awarding of costs in favour of a successful party in proceedings.

[186] In its Report No. 10 on indemnification, relief and insurance in relation to company directors and officers, this Committee recommended[76]

76 At para. [75].

that a business judgment rule similar in some respects to that which applies in United States jurisdictions be introduced into Australian law.

[187] If the Committee's recommendations in Report No. 10 are adopted, a director or officer would not be liable to pay compensation to the with which she or he is connected for a breach of the duty of care and diligence set out in section 229(2) of the Companies Act 1981 (Cwlth) unless the Court hearing the matter was satisfied that at the relevant time the director or officer:

(a) had an unauthorised interest in the transaction of the company to which the judgment relates;

(b) had not informed himself or herself to an appropriate extent about the subject of the business just the implementation of which is said to constitute a breach of duty;

(c) did not act in good faith for a proper purpose; or

(d) acted in a manner that a reasoneble director with his or her training and experience could not possibly regard as being for the benefit of the comp.

In that Report "business judgment" was defined to include any judgment concerning a company's business operations except any just as to constitutional totters[77] within the company, appointment of executive officers or the company's solvency.

[188] The question arises as to what effect the introduction of the business judgment rule as proposed by the Committee would or should have on the outcome of an application to take derivative proceedings or of the proceedings themselves.

[189] There is a further question as to whether the proposed derivative action provision should specifically provide criteria of the kind found in the American Law Institute's Tentative Draft No. 6 to determine the validity of any recommendation of the board or general meeting of a company to terminate derivative proceedings and also give the relevant Court guidelines for determining whether such action is supportable as being in the best interests of a company.

[190] If adopted as recommended by this Committee, the business judgment rule would be irrelevant to either an application for leave to take derivative proceedings or subsequent litigation where lack of good faith, fraud, conflict of interest or improper purpose are alleged to be ingredients of the relevant breach of duty on the part of any director or officer. The statutory rule would not, strictly, be capable of being applied where all that is sought by way of the derivative proceedings is recovery from a third party where there is no intention on the part of an applicant to pursue any director or officer for failure to prosecute the company's cause of action against the third party. It would only have potential formal application in the case of an allegation that any director or officer is in breach of the

77. For example, a decision to refuse to accept a nomination of a person for election as a director.

duty relating to the exercise of reasoneble care and diligence and thereby liable to compensate the company directly. This is not to ignore the possibility that the Court might, in regard to a matter involving action against only a third party, take account of a number of the elements that would be otherwise necessary for application of the business judgment rule, in order to determine whether such action against the third party appears to be in the best interests of the relevant company.

[191] There would not appear to be any good reason why the proposed business judgment rule could not be raised by a director or officer as a defence to the derivative action proper. Should the likelihood of this occurring influence the outcome of the application for leave?

[192] Strictly speaking, the business judgment rule could not be applied for the purpose of determining the fate of the application for leave, as the proposed rule only relates to a liability to pay compensation to the company, which liability could not be imposed on completion of interlocutory proceedings such as an application for leave.

[193] However, the Committee thinks that the same considerations should be relevant as in the case of advance authority or retrospective release by the company in general meeting concerning any breach of duty by a director or officer; see paras [109] to [119] above. If it is clear to the Court hearing the application for leave that the circumstances are such that reliance on the rule will afford a defence to any subsequent proceedings, that Court should not able to be satisfied that the granting of leave would appear to be in the interests of the company.

[194] At paras. [93] to [108] above the Committee examines the standard of proof that should be required to be met in order that the Court may determine that any proposed derivative proceedings would be in the best interests of a company. The Committee concluded that, in general, it should only be necessary to establish such benefit to a company to a prima facie of proof.

[195] However, as there noted by the Committee, any formulation adopted by the Court for deciding whether this standard is satisfied will in all probability be influenced by the particular facts of any individual matter.

[196] Where in an application for leave to commence derivative proceedings a defence based on the business just rule is mounted by the respondent directors or officers, there could be a concern as to the nature and extent of the evidence necessary for the purpose of the Court's determination of the matter. Should it be necessary that the board has undertaken an examination of the matters in the manner detailed in the American Law Institute's Tentative Draft No. 6 and that the Court have regard to similar criteria regarding the benefit to the company which are enunciated by that Institute?

[197] One problem in simply adopting or adapting the criteria laid down in the Tentative Draft could be the resulting length of time involved on the hearing of an application.[78]

*78. In **Kaplan v Wyatt** it was noted that the special litigation committee procedure in the United States can result in inordinate delay in the resolution of motions to dismiss; see*

[198] Apart from that consideration, it may not be the case that the criteria considered by one body to be ideal for the United States jurisdictions would in any event be capable of application in their entirety to the Australian system. As noted above, the effect of contingency fees payable to the United States legal profession and the absence of any general rule as to costs based on success in litigation would at this time have little relevance to this country.

[199] Additionally, the system of board committees, at least for the purpose of assessing or managing litigation involving a ~, is not nearly as well developed in Australia as is obviously the case in the United States. Nor did this Committee, in the recommendations of Report No. 10, specifically allude to the effect on the applicability of the business just rule of the terms of any advice obtained from counsel independent of the relevant board.

