COMMENT

DISENTANGLEMENT OF SHAREHOLDERS' PERSONAL ACTION FROM DERIVATIVE ACTION—RECENT CANADIAN EXPERIENCE

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Ever since the famous case *Foss* v. *Harbottle*[1] was decided, shareholders of companies have been fighting to widen the ambit of their rights to bring actions against directors and controlling shareholders. A shareholder can bring a personal action against a company and, if necessary, against the directors in order to vindicate his rights arising out of the Companies Act (for example, the right to rectify the register of members under UCA section 155 as in *Ngurli Ltd* v. *McCann*)[2] or, the articles (for example, the right to prevent persons holding office as directors in breach of the articles as in *Kraus* v. *J.G. Lloyd Pty Ltd*).[3] The usual remedy sought in such an action is in the form of a declaration or injunction against the wrongdoers. At present, there is an uncertain area where it is not clear whether a shareholder can bring a personal action for wrongs committed by the directors and the controlling shareholders. "The shareholder's personal right of action probably extends to a right to have the constitution (memorandum and articles) generally observed, a right which is limited by principle [established in *Foss* v. *Harbottle*], but as yet limited to an uncertain extent."[4]

Under the exceptions to the rule in *Foss* v. *Harbottle,* a shareholder is allowed to bring a corporate or derivative action against third parties including the directors, in order to redress an injury caused to the company.

> A shareholder's derivative suit seeks to recover for the benefit of the corporation and its whole body of shareholders when injury is caused to the corporation that may not otherwise be redressed because of the failure of the corporation to act . . . "although the corporation is made a defendant in a derivative suit, the corporation nevertheless is the real plaintiff and it alone benefits from the decree; the stockholders derive no benefit therefrom except the indirect benefit resulting from a realization upon the corporation's assets".[5]

Discussing the characteristics of such an action, Gower states:

> The plaintiff shareholder must sue in a representative capacity[6] on behalf of himself and all the other members other than the real defendants . . . If, therefore, judgment is given for the defendants a

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[1] (1843) 2 Hare 461; 67 E.R. 189.

[2] (1953) 90 C.L.R. 425.

[3] [1965] V.R. 232.

[4] J. W. Wedderburn, "Going the Whole Hogg v. Cramphorn" (1968) 31 M.L.R. 688.

[5] *Jones* v. *Ahmanson and Co.* (1969) 460 Pac. Rep. 2d 464, 470 *per* Traynor C.J., there citing Rules of Civ. Proc. for U.S. District Courts, Advisory Committee Notes (1966).

[6] But see *Feld* v. *Glick* (1975) 56 D.L.R. 3d 649 (discussed *supra*).

> second derivative action cannot be brought by another member, for the matter will be *res judicata* as regards all of them.[7]

A derivative action is most often brought claiming damages, although a claim for a declaration or an injunction is possible. In the United States, a large number of such actions are brought every year where the judiciary readily grant a civil right of action for breaches of the Securities Acts. Emphasizing the need and importance of allowing such actions in the modern complex business world, Professor Rostow referred to such actions as "the most important procedure the law has yet developed to police the internal affairs of corporations".[8]

On the question whether a personal action as distinguished from a derivative action is possible when directors act for an improper purpose, other than taking corporate property, company law seems to be still in a maze. Gower seems to hold the view that "every case of improper action by the directors would involve a breach of the member's personal rights".[9] The Australian courts have long recognized the *locus standi* of a shareholder to bring a personal action against directors who have been found to have issued shares for an improper purpose in breach of their fiduciary duties. In *Ngurli* v. *McCann*, the plaintiff shareholders brought personal actions against the director to set aside an issue of shares alleged to have been made for an improper purpose. The High Court held:

> . . . the plaintiffs have a clear right to sue in their own names to remedy the breach of trust. They are entitled to a declaration that the allotment of the . . . shares was invalid and should be set aside and to an order for the rectification of the register.[10]

