

**THE RELATIONSHIP OF THE RULE IN *FOSS* v.  
*HARBOTTLE*  
TO THE STATUTORY REMEDIES FOR MINORITY  
SHAREHOLDERS**

by  
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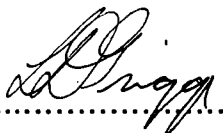
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**Master of Laws**

**University of Tasmania**

## Declaration

This thesis contains no material which has been accepted for the award of any other higher degree or graduate diploma in any tertiary institution and that, to the best of the candidates knowledge and belief, the thesis contains no material previously published or written by another person, except when due reference is made in the text of the thesis.

  
.....  
L. D. Griggs

## Abstract

In this thesis I consider the problem of the minority shareholder in the private corporation who seeks to recover compensation on behalf of the company where the wrongdoers are in control and thus prevent any action being taken. At common law the minority shareholder was severely restricted by the Rule in *Foss v. Harbottle*. This stated that the company was the proper plaintiff for wrongs done to it and that internal irregularities could be cured by the company in general meeting. From this various exceptions developed to allow the minority shareholder the right to bring a derivative action on behalf of the corporation. The conditions to allow this to happen were, however, extremely restrictive. Accordingly various law reform committees recommended the introduction of statutory remedies to alleviate the problems of the minority shareholder. In Australia, the principal statutory remedy introduced was the oppression remedy, now contained in s.260 of the *Corporations Law*. This remedy has suffered from a number of defects. The judiciary has given s.260 a more narrow scope than was arguably intended and there are a number of problems with the wording of the section and its interrelationship with other areas of the law. It is therefore apposite to consider the alternatives offered to the minority shareholder in England, Canada and the United States, as well as other common law options available in Australia. These options including the personal action by the minority shareholder to recover on the basis that there has been a breach of the constitution of the company and/or an action in tort. Both Canada and the United States have developed a procedural framework to allow shareholders to bring a derivative action and this appears to provide the member with easier access to the courts than the present Australian options. Finally, I conclude by submitting that the existing avenues; the oppression remedy, the personal action and the tortious remedy do not provide convenient avenues for the minority shareholders to pursue wrongs to the corporation by those in control and that Australia would benefit from the introduction of the statutory derivative action.

The law is stated as at 31/8/1992.

  
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L. D. Griggs

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## CHAPTER 1

### INTRODUCTION

The theme of this thesis is to contrast the remedies developed by the judiciary in the Courts of Law to assist minority interests in private companies, with the remedies the legislature have put in place to assist these same interests. It will concentrate on the minority shareholder, that is, the person unable to command a majority in the general meeting, who is seeking to correct an abuse of management. In this sense the thesis will consider wrongs done to a private company, for which the company is unable or unwilling to bring proceedings in its own name.<sup>1</sup> The minority shareholder is in effect seeking to return to the company property or profits of the company which have been misappropriated by the controllers of the company:

One would expect those concerned for the integrity and future of private business institutions to applaud the intrepid souls who ferret out corporate wrongdoing, and risk their own time and money against a contingency of being rewarded if in the end sin is found to have flourished. Not at all. Such men are not treated as honoured members of the system of private enterprise, but as scavengers and pariahs... At least they are viewed as necessary evils, the Robin Hoods of the business world,

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<sup>1</sup> The company is of course a separate legal entity, *Salomon v. Salomon* [1897] A.C. 22.



for whom a patronising word may sometimes be said,  
when they succeed in revealing some particularly  
horrendous act.<sup>2</sup>

The first thing that becomes apparent upon researching this area is that the right of a minority shareholder to bring an action to a court of law to rectify an abuse of management was very limiting. The minority shareholder had to establish standing to bring an action, fraud by the wrongdoers, and that the wrongdoers were in control of the company. The courts were always reluctant to interfere in commercial decisions. What is disappointing is that the legislative remedies, such as s.260 of the *Corporations Law* 1990, have only ameliorated that attitude to a small extent, and it has only been in the most blatant cases of injustice that the minority shareholder has been successful.<sup>3</sup>

The statutory remedies are not just limited to minority shareholders, however it is unlikely that a majority shareholder would ever need to rely on the provisions:

Shareholders who command a majority can look after themselves. They can dictate the board's composition and

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<sup>2</sup> S.M. Beck, "The Shareholders Derivative Action" (1974) 52 *Can. B.R.* 159 at p.163. Beck was quoting from E. Rostow, "To Whom and for What Ends is Corporate Management Responsible?" in Mason (ed.), *The Corporation in Modern Society* (1959) p.49.

<sup>3</sup> The wording of s.260 is, in substance, unchanged from its predecessor, s.320 of the *Companies (Tas) Code* 1981.

indirectly much of its management policy. They can pass resolutions and, if numerous enough, change the constitution of the company ... the realities of corporate life dictate that majority decisions usually prevail and that decision making rests with relatively few persons in the corporate hierarchy.<sup>4</sup>

This paper will be primarily concentrating on the situation where a wrong is done to the company and the directors are unwilling to bring an action in the name of the company. In essence I will be considering the derivative action:

A derivative action is an exception to the elementary principle that A cannot, as a general rule bring an action against B to recover damages or secure other relief on behalf of C for an injury done by B to C. C is the proper plaintiff because C is the party injured, and therefore the person in whom the cause of action is vested. This is sometimes referred to as the rule in *Foss v. Harbottle* when applied to corporations, but it has a wider scope and is fundamental to any rational system of jurisprudence.<sup>5</sup>

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<sup>4</sup> J.F. Corkery, "Oppression or Unfairness by Controllers - What can a Shareholder do about it? An analysis of s.320 of the *Companies Code*" (1985) 9 *Adel. L.R.* 437 at p.439.

<sup>5</sup> *Prudential Assurance Co. Ltd. v. Newman Industries* [1982] 2 All E.R. 354 at p.357.

The dissertation will also be concentrating on the private or proprietary company rather than the public company.<sup>6</sup> The shareholder in the public company listed on the stock exchange will generally have no role to play in management and if there are abuses of management the minority shareholder will be able to cut his losses by selling on the stock exchange. The shareholder in the private company will not have this option, and is thus susceptible to abuses of management. The private company will generally have some, if not all, of the following characteristics:

- (i) Small number of shareholders.
- (ii) Restrictions on transferability.<sup>7</sup>

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<sup>6</sup> For a discussion of the minority shareholder's role in the control of the public company see A.A. Berle, "Modern Functions of the Corporate System" (1962) 62 *Columb. L. Rev.* 433; J.L. Weiner, "The Berle-Dodd Dialogue on the Concept of the Corporation" (1964) 64 *Columb. L. Rev.* 1458.

<sup>7</sup> Section 116 of the *Corporations Law* provides that -

A company having a share capital (other than a no liability company) may be incorporated as a proprietary company if a provision of its memorandum or articles -

- (a) restricts the right to transfer its shares.
- (b) limits to not more than 50 of the number of its members.
- (c) prohibits any invitation to the public to subscribe for any shares in the company; and
- (c) prohibits any invitation to the public to deposit money with the company

- (iii) Remuneration for shareholders will generally be by salary rather than dividend.
- (iv) Shareholders will usually be entitled to participate in the management of the company.
- (v) The business may previously have been run as a partnership, and may have been incorporated to obtain the benefits of incorporation and limited liability.

It is important to examine this area of the law to determine if the position of the minority shareholder in the private company has been improved by the legislation and to consider what reforms, if any, are needed to further assist the minority shareholders.

It should be noted that the structure and general composition of Australia's minority shareholders protection laws is not being put into question by this thesis. What this paper intends to address is whether minority shareholder litigation can be facilitated by changes to the present framework. The policy assumptions that underlie the rule in *Foss v. Harbottle* and the statutory remedies will not be examined.

The difficulties facing the minority shareholder in a small private company include some or all of the following:

- (i) The withholding of information so that the shareholder is unable to properly evaluate the decisions of management.
- (ii) The misappropriation of company assets by the directors for their own use.<sup>8</sup>
- (iii) The dilution of voting power through share issues. For example, in *Clemens v. Clemens*<sup>9</sup> the share issue if it had been validated would have removed the power of the minority shareholder to block a special resolution.
- (iv) Exclusion from management.<sup>10</sup>
- (v) A refusal to register share transfers which results in the minority shareholder being 'locked in,' and unable to realise his investment.<sup>11</sup>
- (vi) A refusal to distribute dividends, which means that if the shareholder is locked in he or she will be receiving no return on his investment.<sup>12</sup>
- (vii) Management inefficiency such as the sale of assets at a gross undervaluation.<sup>13</sup>

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<sup>8</sup> See, for example, the facts of *Cook v. Deeks* [1916] 1 A.C. 554.

<sup>9</sup> [1976] 2 All E.R. 268.

<sup>10</sup> For example, *Ebrahimi v. Westbourne Galleries Ltd.* [1972] 2 All E.R. 492.

<sup>11</sup> See *Australian Metropolitan Life Assurance v. Ure* (1923) 33 C.L.R. 199.

<sup>12</sup> See *Re G. Jeffrey Pty. Ltd.* (1984) 2 A.C.L.C. 421.

<sup>13</sup> See the facts of *Pavlides v. Jensen* [1956] Ch. 565.

(viii) Self interested contracts and disloyalty such as the favourable treatment of a company controlled by the directors.<sup>14</sup>

As Beck comments:

The shareholder in the private company is still likened to the capitalist of old - a man who invests all, or a large portion of his capital in the enterprise, is himself one of the managers and has a day to day knowledge of the workings of the company and the activities of management. In so far as there is fraud or over-reaching by fellow directors or shareholders, he is in a position to personally blow the whistle and to seek a remedy. He does not, however, have the securities market exit and if he cannot find redress in the narrow and tortuous legal avenues open to him he may well fit unhappily into the corporate jargon of being "locked in", "frozen out", "squeezed" or simply oppressed.<sup>15</sup>

By contrast with the shareholder in the private company the shareholder in the public company has received substantial protection. There is now a number of statutory provisions

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<sup>14</sup> *Re Norvabron* [1986] 11 A.C.L.R. 33.

<sup>15</sup> S.M. Beck, *op. cit.* at p.161.

which provide protection for the investor in the public company. These include the Chapter 6 of the *Corporations Law, Australian Securities Commission Act* 1989, and the Stock Exchange Listing Rules will also have some protection for the investor in the public company. As the private company is prohibited from inviting the public to subscribe for shares in the company, these Acts do not have the same degree of relevance to the investor in the private company.

In considering the legislation which is available to the minority shareholder, the initial impression is that the legislation was drafted because of the deficiencies of the common law. The preconditions for bringing a derivative action, that is an action whereby the minority sues to recover on behalf of a company, were restrictive and notoriously difficult to establish. The ingredients being, that the shareholder had to establish standing, fraud by the wrongdoers, and that the wrongdoers were in control of the company. The minority shareholder must also establish that the company in general meeting has not approved the conduct in question.<sup>16</sup> It was for these reasons that the statutory remedy for oppression was introduced. Chapter 2 addresses the difficulties facing the minority shareholder at common law, as well as considering the concerns of the law reform commissions which investigated the problems facing the minority shareholders.

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<sup>16</sup> See the discussion of these points in Chapter 2.

