CORPORATE GOVERNANCE, SHAREHOLDER LITIGATION AND THE PROSPECTS FOR A STATUTORY DERIVATIVE ACTION

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I. INTRODUCTION

> [The shareholder derivative action is] the chief regulator of corporate management.[1]

> [It must be recognized] that the derivative action is neither the initial nor the primary protection for shareholders against managerial misconduct.[2]

The subject of shareholder derivative actions[3] is now on the political agenda with a recommendation from the Companies and Securities Law Review Committee ("CSLRC") that there be enacted in Australia a statutory derivative action.[4] This recommendation has been endorsed by the House of Representatives Standing Committee on Legal and Constitutional Affairs.[5]

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1 *Cohen v Beneficial Industrial Loan Corp* 337 US 541, 548 (1949).

2 American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* Proposed Final Draft, 1992 p 587

3 A shareholder derivative action is a legal action brought by a shareholder based on a cause of action belonging to the company and not the shareholder.

4 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, 1990).

5 Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs *Corporate Practices and the Rights of Shareholders* (1991) Recommendation 26.

Yet, as the two quotations above demonstrate, there are different views concerning the effectiveness of such actions. One of the problems with the CSLRC report is that it does not attempt to identify the goals of shareholder litigation. In fact, the main justification given in the report for the recommendation is perceived deficiencies in the common law imposing restrictive standing requirements on shareholders.[6] It is therefore significant that, in addition to the CSLRC not identifying the goals of shareholder litigation and the role that a statutory derivative action would play in accomplishing these goals, a year before the CSLRC produced its report, an English academic published an article stating that Australian judges had generally ignored these perceived common law deficiencies in shareholder litigation.[7]

The object of this article is to critically examine the role of shareholder litigation in corporate governance. In Part II I argue that the main purpose is the reduction of agency costs between managers of companies and shareholders. However, there are a number of mechanisms which share this purpose. These include regulatory agencies (such as the Australian Securities Commission ("ASC") and the Australian Stock Exchange ("ASX")), independent directors and also market forces (such as the market for corporate control and the product market). Therefore, the task is one of evaluating the respective merits of these mechanisms. In Part III I examine the proposed CSLRC statutory derivative action. I argue that the justification advanced by the CSLRC in support of its recommendation is misconceived for two reasons. First, a statutory derivative action cannot be justified on the basis of common law deficiencies when, as Sealy has demonstrated, Australian judges have generally ignored these deficiencies. In fact, since Sealy published his article in 1989, Australian judges have indicated an even greater willingness to avoid problems that otherwise might be created by *Foss v Harbottle* by expanding the statutory oppression remedy.[8] Second, the main impediment to shareholders contemplating litigation is not deficiencies in the common law concerning standing but a lack of incentives to commence litigation deriving from a number of factors including the cost of litigation and the fact that if the action is successful any recovery accrues to the company and not the plaintiff shareholder. These problems need to be addressed if shareholder litigation is to be meaningful.

It is to be noted that shareholder litigation may involve a role for a number of bodies. These include the plaintiff shareholder, the other shareholders in the company, the directors and of course the courts. Depending upon the precise form of the shareholder derivative action, each of these bodies is given a greater or lesser role. For example, in recent years shareholder derivative actions in the

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6 These are deficiencies arising from the decision of the Court of Chancery in *Foss v Harbottle* (1843) 2 Hare 461; 67 ER 189. See notes 43-4 *infra* and accompanying text.

7 LS Sealy "The Rule in Foss v Harbottle: The Australian Experience" (1989) 10 *Company Lawyer* 52. See notes 50-67 *infra* and accompanying text.

8 *Corporations Law* s 260. An example discussed later in this article is *Jenkins v Enterprise Gold Mines NL* (1992) 6 ACSR 539. See notes 61-5 *infra* and accompanying text.

United States have seen an enhanced role for directors with the establishment of shareholder litigation committees. These committees, comprised of independent directors, are called upon to evaluate the merits of shareholder derivative actions.[9] A different approach is adopted by the CSLRC. It proposes that, rather than introducing shareholder litigation committees, the court will be required to make an initial decision whether or not the derivative action appears to be in the interests of the company. If so, the action can then proceed to be heard on its merits. Clearly, this proposal gives an enhanced role to the court rather than to the directors in determining the resolution of shareholder derivative actions. In Part IV I evaluate the competence of each of the plaintiff shareholder, the other shareholders in the company, independent directors and the courts to be determining the resolution of shareholder derivative actions. This is essential if shareholder litigation is to accomplish the goals identified in Part II.

II. SHAREHOLDER LITIGATION AND CORPORATE GOVERNANCE

One of the major themes of corporate law concerns the tension between control and accountability. In large public companies managers are given significant discretion in the running of the business. Indeed, this discretion is so broad that it effectively means management control of these companies. This control can lead managers to act in their own interests rather than in the interests of shareholders. Consequently, much of the existing corporate regulatory structure concerns itself with endeavouring to ensure the accountability of managers without unduly encroaching upon their discretionary powers.[10]

The divergence of interest between managers and shareholders results in costs (agency costs) that can be divided into several categories:

- Monitoring costs incurred by shareholders to ensure that managers are acting in the interests of the shareholders.
- Bonding costs incurred by managers with the purpose of assuring shareholders that their interests are being pursued.[11]

According to one commentator "[t]he derivative suit is a monument to the problem of agency costs; it would make no sense to allow a shareholder to bypass the corporate management in bringing a suit against an officer if one

9 See notes 106-18 *infra* and accompanying text.

10 RC Clark *Corporate Law* (1986) pp 33-34; JH Farrar, N Fury and B Hannigan *Farrar's Company Law* (3rd ed 1991) pp 9-10.

11 MC Jensen and WH Meckling "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305; MP Dooley and EN Veasey "The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared" (1989) 44 *Business Lawyer* 503 at 527.

could be confident that management always acted in the shareholders' interest".[12] The American Law Institute has argued that the shareholder derivative action reduces agency costs in a number of ways. First, it operates to deter mismanagement (by imposing the threat of liability) and therefore aligns the interests of managers and shareholders. Second, it can reduce one part of the agency costs; namely, monitoring costs incurred by shareholders.

> Both because the plaintiff's attorney is typically a specialist in such litigation and because shareholder coordination is not necessary in the case of the derivative action, it seems reasonable to believe that the availability of this action economizes on costs that otherwise would be necessarily incurred if shareholders were required to take collective action. For example, the costs incurred when a plaintiff's attorney obtains an injunction are likely to be far less than those that stockholders would have to incur to organize a proxy fight or that a hostile bidder would face in determining whether to make an unsolicited tender offer.[13]

However, there are a number of ways in which agency costs can be reduced other than by shareholder litigation. These include shareholder voting, the work of corporate regulators and market forces. In order to understand what role should be assigned to shareholder litigation, it is necessary to consider both the advantages and the limits of these other mechanisms.

Corporate regulators such as the ASC and the ASX play an important role in deterring mismanagement and thereby reducing agency costs by enforcing the *Corporations Law* and the Stock Exchange Listing Rules.[14] Yet it is impractical to rely exclusively on public enforcement. This has to be balanced by private enforcement for several reasons. First, limits on the funding of corporate regulators means that they cannot, of necessity, pursue all breaches of the law. Second, there is no reason to believe that the priorities established by a corporate regulator for enforcement are necessarily the correct ones. This dictates a role for private enforcement. Third:

> ...When the legal system assigns a substantial enforcement role to private litigation, there is less need to rely on public agencies and in turn the tendency of such public agencies to expand their jurisdiction is less likely to produce excessive bureaucratic regulation of private enterprise. In addition, absent private enforcement, the State holds a monopoly on the access to remedies and it can determine, sometimes arbitrarily or for political reasons, not to enforce rights or duties it had previously guarded. Thus, private enforcement serves a fail-safe function and ensures greater stability in the application of law.[15]

It might be argued that an enforcement mechanism available to shareholders, other than litigation, is the right to vote. In other words, managers will act in the interests of shareholders because otherwise shareholders might vote for their

12 RA Posner *Economic Analysis of Law* (3rd ed, 1986) p 389.

13 American Law Institute note 2 *supra* p 600.

14 It is stated in the Chairman's Foreword to the *Australian Securities Commission Annual Report 1990-1991* that "we see our mission as achieving maximum credibility of Australian corporations and markets. We intend to enforce the standards apparently abused with such recklessness over the past few years. Our longer-term aim is to establish a climate of compliance, ethics and responsibility"; p 3.