A similar action arose in *Harlowe's Nominees Pty Ltd* v. *Woodside (Lakes Entrance) Oil Co. N.L.*,[11] where the plaintiff shareholder brought a personal action against the directors to set aside the issue of shares alleged to have been made for an improper purpose. Dismissing the action, the Court held that the allotment and issue of the shares had not prevented the plaintiff shareholder from obtaining the voting power be expected to obtain by buying shares on the open market. In another Australian case, *Howard Smith Ltd v. Ampol Petroleum Ltd*,[12] the plaintiff shareholders brought personal actions against the directors to cancel an issue of shares which had had the effect of converting the plaintiffs' position from majority shareholders into minority shareholders.

Upholding the decision of Street C.J. in Eq. of the Supreme Court of New South Wales, the Privy Council ruled for the plaintiffs, holding that the directors had exercised their fiduciary power of issuing shares for an improper purpose. In the American case, *Jones* v. *Ahmanson & Co.*,[13] the plaintiff shareholder brought an action against the controlling shareholders. The gravamen of her cause of action was injury to herself and the other minority shareholders. The Court held: "If the injury is not incidental to

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[7] L. C. B. Gower, *The Principles of Modern Company Law* (1969, 3rd ed.) 591.
[8] E. V. Rostow in E. S. Mason (ed.), *The Corporation in Modern Society* (1959) 49.
[9] Gower, note 7 *supra* at 586.
[10] (1953) 90 C.L.R. 425, 447.
[11] (1968) 121 C.L.R. 483.
[12] [1974] 1 All E.R. 1126; for a comment on the case, see S. Ahmed, "Fiduciary Powers of Directors" (1976) 124 New L.J. 1111.
[13] (1969) 460 Pac. Rep. 2d 464.

an injury to the corporation an individual cause of action exists."[14] The Court refused to allow the controlling shareholders to use their powers for the purpose of promoting a marketing scheme that benefited themselves alone to the detriment of the minority.

In the recent Canadian case, *Goldex Mines Ltd* v. *Revill*,[15] the question which came before the Ontario Court of Appeal for a positive answer was put in these terms: "Where the same acts of directors or of shareholders cause damage to the company and also to shareholders or a class of them, is a shareholder's cause of action for the wrong done to him derivative?"[16] In the earlier Canadian case, *Farnham* v. *Fingold*,[17] the Ontario Court of Appeal was not required, on the facts of that case, to answer this question. Analysing the complex features of shareholder litigation, Professor Beck stated:

> The critical threshold question in shareholder litigation . . . is whether the action is personal or derivative. It was the answer to this question that tripped the plaintiff in *Farnham* v. *Fingold*, which was potentially the most significant corporate action ever launched in Canada, and which has bedevilled the course of action in *Goldex Mines Ltd* v. *Revill*.[18]

These two cases were the first in Canada to discuss the distinguishing features between a personal action and a derivative action in light of the requirements of section 99 of the Ontario Business Corporations Act (1970). Under this Act, a shareholder is entitled to bring a derivative action only after obtaining leave of the court. Under common law, "the right to bring a derivative action is afforded the individual member as a matter of grace"[19] by the court "where it is impracticable for the company to do so".[20] Commenting upon the Act, Beck stated: "It was . . . to open the door to a wider range of shareholders' derivative actions that section 99 was included in the Ontario Act . . ."[21] But he would not seem to hold an optimistic view of the introduction of this section in stating: "Certainly the requirement that leave of the court be obtained to commence the action and approval be obtained to settle or discontinue it may be felt to have their drawbacks".[22] That the interpretation by the courts of this section raised complexities was admitted by Reid J. in *Re Goldhar and Quebec Manitou Mines Ltd*,[23] while commenting on another section of the same statute:

> The casting of directors' obligations into a statutory form in Ontario holds no promise that their enforcement will be any easier if two recent examples, *Farnham* and *Goldex* [requiring interpretation of section 99] are any guide.[24]