[200] The Committee does not consider that the proposed provision should attempt to set out all the criteria that should be relevant to the Court's determination whether a recommendation on the part of a board of directors to resist the institution of derivative proceedings, which recommendation it is claimed attracts the operation of the business judgment rule, should be conclusive as to the fate of an application for leave. The same would apply in the case of any purported resolution of the company in general meeting contrary to the institution of proceedings; the sufficiency of the vote of the general meeting would depend on the particular circumstances of each case.

[201] The proposed Australian derivative action provision, in following the terms of the Ontario legislation, does take up one of the matters particularized by the American Law Institute in Tentative Draft No. 6. In appropriate circumstances the Court is empowered to order that any hearing in which termination is proposed may be adjourned pending notice to any person whose interests the Court considers may be substantially affected by that proposal and the consideration of any. evidence and argument presented by any party to whom that notice was given.[79]

[202] Apart from the question of what effect a claimed application of the business just rule should have on the fate of an application for leave, there is the further consideration of the matters the Court should take into account when requested to sanction the terms of any proposed settlement of derivative proceedings that have been commenced.

[203] At para. [183] above the Committee quotes Part 7.13(b) of the American Law Institute's Tentative Draft No. 6 concerning criteria for determining whether a proposed settlement is in the best interests of the relevant company.

American Law Institute, Tentative Draft NO. 6 at pp. 89 and 90.

79. Due to the range of persons who are specifically granted standing to apply for leave under the proposed legislation, the Committee does not see merit in providing only for notice in this situation to shareholders, as is the case with the American Law Institute's Tentative Draft No. 6.

[204] In its submission to Discussion Paper No. 11 the Law Council of Australia set out the following extract from an Ontario decision, **Sparling v Southam Inc,**[80] concerning the approach the Court should take to proposed settlements:

"There is an overriding public interest in favour of settlement ..... In deciding whether or not to approve a proposed settlement the court must be satisfied that the proposal is fair and reasonable to all shareholders ..... The court must recognize that settlements are by their nature compromises ..... Acceptable settlements may fall within a broad range of upper and lower limits ..... It is not the court's function to substitute its judgment for that of the parties who negotiate the settlement ..... to litigate the merits of the action ..... [or] to simply rubber-stamp the proposal. The court must consider the nature of the claims that were advanced in the action, the nature of the defences to those claims that were advanced in the pleadings, and the benefits accruing and lost to the parties as a result of the settlement."

[205] Such an approach, which is obviously in terms more general than that enunciated by the American Law Institute, would appear to provide a suitable yardstick for present Australian purposes.

[206] If the derivative action provision proposed by the Committee is often utilized, more detailed criteria will no doubt in due course be enunciated by the Australian Courts. It does not seem to the Committee appropriate to attempt to pre-empt that development by necessarily adopting criteria which are considered appropriate for the United States.

Sub-section (10): Security for costs:

"(10) An applicant i~ not required to give security for costs in relation to any application rode under sub-section (2) or proceedings taken puts t to leave granted under sub-section (2)."

[207] AS noted in Discussion Paper No. 11, under general law a company can be in a different position from a natural person on the question of providing security for costs in relation to proceedings in which the company is plaintiff. Whereas ordinarily the poverty of a natural person plaintiff will not by itself found an order for security for costs, the Courts have displayed a greater willingness to order such security where it is likely that an impecunious company will not be able to meet the costs of the defendants if just is given in their favour. Such an attitude is in part based on a concern that the controllers of a company without funds could expose a defendant to costs without in any way risking their personal assets.

80. (1988) 66 O.R. (2d) 225; the extract is to be found at p. 230.

[208] Section 533(1) Companies Act provides that the Court may order that security for costs be given by a plaintiff corporation "..if it appears by credible testimony that there is reason to believe that the corporation will be up able to pay the costs of the defendant if successful in his defence.." and may order that proceedings are stayed until sufficient security is provided.

[209] The proposed derivative action provision should not alter this situation. As the company will be the plaintiff on the record in any derivative proceedings undertaken after the granting of leave, the company should still be subject to the provisions of section 533(1) of the Act. As well, there should be nothing in the nature of the derivative action that would alter the attitude of the Courts to the position of an impecunious plaintiff company.

[210] What the proposed provision seeks to do is to ensure that an applicant for leave to take derivative proceedings or any person, other than the relevant company, having the conduct of such proceedings is not exposed to any liability to give security for costs. This view arises from the fact that derivative proceedings would be taken to protect the interests of the company in question. The financial standing of an applicant for leave or controller of subsequent proceedings should not be a relevant factor in regard to whether derivative action is permitted to proceed or not.

[211] Discussion Paper No. 11 also raised the question whether an applicant for leave should be required to give any undertaking as to damages.