15 American Law Institute *Principles of Corporate Governance and Structure: Restatement and Recommendations* (Tentative Draft No 1, 1982) pp 220-1.

removal. However, it is now widely recognised that shareholder voting in large public companies tends not to be a potent force. The reason is that it suffers from a collective action problem.

> The act of voting, and becoming informed enough to vote intelligently requires an investment of time, which is a scarce resource. Yet a shareholder's vote is unlikely to affect whether a proposal wins or loses. The cost and futility of becoming informed leads shareholders to choose rational apathy: they do not take the time to consider particular proposals, and instead adopt a crude rule of thumb like "vote with management". Collective action theory also tells us, the critics argue, that shareholders will not make economically motivated proposals or actively oppose manager proposals unless the potential gains are much larger than the cost of the effort. A shareholder proponent bears most of the cost of a proxy campaign, but receives only a pro rata share of the gains from success, while other shareholders free-ride on her efforts. Free-rider problems work in tandem with the rational apathy of the free riders to discourage shareholder proposals from being made.[16]

There are a number of other ways whereby shareholders or managers may reduce agency costs. For example, it is claimed that independent directors are an effective means of ensuring management accountability to shareholders and there has been a recent recommendation by a number of associations, including the Australian Institute of Company Directors and the Business Council of Australia, for each board of directors of a public company to have at least two independent directors.[17] Some commentators question such calls for increasing the number of independent directors on the basis that these directors increase the cost of running companies because of their lack of familiarity with the business.[18] However, there is empirical evidence that the appointment of independent directors does result in an increased share price and therefore is perceived to be a positive development by shareholders.[19] Other ways in which managers provide assurances to shareholders that their interests are being pursued include the voluntary disclosure of corporate information[20] and the use of accountants and auditors to verify this information.[21] Investors in a range of collective investment schemes such as superannuation, companies issuing debentures and public unit trusts, may contract to employ the services of a third

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16 BS Black "Shareholder Passivity Reexamined" (1990) 89 *Michigan L Rev* 520, pp 527-8.

17 Business Council of Australia et al *Corporate Practices and Conduct* (1991) pp 5-6. For similar recommendations in the United Kingdom, see the Institute of Chartered Accountants, the Institute of Directors and PRO-NED *The Changing Role of the Non-Executive Director* (1991).

18 DR Fischel "The Corporate Governance Movement" (1982) 35 *Vanderbilt L Rev* 1259 at 1282-4. See also V Brudney "The Independent Director - Heavenly City or Potemkin Village?" (1982) 95 *Harv L Rev* 597.

19 S Rosenstein and JG Wyatt "Outside Directors, Board Independence and Shareholder Wealth" (1990) 26 *Journal of Financial Economics* 175.

20 RW Leftwich, RL Watts and JL Zimmerman "Voluntary Corporate Disclosure: The Case of Interim Reporting" (1981) 19 *Journal of Accounting Research* 50. For further analysis of this issue, see M Blair "The Debate Over Mandatory Corporate Disclosure Rules" (1992) 15 *UNSWLJ* 177.

21 RL Watts and JL Zimmerman "Agency Problems, Auditors and the Theory of the Firm: Some Evidence" (1983) 26 *Journal of Law and Economics* 613.

party such as a trustee to protect their interests against the possibility of mismanagement by those administering the scheme.[22]

It also needs to be recognised that there are a number of market forces that, depending upon the circumstances, operate to align the interests of shareholders and managers.[23] These include the product market, capital market, market for corporate control and the labour market for managers. While these market forces can operate to reduce agency costs they are subject to limitations. For example, the product market in which a company operates may not be competitive with the result that the company can be operating inefficiently without this inefficiency being disciplined by the market.[24] The market for corporate control may have little or no application to private companies. Yet private companies constitute the vast bulk of companies in Australia.[25] The *Corporations Law* requires a private company to restrict the right of shareholders to transfer their shares[26] which inevitably limits the application of the market for corporate control. A number of other factors may limit this market including defensive tactics employed by managers of companies which are potential takeover targets.[27] More generally, the activeness of the market for corporate control can vary significantly as the following statistics demonstrate:

TAKEOVERS CONDUCTED IN AUSTRALIA 1988-1991[28]

	Number of Takeovers	**Number Opposed**	**Percentage Opposed**
1988	289	70	24
1989	179	30	17
1990	97	12	12
1991	86	22	26

22 M Blair and I Ramsay "Collective Investment Schemes: The Role of the Trustee" in (1992) 1(3) *Australian Accounting Review* 10.

23 I Ramsay "Company Law and the Economics of Federalism" (1990) 19 *Federal L Rev* 169 at 181-4.

24 For a range of views and evidence on this subject, see PA Geroski, L Philps and A Ulph *Oligopoly, Competition and Welfare* (1985); MA Utton *Profit and Stability of Monopoly* (1986); WG Shepherd *Market Power and Economic Welfare* (1970); K Cowling *Monopoly Capitalism* (1982); J Tirole *The Theory of Industrial Organization* (1988).

25 As at 30 June 1991 there were 10,402 public companies limited by shares and 871,648 private companies limited by shares: Australian Securities Commission *Annual Report 1990-91*, appendix 2.

26 *Corporations Law* s 116.

27 For a legal analysis of defensive tactics under Australian law, see T Steel "Defensive Tactics in Company Takeovers" (1986) 5 *Co & Sec LJ* 30. For empirical evidence that target companies are increasingly using defensive tactics, see RS Casey and PH Eddey "Defence Strategies of Listed Companies Under the Takeover Code" (1986) 11 *Australian Journal of Management* 153.

28 Corporate Adviser *Analysis of Takeover Activity January-December 1989* (1990) and *Analysis of Takeover Activity January-December 1990* (1991); *Analysis of Takeover Activity January-December 1991* (1992) Tables 1, 6 and 7.

In addition, Coffee[29] has argued that the market for corporate control applies only within a limited range. Companies in which the degree of inefficiency is not extreme enough to create a sufficient reduction in the share price to cause a takeover and companies in which the degree of inefficiency is so extreme as to preclude a takeover because it is such a risky undertaking, fall outside this range and the market for corporate control may only weakly discipline these companies. In support of Coffee's argument, it is easy to identify a number of public companies in Australia, shareholders in which have sustained systematic losses.[30] Finally, the market for corporate control may be inadequate to deal with one-time defalcations by managers.[31]

This discussion means that there is a role for shareholder litigation in reducing agency costs. However, shareholder litigation needs to be viewed as one of a number of mechanisms that have this goal. Moreover, it should not be assumed that shareholder derivative actions are an unqualified good. Not all derivative actions brought on behalf of a company will be in the interests of that company. In addition, a common argument made opposing shareholder litigation is that it deters legitimate risk-taking on the part of managers. One commentator has responded to this argument in the following terms:

> In its most rigorous form, the duty of care only requires that managers have a reasonable basis for their decisions, despite the availability of more compelling alternative choices available to them..... Simply stated, the duty of care is a standard of minimum legal performance... Care violations exist and serve to compensate the corporation for egregious managerial behaviour... The threat of liability for such extreme conduct will discourage no meaningful entrepreneurial activity.[32]

It should also be noted that empirical studies have found that the view that there is excessive shareholder litigation in the United States is an exaggeration. One study of 179 public companies in the United States found that, on average, a company is involved in shareholder litigation only once every 17.5 years.[33] The author of the study found that larger companies tend to be more involved in shareholder litigation. However, even for this group of companies (the largest

29 JC Coffee "Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance" (1984) 84 *Columbia L Rev* 1145 at 1203-4.

30 For extensive documentation of shareholder losses within the Independent Resources group of companies over an extended period of time, see *Re Spargos Mining* NL (1990) 3 ACSR 1; *Jenkins v Enterprise Gold Mines NL* (1992) 6 ACSR 539 and the submission by the Shareholder Action Group to the House of Representatives Standing Committee on Legal and Constitutional Affairs Inquiry into Corporate Practices and the Rights of Shareholders (1990).