Chapters 3 and 4 examines the efficacy of the statutory remedies provided for the minority shareholders. It will also consider the judicial attitude to these remedies, to determine if the court has reversed its previous reluctance to assist the minority shareholder. Possible deficiencies in the legislation will also be investigated.

Chapter 5 will discuss the principal comparative remedies available to the minority shareholder in the United States, Canada and England. In the North American jurisdictions the common law derivative action has been put into a statutory form. The advantages and disadvantages of this procedure, over what Australia has done will be considered.

It must of course be noted that institutional differences between Australia and the United States will always make litigation more attractive in the latter jurisdiction. These differences include contingency fees, the availability of class actions and the situation where a successful defendant in the United States usually pays his own costs; whereas, the unsuccessful plaintiff in Australia will pay the taxed costs of the defendant. It is not the aim of this thesis to consider the procedural disincentives to litigation in this country or the availability of alternative dispute resolution techniques.



The shareholders remedy via a personal action will also be considered.<sup>17</sup> This thesis will primarily be considering wrongs done to the company and thus it may be argued that the personal action would have no application. However, it will be submitted that a wrong to the company can also be a wrong to the shareholder, via the diminution in the value of that person's investment. In addition to this it may be possible for a corporate wrong to be viewed as a breach of the statutory contract, or as a dilution of the shareholder's control within the company thus providing a personal action for the minority shareholders. Also there will be a consideration of a tortious action by the minority shareholder to remedy a corporate wrong. It may be argued that the directors wrong to the company may also support an action in deceit or conspiracy by the minority shareholders.

The final chapter will conclude with a review of the problems surrounding the minority shareholder, and a consideration of the proposals for reform in this area:

It is a fundamental principle of our law that a company is a legal person, with its own corporate identity, separate and distinct from the directors or shareholders and with its own property rights and interests to which it alone is entitled. If it is defrauded by a wrongdoer, the company

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<sup>17</sup> See Chapters 6 and 7.

itself is the one person to sue for damage. Such is the rule in *Foss v. Harbottle*.

[S]uppose [however] that [the company] is defrauded by insiders who control its affairs, by directors who hold a majority of the shares - who then can sue for damages? Those directors [who] are themselves the wrongdoers...will not authorise...proceedings to be taken...against themselves...If a general meeting is called, they will vote down any suggestion that the company should sue themselves. Yet the company is the one person who is damnified. It is the one person who should sue. In one way or another some means must be found for the company to sue. Otherwise...[i]njustice would be done without redress.<sup>18</sup>

Thus in summary the thesis will firstly examine the difficulties of the minority shareholder at common law, and the need for reform of the common law. The legislation will then be considered, and any problems with the legislation will be discussed. Alternative remedies for the minority shareholder in tort or in equity will be considered, as will the solutions offered by other jurisdictions. The thesis will conclude with a recommendation that the position of the minority shareholder will be improved by way of legislative amendment, with the introduction of a statutory derivative action.

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<sup>18</sup> *Wallersteiner v. Moir* (No. 2) [1975] Q.B. 373 at p.390.

## CHAPTER 2

### THE DERIVATIVE SUIT - FROM CONCEPTION TO STATUTORY REFORM

The introduction of the derivative action arose from the abuses of management occurring in associations and corporations. The courts were required to develop a process which would allow a shareholder, or a member of the corporation or association to complain about abuses by the controllers of the entity. If a process was not developed by the courts the matter would then go without remedy and the controllers would have a free hand to divert the assets of the corporation to their own use. The reason for this is that the proper plaintiff, the corporation or association, would not bring the action, as the wrongdoers were in control of the association. Thus "the shareholders' right to command a judicial forum comes in answer to a demonstration of need".<sup>1</sup>

#### The History of the Derivative Action

The common law always imposed its rules on natural persons, and it followed from this that when disputes arose concerning

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<sup>1</sup> That need was to correct the abuses of management occurring in associations and corporations.

associations those same rules would be imposed upon the associations. As early as 1307 Edward I required the abbot to keep the corporate seal in a particular place so as to prevent its use to the detriment of members. Similarly, ordinary corporations were subject to visitation by the King, while ecclesiastical and eleemosynary corporations were subject to visitation by the bishop, and founder respectively.<sup>2</sup> During the sixteenth century, the *Charitable Gifts Act* 43 Eliz.1,c.4, provided the Chancellor with a mandate to inquire into corporate affairs on the complaint of any party aggrieved.

Examples of this visitorial power, and the authority of the Chancellor are *Eden v. Foster*<sup>3</sup> and *Charitable Corporation v. Sutton*.<sup>4</sup> In *Eden v. Foster* the issue before the Court was whether the Crown could exercise a right as a visitor against a school founded by the King. It was held by the Court of Chancery, that where the King is founder then he can exercise visitorial rights, whereas if a private person is founder, then by implication that person or someone nominated by him can be a visitor.

In *Charitable Corporation v. Sutton* an action was brought against Committee-men (directors) for breach of trust, fraud and

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<sup>2</sup> See W.S. Holdsworth, *A History of English Law Volume IX Methuen and Co. Ltd.* 1926 at p.58-59 where he details this development.

<sup>3</sup> (1725) 2 P.Wms 325, 24 E.R. 750.

<sup>4</sup> (1742) 2 Atk 400, 26 E.R. 642.

mismanagement, the action being brought by the corporation. In holding the committee-men liable the Lord Chancellor stated, "[i] will never determine that frauds of this kind are out of the reach of courts of law or equity, for an intolerable grievance would follow from such a determination".<sup>5</sup>

*Charitable Corporation v. Sutton* was a case of a corporation seeking relief against wrongdoers, the next step was not just to allow protection to members, but to allow members themselves to institute proceedings. This was achieved in *Adley v. Whitstable Company*.<sup>6</sup>

A member of the Whitstable Company sought an account of profits denied to him by virtue of a by-law, which penalised any member who worked for a rival company. The Whitstable Company submitted that the Court of Chancery had no jurisdiction to hear the matter. To this the Court of Chancery stated that, "unless I can be satisfied that the party has such a remedy at law as ought to bar his application to a Court of Equity, I conceive he has a right to apply here for such relief".<sup>7</sup> The decision is important in that it was the first time that a shareholder was permitted to litigate an intra-corporate dispute.

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<sup>5</sup> *Id.* at p.645.

<sup>6</sup> (1810) 17 Ves Jun 315, 34 E.R. 122.

<sup>7</sup> *Id.* at p.126.

*Adley v. Whitstable Company* involved a shareholder challenging a by-law which affected all members. The next step in the development of remedies for minority shareholders was to allow a shareholder to come to equity on behalf of himself, and all other shareholders, for the redress of a wrong done to the company. This was achieved by the introduction of the representative derivative action.

In *Hichens v. Congreve*<sup>8</sup> a suit was instituted by certain shareholders in the Arigna Mining Company on behalf of themselves and all other shareholders, except the Defendants, against the chairman and acting directors of the company, and other persons connected with the company, alleging a promotional fraud. The relief sought was that the moneys misappropriated be restored to the company. The defendants filed a demurrer claiming the shareholders had no jurisdiction to come to equity, but this was overruled by the Lord Chancellor. The Lord Chancellor stating:

In the present case, it appears to me that justice may be done in one suit. All shareholders stand in the same situation; the property has been taken out of their common fund; they are entitled to have that property brought back again for the benefit of the concern.<sup>9</sup>

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<sup>8</sup> (1828) 4 Russ & M. 562, 38 E.R. 917.

<sup>9</sup> *Id.* at p.922.

Similarly in *Wallworth v. Holt*,<sup>10</sup> shareholders of a joint stock bank brought a representative suit against the directors requesting an accounting of the assets of the bank. A demurrer for want of equity, and want of partners was overruled. Lord Chancellor Cottenham commenting that:

I think it the duty of this Court to adopt its practice and course of proceeding to the existing state of society, and not by too strict an adherence to forms and rules, established under different circumstances, to decline to administer justice, and to enforce rights for which there is no other remedy.<sup>11</sup>

Similarly in *Preston v. The Grand Collier Dock Company*<sup>12</sup> the representative suit was sanctioned as there was, 'a plain equity for the Plaintiff to be relieved'.<sup>13</sup> Prunty comments, that the representative suit, "made the action possible, it permitted the adoption of the class action where there was no other basis for jurisdiction."<sup>14</sup>

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<sup>10</sup> (1841) 4 My & Cr. 619, 41 E.R. 238.

<sup>11</sup> *Id.* at p.244.

<sup>12</sup> (1840) 11 Sim 327, 59 E.R. 900.

<sup>13</sup> *Id.* at p.907.

<sup>14</sup> B.S. Prunty, "The Shareholders' Derivative Suit: Notes on its Derivation" (1957) 32 *New York University Law Review* 980 at p.983.

*Hichens v. Congreve*, *Wallworth v. Holt*, *Preston v. Grand Collier* all show that the right of shareholders to sue on behalf of themselves and all other shareholders, to redress a wrong done to the members of the company, or to the company, was recognised prior to the 1843 decision of *Foss v. Harbottle*.<sup>15</sup>

### The Decision of *Foss v. Harbottle*

The decision in *Foss v. Harbottle* represented a major statement of the law in regard to minority shareholders; though it cannot be seen as a major advance for minority shareholders. The pleadings in *Foss v. Harbottle* were as complete as those utilised in *Hichens v. Congreve* and *Preston v. Grand Collier* yet the minority shareholders were denied any standing to remedy what they saw as a misapplication of the corporate funds by the directors of the company. Seen in this sense, the decision can be seen as a restriction rather than an expansion of the right of a shareholder to seek judicial intervention.

### The Facts of *Foss v. Harbottle*

The Victorian Park company was incorporated by an Act of Parliament in 1837 to develop ornamental gardens and parks and

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<sup>15</sup> (1843) 2 Ha 461, 67 E.R. 189.



also to erect housing with attached leisure grounds and then to sell or otherwise dispose of the property. There were eight promoters of the scheme; Harbottle, Adshead, Byron, Westhead, Bealey, Denison, Bunting and Lane; the first five were the directors. Foss, one of the shareholders brought a derivative suit alleging that the promoters had conspired together to profit by the establishment of the company, and at the expense of the company. This being achieved by the company purchasing land belonging to the promoters at exorbitant values. The defendants demurred to the bill on the basis that the plaintiffs were not entitled to represent the Victorian Park Company, and this could not be cured by adding the corporation as a defendant.

#### The Arguments by Counsel

The argument by Counsel in support of the demurrers centred on the pleadings used by the plaintiff - the representative derivative action. On behalf of the defendants it was alleged that if the Plaintiffs had any ground for impeaching the conduct of the Defendants, they could have brought proceedings using the name of the corporation, in response to which the Defendants could have applied to the Court to prevent use of the corporate name. The Court would then have been in a position to determine the merits of the plaintiff's claim. Alternatively, the suit may have been brought by the Attorney-General to correct an abuse of powers granted for public purposes.

The plaintiff's argument was that the corporation was not to be treated as an ordinary corporation, and that in fact it was analogous to a partnership, and should be governed by the rules applicable to partnerships.