[212] The need to consider whether an undertaking as to damages should be required by the Court would ordinarily arise in non-derivative matters when the Court is requested to grant an interim or interlocutory injunction.[81]

[213] An undertaking in those circumstances has been described as "...the price that must be paid by almost every applicant for an interim or interlocutory injunction. An injunction will by its nature require a person to do or abstain from doing some act and so is by its nature an order with a tendency to prejudice the person to whom it is directed. The practice of requiring the undertaking recognises that, the injunction being only interim or interlocutory and so the rights of the parties not having been finally determined, it my at a later stage appear that the applicant should in fairness compensate the party enjoined for the harm he has suffered .... Even where a statute authorising the appointment of a receiver[82] on the application of a public authority directs the court not to insist on the usual undertaking as to damages, it has been said that the court may in exercising its discretion take into account whether an undertaking is offered." (Full Court of the Supreme Court of Victoria in **Bond Brewing Holdings Ltd & Ors v National Australia Bank Ltd & Ors** (1990) 8 ACLC 330 at 356).

81. See generally Spry, "Equitable Remedies" 3rd Edition (1984, Law Book Company).

82. The judgment affirms that such an appointment is of the same nature as the granting of an injunction.

[214] In refusing an application for special leave to appeal from the decision of the Full Court, the High Court commented:

"The damage to be apprehended by the making of an order for the appointment of a receiver and manager is not so much that the receiver and manager may so exercise his powers to occasion loss in the business to which he has been appointed. It consists of the consequences flowing from the fact of appointment and the defendant's loss of 'its title to control its assets and affairs'[83]."[84]

[215] The possible damage discussed above is damage which could be suffered by a company simply as a consequence of the appointment of a receiver and manager. Derivative proceedings would be taken for the benefit of the company in question; the company would be the plaintiff on the record. Therefore, in the present context any undertaking could not relate to any damage which might be occasioned to the company, but only damage which could be suffered by the respondents to an application and the defendants to the subsequent proceedings, including any delinquent directors and officers of the company.

[216] There could be occasions when an applicant for leave might seek an injunction to prevent some proposed transaction involving the company, such as the execution of a disadvantageous contract or the disposal of an asset of the company at an undervalue. The directors and officers and, in appropriate circumstances, the general meeting of the company could be enjoined from taking some step. The injunction could be mandatory in nature, requiring the taking of positive action in relation to some business of the company.

[217] It is difficult to see how in these circumstances any undertaking as to damages on the part of an applicant to take derivative action would be possible. If the directors and officers were enjoined, any consequential loss which they could suffer individually from the company being prevented from taking some action would have to be pursued by way of separate proceedings against the applicant alleging an infringement of some personal right or interest. This would also be the case with any member of the company where the general meeting had been enjoined and any third party, for rumple the other party to a proposed contract with the company.

[2183 Therefore, the Committee sees no need arising out of these proposals for legislation regulating the discretion of the Court in regard to any requirement concerning an undertaking as to damages.

83. A phrase taken from the judgment of Viscount Haldane LC in ***Parsons v Sovereign Bank of Canada*** *(1913) AC 160 at 167.*

84. (1990) 8 ACLC 365 at 367.

EXISTING LEGISLATION; AMENDMENT AND AMALGAMATION

[219] As indicated in para. [18] of this Report, the introduction of the proposed derivative action provision will in the Committee's view result in a need to consider the amendment of existing provisions of the Companies Act in order to clarify the causes of action which may arise through the running of a company and the parties who should be able to avail themselves of such causes of action. The Committee later (at para. [276]) proposes that same of the major remedial and enforcement provisions of the Companies Act be placed in a separate division of the Act.

[220] **Section 265B Companies Act.** At present section 265B enables a member to apply to the Court for an order authorising a registered auditor, or a duly qualified legal practitioner, acting on behalf of the member to inspect the company's books. "Books" is defined widely in section 5(1).

[221] As a condition of the Court exercising a discretion to make an order the Court must be satisfied that the member is acting in good faith and that the inspection is to be made for a proper purpose. In **Knightswood Nominees Pty Ltd v Sherwin Pastoral Company Ltd**[85] Brooking J of the Supreme Court of Victoria held that the elements of good faith and proper purpose are parts of a single composite test, namely whether the applicant is "acting and inspecting for a bona fide proper purpose".[86]

[222] In the **Knightswood** case Brooking J also held that what is capable of being regarded as a proper purpose "...must be affected by the consideration that the right to apply for an order is given only to members of the company. In the United States it is accepted that a 'proper purpose' must be a purpose 'germane to his status as a stockholder' or 'reasonably related to the status of a stockholder'... It is a view which I too adopt".[87]

[223] No doubt the access which can be obtained under section 265B will continue to be of significance in cases in which members of companies suspect that their personal interests as members are liable to be adversely affected by some act or commission on the part of management. The question arises whether standing to apply under section 265B should be widened to accommodate the introduction of the proposed derivative action provision.

[224] In para [96] of Discussion Paper No. 11 the Committee made the point that the efficacy of a derivative action provision may be lessened if there is undue restriction on access to information which may disclose that any cause of action belonging to a company is being improperly neglected. Respondents to the Discussion Paper generally agreed with that comment.