31 FH Easterbrook and DR Fischel "Corporate Control Transactions" (1982) 91 *Yale LJ* 698 at 701.

32 JD Cox "Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures" (1984) 52 *George Washington L Rev* 745 at 761-62.

33 TM Jones "An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Law Suits, 1971-1978" (1980) 60 *Boston Univ L Rev* 306 at 313. See also the study by R Romano "The Shareholder Suit: Litigation Without Foundation" (1991) 7 *Journal of Law, Economics and Organization* 55 at 59 referring to shareholder litigation as "an infrequent experience".

40 companies) the incidence of shareholder litigation, adjusted for multiple suits, was only one incidence of shareholder litigation every 11.9 years.[34]

A final issue warrants discussion. The argument that the primary role of shareholder derivative actions is the reduction of agency costs assumes that such actions deter mismanagement. However, it has been argued that civil actions (including shareholder civil actions) cannot yield the optimal level of deterrence and indeed, that this level is very difficult to estimate.[35] Coffee and Schwartz note that United States courts have generally assumed that a compensatory rationale underlies the derivative action.[36] They argue that compensation cannot be the main purpose of derivative actions for three reasons.[37] First, the change in composition of shareholders means that shareholders at the time of the injury who subsequently dispose of their shares prior to a court ordered recovery do not obtain compensation while incoming shareholders receive a windfall gain.[38] Second, the injury to the company resulting from, for example, a breach of directors' duties, is not necessarily the same as the injury suffered by shareholders.[39] Third, it is noted that in the typical derivative action, while the total amount of recovery may be significant, it is generally de minimis on a per share basis. "If all the derivative suit accomplishes is the refund of a few cents per share to thousands of individual shareholders, it is difficult to conclude that such a result justifies the considerable drain on judicial time and court resources that the litigation of this complex form of action creates."[40]

Coffee and Schwartz conclude that while these arguments do not imply that compensation is an illusory goal, they do indicate that the main goal for the derivative action is a deterrence rationale.[41] This goal of deterrence can be viewed as a key element in reducing the agency costs inherent in the management of public companies.

34 TM Jones note 33 *supra* at 317. For a review of several empirical studies of shareholder litigation in the United States, see BG Garth, IH Nagel and SJ Plager "Empirical Research and the Shareholder Derivative Suit: Toward a Better-Informed Debate" (1985) 48 *Law and Contemporary Problems* 137.

35 Comment "The Dilemma of the Double Derivative Suit" (1989) 83 *Northwestern Univ L Rev* 729 at 755.

36 JC Coffee and DE Schwartz "The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform" (1981) 81 *Columbia L Rev* 261.

37 *Ibid* at 302-9.

38 This problem was evident in the decision of the House of Lords in *Regal (Hastings) Ltd v Gulliver* [1967] 2 AC 134.

39 The authors argue that even if an efficient securities market translates an injury suffered by the company into a decline in share values, it may be that the loss of the shareholders will exceed that of the company because the events will be perceived by the marketplace as creating a risk of repetition: note 36 *supra* at 304.

40 *Ibid* at 304-5. One of the findings of Romano's study of derivative actions in the United States was that the per share recovery was small: note 33 *supra* at 62.

41 JC Coffee and DE Schwartz note 36 *supra* at 305.

III. THE PROPOSED STATUTORY DERIVATIVE ACTION: AN EVALUATION

A. THE CSLRC PROPOSAL

The form of the statutory derivative action recommended by the CSLRC is outlined in the Appendix to this article. Its central features can be summarised briefly:

- The court is given the task of determining whether or not a derivative action should proceed. It does this by assessing applications to commence a derivative action according to statutory criteria.
- An application to commence a derivative action can be made by a broad range of applicants which includes any member, or former member of the company or of a related company; any director or officer, or former director or officer, of the company or of a related company; any creditor of the company or of a related company; any holder of an option to take up unissued shares in the company or a related company; the ASC; or any other person who, in the opinion of the court, is a proper person to make an application.
- Prior to granting an application to commence a derivative action, the court must be satisfied of three things:
  - it is probable that the company will not take proceedings;
  - the applicant is acting in good faith with a view to the best interests of the company; and
  - it appears to be in the best interests of the company that proceedings be taken.
- In determining whether these requirements have been satisfied, the court may have regard to any consideration by, or resolution of, any general meeting of the company or of a related company concerning the matters disclosed to the court on the hearing of the application.
- The court is granted wide powers in connection with the application or subsequent derivative proceedings including the power to direct the company or a related company to indemnify the applicant for reasonable legal costs and disbursements incurred in relation to the application or the subsequent proceedings.
- A derivative action cannot be discontinued or settled without the leave of the court.

The justification for the recommended statutory derivative action is explained by the CSLRC in the following terms:

> The focus of this paper has resulted from recognition of a widespread assessment that due to the restrictive nature of the rule in *Foss v Harbottle*, existing law does

> not provide adequate means for the enforcement of the duties of directors and officers where the company improperly refuses or fails to take action.[42]

The inadequacies in the existing law are said to arise from the principles established in *Foss v Harbottle*.[43] These principles are summarised in the judgment of Jenkins LJ in *Edwards v Halliwell*:[44]

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

The main problem with *Foss v Harbottle* has always been that where directors are the wrongdoers they may decide not to have the company commence litigation and therefore may go unpunished. Consequently, four exceptions to the rule that the company itself must vindicate a wrong against it have developed. These are where the transaction:

- is ultra vires or illegal;
- requires the sanction of a special majority;
- infringes the personal rights of a shareholder; or
- amounts to a fraud on the minority.

There are two problems with justifying a statutory derivative action upon perceived inadequacies in the common law. First, as will be demonstrated, this narrow legal approach ignores the lack of incentives that shareholders have to take action in public companies. Shareholder litigation involves both legal issues and economic issues. Economic issues include the expense of undertaking litigation and the collective action problem confronting shareholders.[45] Therefore, it is inappropriate to formulate recommendations concerning shareholder litigation based solely upon legal issues. Second, even if discussion of the need for a statutory derivative action is limited to legal issues associated with inadequacies in the common law, as discussed in the following section, Australian judges have tended to ignore these inadequacies.

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42 Companies and Securities Law Review Committee *Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action* (Discussion Paper No 11, 1990) para 9. It is stated in the report that "existing law is inadequate to provide a method of enforcement where a company improperly refuses or fails to pursue a cause of action": Companies and Securities Law Review Committee note 4 *supra* at [6].

43 (1843) 2 Hare 461; 67 ER 189.

44 [1950] 2 All ER 1064 at 1066.

45 See note 16 *supra* and accompanying text.

B. THE APPROACH OF AUSTRALIAN JUDGES TO SHAREHOLDER LITIGATION

It is undoubtedly the case that *Foss v Harbottle* has created problems in its country of origin.[46] Indeed, the CSLRC cites English authority for the proposition that existing law does not provide adequate means for the enforcement of the duties of directors and officers.[47] There has been voluminous literature on this subject as English judges and academics search for the "true spirit of *Foss v Harbottle*"[48] and expound legal niceties and subtleties on the exceptions to the rule in that case.[49]

Although the CSLRC justified its recommendation for a statutory derivative action on perceived inadequacies in the common law concerning shareholder litigation, a year before the CSLRC report was published, an eminent English academic drew attention to the fact that, unlike their English counterparts, Australian judges have generally ignored the problems that could arise under *Foss v Harbottle*:

> The picture that consistently comes through is one of a willingness to get at the substantial issue undistracted by any consideration of *locus standi* or procedure. Where a *Foss v Harbottle* point has in fact been taken, one frequently finds the judge putting the issue on one side and then, having ruled against the plaintiff on the substance of the case, concluding with a remark such as 'I would not have declined relief on the ground that the action was not properly constituted had I thought that a case [on the merits] had been made out'.[50]

It is therefore intriguing to say the least that, while the CSLRC citing English commentators states that "due to the restrictive nature of the rule in *Foss v Harbottle*, existing law does not provide adequate means for the enforcement of the duties of directors and officers"[51] an English commentator who has studied the Australian cases refers to the "generally apparent willingness of Australian

46 It is said that "there is considerable life left in the rule in *Foss v Harbottle* as it approaches its 150th anniversary": AL Marks and WM Rees "Shareholders' Actions" (1991) 2 *International Company and Commercial Law Review* 39 at 40.