The Decision of the Vice Chancellor Sir James Wigram

The Vice Chancellor held for the defendant on two grounds. The first ground was that the corporation, being a separate entity from the members of the corporation should sue in its own name, and in its corporate character. Sir James Wigram states:

In law the corporation and the aggregate members of the corporation are not the same thing for purposes like this; and the only question can be whether the facts alleged in this case justify a departure from the rule which, prima facie, would require that the corporation should sue in its own name and in its corporate character, or in the name of someone whom the law has appointed to be its representative.<sup>16</sup>

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<sup>16</sup> *Id.* at p.203.

The second ground for the decision of Sir James Wigram has become known as the 'internal management' aspect of the rule of *Foss v. Harbottle*. The Act incorporating the Victorian Park Company provided that the directors were the governing body of the company, subject to the superior control of the members assembled in general meeting. His Honour states:

[I]t is only necessary to refer to the clauses of the Act to show that, whilst the supreme governing body, the proprietors at a special general meeting assembled, retain the power of exercising the functions conferred upon them by the Act of Incorporation, it cannot be competent to individual corporators to sue in the manner proposed by the Plaintiffs on the present record.<sup>17</sup>

His Honour also discussed both *Hichens v. Congreve* and *Preston v. The Grand Collier Dock Co.* Whilst expressing his cordial concurrence with *Hichens*, he distinguishes this case by alluding to the point that the promoters fraud in that case gave rise to an action for misrepresentation. He distinguishes *Preston*, by characterising the wrong in that case as one which could not be ratified by a meeting of shareholders. Prunty comments, "whether these characterisations are accurate or not, one point is clear: in *Foss v. Harbottle* the Vice-Chancellor was announcing his refusal to intervene in business affairs which could be effectively resolved by the members of the organisation

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17 *Ibid.*

in question".<sup>18</sup> Thus Sir James Wigram was the first judicial officer to state openly, and plainly, that the court will not interfere where a majority of members may lawfully ratify the conduct in question. This principle of ratification was to bedevil the minority shareholder when attempting to pursue a wrong done to the company by the controllers. To determine the origin of this principle of majority rule, it is appropriate to briefly discuss the sources of the internal management principle.

The internal management principle can be traced to a series of cases decided by Lord Chancellor Eldon in the early 19th century.<sup>19</sup> Lord Eldon refused to intervene in partnership disputes except where a dissolution was requested. A decision which exemplifies this idea is *Carlen v. Drury*.<sup>20</sup> A partnership of 1600 shares was formed with the aim being to sell beer to the public. One of the articles of the partnership deed provided that the managers may at any general meeting be removed. A bill was filed by the plaintiff and all other shareholders against the managers alleging circumstances of gross mismanagement and neglect on the part of the managers. Lord Eldon bluntly stated, "[t]his Court is not to be required on every occasion to take the management of every Playhouse and

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<sup>18</sup> B.S. Prunty, *op. cit.* at p.983.

<sup>19</sup> *Waters v. Taylor* (1807) 15 Ves 10, 33 E.R. 658. *Carlen v. Drury* (1812) V & B 154, 35 E.R. 61. *Ellison v. Bignold* (1821) 2 Jac & W. 503, 37 E.R. 720.

<sup>20</sup> (1843) V & B 154, 35 E.R. 61.

Brewhouse in the Kingdom. The Plaintiffs have a remedy in their own hands to which they have not resorted".<sup>21</sup>

Similarly in *Ellison v. Bignold*<sup>22</sup> a bill was filed by ten of the directors of the National Union Fire Association, on behalf of themselves and all other members, against the remaining directors of the Union alleging various aspects of mismanagement. The complaining directors had the power under the by-law to regulate whatever they objected to in the defendant's behaviour. Lord Chancellor Eldon dismissed the complainants' bill stating, "[i]f they (the directors) would not act upon their deed, the Court would not manage their affairs for them".<sup>23</sup>

The rule in *Foss v. Harbottle* in its purest form would allow directors and/or majority shareholders to trample completely the interests of minority shareholders. The minority shareholder seeking to redress a wrong done to the company would be met with the defence that the company is the proper plaintiff, or alternatively, that the members in a general meeting have resolved not to institute proceedings, that is, it is a matter of internal management. To correct this imbalance in favour of the directors and/or majority shareholders, generations of judges

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<sup>21</sup> *Id.* at p.62-63.

<sup>22</sup> (1821) 2 Jac. & W. 503; 37 E.R. 720.

<sup>23</sup> *Id.* at p.724.

subsequent to Sir James Wigram V.C. in *Foss v. Harbottle* have developed exceptions to the rule in *Foss v. Harbottle*. In fact, Sir James Wigram, himself provided the forerunner for the development of these exceptions, stating that, "the claims of justice would be found superior to any difficulties arising out of technical rules".<sup>24</sup>

The most often repeated statement of the exceptions to the rule in *Foss v. Harbottle* derive from Jenkins L.J. in *Edwards v. Halliwell*.<sup>25</sup> These were stated as follows:

- (1) "Where the act complained of is wholly ultra vires the company or association".
- (2) "Where the issue is such that it could not 'validly be done or sanctioned by a simple majority of the members...but only by some special majority'".
- (3) Where the "personal and individual rights of (the shareholder) have been invaded".

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<sup>24</sup> (1843) 2 Ha 461; 67 E.R. 189 at p.202.

<sup>25</sup> [1950] 2 All E.R. 1064.

- (4) Where "what has been done amounts to a fraud on the minority and the wrongdoers are themselves in control of the company".<sup>26</sup>

The first three exceptions listed are not exceptions in the correct sense of the word. They are situations where the rule does not have any role to play. The first two exceptions allow a shareholder to bring an action where some *ultra vires* or illegal act has taken place, whereas the third exception is simply a statement that ownership of shares carries with it personal or individual rights. As Maloney comments, "[a]ll are independent actions regardless of the *Foss v. Harbottle* rule. The only true exception is that of fraud on the minority".<sup>27</sup> Consequently, it is this exception which has caused most of the problems.<sup>28</sup> Accordingly, I will now consider the elements of this exception.

#### Fraud on the minority when the wrongdoers are in control

Fraud on the minority, defined loosely, concerns an abuse of power, usually by the directors. The applicant must

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<sup>26</sup> *Id.* at p.1067.

<sup>27</sup> M.A. Maloney, "Whither the Statutory Derivative Action" (1986) 64 *Can. B.R.* 309 at p.311.

<sup>28</sup> In Chapter 6 I will consider the personal rights exception which has recently gained prominence as a way to subvert the Rule in *Foss v. Harbottle*.

show evidence of abuse and furthermore that the conduct was not in the best interests of the company.<sup>29</sup>

The term fraud on the minority though commonly used is strictly speaking inaccurate. In this type of situation we are dealing with the position where a wrong has been done to the company, and the minority shareholder is seeking a right to recover on behalf of the company. The exception would be more accurately categorised as a, "fraud on the company when the wrongdoers are in control".<sup>30</sup> There are two principal elements to this exception that need to be considered, fraud and control.

#### (i) Fraud

The common law definition of fraud is primarily a duty of honesty:

[H]onesty in the stricter sense is by our law a duty of universal obligation. This obligation exists independently of contract or of special obligation. If a man intervenes in the affairs of another he must do so honestly, whatever be the character of that intervention. If

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<sup>29</sup> M.A. Maloney, *op. cit.* at pp. 311-312.

<sup>30</sup> H.H. Mason, "Fraud on the Minority : The Problem of a Single Formulation of the Principle" (1972) 46 *A.L.J.* 67 at p.68.



he does so fraudulently, and through that fraud damage arises, he is liable to make good the damage.<sup>31</sup>

Equitable fraud, or the fraud required to establish a fraud on the minority is wider than this. It extends to an abuse, or misuse of power.<sup>32</sup> Furthermore, an actual intent to cheat must not be proved.<sup>33</sup>

The authorities may go so far as to suggest that mere negligence, which benefits the wrongdoers without any allegation of fraud, may be sufficient to constitute fraud in the sense of fraud on the minority. For example in *Pavlides v. Jensen*<sup>34</sup> a minority shareholder sought to bring an action on behalf of himself and all other shareholders save and except three directors. The action was brought on the basis that the directors were guilty of gross negligence in effecting a sale of a valuable asset worth 1,000,000 pounds for 182,000 pounds. The minority shareholder was unsuccessful.

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<sup>31</sup> *Nocton v. Lord Ashburton* [1914] A.C. 933 at p.954.

<sup>32</sup> *Estmanco. Ltd. v. Greater London Council* [1982] 1 All E.R. 437 at p.445.

<sup>33</sup> *Nocton v. Lord Ashburton* [1914] A.C. 932 at p.954. See the discussion of the concept of equitable fraud in R.P. Meagher, W.M.C. Gummow and J.R.F. Leane *Equity Doctrines and Remedies* 2nd ed. Butterworths at p.323.

<sup>34</sup> [1956] Ch. 565.

This decision can be contrasted with *Daniels v. Daniels*.<sup>35</sup> A minority shareholder in that case sought to bring a derivative action against two directors who were husband and wife, and who controlled the company. It was alleged that they had been negligent in selling land to the wife for 4,250 pounds, the land being subsequently resold four years later for 120,000 pounds. Templeman J. considered that different considerations apply where not only are the directors negligent but they themselves benefit from their negligence. "It would seem to me quite monstrous particularly as fraud is so hard to plead and difficult to prove if the confines of the exception to *Foss v. Harbottle* were drawn so narrowly that directors could make a profit out of their negligence".<sup>36</sup>

The definition of fraud is linked with the issue of what the members in a general meeting can or cannot ratify.

Wedderburn suggests<sup>37</sup> that if the general meeting can ratify the conduct in question then the alleged conduct will not amount to fraud. He goes further and submits that the breaches of fiduciary duty, which cannot be ratified arise where directors act in bad faith, or where the legal or equitable property of the company has been misappropriated. The difficulty with this test is determining what amounts to bad faith, or when the

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<sup>35</sup> [1978] 2 All E.R. 89.

<sup>36</sup> *Id.* at p.96.

<sup>37</sup> (1981) 44 *M.L.R.* 202 at p.205-208.

property of the company has been misappropriated.<sup>38</sup> The debate over what can, or cannot be ratified complicates this area of the law, and was partially responsible for the introduction of the oppression remedy. Recent authority such as *Smith v. Croft (No. 2)*<sup>39</sup> also indicates that ratification may not be an element of fraud, but an element distinct in itself.

In *Smith v. Croft (No. 2)*<sup>40</sup> a company, Film Finances Limited, was in the business of guaranteeing the completion of films on time and within budget. In 1982, the executive directors of Film Finances Limited obtained a majority shareholding amounting to 63% of the voting rights in the company. Film Finances Ltd. then lent money to a number of companies associated with the directors of Film Finances Ltd. The plaintiffs, a number of minority shareholders of Film Finances Ltd. holding approximately 12% of the voting stock then brought a derivative action against the directors alleging *inter alia* that the directors had paid themselves excessive remuneration, and that the payments to the associated company were an *ultra vires* gift. Wren Trust Ltd., the only other substantial shareholder with 20% of the voting stock was opposed to the bringing of the action. His Honour, Knox J. having decided as a preliminary issue that the matter came within the proper

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<sup>38</sup> See the discussion by J.F. Corkery, *Directors Duties and Powers* Longman Professional 1987 at p.165.