85. (1989) 7 ACLC 536.

86. At p. 541.

87. Ibid.

[225] The Committee is of the view that an application under section 265B should be capable of being made not only by a member but also any of the other persons who, under the Committee's recommendations, would be able to apply for leave to bring derivative proceedings. However, as a further safeguard against abuse of the procedure, applicants other than members should be required to satisfy the Court that the predominant reason for the application is a reasonable apprehension that the company has a right of action which is not being pursued by those managing the company and the desire of the applicant to bring derivative proceedings.

[226] Such an amendment would have the effect of removing any doubt as to whether section 265B is intended to assist the bringing of derivative proceedings as well as personal actions. Given the Court's power to prevent abuse of section 265B there seems to be no good reason for allowing this facility to a member but denying it to other persons who could apply for leave to bring derivative proceedings.

[227] There may be cases where a Court having an application under section 265B would more readily make an order on the application of a member than on the application of a creditor, on the basis that a member is a proprietor whereas a creditor is external to the company. In each particular case much will depend on the reason for the application under section 265B, the interest of the applicant and whether the applicant has a reasonable apprehension that the company has suffered loss or is likely to suffer loss.

[228] There is a further question whether it should be possible for the inspection ordered under section 265B to be undertaken by any person other than a registered ~ auditor or duly qualified legal practitioner. Consideration of this aspect is not prompted solely by the Committee's recommendation for the introduction of a statutory derivative action provision; the question is of equal relevance to the case of a member of a company seeking to enforce personal rights.

[229] It seems to the Committee that there may be many cases in which the nature of the information contained in the books to which access is sought is such that a company auditor or legal practitioner may not be the most appropriate person to undertake inspection. For example, the records of a mining company could contain detailed seismological studies. The files of a building company may set out involved engineering specifications. It may be necessary for an inspector appointed under section 265B to determine the status of the results of experts undertaken by a pharmaceutical manufacturer where it is alleged that directors or officers of the company are in breach of duty in failing to apply for the protection afforded by patent rights.

[230] In those examples the purposes for which inspection is ordered would be better served if the inspection were undertaken by someone with appropriate technical qualifications.

[231] The Committee is of the view that, in addition to registered auditors and duly qualified legal practitioners, it should also be possible for inspection to be carried out by any other person who in the opinion of the Court is a proper person to undertake the inspection.

[232] Such an amendment should cater for those cases in which it would be desirable for a party undertaking inspection to possess particular technical qualifications.

[233] One respondent to Discussion Paper No. 11 favoured amendment of section 265B so that it would expressly provide that the Court bas a discretion to authorise inspection of the records of boards of directors and of any committees of the board. It seems to the Committee that the question whether an order for inspection should extend to such records should rest with the Court hearing the application under section 265B and that section 265B should make it clear that the Court has that discretion. There may be cases where inspection of such records will assist a potential applicant for leave to bring a derivative proceeding in deciding whether to apply.

[234] Section 265B does not at present empower the Court to make an order authorising inspection of the books of a company related to that of which the applicant is a member. The provision for statutory derivative proceedings recommended earlier in this Report would allow certain persons connected with one corporation to obtain leave to bring proceedings in the name of a related corporation even though they are not members, former members, directors or officers, former directors or officers or creditors of the related corporation.

[235] In keeping with that idea it seems appropriate that section 265B should be amended to enable any of those persons to apply for an order for inspection of the books of the related corporation. The Court hearing the application will be in a position to decide whether the applicant has an appropriate interest in seeking recovery for, or in preventing injury to, the related corporation.

[236] In Discussion Paper No. 11 the Committee drew attention to the Draft Companies Act proposed by the New Zealand Law Commission.[88] Section 138 of that proposed Act, which was reproduced in Appendix 2 of the Discussion Paper, would allow a shareholder to require a company to provide him or her with information without the shareholder first having to apply to any Court. A "manifestly unreasonable" refusal to provide the information requested could lead to the Court ordering the provision of the information. Seeing that the Committee favours allowing a broader range of persons than shareholders to obtain information from a company, the Committee thinks that each of those applicants should have to obtain a Court order for inspection.

[237] The Committee recommends:

(a) that section 265B 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 265B but any such persons, other than members, shod 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

88. Report No. 9 - "Company Law Reform and Restatement", June 1989.

company's behalf by applying to bring derivative proceedings;

(b) that section 265B 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;

(c) that section 265B 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 265B 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.

[238] **Section 320 Companies Act.** At paras [15] to [19] of Discussion Paper No. 11 the Committee briefly examined the scope of section 320 as one of the principal remedies that a member of a company has in relation to maladministration of the affairs of a company. The conclusion reached in the Discussion Paper was that a Court may not be prepared to find in a particular case that the type of oppressive, unfairly prejudicial or unfairly discriminatory conduct towards members of a company addressed in the provision also necessarily involves a breach of a duty owed by directors and officers to a company alone. Thus the potential for the employment of the section as a means of pursuing a cause of action belonging solely to a company where the company improperly refuses or fails to take action my be limited.