47 Note 4 *supra* at [9].

48 C Baxter "The True Spirit of *Foss v Harbottle*" (1987) 38 *Northern Ireland Legal Quarterly* 6.

49 For an introduction to only a small amount of the English literature on this subject, see R Hollington, *Minority Shareholders' Rights* (1990); DD Prentice "Shareholder Actions: The Rule in *Foss v Harbottle*" (1988) 104 *LQR* 341; OA Osunbor "A Critical Appraisal of 'The Interests of Justice' as an Exception to the Rule in *Foss v Harbottle*" (1987) 36 *International and Comparative Law Quarterly* 1; LS Sealy "Problems of Standing, Pleading and Proof in Corporate Litigation" in BG Pettet (ed) *Company Law in Change* (1987); PG Xuereb "Remedies for Abuse of Majority Power" (1986) 7 *Company Lawyer* 53; GR Sullivan "Restating the Scope of the Derivative Action" (1985) 44 *CLJ* 236; C Baxter "The Role of the Judge in Enforcing Shareholder Rights" (1983) 42 *CLJ* 96; R Gregory "What is the Rule in *Foss v Harbottle*?" (1982) 45 *Mod L Rev* 584; KW Wedderburn "Derivative Actions and *Foss v Harbottle*" (1981) 44 *Mod L Rev* 202; RJ Smith "Minority Shareholders and Corporate Irregularities" (1978) 41 *Mod L Rev* 147; BAK Rider "Amiable Lunatics and the Rule in *Foss v Harbottle*" (1978) 37 *CLJ* 270; AJ Boyle "The Minority Shareholder in the Nineteenth Century: A Study in Anglo-American Legal History" (1965) 28 *Mod L Rev* 317 and KW Wedderburn "Shareholders' Rights and the Rule in *Foss v Harbottle*" [1957] *CLJ* 194 continued [1958] *CLJ* 93.

50 LS Sealy note 7 *supra* at 52.

51 CSLRC note 4 *supra* at [9].

judges to minimise the common law procedural obstacles bequeathed to us, and them, under the rubric of *Foss v Harbottle*".[52]

In the period since Sealy published his article Australian judges have continued the trend that he documented. They have adopted a flexible approach to when standing issues are required to be addressed, they have given new emphasis to the personal rights of shareholders (as an exception to the rule in *Foss v Harbottle*) and they have given increased importance to statutory remedies; most notably, the oppression remedy. With respect to the issue of when standing must be determined, English judges have tended to require that the question of a plaintiff's standing be determined prior to any assessment of the merits of a case.[53] Australian judges tend to be more flexible. Thus, in *Hurley v BGH Nominees Pty Ltd*[54] King CJ of the South Australian Court of Appeal stated that "in many cases a hearing to determine whether there was a prima facie case would be almost as long as a full trial and a good deal less satisfactory. In such cases the only reasonable course may be to determine the issue of standing, if raised as a preliminary issue, on the assumption that the allegations in the statement of claim are correct". The difference in approach is noted by Sealy when he states:

> The saga [that] unfolded in the three English decisions of *Smith v Croft* abundantly demonstrates, in my opinion, the wisdom of the Australian approach to this question. It is fairly obvious, reading between the lines of the reports, that the plaintiff in *Smith v Croft* would never have won his case on the merits and that the evidence could have been heard in a day or two. But - leaving aside the time spent in the initial applications to the Master - the three reported preliminary hearings [to determine the standing of the plaintiff] lasted a total of 22 days, and the judgments together fill 88 pages of the reports.[55]

The existence of such problems was recognised in a recent judgment of the Full Court of the Supreme Court of Western Australia.[56]

> The trial of the preliminary issues [to determine standing] is likely to be protracted and must inevitably, in our view, involve questions of fact. Unless the appellants succeed on each of the issues, very little would be gained when the action came on eventually for trial. On the contrary, if the time and cost of the preliminary issues were added to the time and cost of the trial, a great deal is likely to have been lost. The possibility of appeals in relation to the determination of the preliminary issues could not be regarded as being remote, and again questions of time and cost would arise.

A similar approach to determining standing was adopted in *Eromanga Hydrocarbons NL v Australias Mining NL*.[57]

It was noted above that an exception to the rule in *Foss v Harbottle* exists where the transaction in question infringes the personal rights of a shareholder. Another means by which Australian judges have minimised the problems that

52 LS Sealy note 7 *supra* at 57.

53 *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 (CA).

54 (1983) 31 SASR 250 at 253.

55 LS Sealy note 7 *supra* at 55.

56 *Dempster v Biala Pty Ltd* (1989) 15 ACLR 191 at 194.

57 (1988) 14 ACLR 486.

would otherwise confront shareholders because of *Foss v Harbottle* is by enhancing the personal rights of shareholders. In *Residues Treatment and Trading Co Ltd v Southern Resources Ltd*[58] the Full Court of the Supreme Court of South Australia held that shareholders have a personal right to have the voting power of their shares undiminished by improper actions on the part of the directors, such as the improper issue of shares which has the effect of diluting existing voting rights. This contrasts with several English decisions where improper share allotments were referred to a general meeting of shareholders for ratification.[59] Because a general meeting cannot ratify an infringement of a shareholder's personal right, it must be assumed that, for the purposes of these decisions, improper share allotments do not infringe a personal right.[60]

Perhaps the most important way in which Australian judges have minimised obstacles to shareholder litigation that might otherwise have arisen as a result of *Foss v Harbottle* is by giving an enhanced role to statutory provisions designed to protect shareholders. The most prominent example is the oppression remedy contained in s 260 of the *Corporations Law*. One of the respondents to the Discussion Paper published by the CSLRC had argued that the oppression remedy provides derivative proceedings of the type contemplated by the CSLRC - referring particularly to s 260(2)(g) which grants the court power 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.[61] In its report, the CSLRC stated that a court may not be prepared to find in a particular case that the type of oppressive conduct towards members of a company (required by the terms of s 260) also necessarily involves a breach of a duty owed by directors and officers to the company.[62] One commentator has referred to this as a "surprisingly narrow view of the scope of [s 260]".[63] It now appears that the narrow view of the CSLRC concerning s 260 has been superseded by the decision of the Full Court of the Supreme Court of Western Australia in *Jenkins v Enterprise Gold Mines NL*.[64] In that case, repeated breaches of directors' duties were held to constitute oppression of the applicant shareholder. The court stated:

> Where the directors act in breach of their fiduciary duty that fact will be relevant to determine whether there has been unfairness in the context of oppression... It follows that oppression may be established where the controlling directors have pursued a course of conduct designed by them to advance their own interests or

58 (1988) 14 ACLR 569.

59 *Hogg v Cramphorn Ltd* [1967] Ch 254; *Bamford v Bamford* [1970] Ch 212.

60 JH Farrar et al note 10 *supra* pp 448-9.

61 CSLRC note 4 *supra* at [240].

62 *Ibid* at [238]

63 J Hill "Protecting Minority Shareholders and Reasonable Expectations" (1992) 10 *Co & Sec LJ* 86 at 102. The author concludes that "ironically, in order to achieve a similar result to that which might have obtained through a liberal interpretation of [s260] the Companies and Securities Law Review Committee has proposed the introduction of a statutory derivative action": *ibid* at 103.

64 (1992) 6 ACSR 539.

the interests of others of their choice to the detriment of the company or to the detriment of minority shareholders.[65]

Given that Australian judges have recently given an expansive interpretation to the oppression remedy and that facts which constitute a wrong to the company (such as a breach of directors' duties) can be the subject of both a statutory derivative action and an oppression application under s 260, it may be that many shareholders will prefer to make use of the oppression remedy. This is because under the derivative action proposed by the CSLRC the applicant must first obtain the leave of the court and the court must be satisfied of certain matters. Leave of the court is not required to bring an oppression application.