<sup>39</sup> [1987] 3 All E.R. 909.

<sup>40</sup> *Ibid.*

boundaries of the exception to the rule in *Foss v. Harbottle*,<sup>41</sup> then went on to formulate a third limb for the minority shareholder to satisfy before he could bring a claim under the rule in *Foss v. Harbottle*. Stamp, in his discussion of *Smith v. Croft (No. 2)* states:

It was necessary for the minority shareholder to establish that the independent shareholders were not opposed to the bringing of the claim. In order to determine whether any particular shareholder was independent one had to apply a test based on the *Allen v. Gold Reefs of West Africa Ltd.* [1900] 1 Ch. 656 formulation for alteration of articles, i.e. whether there was a substantial risk of the votes having been cast in order to support the defendant as opposed to securing the benefit of the company. In the present case the Wren Trust passed this test and accordingly the plaintiffs' application was struck out.<sup>42</sup>

This third limb makes the claim of a minority shareholder even less likely to succeed. The views of majority shareholders should be sought initially to determine if a fraud has been committed,<sup>43</sup> not at some later stage after fraud has been found

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<sup>41</sup> His Honour by determining this as a preliminary issue was adopting the procedure used by the Court of Appeal in *Prudential Assurance v. Newman Industries (No. 2)* [1982] 1 All E.R. 354; this issue of standing will be discussed later.

<sup>42</sup> M. Stamp, "Minority Shareholders : Another Nail in the Coffin" (1988) 9 *Co. Law*. 134 at p.135.

<sup>43</sup> See the excellent discussion of what can be ratified in R. Baxt, "Judges in their Own Cause : The Ratification of Directors' Breaches of Duty" (1978) 5 *Mon. Uni. L.R.* 16.

to exist. In effect the majority shareholders are being allowed 'a second bite of the cherry'.<sup>44</sup>

First, the [majority shareholders] may use their votes to ratify any wrongs they have committed, provided that the ratification would not amount to a fraud. If ratification of the wrong would amount to a fraud, or the majority are unable to carry such a vote, they may attempt to convince the independent shareholders that it is not in the best interests of the company that a claim be brought.<sup>45</sup>

The onus of establishing the independence or otherwise of the shareholders, who object to the bringing of proceedings is also cast upon the minority shareholder.<sup>46</sup> The minority shareholder will be required to show that the exercise of voting power by the shareholders to forestall proceedings was not, "bona fide for the benefit of the company as a whole".<sup>47</sup> This principle is objectionable as it is subjectively, rather than objectively based.<sup>48</sup> The test is whether, the particular shareholders of that company think the resolution is for the benefit of the company as a whole, rather than whether the hypothetical reasonable

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<sup>44</sup> M. Stamp, *op. cit.* at p.135.

<sup>45</sup> *Ibid.*

<sup>46</sup> *Shuttleworth v. Cox Brothers* [1927] 2 K.B. 9 at p.18.

<sup>47</sup> *Allen v. Gold Reefs of West Africa Ltd.* [1900] 1 Ch. 656 at p.671.

<sup>48</sup> L. Crabb, "Minority Protection and Section 75" (1982) 3 *Co. Law* 3 at p.4.

shareholder would think the resolution is for the benefit of the company as a whole.<sup>49</sup>

(ii) Control

The meaning of the concept of control is still uncertain.<sup>50</sup>

Control can obviously be displayed if the wrongdoers have 51% of the voting stock. However, control can also be obtained by far smaller shareholdings. As stated by the Court of Appeal in *Prudential Assurance v. Newman Industries (No. 2)*<sup>51</sup> control, "embraces a broad spectrum extending from an overall absolute majority of votes at one end to a majority of votes at the other end made up of those likely to be cast by the delinquent himself plus those voting with him as a result of influence or apathy".<sup>52</sup> While this statement does not precisely define the minimum requirement for control it still indicates that control now extends from purely de-jure control to at least de-facto control.

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<sup>49</sup> *Shuttleworth v. Cox Brothers* [1927] 2 K.B. 9 at p.18.

<sup>50</sup> See a further discussion on the aspect of control in Chapter 7.

<sup>51</sup> [1982] 1 All E.R. 354.

<sup>52</sup> *Id.* at p.364.

### Standing to Sue

An additional problem for the minority shareholder besides establishing fraud and control is that at the start of proceedings, the company, at the behest of the directors will seek to strike out the proceedings on the basis that the company is the proper plaintiff. This occurred in the decision of *Foss v. Harbottle* itself. In Tasmania, the *Rules of the Supreme Court* 1965 allow two avenues for the company to have the action struck out. For example, Order 16 provides that:

Any defendant to an action may within ten days after appearance, or at any time by leave of the Court or a judge, apply to a judge for summary judgment and the judge if satisfied that the action is frivolous or vexatious and that the defendant has a good defence on the merits or that the action shall be disposed of summarily or without pleadings, may order that judgment be entered for the defendant.

Order 28, Rule 4, also provides that:

The court or a judge may order any pleading to be struck out on the ground that it discloses no reasonable cause of action or answer and, in any such case or in case of the action or defence being shown by the pleadings to be

frivolous or vexatious, the Court or a judge may order the action to be stayed or dismissed or judgment to be entered accordingly, as may be just.

Recent authority indicates that it is the latter order which is more appropriate.<sup>53</sup>

The application of the rule in *Foss v. Harbottle* to the locus standi of the minority shareholders was before the English Court of Appeal in *Prudential Assurance v. Newman Industries (No. 2)*. The facts of this case can be briefly summarised.

Prudential Assurance was a minority shareholder in Newman Industries. Two of the directors of Newman Industries, Bartlett and Laughton, were also directors of a 'friendly company', T.P.G. In 1975, T.P.G. was in serious financial difficulties. Bartlett and Laughton devised a plan whereby Newman Industries would purchase T.P.G.'s assets, in exchange for a cash payment, and Newman Industries assuming all of the liabilities of T.P.G. The valuation placed on T.P.G. was erroneous due to misleading information supplied by Bartlett and Laughton. Bartlett and Laughton persuaded the Board of Directors of Newman industries to accept the transaction and a meeting of shareholders subsequently approved the transaction by a small majority. Prudential Assurance then brought a

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<sup>53</sup> *Smith v. Croft (No. 2)* [1987] 3 All E.R. 909.



derivative action against Bartlett and Laughton seeking equitable damages for a breach of fiduciary duty by Bartlett and Laughton to Newman Industries.

The English Court of Appeal decided that the first issue to be considered was whether the plaintiff was entitled to maintain the derivative claim against the defendants. The plaintiff was required before proceeding to establish a *prima facie* case, and that the action fell within the proper boundaries of the exception to the rule in *Foss v. Harbottle*. In determining this the allegations in the statement of claim which alleged fraud and control on behalf of Bartlett and Laughton were not to be treated as facts.

The Court was also of the view that if the standing of the plaintiff was not decided as a preliminary issue then:

...the rule in *Foss v. Harbottle* can have little, if any role to play. Either the wrong is proved, thereby establishing conclusively the rights of the company or the wrong is not proved so *cadit quaestio*.<sup>54</sup>

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<sup>54</sup> *Prudential Assurance v. Newman Industries (No. 2)* [1982] 1 All E.R. 354 at p.365.

The Court of Appeal, by their approach, did nothing to improve the position of the minority shareholder who is attempting to right a wrong done to the company. In essence they reasserted the rationale for the rule in *Foss v. Harbottle*; that being that business decisions were best left to the commercial community. They have 'firmly reasserted conservative orthodoxy'.<sup>55</sup>

The decision of the English Court of Appeal in *Prudential Assurance v. Newman Industries (No. 2)* has been questioned by the South Australian Supreme Court in *Hurley and Anor. v. B.G.H. Nominees Pty. Ltd.*<sup>56</sup> The Court considered that the issue of the minority shareholder's standing to bring a derivative action ought to be determined in each individual case according to the circumstances of that case.<sup>57</sup> In the matter before the Court the question of standing was determined upon the basis that the allegations of fraud and control in the statement of claim were to be treated as facts.<sup>58</sup>

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<sup>55</sup> A.J. Boyle, "The Prudential, the Court of Appeal and *Foss v. Harbottle* " (1981) 2 *Co. Law* 264 at p.266.

<sup>56</sup> [1982] 6 A.C.L.R. 791.

<sup>57</sup> See the comments by King C.J. *Id.* at p.795.

<sup>58</sup> The Full Court of Western Australia in *Dempster v. Biala Pty. Ltd.* (1989) 15 A.C.L.R. 191 at p.193 also considered that there is no universal rule that the question of standing should be determined as a preliminary issue and that each case must be considered on its merits. The Court followed an earlier Western Australian Supreme Court decision on this point *Eromanga Hydro Carbons N.L. v. Australian Mining N.L.* (1988) 14 A.C.L.R. 486.

### Resolution of Conflict between Hurley and Prudential

The conflict between *Hurley v. B.G.H. Nominees* and *Prudential Assurance v. Newman Industries* could possibly be resolved by the adoption of the procedure that is utilised when the granting of an interlocutory injunction is in issue. The House of Lords in *American Cyanamid v. Ethicon*<sup>59</sup> decided that the Court did not have to find that there was a prima facie case before they would grant an interlocutory injunction; they only had to be satisfied that the claim was not frivolous or vexatious and that there was a serious question to be tried. The Court, on the preliminary matter, was not to "resolve conflicts of evidence as to facts".<sup>60</sup>

Having decided that there was a serious question to be tried, the Court would then go on to consider whether the balance of convenience lies in granting the interlocutory injunction. This decision has been followed by the High Court of Australia in *A. v. Hayden*.<sup>61</sup>

It is submitted that a Court could utilise this procedure when considering an application to strike out a derivative action. First, is there a serious question to be tried, if so, does the balance of convenience remain in allowing the action to proceed

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<sup>59</sup> [1975] 1 All E.R. 504.

<sup>60</sup> *Id.* at p.510.

<sup>61</sup> See *A. v. Hayden* (1985) 59 A.L.J.R. 7 and *Murphy v. Lush* (1986) 60 A.L.J.R. 523.

in the name of the minority shareholder. The adoption of this procedure may go some way towards alleviating some of the difficulties facing the minority shareholder in obtaining locus standi to redress a wrong done to a company.

### Subsidiary problems with the Rule in *Foss v. Harbottle*

The minority shareholder, even if he has established fraud, control, standing to sue, and that the independent shareholders have not ratified the wrongdoing, will still face a number of other obstacles. First, the alleged wrongdoers control all the information which the minority shareholder requires to establish his case. The plaintiff has to rely on the rules of discovery applicable to individual litigation and 'it is submitted that these are totally inadequate in the special circumstances of a shareholder suing directors'.<sup>62</sup> The second problem that could arise results from the company being joined as a nominal defendant, despite the fact that if the minority shareholder is successful, the beneficiary of the judgment will be the company. The problem the plaintiff faces is that if he/she is unsuccessful, costs may be awarded against him/her. In effect, the minority shareholder is bearing the risk of failure, but won't enjoy the fruits of any success. This problem however, has been alleviated somewhat by the decision of the English Court of

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<sup>62</sup> O.C. Shriener, "The Shareholder's Derivative Action" (1979) 96 *South African L.J.* 203 at p.237. The applicable Tasmanian provision for discovery is Order 33 of the *Rules of the Supreme Court* 1965.