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[14] *Id.*, 471.
[15] (1975) 54 D.L.R. 3d 672.
[16] *Id.*, 676.
[17] (1973) 29 D.L.R. 3d 279.
[18] S. M. Beck, "The Shareholders' Derivative Action" (1974) 52 Can. Bar Rev. 159, 169. Beck wrote the article before *Goldex* was decided by the Court of Appeal.
[19] Gower, note 7 *supra* at 592.
[20] *Id.*, 587.
[21] Beck, note 18 *supra* at 168.
[22] *Id.*, 169.
[23] (1976) 61 D.L.R. 3d 612.
[24] *Id.*, 614-615.

In *Goldex*, the plaintiffs alleged that an information circular approved by the defendant directors and sent out with the notice calling the annual meeting of the company was false and misleading. They claimed that the resolution of the directors approving the annual report was a nullity. They further alleged that all proxies obtained by the defendant directors in response to the solicitation of proxies accompanied by the information circular and the annual report were null and void. The Ontario Court of Appeal held that while the preparation, approval and circulation to shareholders of a false and misleading annual report was undoubtedly a wrong to the company, the circulation of such a report to shareholders, accompanied by a solicitation on behalf of the directors of the shareholders' proxies, was also a wrong to shareholders as such, affecting their own personal rights. It further held that an action attacking such a report, seeking a declaration or an injunction or both, was not derivative, and leave of the court to bring it was not necessary.

In recognizing a shareholder's right to bring a personal action in such circumstances, it appears that the Ontario Court of Appeal followed the principle propounded in the leading American case, *Borak* v. *J.I. Case Co.*,[25] where it was stated that "the same allegations of fact might support either a derivative suit or an individual cause of action by shareholders".[26] It is submitted that the possibility of bringing either a personal action or a derivative action upon the same set of facts can also be found in *Ngurli*, where the High Court held:

> [The plaintiff shareholders] have individual statutory rights to have the register rectified . . . Apart from statute the case is one which falls squarely within the words of Lord Davey in *Burland* v. *Earle*,[27] that where the acts complained of are of a fraudulent character the minority can sue where the persons against whom the relief is sought hold and control the majority of shares in the company and will not permit an action to be brought in the name of the company.[28]

There is little doubt that *Goldex* will be looked upon as an important step in Canada in extending the *locus standi* of shareholders to bring personal actions against directors and controlling shareholders.

In the next case in Ontario, *Feld* v. *Glick*,[29] the question to be decided was whether, in a case where there were only two shareholders and one of them was the plaintiff and the other a co-defendant with the company in question, the action was a derivative action requiring leave of the court under section 99 of the Business Corporations Act. The Court was inclined to hold that section 99 applied to all actions that were brought for breaches of duties owed to a corporation, whether or not pleaded in representative form. However, since the point was doubtful, and other issues were raised in the action which could be resolved at the trial, the Court dismissed the application of the defendant to strike out the statement of claim of the plaintiff for want of leave of the court under section 99.

In the most recent case in Ontario, *Re Goldhar and Quebec Manitou Mines Ltd*,[30] the plaintiff shareholders brought actions against the directors

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[25] (1963) 317 F. 2d 838 (7th Cir.).
[26] *Id.*, 845.
[27] [1902] A.C. 83.
[28] (1953) 90 C.L.R. 425, 447.
[29] (1975) 54 D.L.R. 3d 672.
[30] (1976) 61 D.L.R. 3d 612.

under section 261 of the above-named Act, circumventing the requirement of obtaining leave of the court under section 99. Dismissing the action, the Court held that section 261 applied only to matters that could be readily dealt with on summary application and should not be used to determine complex issues involving corporate control. The Court quoted with approval the statement of Hughes J. in *Goldex*: ". . . all derivative actions are embraced by the provisions of section 99 of the Business Corporations Act which provides an exclusive code for their conduct in Ontario."[31]

It is not easy to ascertain from the reports of some of the relevant cases whether a shareholder brought a personal action or a derivative action. Both actions, in some circumstances, may be in representative form.