Another statutory provision which, according to one commentator, renders the problems in *Foss v Harbottle* "probably non-existent" is s 1324 of the *Corporations Law*.[66] This section empowers the court, on the application of the ASC or a person whose interests have been, are or would be affected by the conduct in question, to grant an injunction to restrain a person who has engaged or is proposing to engage in conduct that would constitute a contravention of the *Corporations Law*. While s 1324 is extremely broad in its application it is subject to the limitation that the action must involve conduct by the defendants that constitutes a breach of the *Corporations Law*. It has been observed that while s 232 of the *Corporations Law* concerning directors' duties will include much of what is typically involved in derivative actions, in an action brought against defendants who are not officers or directors of the company, the claim asserted on the company's behalf may not involve any alleged breach of the *Corporations Law*.[67]

It is therefore apparent that, if there are difficulties in enforcing the duties of directors and officers as asserted by the CSLRC, this is not because of deficiencies in the common law resulting from *Foss v Harbottle*. Australian judges have ignored what otherwise might have been impediments to the standing of shareholder litigants and have also recently given an expansive interpretation to the oppression remedy. Rather, the reason why breaches of directors' duties may go unpunished is because of the lack of incentives to commence litigation.

C. THE NEED TO EXAMINE THE INCENTIVES OF SHAREHOLDERS TO COMMENCE LITIGATION

The CSLRC based its recommendation for a statutory derivative action upon Canadian legislation.[68] It is therefore pertinent to refer to the Canadian experience of shareholder derivative actions. Significantly, it has been said that

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65 *Ibid* at 552.

66 R Baxt "Will Section 574 of the Companies Code Please Stand Up! (And Will Section 1323 of the Corporations Act Follow Suit)" (1989) 7 *Co & Sec LJ* 388 at 391.

67 DA DeMott "Shareholder Litigation in Australia and the United States: Common Problems, Uncommon Solutions" (1987) 11 *Syd L Rev* 259 at 281.

68 *Business Corporations Act* 1982 (Ontario), ss 244-248.

there has been only limited use of the statutory derivative action in Canada.[69] Another commentator refers to the lack of "abundance of judicial authority" arising from statutory derivative actions in Canada.[70]

There are several reasons why the statutory derivative action has been little utilised in Canada. To begin with, the oppression remedy (which does not require the leave of the court to commence proceedings) has lessened the importance of the statutory derivative action.[71] A more fundamental reason is the lack of incentives to commence litigation.[72] In a derivative action, the shareholder is confronted by several disincentives. First, there is the expense of litigation and the prospect that the shareholder may have to pay the legal expenses of the defendant if the action is unsuccessful. An example will illustrate. A shareholder believes that a derivative action she is contemplating commencing has a 70 per cent chance of success. This no doubt seems high. Yet it means that there is a 30 per cent chance that the shareholder will pay both her own legal expenses and the legal expenses of the defendants. Because the defendants' expenses will typically be greater than the plaintiff's,[73] the prospect of bringing the action is daunting, even for a shareholder who is extremely wealthy. Second, even if the litigation is successful, any damages recovered accrue to the company (ie to all the shareholders) and not just to the shareholder bringing the action. Because the plaintiff shareholder will therefore receive only a pro rata share of the gains of a successful action (and then only indirectly) the fact that other shareholders will free-ride on the plaintiff shareholder's action creates a disincentive to commence litigation. This can be seen as part of the collective action problem confronting shareholders which was previously referred to in the context of shareholder voting.[74]

The CSLRC has noted that legal costs can operate as a disincentive to litigation[75] and has recommended that the court be empowered to make an order directing the company or a related company to indemnify the plaintiff for reasonable legal costs and disbursements incurred by the plaintiff in relation to

69 JD Wilson "Attorney Fees and the Decision to Commence Litigation: Analysis, Comparison and an Application to the Shareholders' Derivative Action" (1985) 5 *Windsor Yearbook of Access to Justice* 142 at 171.

70 MS Baxter "The Derivative Action Under the Ontario Business Corporations Act: A Review of Section 97" (1982) 27 *McGill LJ* 452 at 475.

71 B Cheffins "The Oppression Remedy in Corporate Law: The Canadian Experience" (1988) 10 *University of Pennsylvania Journal of International Business Law* 305 at 333. See also DH Peterson *Shareholder Remedies in Canada* (1991) at [17.2].

72 On incentives to litigate generally, see S Shavell "The Social Versus the Private Incentive to Bring Suit in a Costly Legal System" (1982) 11 *Journal of Legal Studies* 333.

73 There are several reasons why we might expect the defendants' expenses to be greater than the plaintiffs. First, the financial burden of discovery is heavier for the defendants who will often have to comply with detailed discovery requests. Second, the defendants may need to engage several law firms: one for those involved in the transaction in question and another for the company. For elaboration of these points, see JC Coffee "The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation" (1985) 48 *Law and Contemporary Problems* 5 at 17.

74 Note 16 *supra* and accompanying text.

75 CSLRC note 4 *supra* at [128].

the application and subsequent derivative proceedings. However, a strong argument can be made that once the court grants leave to the plaintiff to commence derivative proceedings on behalf of the company, it should be mandatory and not discretionary for the company to pay the costs of the proceedings. After all, prior to granting leave, the court must be satisfied that it appears to be in the best interests of the company that proceedings be taken, that the plaintiff is acting in good faith with a view to the best interests of the company and that it is probable that the company will not itself commence proceedings. If these requirements are met, it is difficult to see why the company should not be required to pay the costs of the legal action. Indeed, to the extent to which the action is successful and yet the company has not been required to pay the legal costs of the plaintiff, this can be viewed as a form of unjust enrichment given that the company receives the benefit of the plaintiff's action.[76]

A further issue warrants discussion - the role of the plaintiff shareholder's attorney. It has been said that in the United States, because of the obstacles facing shareholders contemplating litigation, the derivative action depends upon the plaintiff's attorney.[77] Because the attorney is seen as an entrepreneur by some commentators[78] this means that consideration must be given to aligning the interests of the attorney with those of his or her client. The notion of the plaintiff's attorney as the driving force behind derivative actions arises from the use of contingency fees. The risk of litigation thereby shifts to the plaintiff's attorney. However, contingency fees do not alter the deterrent effect of existing rules on legal fees, merely who faces the risk of loss.[79] Yet it may be that the use of contingency fees allows for more derivative actions because attorneys are better able to internalise the risks of litigation than individual shareholders.

> The individual plaintiff must determine his expected value in the context of only one litigation while attorneys are able to calculate expected value over a wide range of actions. This permits a process analogous to portfolio diversification and allows the prosecution of some risky cases as there may be relatively safer litigation in the "portfolio".[80]

Consequently, if the goal is to enable worthwhile derivative actions to be commenced,[81] then either the company must pay the expenses of the plaintiff shareholder or the plaintiff's attorney has to be made an interested party by the use of contingency fees.

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76 JD Wilson note 69 *supra* at 177.

77 PJ Ryan "Strange Bedfellows: Corporate Fiduciaries and the General Law Compliance Obligation in Section 2.01(a) of the American Law Institute's Principles of Corporate Governance" (1991) 66 *Washington L Rev* 413 at 493-4.

78 JC Coffee note 73 *supra*. See also JR Macey and JP Miller "The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform" (1991) 58 *University of Chicago L Rev* 1.

79 JD Wilson note 69 *supra* at 173.

80 *Ibid* at 173-4.

81 That is, actions which are in the interests of the company. I examine who should determine whether derivative actions are in the interests of the company in Part IV.

D. STANDING TO COMMENCE DERIVATIVE PROCEEDINGS: WHO MAY APPLY?

It was noted above that under the CSLRC proposal, a broad range of applicants can apply to the court for leave to commence derivative proceedings. While some of these classes of applicants are uncontroversial, other classes warrant discussion. Coming within the uncontroversial category are shareholders, directors and officers. The CSLRC notes that directors and officers typically have more information concerning the operation of a company's affairs than shareholders and are therefore better placed to determine when litigation is desirable. Moreover, directors and officers of a company are unable to take proceedings under the oppression remedy as standing under that provision is limited to shareholders and the ASC.[82]

More controversial are the recommendations to include creditors as a class of applicants and also shareholders, directors, officers and creditors of related companies. The main justification given by the CSLRC for allowing creditors to bring an application is that creditors may in some situations be in receipt of better relevant information than that available to other "outsiders".[83] The CSLRC is not the first to suggest that creditors have standing to bring derivative actions.[84] Yet the recommendation opens up a complex area that has not been discussed by those who support such an action. Shareholders and creditors in a company have different incentives. In particular, creditors face four main problems:[85]

- the payment of excessive dividends;
- the incurring of debt with similar or higher priorities;
- the substitution of non-saleable assets for saleable assets; and
- excessive risk-taking.[86]

The point that follows is that we would typically expect creditors to protect their position against these problems by use of contractual provisions. A proposal to allow creditors to bring derivative proceedings may result in creditors endeavouring to use the courts as a forum to argue for protection by means of an expanded definition of directors' duties. Some may see this as desirable. However, there are significant reasons why directors' duties should

82 CSLRC note 4 *supra* at [26]-[37].

83 *Ibid* at [50].