Appeal in *Wallersteiner v. Moir*.<sup>63</sup> The Court of Appeal in *Wallersteiner* arguing by analogy with trustees,<sup>64</sup> or agents,<sup>65</sup> held that a minority shareholder can seek an indemnity order so that, in the event of loss, a company would *prima facie* be responsible for the payment of costs. The procedure to be followed by the minority shareholder in seeking an indemnity is as follows:

1. The shareholder should apply ex-parte by summons to the master.
2. The summons should be supported by the opinion of counsel.
3. The Court could, in appropriate circumstances, join other persons.
4. The evidence presented before the hearing would not normally be made available to the defendants should the principal action proceed.

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<sup>63</sup> [1975] Q.B. 373.

<sup>64</sup> See *Re Beddoe* [1893] 1 Ch. 547.

<sup>65</sup> *Re Famatina Development Corporation* [1914] 2 Ch. 271.

5. The Court could require the minority shareholder to proceed to a certain stage and then require him to return to the Court for further directions.

Some ten years later in *Smith v. Croft (No. 1)*<sup>66</sup> the Wallersteiner procedure was modified somewhat by the decision of Walton J. His Honour considered that applications should generally not be ex-parte; the relevant evidence should be shown to the company, and Walton J. also thought it important to consider the liquidity of the plaintiff, to determine if the plaintiff had sufficient financial resources to finance the action on his own. This point is justifiably subject to criticism by Prentice.<sup>67</sup> The plaintiff is bringing his application as a "representative" of the company and his financial resources should be irrelevant in determining the status of the plaintiff to bring the action.

### Legislative Reform

The rule in *Foss v. Harbottle* poses a serious impediment to the minority shareholder seeking to redress a wrong done to the company. He must grapple with the intricacies of fraud, control, ratification and standing to sue, together with subsidiary

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<sup>66</sup> [1986] 2 All E.R. 551.

<sup>67</sup> D.D. Prentice, "*Wallersteiner v. Moir* : A Decade Later" [1987] *Conv. and Prop. Law* 167. He considered that on grounds both of principle and practicality, the wealth of the plaintiff should not be a relevant consideration.

matters such as discovery and costs. For these reasons, many law reform committees<sup>68</sup> have all suggested a statutory remedy for minority shareholders.

Along these lines Corkery notes that:

The difficulties of a minority shareholder seeking to bring a derivative action are legendary. The so called rule in *Foss v. Harbottle* even with its 'exceptions' stultifies minority shareholder action against corporate mischief. Simply getting standing is very difficult.... Defining and proving fraud on the minority, showing the wrongdoers are in effective control of the company and grappling with the intricacies of corporate ratifiability befuddle the minority shareholder who lacks influence and access to corporate funds, information and procedures.<sup>69</sup>

It is now proposed to briefly detail the major concerns of the law reform committees who have considered the plight of the minority shareholder.

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<sup>68</sup> E.G. Cohen Report, Cmd. 6659, United Kingdom 1945; Jenkins Reports Cmd 1749, United Kingdom 1962; Lawrence Report, Interim Report of the Select Committee on Company Law, Ontario 1967; Dickerson Report, Proposals for a New Business Corporations law for Canada, Ottawa, 1971.

<sup>69</sup> J.F. Corkery, "Oppression or Unfairness by Controllers" (1985) 9 *Adel. Law Review* 437 at p.458. For a recent decision discussing the rule in *Foss v. Harbottle* see *Farrow v. Registrar of Building Societies* [1991] 2 VLR 589.

Cohen Committee:- United Kingdom

The United Kingdom Cohen Committee<sup>70</sup> were concerned with two particular practices which, in their opinion, amounted to oppressive conduct of minority shareholders. These practices were restrictions on the transfer of shares, which resulted in minority members having to sell their shares to directors at an undervalue,<sup>71</sup> and excessive remuneration paid to directors which left nothing for shareholders by way of dividend.<sup>72</sup> The Committee saw these practices as illustrations of a general problem.<sup>73</sup> Accordingly they considered that an oppression section should be introduced so that the Court would be empowered to make whatever settlement was just and equitable on the facts of the case before them:

[The Court] should be empowered instead of making a winding up order to make such other order, including an order for the purchase by the majority of the shares of the minority at a price to be fixed by the Court.<sup>74</sup>

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<sup>70</sup> 1945 Cmd. 6659.

<sup>71</sup> *Id.* at para. 58.

<sup>72</sup> *Id.* at para. 59.

<sup>73</sup> *Id.* at para. 60.

<sup>74</sup> Cohen Report Cmd. 6659, para. 60.



It is clear that the Cohen Committee were addressing their remarks to disputes between members of small private companies, commonly known as quasi-partnerships. The characteristics of these companies often include a small number of shareholders, restrictions on the transferability of shares, shareholder participation in management and shareholders being remunerated as officers of the company rather than by the declaration of dividends.<sup>75</sup>

The legislation<sup>76</sup> which was based on the Cohen Report was not however restricted to private companies, but 'by requiring facts justifying a winding up order, it remained firmly anchored to quasi-partnership companies'.<sup>77</sup>

#### Jenkins Committee - United Kingdom

The legislation based on the Cohen Committee came up for review in 1962 with the Jenkins Committee.<sup>78</sup> The Committee noted,<sup>79</sup> that while it may be theoretically desirable for shareholders to have a more effective voice in management, in

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<sup>75</sup> See the comments by G. Shapira, "Minority Shareholders' Protection - Recent Developments" (1982) *N.Z.U.L.R.* 134 at p.138.

<sup>76</sup> See the *Companies Act* 1948, s.210.

<sup>77</sup> *Ibid*

<sup>78</sup> 1962 Cmnd. 1749.

<sup>79</sup> *Id.* at para. 14.

practice, the officers of the company must be given a reasonably free hand in the day to day management of the company:

It is no doubt necessary for the protection of shareholders that activities of companies and those responsible for their management should be subject to a considerable degree of statutory regulation and control...[However we recognise the] undesirability of imposing restrictions which would seriously hamper the activities of honest men in order to defeat an occasional wrongdoer and the importance of not placing unreasonable fetters upon business which is conducted in an efficient and honest manner.<sup>80</sup>

The Committee then goes on to discuss the oppression remedy which resulted from the recommendations of the Cohen Committee. They state:

Many witnesses have, however, expressed their opinion, with which we agree, that even as interpreted ... the section as it stands calls for amendment if it is to afford effective protection to minorities in circumstances such as those with which it is intended to deal.<sup>81</sup>

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<sup>80</sup> Jenkins Report, 1962 Cmnd. 1749 at para. 11.

<sup>81</sup> *Id.* at para. 200.

The Jenkins Committee also considered the restrictive conditions of the rule in *Foss v. Harbottle*.<sup>82</sup> After reference to the requirements of fraud and control,<sup>83</sup> the Committee recommended that the statutory oppression remedy should be extended to not only cover acts which were unfairly prejudicial, but also to allow a court to order that proceedings be brought in the name of the company by such person, or persons as the court may direct.<sup>84</sup>

It is not our intention to encourage litigation in cases in which, for instance, an independent majority has reached a bona fide decision to the effect that in the interests of the company as a whole no action should be taken. But we think that the discretion we propose should be given to the Court in such cases and the probable liability for costs of an unsuccessful litigant will be a sufficient safeguard against abuse.<sup>85</sup>

The potential for this provision is enormous. As Shapira comments:

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<sup>82</sup> *Id.* at para. 206.

<sup>83</sup> *Ibid.*

<sup>84</sup> *Id.* at paras. 206, 303-304.

<sup>85</sup> Jenkins Report, 1962, Cmnd 1749 at para. 207; the legislation was comprehensively reformed in 1980 and the recommendations of the Jenkins Committee are now contained in *Companies Act 1985* (U.K.) ss.459-461.

The statutory jurisdiction may supersede *Foss v. Harbottle*. Alternatively, it may perhaps be possible to use (the section) as a statutory base to reform the unsatisfactory aspects of the rule while retaining its main advantage - the protection of the company against being forced into vexatious or uneconomic litigation.<sup>86</sup>

#### Macarthur Committee - New Zealand

The Macarthur Committee,<sup>87</sup> largely endorsed the recommendations made by the Jenkins Committee. They similarly considered that the term 'unfairly prejudicial' should be added to oppression and that the court should be in a position to order the company to institute, prosecute, defend or discontinue proceedings.<sup>88</sup> Like the legislation emanating from the recommendations of the Jenkins Committee the legislation resulting from the Macarthur Committee represented a considerable step forward in the protection of the interests of minority shareholders, particularly those in quasi-partnerships.

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<sup>86</sup> G. Shapira, *op. cit.* at p.162.

<sup>87</sup> Final Report of the Special Committee to Review the Companies Act, March 1973 (hereafter referred to as the Macarthur Committee).

<sup>88</sup> *Id.* at para. 364 ff.

Lawrence Committee - Canada

The Lawrence Committee<sup>89</sup> disagreed with the reform measures adopted in the United Kingdom. After analysing the rule in *Foss v. Harbottle* and the oppression remedy utilised in the United Kingdom, they state:

It is sufficient for the Committee to state that the very existence of [the oppression section] is a recognition by the Parliament of the United Kingdom that the rights of minority shareholders were inadequate and that new and different remedies were therefore required to redress wrongs done to the company or to minority shareholders. In our opinion [the oppression section] raises as many problems as it lays to rest and, more importantly, is objectionable on the ground that it is a complete dereliction of the established principle of judicial non-interference in the management of companies. The underlying philosophy of [the oppression section] has an air of reservation and defeatism about it, as if the legislature was unable to offer any solution to the plight of minority shareholders other than abandoning the problems to the judiciary to be dealt with *ad hoc* on the basis of determining, from case to case, whether or not "the affairs

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<sup>89</sup> Interim Report of the Select Committee on Company Law, Ontario, 1967 (hereafter referred to as the Lawrence Committee).

of the company are being conducted in a manner oppressive to some part" of the shareholders.<sup>90</sup>

The Lawrence Committee then considered the alternatives to an oppression section, and concluded that the statutory derivative action would be the most appropriate means of achieving relief for minority shareholders against the rule in *Foss v. Harbottle* 91:

The Committee therefore recommends that the Ontario Act be amended by adding a substantive provision to the effect that a shareholder of a company may maintain an action in a representative capacity for himself and all other shareholders of the company suing for and on behalf of the company to enforce any rights, duties or obligations owed to the company which could be enforced by the company itself or to obtain damages for any breach thereof.<sup>92</sup>

The Committee also thought that to avoid the problems that occurred in America with the use of the derivative action,<sup>93</sup> the shareholder should have to establish that he is acting *bona fide*,

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<sup>90</sup> *Id.* at p.60.

<sup>91</sup> *Id.* at p.62.

<sup>92</sup> *Id.* at p.63.