[239] Mr G Stapledon, one of the respondents to the Discussion Paper, questioned the Committee's conclusions as to the reach of section 320 where breach of a duty owed solely to a company is involved, arguing that the ability of the Court to intervene where it is satisfied that the affairs of a company, or some act or omission or proposed act or omission on behalf of a company was, is or would be "contrary to the interests of the members as a·whole"[89] widens the scope of the provision.

[240] When coupled with the power of the Court to order that proceedings be instituted, prosecuted, defended or discontinued by the company or by a member in the name and on behalf of the company under section 320(2)(g), it is the view of Mr Stapledon that section 320 already could provide derivative standing of the type with which this Report is concerned.

89. An addition resulting from amendment of the provision in 1983.

[241] The Committee does not intend to traverse the history of section 320 or its predecessor provisions[90] nor attempt a summary of the cases in which this provision has been held to afford relief to company members.

[242] Section 320 is not the easiest provision to come to terms with; it is difficult to predict with confidence the types of situations to which the section should be held to be applicable. For present purposes the only aspects of the provision which require consideration are the scope of the phrase "contrary to the interests of the members as a whole" and whether, taking account of section 320(2)(g), the introduction of the proposed derivative action provision would result in a need to amend the existing provision.

[243] Some recent decisions illustrate the variety of approach to the ambit of the provision. In **Re Spargos Mining NL**[91] Murray J observed[92] that the import of the phrase "contrary to the interests of the members as a whole" seems to have been given no attention in the decided cases but that "it emphasises the considerable breadth of the power of curial intervention which the section creates."[93]

[244] Later in the reasons for judgment Murry J addresses the question whether the 1983 amendment to section 32094 establishes a separate ground for intervention. His Honour expresses some doubt as to the bases for the decision in **Morgan v 45 Fiers Avenue Pty Ltd**[95] in which it was held that the elements of section 320(2)(a) should be looked at as a composite whole, in other words that oppression, unfair prejudice or unfair discrimination towards a member or members and any conduct inimical to the interests of the members as a whole should be viewed as different aspects of a fundamental yardstick of "commercial unfairness".

[245] In the event Murray J found it unnecessary for the purposes of the decision in **Spargos** to determine whether the relevant phrase broadens the ambit of section 320.[96]

90. Section 186 "uniform" Companies Act 1961 etc.

91. Unreported; judgment of Murray J of the Supreme Court of Western Australia delivered 21 September 1990.

92. At p. 92 of the reasons for judgment.

93 .Ibid.

94. By which the "contrary to the interests of the members as a whole" element was introduced.

95 (1986) 10 ACLR 692.

96. It is of interest to note that his Honour concluded that unfairness towards a particular member, a group of members of the members as a Whole could exist in harm suffered as a result of the conduct of management in not ensuring that there is reasonable commercial justification for a particular course of action or "simply in the decision-making processes within the

[246] The majority of the High Court[97] in **Wayde & Anor v New South Wales Rugby League Ltd,**[98] in noting the grounds for a conclusion that the board of the company in that case had acted properly in the exercise of a power in excluding a rugby football club from participation in a competition under the control of the company and alluding to the caution which a Court must exercise in any intervention in the management of the affairs of a company, concluded that "the appellants faced a difficult task in seeking to prove that the decisions in question were unfairly prejudicial to [the relevant football club] **and therefore not in the overall interests of the members as a whole.**"[99] (emphasis supplied).

[247] Their Honours should perhaps not be taken as saying that the only circumstance in which the interests of the members as a whole could be said to be adversely affected would be where unfair prejudice to one of their number was made out or that action inimical to the interests of the totality of the membership, in the absence of some particular prejudice to perhaps a minority of members, would be excluded from the ambit of the provision. Apart from that comment, it is difficult to see how the majority judgment in that case could be seen as in any sense determinative of the question whether section 320 encases any act or omission of directors and officers constituting strictly a breach of duty to a cc~ alone. If anything, their Honours' comments would tend to support a contrary conclusion, namely that the elements set out in section 320 should be viewed as a composite whole.

[248] Until the matter is decided authoritatively by the Courts, the Committee, whilst taking full account of the arguments propounded by Mr Stapledon, is not prepared to assert that section 320 in its present form is necessarily capable of being successfully applied to any situation which discloses that directors and officers of a company are in breach of a duty which the relevant Court has no difficulty in determining is owed solely to the company. That sort of case would be one where the evidence does not disclose anything in the nature of oppression, unfair prejudice or unfair discrimination (whether those effects are several or are all elements of something which can be characterized as "unfair" or "commercially unfair") towards a member or members of a company, whether a single member, a minority group or the totality of members. There can be cases where the company has a cause of action to obtain a court order that a director disgorge to the company a profit gained in breach of fiduciary duty even though that gain represented no loss to the company and, in that sense, was not prejudicial to "the interests of the members as a whole". **Regal (Hastings) Ltd v Gulliver**[100] is an example.

company"; pp. 97 and 98 of the reasons for judgment.