84 Note "Creditors' Derivative Suits on Behalf of Solvent Corporations" (1979) 88 *Yale LJ* 1299. "Offering a derivative right to creditors would allow private enforcement actions to reach a large class of corporations from which they are foreclosed today, thereby encouraging more honest behaviour on the part of corporate management": *ibid* at 1314-15.

85 CW Smith and JB Warner "On Financial Contracting: An Analysis of Bond Covenants" (1979) 7 *Journal of Financial Economics* 117.

86 Shareholders in a leveraged company have incentives to engage in excessive risk-taking. This is because if these projects should prove successful, the excess profits will be distributed among the shareholders as dividends and will not be shared with the creditors. Company losses however are shared among both shareholders and creditors.

be seen as being owed to shareholders rather than creditors.[87] What this means is that the recommendation to allow creditors to commence derivative actions deserves much more discussion than it has received.

There is more justification for the recommendation that shareholders, directors and officers of related companies be permitted to make an application to the court to commence a derivative action. One need look no further than the saga of the Independent Resources group of companies and the litigation that has ensued in order to see that there clearly will be circumstances where a shareholder of a company should be granted standing to commence proceedings on behalf of a related company. There is also a strong policy reason for why such actions should be permitted:

> The presence of an extra corporate layer reduces the likelihood that someone will even detect the wrongdoing, much less bring suit to correct it. The reporting requirements even for large, publicly held corporations demand little disclosure of subsidiary activity. The parent corporation may consolidate information about the financial performance and condition of the subsidiary into its own financial statements, further hampering investigation.[88]

E. SUMMARY

We have seen that there is a role for shareholder litigation in reducing the agency costs associated with the management of companies. Derivative actions can be an important part of shareholder litigation. However, a statutory derivative action cannot be justified on the grounds of perceived deficiencies in the common law when Australian judges have generally ignored these deficiencies.

While statutory provisions such as the oppression remedy are of increasing importance, a statutory derivative action can be justified on the basis that these other provisions are different in scope to the derivative action. For example, the oppression remedy does not allow directors and officers to bring proceedings while the proposed statutory derivative action does allow this. A director or officer will frequently be better placed then a shareholder to know whether a derivative action should be commenced because of the superior information possessed by the director or officer.

Yet, even accepting the desirability of a statutory derivative action, there are problems with the derivative action proposed by the CSLRC. Its recommendation to include creditors as a class of applicants has not been adequately justified. More importantly, the proposal does not sufficiently address the economic impediments to shareholder litigation. As has been

87 JR Macey "An Economic Analysis of the Various Rationales For Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties" (1991) 21 *Stetson L Rev* 23.

88 Comment, "The Dilemma of the Double Derivative Suit" (1989) 83 *Northwestern Univ L Rev* 729 at 757. See also the Australian Securities Commission Class Order (Instrument 996/91) made on 19 December 1991 which exempts certain wholly owned subsidiaries from compliance with accounting provisions of the *Corporations Law* where, inter alia, the parent company prepares consolidated accounts and a deed of cross guarantee is executed. The effect of this Class Order is to require less disclosure of accounting information for these wholly owned subsidiaries.

demonstrated in this Part, it is impossible to have an informed debate on the need for a statutory derivative action without considering the collective action problem that confronts shareholders and evaluating possible solutions to this problem, including a mandatory requirement for the company to pay the costs of the derivative action once the court allows the action to proceed, or shifting the risk of litigation to the plaintiff shareholder's attorney by the use of contingency fees.

IV. AN INSTITUTIONAL COMPETENCE APPROACH TO SHAREHOLDER LITIGATION

There is an important question which has been insufficiently addressed in discussions of shareholder derivative actions in Australia. Who best determines whether a derivative action is in the interests of the company? There are four decision-making bodies which could fill this role:

- the plaintiff shareholder;
- the shareholders in general meeting;
- independent directors who are not defendants in the derivative action; or
- the court.

In this Part I examine the competence of each of these bodies to determining the merits of shareholder derivative actions. It is to be noted that approaches differ between jurisdictions with respect to this issue. Under the Canadian legislation and the CSLRC proposal, the court is given the task of determining whether the plaintiff shareholder has standing to bring a derivative action and, as we have seen, the court must be satisfied that it appears to be in the best interests of the company that proceedings be taken. In other words, the court is given a gate-keeper role which it undertakes prior to any review of the merits of a particular action. In the United States, this gate-keeper role is generally given to a committee of independent directors who are required to determine whether the derivative action is in the interests of the company.[89]

An important feature of the CSLRC proposal is that a gate-keeper role is also given to the shareholders in general meeting. The proposal contains a provision that in determining whether the standing requirements have been satisfied (ie that it appears to be in the best interests of the company that proceedings be taken, etc) 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".[90] The CSLRC proposes a significant role for the shareholders when it states that:

> [I]n practice, in all but the most urgent cases, the Court might require that a meeting be convened, the application [by the plaintiff shareholder] being

89 See notes 106-18 *infra* and accompanying text.

> 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.[91]

When the court in *Foss v Harbottle* held that a shareholder could not bring an action in relation to a matter that could be ratified by the shareholders in general meeting, it demonstrated an uncritical faith in the ability of shareholders to be undertaking decisions in the interests of the company. Shareholders in a public company are frequently an inappropriate decision-making body. A criticism of the CSLRC proposal is that, like the judgment in *Foss v Harbottle*, it demonstrates an uncritical faith in the decision-making ability of shareholders.

The following sections analyse the competence of the plaintiff shareholder, the shareholders in general meeting, independent directors and the courts to make decisions concerning a derivative action.

A. THE PLAINTIFF SHAREHOLDER

The plaintiff shareholder is not the appropriate person to be determining whether or not a derivative action is in the interests of the company. The problem is that because a shareholder with only a small investment can bring a derivative action on behalf of the company, the shareholder has little incentive to consider the effect of the derivative action on other shareholders.[92] One need only recall the words of the counsel for the company in the *Prudential Assurance* case that "it is the concern of the board that the company shall not be killed by kindness"[93] to appreciate this. A further complicating factor is that there can be a divergence of interests between the plaintiff shareholder and his or her attorney.[94] For all of these reasons, it is necessary that some body, other than the plaintiff shareholder, determine whether a derivative action is in the interests of the company.

B. THE SHAREHOLDERS IN GENERAL MEETING

As noted above, the CSLRC gives a significant gate-keeper role to the shareholders in general meeting when it states that, in practice, in all but the most urgent cases, the court might require that a meeting of shareholders be convened and the application by the plaintiff shareholder adjourned pending the decision of the general meeting. Provided certain criteria are met, the CSLRC states that the decision of the meeting, if accepted as valid by the court, "should

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90 CSLRC note 4 *supra* at [23].

91 *Ibid* at [117].

92 DR Fischel and M Bradley "The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis" (1986) 71 *Cornell L Rev* 261 at 271.

93 *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257 at 263 (referring to the view of the board of directors that continuation of the derivative action was not in the interests of the company).