<sup>93</sup> *Id.* at p.62-63.

and that it is *prima facie* in the interests of the company that the action be brought.<sup>94</sup>

The Committee were particularly concerned that minority interests bring derivative actions, "solely for the purpose of provoking secret settlements with the companies even in circumstances when the action is not well founded".<sup>95</sup> They considered that, by requiring the twin elements of *bona fides* of the applicant, and that it be in the interests of the company, the problems surrounding the derivative action could be resolved. It is submitted that these elements are a necessary part of a derivative action so as to avoid the problem of strike suits and the vexatious minority shareholder.

#### Dickerson Committee - Canada

The Dickerson Committee,<sup>96</sup> when considering a corporation's law for Canada, adopted the premise that:

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<sup>94</sup> *Id.* at p.63.

<sup>95</sup> The Lawrence Committee at p.63.

<sup>96</sup> Proposals for a New Business Corporation Law for Canada, Ottawa, 1971 (hereafter referred to as the Dickerson Committee).

...a corporation's Act should be largely self-enforcing by civil action initiated by the aggrieved party not by severe penal sanctions or sweeping investigatory powers.<sup>97</sup>

On the basis of this premise, the Dickerson Committee submitted that not only should a minority shareholder have the right to bring a statutory derivative action, but that an oppression section should also be introduced, implicitly therefore disagreeing with the criticisms of an oppression section by the Lawrence Committee.

The Dickerson Committee saw great promise in the statutory derivative action commenting that:

...in effect, this provision abrogates the notorious rule in *Foss v. Harbottle* and substitutes for that rule a new regime to govern the conduct of derivative actions ... we have relegated the rule to legal limbo without compunction, convinced that the alternative system recommended is preferable to the uncertainties - and obvious injustices - engendered by that infamous doctrine.<sup>98</sup>

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<sup>97</sup> *Id.* at p.161.

<sup>98</sup> *Ibid.*



The Dickerson Committee saw the oppression section as being used in a different context to the statutory derivative action.

The object of the statutory derivative action was to remedy a wrong done to the company, whereas the oppression section:

...will be invoked most frequently - but not always - in respect of a corporation the shares of which are held by only a relatively small number of persons, so-called "close corporation" since its usual object is to remedy any wrong done to minority shareholders.<sup>99</sup>

The Committee also recognised that in many instances a wrong to the minority shareholder will also be a wrong to the corporation. In those instances, the minority shareholder may select the remedy that, in his opinion, will best resolve the problem.<sup>100</sup> The Canadian experience with the statutory derivative action has been relatively successful, and the possibility of its introduction in Australia will be considered at a later stage.

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<sup>99</sup> *Id.* at p.162.

<sup>100</sup> *Ibid.*

Australia:

Australian company law has traditionally been based on legislation of the United Kingdom.<sup>101</sup> The first Australian companies legislation was introduced in the 1860s and 1870s when the *English Act* of 1862 was adopted by each colony. Generally, English reforms and consolidations were transcribed.<sup>102</sup> The recommendations of the Cohen Committee were first adopted by Victoria in 1958, and the oppression section was then reproduced in the uniform Companies Act 1961.<sup>103</sup> The scope of the section, now section 260, was expanded in the Companies Code 1981, and was substantially amended in 1983. In 1983 the terms unfairly prejudicial, unfairly discriminatory and contrary to the interests of members as a whole were added. The range of remedies was also expanded in line with the recommendations of the Jenkins Committee.<sup>104</sup>

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101 See for example the comments by A.C. Castles, *An Australian Legal History*, Law Book Co. 1982 at p.453ff.

102 See the comments by P. Redmond, *Companies and Securities Law*, Law Book Co. 1988 at p.31.

103 The initial oppression section being s.186 of the *Uniform Companies Act* 1961.

104 The problems associated with the legislation will be considered in Chapter 4 of the thesis. This section follows from the recommendations of the Jenkins Report, see for example the comments of the N.S.W. Attorney-General in the N.S.W. Legislative Assembly 1971, Volume 91 *Hansard* at p.911-912.

## CHAPTER 3

### THE INTERPRETATION OF THE OPPRESSION REMEDY BY THE JUDICIARY.

The various law reform committees such as the Cohen<sup>1</sup> and Jenkins<sup>2</sup> Committee outlined some of the problems associated with the fraud on the minority exception to the Rule in *Foss v. Harbottle*<sup>3</sup>. In response to these problems the oppression section was introduced in England in 1947 and adopted by Queensland in 1955;<sup>4</sup> Victoria in 1958;<sup>5</sup> and Tasmania in 1958.<sup>6</sup> It was introduced Australian wide in the *Uniform Companies Act* 1961.<sup>7</sup> The 1981 *Companies Code* added to the forerunner of s.260 two further grounds to establish oppression; "that the directors have acted in the affairs of the company in their own interests and not in the interests of members as a whole," and, "that directors of the company have acted in affairs of the company in any other manner whatsoever that is unfair or unjust to other members". The 1983 amendments to the predecessor of s.260 were introduced by the *Companies and Securities Legislation (Miscellaneous Amendments) Act* 1983 and result principally from the

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<sup>1</sup> (1945) Cmd 6659.

<sup>2</sup> (1962) Cmd. 1749.

<sup>3</sup> [1843] 2 Ha. 461; 67 E.R. 189.

<sup>4</sup> *Companies Act* (Qld.), s.379A.

<sup>5</sup> *Companies Act* (Vic.), s.94.

<sup>6</sup> *Companies Act* (Tas.), s.128.

<sup>7</sup> Section 186 of the *Uniform Companies Act* (Tas.).

recommendations of the Jenkins Committee and the Ghanaian Companies Report of 1961.<sup>8</sup> The substantive provisions of s.260 of the *Corporations Law* now read:

**PART 3 - 4 - Oppressive Conduct of Affairs**

**SECTION 260: REMEDY IN CASES OF  
OPPRESSION OR INJUSTICE.**

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

(a) by a member who believes -

(i) that affairs of the company are being conducted in a manner that is oppressive or unfairly prejudicial to, or unfairly discriminatory against a member or members, or in a manner that is contrary to the interests of the members as a whole; or

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<sup>8</sup> These two reports were primarily the work of English company law reformer, L.C.B. Gower, see the comments of J.F. Corkery, "Oppression or Unfairness by Controllers - What Can a Shareholder do about it? An Analysis of s.320 of the Companies Code" (1988) 9 *Adel. Law. Rev.* 437 at p.438.

- (ii) that an act or omission, or a proposed act or omission, by or on behalf of the company, or a resolution, or a proposed resolution, of a class of members, was or would be oppressive or unfairly prejudicial to, or unfairly discriminatory against, a member or members or was or would be contrary to the interests of the members as a whole; or

260(2) [**Orders that Court may make**] If the Court is of the opinion -

- (a) that affairs of a company are being conducted in a manner that is oppressive or unfairly prejudicial to, or unfairly discriminatory against, a member or members (in the section called the "oppressed member or members") or in a manner that is contrary to the interests of the members as a whole; or
- (b) that an act or omission, or a proposed act or omission, by or on behalf of a company, or a resolution, or a proposed resolution, of a class of members of a company, was or would be oppressive or unfairly prejudicial to, or unfairly discriminatory against, a member or members (in this section also called the "oppressed member or members") or was

or would be contrary to the interests of the members as a whole,

the Court may, subject to sub-section (4), make such order or orders as it thinks fit, including, but not limited to, one or more of the following orders:

- (c) an order that the company be wound up;
- (d) an order for regulating the conduct of affairs of the company in the future;
- (e) an order for the purchase of the shares of any member by other members;
- (f) an order for the purchase of the shares of any member by the company and for the reduction accordingly of the company's capital;
- (g) an order directing the company to institute, prosecute, defend or discontinue specified proceedings, or authorising a member or members of the company to institute, prosecute, defend or

discontinue specified proceedings in the name and on behalf of the company;

- (h) an order appointing a receiver or a receiver and manager of property of the company;
- (j) an order restraining a person from engaging in specified conduct or from doing a specified act or thing;
- (k) an order requiring a person to do a specified act or thing.

**260(5) [Interpretation]** In this section and in paragraphs 461(1)(f), (g) and (h):

- (a) a reference to a member, in relation to a company, includes, in the case of a company limited by shares, or a company limited both by shares and by guarantee, a reference to a person to whom a share in the company has been transmitted by will or by operation of law;

(b) a reference to affairs of a company being conducted in a manner that is oppressive or unfairly prejudicial to, or unfairly discriminatory against, a member is a reference to affairs of a company being conducted in a manner that is oppressive or unfairly prejudicial to, or unfairly discriminatory against, a person who is a member, whether in his capacity as a member or in any other capacity; and

(c) a reference to an act or omission by or on behalf of a company or a resolution of a class of members of a company being oppressive or unfairly prejudicial to, or unfairly discriminatory against, a member is a reference to an act or omission by or on behalf of a company or a resolution of a class of members of a company being oppressive or unfairly prejudicial to, or unfairly discriminatory against, a person who is a member, whether in the person's capacity as a member or in any other capacity.

I will briefly outline who can apply for relief under the section, then consider the grounds for relief, and finally examine a number of issues that may arise in respect of the legislation.



### Who can apply for relief

Section 260(5) provides that in s.260 and in s.461(1)(f), (g) and (h) a reference to a member includes a reference to a person to whom a share in the company has been transmitted by will or by operation of law. This provision allows executors, administrators and trustees in bankruptcy to bring proceedings. Prior to the 1983 amendments this was not possible. Section 260(5) also makes it clear that a member who has been oppressed in some capacity, other than that as a member, will still be able to institute proceedings under s.260. Thus, a solicitor who is also a member, but who has been injured in his capacity as a solicitor will still be able to claim oppressive or unjust conduct.

Section 260 however, does not allow a former member who has been denied his shares in an oppressive or unjust manner to bring proceedings. This may be contrasted with s. 231 of the *Canadian Business Corporations Act 1974* which permits persons other than members to apply. The Canadian legislation allows standing to former shareholders, former officers and "any other person who, in the discretion of the Court, is a proper person to make an application". This would be a useful improvement to our legislation particularly in the instance of a person who has lost their shareholding due to oppressive or unjust conduct. If this legislation is to be regarded as remedial legislation designed to correct the abuses of those in control,

then a person should not be denied a remedy by the requirements that he be a member at the time of the bringing of the action. Relief should not be denied for purely technical reasons.

Section 260, read literally, does not require that the person bringing the action be a member at the time of the oppressive or unjust conduct. Indeed, a member could purchase shares to allow them to pursue proceedings against the wrongdoers; in effect members of the public could act as corporate watchdogs. This possibility is arguably not likely in the case of the incorporated partnership as the directors usually have the right to refuse a transfer of shares in a close corporation of that type. If a member did purchase shares after the oppressive or unjust conduct had occurred, that person may not have the range of remedies otherwise available to an affected member. It is difficult to see that a court would make an order for the purchase of a member's shares where that member did not have a shareholding at the time of the unjust conduct; that shareholder not being able to argue that there has been a diminution in the value of his shareholding as a result of the conduct in question. The shareholder would presumably have brought into the company at the prevailing market price.<sup>9</sup>

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<sup>9</sup> In *Re Spargos Mining NL* (1990) 3 A.C.S.R. 1 the shareholders were allowed standing even though they were not members at that time of the unjust conduct.