97. Mason ACJ, Wilson, Deane and Dawson JJ.

98. (1985) 3 ACLC 799.

99. At p. 8O4.

100. [1967] 2 AC 134n; [1942] 1 All ER 378.

[249] In short, the Committee is unable to be confident that section 320 could, even on a wide interpretation, provide for anyone other than a to seek to pursue a cause of action belonging to it where the itself improperly refuses or fails to take action. If it were otherwise, there would have not been a need for consideration of the introduction of an Ontario-type derivative action provision.

[250] There is a question whether acceptance of the Committee's recommendation relating to introduction of the statutory derivative action provision would require amendment to section 320, particularly section 320(2)(g)which provides for an order that the company undertake specified litigation or which allows for the Court to authorize a member or members to undertake such litigation "in the name and on behalf of the company".

[251] That wording is virtually identical to that suggested by the Committee for the proposed derivative action provision. At first sight it might be thought that there could be confusion as to which provision is the appropriate one under which to proceed in any given set of circumstances. However, if the Committee's reservations about the reach of section 320 are correct, section 320(2)(g) is not a true derivative provision, in the sense of standing deriving from that of a company, as any standing thereunder would be generated by a wrong done to members **qua** members.

[252] In any event the answer seems to be that it is not necessary to amend section 320, as the causes of action in relation to that provision and the intended section 320A are not intended to be seen as co-extensive. It does not appear appropriate to contemplate removing the power that the Court presently has under section 320(2)(g) to order that there be undertaken litigation by a company or an authorized person in the name and on behalf of a company. That mode of proceeding should still be available in a case where the facts complained of fall squarely within the accepted bounds of section 320 where that provision is viewed solely as a remedy against "oppression".

[253] There may be cases where the facts justify applications under both section 320 and the proposed section 320A. In some situations an applicant might out of caution express an application in the alternative where the relevant facts do not clearly indicate that only one type of action should be pursued. These possibilities do not seem to the Committee to be potentially harmful or injurious. If truly "mixed" causes of action arise from the same set of circumstances, it is the opinion of the Committee that joinder should be permitted in any event. The pleading of an alternative cause of action is often employed in general litigation where there may be uncertainty as to the appropriate avenue of proceeding. This practice would not appear in the ordinary case to attract any censure by the Courts.

[254] **Sections 541 and 542 Companies Act.** At paras. [33] to [37] and paras. [26] to [32] of Discussion Paper No. 11, the Committee considered, respectively, the provisions of sections 541 and 542 of the Companies Act.

[255] Section 541 provides that where it appears to the Commission or a "prescribed person" (official manager, liquidator, provisional liquidator or person authorized by the Commission) that a person who has taken part or been concerned in the promotion, formation, management, administration or winding up of, or has otherwise taken part or been concerned in affairs of a

corporation has been or my have been guilty of fraud, negligence, default, breach of trust, breach of duty or other misconduct in relation to the corporation, or a person may be capable of giving information relating to such promotion etc. of the corporation, the Commission or the prescribed person may apply to the Court for orders in relation to that person. On granting an application, the Court is empowered to order that a person attend before the Court and give evidence on oath or affirmation as to matters relevant to the corporation; section 541(3). The Court is empowered to order that person to produce any books in his or her possession or under his or her control relevant to the matters the subject of the examination; section 541 (9).

[256] In Discussion Paper No. 11 the Committee raised a doubt as to the applicability of section 541 to solvent companies. The original purpose of section 541 and its predecessor provisions is clear:

" ..... we are of the opinion that sec. 541 is directed to similar ends to those to which the former sec. 250 %~s directed and that in general the object of a public examination prima facie directed by subsec. (4) is likewise to inform the public of the affairs of companies which have gone into liquidation or which in other ways have failed, as well as giving an opportunity to liquidators or other persons applying for examinations to obtain information about the conduct and affairs of companies."[101]

[257] Discussion Paper No. 11 raised the question whether the legislation should be amended to make it clear that section 541 should apply in the case of solvent companies and whether the range of persons who are specifically granted standing to apply for an examination to be conducted should be widened to include members and creditors of a company.

[258] All the respondents to the Discussion Paper who specifically addressed the issue agreed that such amendments should be made.

[259] At para. [237] of this Report the Committee recommends that section 265B Companies Act be amended to provide that any person who could apply for leave to commence derivative proceedings under the proposed section 320A Companies Act be granted standing to apply under section 265B for inspection of the records of a company or a related corporation on satisfying the Court that the applicant's predominant reason is the pursuit of a cause of action belonging to the amp or related corporation which it is apprehended will remain unlitigated in the absence of action by the applicant. The Committee also proposes expanding the categories of those who would be able to undertake the actual examination of a company's books under section 265B by the addition of a general discretionary power in the Court.