94 JR Macey and JP Miller note 78 *supra*.

be conclusive as to the fate of the application".[95] One commentator believes that this type of requirement "reflects scepticism about the effectiveness of derivative litigation".[96] The requirement reveals the same faith in the abilities of shareholders in a general meeting to be making proper decisions as did the judgment in *Foss v Harbottle.*

There are two problems with such a reliance upon shareholders. The first is legal. It will be recalled that one of the two principles arising from the rule in *Foss v Harbottle* is that an individual shareholder is not permitted to commence a derivative action for a breach of duty by a director if a majority of the shareholders can ratify that breach. A similar principle no doubt underlies the CSLRC proposal. In other words, the court should not be intervening where the shareholders in general meeting can vote to ratify a breach of duty by a director. However, the law is in considerable uncertainty as to what breaches may be ratified by shareholders. Commentators have not been able to satisfactorily distinguish between cases such as *Regal (Hastings) Ltd v Gulliver*[97] (where it was suggested that shareholders could ratify the breach of duty by directors) and *Cook v Deeks*[98] (the breach of duty by the directors was held not to be ratifiable). One commentator has referred to "the uncertain boundaries of majority rule" in this area of the law.[99]

The problems that courts confront when addressing the issue of majority rule are clearly revealed in the Independent Resources litigation. One of the many transactions challenged by the plaintiff shareholder concerned a preference share issue by Independent Resources Ltd. The directors had the share issue ratified by the shareholders in general meeting and the question before the court was what attitude it should take to the ratification. The trial judge held as follows:

> It will have been noted that I have taken a view that oppression was established in relation to the IRL preference share issue in a way which adversely reflected upon the propriety of that transaction in its substance, but at the same time, that was a transaction which ultimately went before the shareholders in a general meeting, and by a process with which I have not thought it proper to interfere, the shareholders ratified the transaction. It would be unthinkable then that the court should take any action with respect to it, not being prepared to take the grave step of setting aside the ratification in question.[100]

However, on appeal, the ratification was overturned on the basis that those who were responsible for the oppressive conduct controlled the voting power of the general meeting at which the ratification took place. The court stated that even assuming that everything that occurred at the meeting was legally and technically correct, the meeting gives "a good illustration of the inefficiency of

95 CSLRC note 4 *supra* at [117].

96 DA DeMott "Demand in Derivative Actions: Problems of Interpretation and Function" (1986) 19 *University of California, Davis Law Review* 461 at 475-6.

97 [1942] 1 All ER 378.

98 [1916] AC 554.

99 SM Beck "The Shareholders' Derivative Action" (1974) 52 *Canadian Bar Review* 159 at 199.

100 *Re Enterprise Gold Mines NL* (1991) 3 ACSR 531 at 590, *per* Murray J.

reliance upon a subsequent general meeting of shareholders to give relief from a transaction which the learned trial judge had found was oppressive".[101]

Quite apart from the legal problems associated with decisions taken by shareholders in general meeting, there is the fundamental problem that shareholders may be an inappropriate decision-making body for assessing the merits of a derivative action and whether it is in the company's interests for the litigation to proceed.[102] We have seen that shareholders suffer a collective action problem when voting which undermines their effectiveness as a decision-making body.[103] A rational small shareholder in a public company will not expend the time and effort to evaluate whether a derivative action is in the interests of the company because the shareholder's costs outweigh any expected benefits. This is because the shareholder's vote would have only a small effect on the outcome and the small shareholding means that any gain by reason of the derivative action being successful will only be small.[104] Even if a shareholder cannot assess the merits of a proposed derivative action, the shareholder may not abstain from voting but may vote in accordance with a recommendation of directors that the action be discontinued. This is because the interests of shareholders and directors overlap on many issues so that the shareholder can reasonably expect that most proposals emanating from directors for consideration at a general meeting are in the interests of shareholders. A rational shareholder will consequently vote uniformally in favour of proposals from directors even if the shareholder recognises that some of these proposals may not be in his or her interests.[105]

C. INDEPENDENT DIRECTORS

Another possible decision-making body for determining whether a derivative action is in the interests of the company is a committee of independent directors. The use of Special Litigation Committees ("SLCs") comprised of independent directors is common in the United States. It derives, in part, from Rule 23.1 of the *Federal Rules of Civil Procedure* which provides that the "complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority". A key question is the extent to which a court should defer to a

101 *Jenkins v Enterprise Gold Mines NL* (1992) 6 ACSR 539 at 558.

102 RC Clark note 10 *supra* at 649.

103 BS Black note 16 *supra*.

104 KE Scott "Corporation Law and the American Law Institute Corporate Governance Project" (1983) 35 *Stan L Rev* 927 at 945.

105 LA Bebchuk "Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments" (1989) 102 *Harv L Rev* 1820 at 1839. Bebchuk observes that there is empirical evidence confirming that shareholders will sometimes vote for proposals that are not in their interests, referring to anti-takeover amendments which have been accompanied by reductions in the companies share prices even though the amendments were approved by shareholders.

recommendation of a SLC.[106] Some courts have shown considerable deference to recommendations of SLCs and applied the business judgement rule. Employing this approach, a New York court held that it would defer to the business judgement of the SLC and not examine the merits of its recommendation that a derivative action be discontinued where the committee was comprised of disinterested directors and appropriate procedures were followed.[107]

It may be that the application of the business judgement rule to recommendations of SLCs is inappropriate because the rule is premised on the realisation that shareholders assume the risk of errors in business judgement by directors. Yet it cannot be said that shareholders assume the risk of breaches of fiduciary duties by directors, which is typically the substance of derivative actions.[108] A different approach to that of the New York court was adopted by the Delaware Supreme Court in *Zapata Corp v Maldonado*.[109] The court rejected any notion of wholesale deference to the recommendation of the SLC and applied a two part test. First, the court should inquire into the independence and good faith of the committee and the grounds supporting its recommendation. Second, the court applies its own independent business judgement to determine whether the derivative action should be dismissed. The court retains the discretion to decide whether or not it will apply the second part of the test.[110]

This difference in approach to the question of deference to the recommendations of SLCs is reflected in approaches to codifying the statutory derivative action in the United States.[111] The Model Business Corporation Act drafted by the American Bar Association's Committee on Corporate Governance provides that a derivative action shall be dismissed by the court where a committee of independent directors has determined in its business judgement that the action is not in the best interests of the company. However, the American Law Institute in its Corporate Governance Project allows more scope for judicial review of the recommendations of SLCs.[112]

One reason why independent directors might play a useful role in assessing the merits of derivative actions is that directors possess more information about the company's affairs than a shareholder who does not have ready access to this information.[113] However, one important statistic casts doubt on the use of

106 JS Solovy, B Levenstam and DS Goldman "The Role of Special Litigation Committees in Shareholder Derivative Litigation" (1990) 25 *Tort and Insurance Law Journal* 864.

107 *Auerbach v Bennett* 47 NY 2d 619, 393 NE 2d 994 (1979).

108 L Larose "Suing in the Right of the Corporation: A Commentary and Proposal for Legislative Reform" (1986) 19 *University of Michigan Journal of Law Reform* 499 at 538.

109 430 A2d 779 (Del 1981).

110 *Kaplan v Wyatt* 499 A2d 1184 (Del 1985).

111 Comment "Deciding Who Should Decide to Dismiss Derivative Suits" (1990) 39 *Emory Law Journal* 937 at 955-7.

112 American Law Institute note 2 *supra* at 725-66.

113 Note "Alleging Demand Futility in Federal Court" (1987) 44 *Washington and Lee Law Review* 955 at 965.

committees of independent directors. No such committee in the United States has ever recommended that a derivative action in its entirety be continued.[114] The credibility of reliance upon independent directors "is called into question by the uniformity with which committees determine derivative actions not to be in the corporation's best interests".[115] This record demonstrates what some commentators refer to as structural bias on the part of independent directors.

> Commentators have explained in detail why the SLC's independence may be more apparent than real. Their concern is founded on the observation that the defendants and the members of the SLC share a common cultural bond: directorship of a public corporation. The natural empathy and collegiality that this bond engenders makes an adverse judgment of a colleague's behaviour distasteful at best. Also, when the committee is formed after the instigation of the derivative suit, the situation is rife with opportunities for the defendants to select for committee membership those directors most sympathetic to their position. The committee's independence may be further undermined by its members' desire to curry favor with their fellow directors or with the business community in general. Finally, SLCs operate under the constant threat of dissolution should they displease the board by pursuing the plaintiff's cause with excessive zeal.[116]

One commentator asserts that this structural bias, when applied to SLCs, equates to "an inescapable and conclusive presumption against nearly any derivative suit" on the part of members of the committee.[117] The argument of structural bias might apply to all decisions of independent directors. However, it may have special application to an assessment of whether a director should be sued in a derivative action.