Finally, s.260 is not restricted to minority shareholders, there is nothing to stop a majority shareholder bringing an action, though considering the control that can be exercised by the majority in a general meeting, it is difficult to envisage situations where a majority shareholder would need to utilise s.260.

### Grounds for relief

Four grounds for relief are stated in section 260. The conduct complained of must be either:

- (i) oppressive;
- (ii) unfairly prejudicial;
- (iii) unfairly discriminatory; or
- (iv) contrary to the interests of members as a whole.

It is now appropriate to consider how the judiciary has defined these terms.

Oppression:

The earliest statutory protection for minority shareholders was generally limited to a winding up of the company on the just and equitable ground.<sup>10</sup> This remedy has a serious limitation in that if the minority are successful, the company will be terminated. Upon termination the assets of the company will be realised, and it may be that the only willing purchasers will be the majority from whose conduct the minority are claiming to seek relief. It was these limitations that led the Cohen Committee<sup>11</sup> to recommend that an oppression section be introduced.

Oppression has been generally interpreted in one of three ways:

- (i) "burdensome, harsh and wrongful."<sup>12</sup>
- (ii) "an unfair abuse of powers and an impairment of confidence in the probity with which the company's affairs are being conducted as distinguished from

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<sup>10</sup> See now ss.460-1 of the *Corporations Law*.

<sup>11</sup> (1945) Cmd 6659.

<sup>12</sup> *Scottish Co-operative Wholesale Society Ltd v. Meyer* [1959] A.C. 324 at p.342 per Viscount Simonds.

mere resentment on the part of the minority at being outvoted on some issue of domestic policy."<sup>13</sup>

- (iii) "at the lowest involve a visible departure from the standards of fair dealing, and a violation of the conditions of fair play on which every shareholder who entrusts his money to the company is entitled to rely."<sup>14</sup>

The oppression section, even with the restrictive interpretations adopted did allow the judiciary to take a positive role in the regulation and control of corporate behaviour. However, Wishart comments, "[a]s the judiciary became more aware of the extent of possible regulation offered to it, the judges tightened the description of 'oppressive behaviour' to exclude all but positive wrongs. In *Re Lundie Brothers Ltd.*,<sup>15</sup> they went so far as to apply the proper plaintiff aspect of the rule in *Foss v. Harbottle*"<sup>16</sup>

The judiciary thus adopted a highly restrictive approach as to what constitutes oppressive behaviour. This was after initially

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<sup>13</sup> Cooper C.J. in *Elder v. Elder and Watson* [1952] S.C. 49 at p.55.

<sup>14</sup> *Ibid.*

<sup>15</sup> [1965] 2 All E.R. 692; [1965] 1 W.L.R. 1051.

<sup>16</sup> D. Wishart, "A Fresh Approach to Section 320" (1987) 17 W.A.L.R. 94 at 99.

adopting a broad approach to the definition of oppression. This change of attitude by the judiciary occurred because of a desire not to interfere or regulate the internal affairs of companies. They were not to be the arbiters of business judgment. The court rather than considering the purpose of the legislation or the intent of the legislature chose a highly legalistic method of interpretation; that of considering the dictionary meaning of the words in question. This approach by the courts allowed the confines of the rule in *Foss v. Harbottle* to be reimposed. This general theme of non-interference by the court in business decisions was expressed by Lord Wilberforce in *Howard Smith v. Ampol Petroleum Ltd.*<sup>17</sup> His Honour stated:

It would be wrong for the court to substitute its opinion for that of the management, or indeed to question the correctness of the management's decision ... if bona fide arrived at. There is no appeal on merits from management decisions to courts of law: nor will courts of law assume to act as a kind of supervisory board over decisions within the powers of management honestly arrived at.<sup>18</sup>

It is this type of policy decision which has influenced the judiciary's thinking on the interpretation of s.260, and the issue that must now be considered is to what extent the 1983

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<sup>17</sup> [1974] A.C. 821.

<sup>18</sup> *Id.* at p.832.

amendments to the statute, that is the extent to which the addition of the terms unfairly prejudicial, unfairly discriminatory and contrary to the interests of members as a whole has overridden the courts traditional reluctance to interfere in management of companies. As Shapira comments:

Is the [1983] amendment to be construed as a deliberate, across the board, departure from a century and a half of pronounced policy of judicial non-intervention in corporate affairs.<sup>19</sup>

Unfairly Prejudicial/Unfairly Discriminatory/Contrary to the Interests of Members as a Whole

The first major decision that considers the amendments to the legislation is *Re G. Jeffrey (Mens Store) Pty. Ltd.*<sup>20</sup> In this case two companies were formed by G. Jeffrey to run his two businesses. He was the majority shareholder and governing director in both companies. After his death, the shareholding in each company passed in the following manner: 30 percent to each of his sons, Richard and Anthony, 20 percent to his widow and 10 percent to each of his two daughters. Richard, Anthony and the widow were the directors of each company. Richard

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<sup>19</sup> G. Shapira, "Minority Shareholders' Protection - Recent Developments" [1982] 10 *N.Z.U.L.R.* 134.

<sup>20</sup> (1984) 9 *A.C.L.R.* 193.

was to be managing director of one company, Anthony the managing director of the other company. The company under the management of Anthony declined financially, whilst the company under the control of Richard prospered. Accordingly, Richard replaced Anthony as managing director, Anthony ceasing to be an officer of the company, but retaining his shareholding in the company. The company prospered under Richard who also gained control of a further 10 per cent of the shareholding, and came to a voting arrangement with the widow as to her 20 per cent. In practical terms Richard had control of both companies and treated them as his own. Anthony became displeased at what he saw as an authoritarian approach by Richard to decision making. He wished for a greater role in management and unsuccessfully argued at company meetings that assets of the company could be more profitably employed. Anthony also wanted a greater distribution of dividends but Richard insisted on accumulating substantial cash reserves. Ultimately Anthony requested Richard to buy his shares but the price offered by Richard was unrealistically low. Anthony then sought various orders under the then equivalent of s.260, or a winding up of the company under the precursor to ss.460-461 of the *Corporations Law*.

The main issue before His Honour Crockett J. in the Supreme Court of Victoria, was whether Richard had acted in the affairs of the company in a manner that was oppressive, unfairly prejudicial or unfairly discriminatory against a member, in this instance, Anthony. This Honour first examined the term



oppression and considered that it should be given the same interpretation as it was given prior to the amendments.<sup>21</sup> The statement by Menhennitt J. in *Re Tivoli Freeholds*,<sup>22</sup> that oppression involves conduct which is unfair, burdensome, harsh or which lacks probity was approved.<sup>23</sup> He considered that the newly introduced expressions clearly contemplate conduct of greater amplitude than is understood by the term "oppressive". The new subsection has made the task of the applicant shareholder less onerous in respect of the conduct about which he is entitled to complain.<sup>24</sup> Crockett J. however, was not persuaded that the affairs of the company had been conducted in an unfairly prejudicial or unfairly discriminatory manner against Anthony. In finding for Richard, Crockett J. held that on the facts that Richard had continued to conduct business in much the same way as the applicants father had conducted the business, and that on the commercial wisdom of retaining profits rather than distributing dividends, the court would not make a judgment:

In relation to commercial questions such as retention of profits for use in the business I should in this case ... be unprepared to take any action so long as the managing director was acting bona fide and in what he honestly

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<sup>21</sup> *Id.* at p.198.

<sup>22</sup> [1972] V.R. 445.

<sup>23</sup> (1984) 9 A.C.L.R. 193 at p.198.

<sup>24</sup> *Ibid.*

believed were the best interests of each company's members.<sup>25</sup>

His Honour whilst recognising the greater possibilities of the new legislation still indicated that the policy of non-interference by the judiciary in commercial decisions would still influence the court in this area and ultimately would be paramount to the intention of the legislature.

This recognition by Crockett J. that the amendments to the legislation have made the task of the minority shareholder less onerous was also recognised by the New Zealand Court of Appeal in *Thomas v. H.W. Thomas Ltd.*<sup>26</sup> In *Thomas v. H.W. Thomas Ltd.*<sup>27</sup> the company of H.W. Thomas Ltd was established in 1930 to carry on the business of general carriers. The issued capital was 3000 shares of \$2 each. H.W. Thomas, the founder of this company was the first managing director. The articles of association conferred upon him all the powers of the directors, and required any other director to conform to his wishes. At the time of the action, Alan Thomas, a grandson of H.W. Thomas was the managing director pursuant to the same article. He held 50 shares. Another grandson of H.W. Thomas, Malcolm Thomas, held 1000 shares. The remaining

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<sup>25</sup> *Ibid.*

<sup>26</sup> (1984) 2 A.C.L.C. 610.

<sup>27</sup> *ibid.*

shares were held by various family members. Transference of shares was within the control of the managing director. The financial management had for the most part been conservative. Large profits were not made and the company had only distributed modest dividends. Accumulated revenue reserves stood at \$220,000. In 1980 Malcolm Thomas unsuccessfully moved a motion at the annual general meeting that certain assets be sold and that the proceeds be invested in income earning investments. In 1981, he gave notice that he wished to sell his shares; nothing further proceeded from this. In 1982, he complained that he was locked into the company and that the affairs of the company were being conducted in a manner that was unfairly prejudicial and/or unfairly discriminatory to him.

His Honour Richardson J. in similar terms to *Re G. Jeffrey Pty Ltd.* agreed that Parliament in using the words unfairly prejudicial and unfairly discriminatory were providing shareholders a wider base on which to found a complaint.<sup>28</sup> Richardson J. adopted an approach that was in some respects to be repeated by the High Court in *Wayde v. N.S.W. Rugby League*.<sup>29</sup>

His Honours states:

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<sup>28</sup> *Id.* at p.616.

<sup>29</sup> (1985) 59 A.L.J.R. 798.

Fairness cannot be assessed in a vacuum or simply from one member's point of view. It will often depend on weighing conflicting interests of different groups within the company. It is a matter of balancing all the interests involved in terms of the policies underlying the companies legislation in general and s.[260] in particular: thus to have regard to the principles governing the duties of a director in the conduct of the affairs of a company and the rights and duties of a majority shareholder in relation to the minority; but to recognise that s.[260] is a remedial provision designed to allow the court to intervene where there is a visible departure from the standards of fair dealing; and in the light of the history and structure of the particular company and the reasonable expectations of members to determine whether the detriment occasioned to the complaining member's interests arising from the acts or conduct of the company in that way is justifiable.<sup>30</sup>

The judgment is important in the context of the interpretation of s.260 because it recognises that the intent and purpose of the legislature was to provide a remedy to the minority shareholder, and that in considering whether detriment had been occasioned, the history, type and structure of the family company was important. The judgment also recognises that a balancing of interests will be appropriate. This balancing of interests must not only consider the policy of the legislature as regards s.260,

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<sup>30</sup> *Thomas v. H.W. Thomas Ltd* (1984) 2 A.C.L.C. 610 at p.618.

but also the principle that a court will not readily interfere with business management.

Having stated the principles Richardson J. considers the facts of the case before him. The history of the company involved traditionally conservative financial policies and involvement in a narrow field, that being the transport field. Accordingly "it would be unrealistic in a family company to ignore family considerations of that kind."<sup>31</sup> This being so, it was found that there had not been any unjust conduct.