[260] The primary factor behind those recommendations relating to section 265B was the realization that a provision concerning standing to apply to take derivative action could be of doubtful utility where the information available to any person concerned about the operating of a company was unduly restricted. The same consideration would form the basis of any

101. Full Court of the Supreme Court of Victoria in **Friedrich v Herald and Weekly Times Ltd & Anor** (1990) 8 ACLC 109 at 115.

recommendation as to section 541.

[261] Notwithstanding any obligation a director or officer of a company may generally have to assist a liquidator of the company in private examination or otherwise, the rationale behind the provisions of section 541 is the probability of greater information being extracted where the answers of anyone subject to such an examination are given on oath or affirmation and the possibility of penal sanction for any person failing to give evidence as required, or giving false evidence.

[262] In the case of an application made to further the taking of derivative proceedings in respect of a solvent company and in the absence of presently quantifiable loss to that company, the Court may be less inclined to grant an application in the exercise of its discretion than in the case of a company which has gone into insolvent liquidation. Unless the particular matter required urgent action, the Court might consider that the course of evidence presented during the hearing of the derivative proceedings proper should afford the applicant sufficient information as to the issues in question.

[263] On the other hand, there may be instances where an application under section 541, notwithstanding the original purpose of the provision which has been recognised in decisions such as **Friedrich v Herald and Weekly Times Ltd & Anor** (supra), might be entirely appropriate to the circumstances of the case. It seems to the Committee that the success of any application should turn on the particular facts disclosed.

[264] There does not seem to the Committee any good reason not to take advantage of the legislative amendments proposed elsewhere in this Report to also put beyond doubt that the provisions of section 541 are available to any person who would have standing to apply for leave to take derivative proceedings on behalf of a company, and also to make it clear that the section applies where the solvency of any company is not in question. Such an amendment would provide a means of gathering information complementary to the revised section 265B. The requirements as to the matters about which the Court must be satisfied before an order could be made under the amended section 265B should also apply in the case of such an amended section 541. Where the company concerned is not shown to be insolvent, the examination should be private unless the Court otherwise orders.

[265] The Committee **recommends** accordingly.

[266] Section 542 provides that if on the application of an official manager, liquidator, provisional liquidator or person authorized by the Commission, the Court is satisfied that a person is guilty of "fraud, negligence, default, breach of trust or breach of duty" in relation to a corporation and that as a result the corporation has suffered, or is likely to suffer, loss or damage, the Court my make appropriate orders against, or in relation to, that person. Under section 542(4), the orders that may be made include an order directing the person to pay money or transfer property to the corporation or an order that the person pay to the corporation the amount of such loss or damage.

[267] Section 542 provides for sum recovery by a prescribed person without the necessity of instituting proceedings in the normal course by issuing a writ of summons. Its predecessor provisions operated in respect

of "misfeasance", a ground encompassing something in the nature of a breach of trust which caused actual loss to a company. Broadly, the aim of those predecessor sections, including section 367B "uniform" Companies Act 1961, was to assist in the orderly liquidation of a camping.

[268] The terms of section 542 encompass more than "misfeasance"; as noted by Corkery,[102] the grounds which section 542 specifies have equivalents in other provisions of the Companies Act such as section 229, which deals generally with the duties of directors and officers. Unless there was to be a restrictive interpretation of those grounds, so that recourse to section 542 was only held to be available in a case where something approximating "misfeasance" as traditionally understood was made out, section 542 would offer little in addition to the other remedies available under the legislation other than a summary procedure in cases of urgency. The provision is more restrictive than other remedies in one sense, in that it requires an actuality or likelihood of identifiable loss to the relevant company.

[269] Discussion Paper No. 11 questioned whether section 542 should be amended to make it clear that the recovery procedure is available to a member or creditor of a company. There was broad agreement amongst respondents that such an amendment should be undertaken.

[270] Although the relevant issue in Discussion Paper No. 11 mentioned only members or creditors, there would not appear to be any foundation for so limiting the provision for wider standing under section 542 if it is decided that amendment is required.

[271] The most cogent reason in favour of extending standing to the range of persons which the Committee has recommended should be able to pursue derivative action on behalf of a company would be the availability in an urgent case of the summary procedure afforded by section 542.

[272] However, it is the Committee's view that a distinction should be drawn between the information-gathering purpose of section 541 and the recovery function of section 542. As previously noted, the threshold for invoking the procedure of the latter provision is proof of loss to a company resulting from a breach of duty etc by a person in relation to the company. The provision for summary recovery after such proof of loss is justified by the need to realize the assets of a company and, as far as possible, to meet the claims of creditors expeditiously in order that a liquidation is conducted in an orderly and effective manner.

[273] If the Committee's other recommendations are accepted, an applicant for leave to take derivative action would only need to establish prima facie that san cause of action belonging to a company was being improperly neglected as one of the criteria for the granting of leave. Therefore it is to be anticipated that in at least same such applications the Court would not be apprised of evidence in any way sufficient to justify any order for recovery of the type contemplated by section 542. In many cases such evidence should only be made available to the Court on completion, or at least during the hearing, of the derivative proceedings.

102. "Directors' Powers and Duties" (1987, Longman) at pp. 224 and 225.