> [T]his process of director selection and socialization, which encumbent management dominates, may cause even the outside director to perceive his role, once litigation is commenced, as that of a buffer by which to shelter and protect management from hostile and litigious stockholders. In particular, a derivative action evokes a response of group loyalty, so that even a "maverick" director may feel compelled to close ranks and protect his fellows from the attack of the "strike suiter." As a result, an outside director independent enough to oppose the chief executive officer with respect to a proposed transaction that he thinks is unfair or unwise may still be unable to tell the same officer that he thinks a suit against him has sufficient merit to proceed. The latter vote would be a far more personal and stigmatizing form of opposition. In short, prospective rejections can be diplomatic and couched in terms of the appearances of impropriety, but a refusal to protect one's peers once events have transpired is seen as disloyal treachery.[118]

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114 DA DeMott note 67 *supra* at 277.

115 *Id.* DeMott notes that in some reported cases, the committee's recommendation appears to be at odds with advice as to the merits of the action received from the company's outside lawyers.

116 JD Cox "Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the ALI Project" [1982] *Duke LJ* 959 at 962-3. See also JD Cox and H Munsinger "Bias in the Board Room: Psychological Foundations and Legal Implications of Corporate Cohesion" (1985) 48 *Law and Contemporary Problems* 83.

117 PN Edwards "Compelled Termination and Corporate Governance: The Big Picture" (1985) 11 *Journal of Corporation Law* 373 at 398.

118 JC Coffee and DE Schwartz note 36 *supra* at 283 (footnotes omitted). This structural bias may be reflected in excessive delays in the deliberations of SLCs, leading one Delaware judge to comment upon SLCs in the following terms: "It sidetracks derivative litigation as we have heretofore known it for

Consequently, the use of committees of independent directors to be assessing the merits of derivative actions is unwarranted, at least without the addition of substantive judicial review. If judicial review of the merits of a decision of a committee of independent directors is utilised, this may be seen as an undesirable duplication of tasks.

D. COURTS

Some may doubt whether courts are the best body to be determining whether a derivative action is in the interests of the company.[119] There are problems with an over reliance on courts.[120] For example, courts may adopt different interpretations of the same statutory provision resulting in considerable uncertainty for the business community.[121] Moreover, courts are inappropriate for certain tasks such as reviewing managerial incompetence, under-performance or inefficiency.[122] Yet courts do have expertise in evaluating the potential success of litigation.[123] To the extent to which most derivative actions would concern alleged breaches of directors' duties, most litigation would concern the duty of loyalty rather than the duties of care and diligence.[124] Courts have a lengthy history of determining cases involving the duty of loyalty and have developed considerable expertise and knowledge in this area.[125] The view of two commentators is that the "talents that a court is generally thought to lack - business intuition, a feel for the marketplace, and the ability to trade off risk for return - are not here called for to the same degree. Indeed, to the extent

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approximately two years at a minimum while the Committee goes through its functions and while the plaintiff awaits his chances to resist them". Quoted in JC Coffee note 73 *supra* at 25.

119 FA Gevurtz "Who Represents the Corporation? In Search of a Better Method for Determining the Corporate Interest in Derivative Suits" (1985) 46 *University of Pittsburgh L Rev* 265 at 296-313. Fischel and Bradley assert that judges "lack business expertise and strong incentives to maximize the value of the firm": note 92 *supra* at 273.

120 IM Ramsay "Courts and Corporate Law", unpublished manuscript on file with the editors.

121 Consider, for example, the judicial interpretations of s592 of the *Corporations Law* which imposes personal liability upon a director or manager of a company when the company incurs a debt and the director or manager would or should have known that the company was insolvent. Courts have recently expounded fundamentally different interpretations of this section: compare *Statewide Tobacco Services Ltd v Morley* (1990) 2 ACSR 405 with *Group Four Industries Pty Ltd v Brosnan* (1991) 5 ACSR 649. One commentator has referred to these cases in the following terms: "If the judges cannot agree on what the law is, how can a practitioner possibly hope to advise his client, and how can lawyers possibly expect the commercial community to respect the law": G Sutherland, "The Need for Certainty in Commercial Law" (1991) (4) *Commercial Law Quarterly* 4.

122 IM Ramsay note 120 *supra*.

123 T Frankel and WM Barsky "The Power Struggle Between Shareholders and Directors: The Demand Requirement in Derivative Suits" (1983) 12 *Hofstra L Rev* 39 at 52.

124 There are only a small number of reported cases concerning the duties of care and diligence: HAJ Ford and RP Austin *Ford's Principles of Corporations Law* (6th ed 1992) at [1527]-[1528]; JF Corkery *Directors' Powers and Duties* (1987) ch 8.

125 HAJ Ford and RP Austin *ibid* ch 15; JF Corkey *ibid* chs 5-7. The expertise and experience of the Delaware courts in corporate law is one factor which contributes to that state's attractiveness as a state of incorporation for many companies: R Romano "Law as a Product: Some Pieces of the Incorporation Puzzle" (1985) 1 *Journal of Law, Economics and Organization* 225.

that the determination hinges on an appraisal of the merits of the litigation, the court's perspective and expertise are superior to the boards".[126] This analysis supports the recommendation of the CSLRC that the courts should occupy a gate-keeper role with respect to determining whether a shareholder derivative action is in the interests of the company.

V. CONCLUSION

Given that the statutory derivative action proposed by the CSLRC is based upon Canadian legislation, it is relevant to refer to the conclusion of one Canadian commentator that "the use of the shareholders' derivative action will rarely, if ever, be economically rational".[127] The reason has been explored in this article. Shareholder action in a public company generally suffers from a collective action problem. Shareholder derivative actions are particularly vulnerable to this problem because the expense of litigation (including the possibility of the plaintiff paying the legal expenses of the defendant) combined with the fact that any damages recovered accrue to the company, create a powerful disincentive to commence litigation.

The debate in Australia concerning the need for a statutory derivative action, with its emphasis on *Foss v Harbottle*, has had a narrow legal focus. The existence of collective action problems means that a broader inquiry than that hitherto undertaken by those advocating a statutory derivative action is warranted. This article has focussed upon three issues arising from such an inquiry. First, it examined the role of shareholder litigation in corporate governance. As was observed in Part II, shareholder litigation cannot be viewed in isolation from a number of mechanisms that relate to corporate governance. Second, the article considered possible solutions to the collective action problem evident in shareholder litigation including a mandatory requirement for the company to pay the costs of the derivative action once the court allows the action to proceed and also shifting the risk of litigation to the plaintiff shareholder's attorney by the use of contingency fees. Finally, an evaluation of the competence of various bodies to determine whether a derivative action is in the interests of the company (prior to the merits of the case being examined) was undertaken. This led to the conclusion that this task should be given to the courts.

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126 JC Coffee and DE Schwartz note 36 *supra* at 282-3.

127 JD Wilson note 69 *supra* at 175.

APPENDIX

RECOMMENDATION OF THE COMPANIES AND SECURITIES LAW REVIEW COMMITTEE

DERIVATIVE PROCEEDINGS ON BEHALF OF A COMPANY

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

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

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

(3) In this section "take proceedings" means -

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

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

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

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

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

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

Court may at any time and subject to any conditions it considers appropriate make -

(a) an order authorising the applicant or any other person to control the conduct of the proceedings;
(b) an order giving directions for the conduct of the proceedings including an order directing the corporation or a related corporation to do, or refrain from doing, anything in order that the proceedings are conducted properly;
(c) an order directing the corporation or a related corporation to indemnify the applicant for reasonable legal costs and disbursements incurred by the applicant in relation to the application whether or not the application is successful;
(d) an order directing the corporation or a related corporation to pay as directed by the applicant, or any other person for the time being having the conduct of the proceedings, the reasonable legal costs and disbursements incurred by the applicant or other person in relation to the proceedings;
(e) an order directing the corporation or a related corporation to deposit with the Court such sum as the Court considers necessary for the purposes of paragraphs (c) and (d), including an order as to the withdrawal or application of such sum;
(f) an order directing that any amount ordered to be paid to the corporation by any party to the proceedings be paid, in whole or in part to -
    (i) any member, or former member, of the corporation or of a related corporation;
    (ii) any creditor, or former creditor, of the corporation or of a related corporation; or
    (iii) any other person or class of 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 matters for which the indemnity was granted or order made was such as to constitute an abuse of the process of the Court.

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

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