> The line between personal and derivative actions is neither clear nor settled and the shareholder who begins his suit believing he has a personal right of action may be met by a ruling that the wrong of which he complains is not to him but to the company and he must comply with the rule [in *Foss* v. *Harbottle*] which may well mean that his grievance will go unremedied.[32]

Commenting on *Farnham* v. *Fingold*,[33] Beck stated: "It was clear in *Farnham* that the plaintiffs were not themselves sure as to whether their claim was personal or derivative and they tried to have it both ways."[34] In *Goldex*, the Court dismissed the action of the plaintiff shareholder as it found that the statement of claim did not attempt to differentiate between claims personal to shareholders and claims which were derivative. The Court also refused to grant leave *nunc pro tunc* under section 99(2). In *Feld* v. *Glick*, although the plaintiff shareholder asserted that all of the claims in the action were personal to her, the Court found it "difficult to escape the conclusion that the pleading *includes*, albeit possibly in alternative form, derivative claims".[35]

In *Ngurli*, the trial judge, Mayo J., dismissed the action of the plaintiff shareholder against the director for issuing shares as he was of the opinion that the wrong was done to the company and not to any individual shareholder. His Honour's decision was reversed both by the Supreme Court and the High Court, which held that

> Any attempt by directors or by the company to exercise [the right to issue new capital] not for the benefit of the company as a whole but so as to benefit the majority to the detriment of the minority could be restrained in a suit brought by the minority against the company and the majority.[36]

In *Bamford* v. *Bamford*,[37] a case involving an issue of shares by directors exceeding their powers, while the trial judge Plowman J. recognized the right of a shareholder to bring a personal action, Russell L.J. in the Court of Appeal thought that in such circumstances a shareholder has no *locus standi* to bring a personal action, but can only bring a derivative action. His Lordship stated: "The harm done by the assumed improperly-motivated

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[31] (1974) 38 C.L.R. 3d 513, 520-521.
[32] Beck, note 18 *supra* at 167-168.
[33] (1973) 29 D.L.R. 3d 279.
[34] Beck, note 18 *supra* at 181.
[35] (1975) 56 D.L.R. 3d 649, 655.
[36] (1953) 90 C.L.R. 425, 477-478.
[37] [1968] 3 W.L.R. 317 (H. Ct); [1969] 2 W.L.R. 1107 (C.A.).

allotment is a harm done to the company, of which only the company can complain."[38] Commenting on this statement, Professor Wedderburn observed: "This seems to put the action and the *locus standi* of the plaintiff not upon a personal basis but upon a 'corporate' or 'derivative' basis."[39]

In *Bamford* v. *Bamford*, while Plowman J. recognized the *locus standi* of the shareholders to bring a personal action, he at the same time held that the breach of fiduciary duty of the directors towards the shareholders could be ratified by the majority shareholders in the general meeting. In similar circumstances in *Hogg* v. *Cramphorn Ltd*[40] Buckley J. allowed the majority shareholders an opportunity to ratify the directors' acts done for "collateral purposes". But there is an important difference between the two cases: while in *Bamford*, the shareholders brought a personal action (accepted as such by Plowman J.), the shareholder in *Hogg* brought a derivative action (thought as such by Wedderburn).[41] In *Goldex Mines Ltd*, there was no argument regarding the possibility of ratification by the majority shareholders in the general meeting of the alleged improper acts done by the directors.