[274] It therefore seems to the Committee inappropriate to provide specific standing under section 542 to those who, it is recommended, have standing to apply for leave to take derivative proceedings under the proposed section 320A. An applicant under that recommended provision who is able to present a clear case to the Court should have little difficulty, assuming the other recommended criteria are met, in obtaining the leave of the Court to undertake derivative proceedings. There would not appear to be anything in the nature of derivative proceedings which alone would justify recourse to the summary procedure for recovery in place of adjudication following a full trial of the issues. In urgent cases, imminent damage to a company could be prevented through the mechanism of the grant of an interim injunction.

[275] The Committee accordingly does not presently recommend amendment of section 542 of the Companies Act.

PROPOSED AMALGAMATION OF LEGISLATION; COMPANIES ACT REMEDIAL PROVISIONS

[276] The Committee **recommends** that Part IX of the panes Act be amended so as to be comprised of at least the following provisions:

Section 320 (present provision);

Section 320A (proposed derivative action provision);

Section 320B (present section 265B); and

Section 320C (present section 265C).

Although the Committee does not at this time recommend bringing the remaining remedial or enforcement provisions of the Act, including sections 541, 542 or 574 into Part IX, there may be a need to consider further consolidation at some future time.

H A J FORD (CHAIRMAN)

G W CHARLTON

D A CRAWFORD

A B GREENWOOD

D R MAGAREY

8 November 1990

APPENDIX 1

LIST OF RESPONDENTS

Mr M A Adams

The Registered Clubs Association of New South Wales

Mr G Stapledon

Institute of Corporate Managers, Secretaries and Administrators Ltd

Associate Professor P Redmond

Commercial Law Association (Victorian Committee)

The Australian Society of Certified Practising Accountants / The Institute of Chartered Accountants in Australia - joint submission

Law Council of Australia (Companies Committee, Business Law Section)

The Law Society of Western Australia (Corporate Lawyers Committee)

APPENDIX 2

ONTARIO BUSINESS CORPORATIONS ACT, 1982 : EXTRACTS

"Sec. 244

Interpretation.

In this Part,

(a) "action" means an action under this Act;

(b) "complainant" means,

(i) a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates,

(ii) a director or an officer or a former director or officer of a corporation or of any of its affiliates,

(iii) any other person who, in the discretion of the court, is a proper person to make an application under this Part.

Sec. 245(1)

Derivative actions.

Subject to sub-section (2), a compliant may apply to the court for leave to bring an action in the name and on behalf of a corporation or any of its subsidiaries, or intervene in an action to which any such body corporate is a party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate.

Sec. 245(2)

Idem.

No action my be brought and no intervention in an action may be made under sub-section (1) unless the complainant has given fourteen days' notice to the directors of the corporation or its subsidiary of his intention to apply to the court under sub-section (1) and the court is satisfied that,

(a) the directors of the corporation or its subsidiary will not bring, diligently prosecute or defend or discontinue the action;

(b) the complainant is acting in good faith; and

(c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.

sec. 24s(3)

Ex parte application

Where a complainant on an **ex parte** application can establish to the satisfaction of the court that it is not expedient to give notice as required under sub-section (2), the court may make such interim order as it thinks fit pending the complainant giving notice as required.

Sec. 245(4)

Interim order.

Where a complainant on an application can establish to the satisfaction of the court that an interim order for relief should be male, the court may make such order as it thinks fit.

Sec. 246

Court order.

In connection with an action brought or intervened in under section 245, the court my at any time make an order it thinks fit including, without limiting the generality of the foregoing,

(a) an order authorizing the complainant or any other person to control the conduct of the action;

(b) an order giving directions for the conduct of the action;

(c) an order directing that any amount adjudged payable by a defendant in the action shall be paid, in whole or in part, directly to former and present security holders of the corporation or its subsidiary; and

(d) an order requiring the corporation or its subsidiary to pay reasonable legal fees and any other costs reasonably incurred by the complainant in connection with the action.

Sec. 248(1)

Discontinuance and settlement.

An application made or an action brought or intervened in under this Part 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 affiliate has been or may be approved by the shareholders of such body corporate, but evidence of approval by the shareholders may be taken into account by the court in making an order under section 206, 246 or 247.

Sec. 248(2)

Idem.

An application made or an action brought or intervened in under this Part shall not be stayed, discontinued, settled or dismissed for want of prosecution without the approval of the court given upon such terms as the court thinks fit and, if the court determines that the interests of any complainant may be substantially affected by such stay, discontinuance, settlement or dismissal, the court may order any party to the application or action to give notice to the complainant.

Sec. 248(3)

Costs.

A complainant is not required to give security for costs in any application made or action brought or intervened in under this Part.

Sec. 248(4)

Idem.

In an application made or an action brought or inked in under this Part, the court may at any time order the corporation or its affiliate to pay to the complainant interim costs, including reasonable legal fees and disbursements, for which interim costs the complainant may be held accountable to the corporation or its affiliate upon final disposition of the application or action."

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