It is submitted that when a shareholder brings a personal action as distinct from a derivative action against the directors for acts done for "collateral purposes", the shareholders in general meeting should not be allowed to ratify such improprieties. Some support for this proposition may be found from the opinion of Wedderburn: "In one respect, the *Hogg* judgment may be thought preferable to that in *Bamford* since it seems to treat actions of this kind as 'corporate' actions" ratifiable by the shareholders in the general meeting.[42] "The vital question of whether some directors' breaches of duty are ratifiable or not, and thus of whether a cause of action remains", Beck says, "may well depend on whether the aggrieved party is seen to be an individual shareholder or the corporation".[43] Judicial support for the above submission can be secured from the clear statement of Helsham J. in the Australian case, *Provident International Corporation* v. *International Leasing Corporation Ltd*:

> A breach of duty owed to an individual shareholder as one of the corporators could not be ratified by a majority of shareholders; any attempt by a majority to ratify a breach of fiduciary duty by directors would be no less a fraud *qua* that shareholder than was the case in the acts of the directors.[44]

Implicit in the Canadian extension of the right of a shareholder to bring a personal action signified by *Goldex*, seems to be a change in the long accepted proposition of law, that "the fiduciary duties are owed to the company and to the company alone".[45] In this context, in the American case, *Gordon* v. *Elliman*, Fuld J. said: "The law is otherwise. This court has recognized 'a relation of the directors to the stockholders' . . . courts frequently compel directors to perform 'acts required by good faith to the

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[38] [1969] 2 W.L.R. 1107, 1115.
[39] J. W. Wedderburn, "Unreformed Company Law" (1969) 32 M.L.R. 563, 564.
[40] [1966] 3 W.L.R. 995.
[41] See J. W. Wedderburn, "Shareholders' Control of Directors' Powers: A Judicial Innovation?" (1967) 30 M.L.R. 78.
[42] Wedderburn, note 4 *supra* at 693.
[43] Beck, note 18 *supra* at 169.
[44] (1969) 89 W.N. (N.S.W.) Pt 1 370, 381.
[45] See Gower, note 7 *supra* at 517.

stockholders'."[46] Wedderburn was perhaps commenting on the narrow view of the scope of the directors' fiduciary duties, when he said: "it is trite law that directors owe such duties not to the shareholders but to the company alone".[47] The traditional view of the scope of the fiduciary duties was expounded by the courts in order to avoid multiplicity of actions by individual shareholders so that internal disputes should be solved by the majority shareholders in the general meeting. This traditional view has sometimes caused injury to the shareholders. Commenting on *Pavlides* v. *Jensen*[48] (where a personal action brought by a shareholder failed), Gower asked: "Is it not, perhaps, time that the rule in *Foss* v. *Harbottle* was decently interred?"[49]

It is now clear that as a result of the decision made in *Goldex* the attitude of the Canadian courts towards the fiduciary duties of the directors has moved closer to that in the United States where the accepted position is that the directors and the majority shareholders in certain cases, stand in a direct fiduciary relationship to the shareholders.[50] In *Jones* v. *Ahmanson*, Traynor C.J. urged the protection of minority shareholders from being injured at the hands of the majority in these words:

> . . . the increasingly complex transactions of the business and financial communities demonstrate the inadequacy of the traditional theories of fiduciary obligation as tests of majority shareholder responsibility to the minority. These theories have failed to afford adequate protection to minority shareholders and particularly to those in closely held corporations whose disadvantageous and often precarious position renders them particularly vulnerable to the vagaries of the majority.[51]

It remains to be seen in Australia whether the ambit of the fiduciary duties of directors towards shareholders will be widened further, allowing shareholders to bring personal actions against directors in matters where hitherto only corporate actions have been permitted.

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[46] (1954) 119 N.E. 2d 331, 340.
[47] Wedderburn, note 4 *supra* at 692.
[48] [1956] 3 W.L.R. 224.
[49] L. C. B. Gower, "Company Law—Minority Stockholder Suits" (1956) 19 M.L.R. 538, 541.
[50] See *Pepper* v. *Litton* (1939) 308 U.S. 295; *Pearlman* v. *Feldman* (1955) 219 F. 2d 173 (2nd Cir.).
[51] (1969) 460 Pac. Rep. 2d 464, 473.