The effect of these two decisions was that the judiciary gave s.260 of the *Corporations Law* an expanded role after the amendments. They saw the amendments as improving the position of the minority shareholder but the section did not allow the courts to intervene in the commercial decision making process.

The High Court had their first opportunity to consider the legislation in *Wayde v. New South Wales Rugby League Ltd.*<sup>32</sup> The New South Wales Rugby League was a company limited by guarantee. It was incorporated to take over the functions of an unincorporated association which had conducted rugby league

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<sup>31</sup> *Ibid.*

<sup>32</sup> (1985) 59 A.L.J.R. 798.

competitions since 1907. Membership of the League consisted of representatives of the various clubs. Clause 3 of the League's memorandum stated the objects of the League. In particular paragraphs 3(b) and 3(j) set out the following objects:

" ...

(b) To foster and control the game of rugby league football throughout the State of New South Wales and the Australian Capital Territory and generally to take such action as may be conducive to its best interests.

(j) To determine which clubs shall be entitled to enter teams in the Rugby League Premiership and other competitions conducted by the League and the terms and conditions upon which and the manner in which clubs shall make and renew such applications."

Article 76 of the League's articles of association facilitated the object in paragraph (j). That article provided:

The League may conduct such competitions between teams representing all or any of the Clubs or Junior

Leagues as the Board of Directors may from time to time determine provided that the Board of Directors may at its discretion invite other clubs to participate in any competition conducted pursuant to the provisions of this clause.

In September 1984, the League decided to limit the number of teams in the Winfield Cup premiership competition in 1985 to twelve teams, and to refuse the application of the Western Suburbs District Rugby League Football Club (West's) for entry into that competition. Two members of the company, in their capacity as representatives of West's sought an injunction pursuant to the predecessor of s.260 of the *Corporations Law*. The two members were successful in first instance<sup>33</sup> but lost an appeal to the New South Wales Court of Appeal.<sup>34</sup> West's representatives then appealed to the High Court.

Mason A.C.J., Wilson, Deane and Dawson J.J. delivered a joint judgment dismissing West's appeal. Brennan J. agreed with the conclusion of the majority in a separate judgment. The joint judgment considered it crucial that the decisions made by the board were made in good faith, and that there was no suggestion that the board had in making the decision taken into

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<sup>33</sup> (1985) 3 A.C.L.C. 158.

<sup>34</sup> (1985) 3 A.C.L.C. 177.

account irrelevant considerations, or had failed to take into account relevant considerations.

It is not a case where the directors of a company in the exercise of the general powers of management of the company, might bona fide adopt a policy or decide upon a course of action which is alleged to be unfairly prejudicial to a minority of the members of the company. In that kind of case it may well be appropriate for the court on an application for relief under [s.260], to examine the policy which has been pursued or the proposed course of action in order to determine the fairness or unfairness of the course which has been taken by those in control of the company. The court may be required in such circumstances to undertake a balancing exercise between the competing considerations disclosed by the evidence: compare *Thomas v. H.W. Thomas Ltd.*<sup>35</sup>

West's argued that while the board of directors may reasonably conclude that a competition involving twelve clubs was preferable to a competition involving thirteen clubs, the fact that a thirteen team competition was not unworkable and that West's was a viable competitor lead to the conclusion that the prejudice to West's by their exclusion so outweighed the benefit to the League as to be unfair. Their Honours answered this by noting

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<sup>35</sup> (1985) 59 A.L.J.R. 798 at p.801.



that the League was expressly constituted to promote the sport and to determine which clubs should be entitled to participate. Accordingly, Wests could only succeed if they could show that the decisions of the board were such that no board acting reasonably could have made them. Wests could not show this and their appeal was dismissed:

Given the special expertise and the experience of the board, the bona fide and proper exercise of the power in pursuit of the purpose for which it was conferred and the caution which a court must exercise in determining an application under [s.260] of the Code in order to avoid an unwarranted assumption of the responsibility for management of the company, the appellants faced a difficult task in seeking to prove that the decisions in question were unfairly prejudicial to Wests and therefore not in the overall interests of the members as a whole. It has not been shown that decisions of the board were such that no board acting reasonably could have made them.

The effect of those decisions on Wests was harsh indeed. It has not, however, been shown that they were oppressive or unfairly prejudicial or discriminatory or that their effect was such as to warrant the conclusion that the

affairs of the League were or are being conducted in a manner that was or is oppressive or unfairly prejudicial.<sup>36</sup>

His Honour Brennan J. adopted a similar analysis to the joint judgment. The test he formulated was based on standards of reasonableness and fair dealing:

The Court must determine whether reasonable directors, possessing any special skills, knowledge or acumen possessed by the directors and having in mind the importance of furthering the corporate object on the one hand and the disadvantage, disability or burden which their decision will impose on a member on the other, would have decided that it was unfair to make that decision.<sup>37</sup>

On this test, Brennan J. considered that while there was prejudice and discrimination against Wests, there was nothing to suggest unfairness. Accordingly, the appeal was dismissed.

The major difference in analysis between the joint judgment and the judgment of Brennan J. is that His Honour specifically

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<sup>36</sup> *Ibid.*

<sup>37</sup> *Id.* at p.803.

considered the term "contrary to the interests of members as a whole", an area not specifically addressed by the joint judgment. His Honour states:

The expression 'the interests of the members as a whole' is not likely to provide a criterion for intervention in respect of a decision made in exercise of a power that is conferred to resolve a conflict of interests between one or more members on the one hand and the League's object of fostering the game on the other.<sup>38</sup>

The relevant expressions to be considered were oppression, unfairly discriminatory and unfairly prejudicial.

The interpretation of s.260 by the High Court is limiting. The Court adopted a test based on what a reasonable board of directors would have done in the same situation. They made no reference to a test of injustice based on the nature of the particular company, its history or the expectation of the founding members. The Court did however, recognise that the amendments to the legislation provided "a greater measure of curial protection to members of a company, especially if they be in a minority, than the protection afforded under earlier

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38 *Ibid.*

Companies Acts."<sup>39</sup> However, the High Court failed to recognise that special considerations may apply to the incorporated partnership. In deference to the High Court the New South Wales Rugby League Ltd. was previously conducted as an unincorporated association rather than as a partnership, and as such the considerations that were applicable in *Thomas v. Thomas* were not directly before the Court. Nevertheless, the Court emphasised the need for caution in usurping the role of management in corporations. They did not consider the possibility that the section was introduced to allow the judiciary to have a supervisory role over the decisions of management. The decision, therefore is restrictive but given that it was an unusual set of facts the opportunity to re-examine s.260 in a truly commercial context will no doubt be given to the High Court at some point in the future.

#### Decisions subsequent to *Wayde v. New South Wales Rugby League*

There has been a succession of decisions subsequent to *Wayde v. New South Wales Rugby League* which have considered the s.260 remedy.<sup>40</sup> In three of these decisions *Sandford v. Sandford*, *Re Norvabron* and *Shears v. Phosphate Co-operative*

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<sup>39</sup> *Wayde v. New South Wales Rugby League Ltd.* (1985) 59 A.L.J.R. 798 at p.803.

<sup>40</sup> *Sandford v. Sandford* (1987) 5 A.C.L.C. 394; *Re Norvabron* (1987) 5 A.C.L.C. 184; *Re Terri Co. Ltd.* (1988) 6 A.C.L.C. 402; *Zephyr Holdings v. Jack Chia Ltd.* (1988) 14 A.C.L.R. 30; *Shears and Anon v. Phosphate Co-operative Co. of Aust. Ltd.* (1989) 14 A.L.C.R. 747; *Parker v. N.R.M.A.* (1990) 1 A.C.S.R. 227; *Re Dernacourt Investments Pty Ltd* (1990) 2 A.C.S.R. 553 and *Re Spargos Mining N.L.* (1990) 3 A.C.S.R. 1.

s.260 was successfully invoked. However it is probably only *Sandford v. Sandford* that can be considered as a liberalisation of the law.

In that case the plaintiff had become involved in a family company which had been founded by his brother Richard Sandford and his brothers wife Itha Sandford. The business was that of a courier service. Mr and Mrs Sandford were initially partners but in 1974, the plaintiff was taken into the business on an equal basis, through the incorporation of the defendant company. Three shares were issued, one each to the plaintiff and Mr and Mrs Sandford. The partnership business was not transferred to the company in any formal way, but the company carried on the business of the partnership from July 1, 1974. Mr and Mrs Sandford carried out the bulk of the work. Salaries paid to the working directors were fixed as high as was acceptable to the Commissioner for Taxation. Dividends were quite modest. In 1977, the directors resolved that 2499 shares be issued to them. In 1983, the plaintiff resigned as a director from the company requesting Mr and Mrs Sandford to purchase his shares. The plaintiff asked for \$200,000 for his shares, the directors valued the shares at \$4,000. The plaintiff sought, *inter alia* an order that Mr and Mrs Sandford purchase his shares. The most important aspect of the plaintiff's case was the allegation that the level of emoluments given to the defendants as directors were too high. This had the effect of reducing the amount of money available for dividend distribution. In response to this, the defendants argued that the

plaintiff had been involved with the establishment of the company and had agreed to the system of remuneration of the directors. Waddell C.J. in the Equity division of the Supreme Court of New South Wales, considered that the plaintiff was an equal shareholder in the business and entitled to a corresponding share of profits. Thus Waddell C.J. concluded that:

The defendants have conducted the affairs of the company in respect of their own salaries and emoluments in their own interests and not in the interests of members as a whole, and that the affairs of the company are being conducted in a manner which is oppressive to the plaintiff.<sup>41</sup>

The importance of this case is difficult to estimate. The plaintiff was able to establish cogent evidence that the dividend policy coupled with the high remuneration was unreasonable. As Baxt comments:

This decision might be seen as an important one in the development of the oppression remedy. It shows that the remedy may be used in a closely held company to force a more reasonable attitude by those in control to minority shareholders insofar as dividends of the company are

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<sup>41</sup> (1987) 5 A.C.L.C. 394 at p.403.

concerned. The cases however, will depend very much on the evidence and the facts that the plaintiff can lead.<sup>42</sup>

The other two decisions where s.260 was successfully invoked are also an example of where a breach of s.260 was readily apparent.

The first of those two decisions to consider is that of *Re Norvabron Pty Ltd*.<sup>43</sup> The facts of this case are somewhat complex. Norvabron Pty Ltd had been incorporated in 1984 with an authorised capital of one million and an issued capital of three dollars; the three one dollar shares being held by Alpine Ltd, which represented the family interests of a Mr Panizza, Salteri Investments, which represented the family interests of a Mr Salteri, and Exben, representing the family interests of a Mr Belgiorno-Nettis. Panizza, Salteri and Belgiorno-Nettis were the directors of Norvabron and two other wholly owned subsidiaries of Norvabron, Transfield and Zincline.

In 1986, Panizza was overridden at a board meeting of Transfield by the other two directors. The other two directors had awarded a sub-contract to one of their own companies at a

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<sup>42</sup> R. Baxt, "Oppression through Failure to pay dividends - the first successful result" [1987] *Company and Sec. L.J.* 102 at p.185; It should be noted that Waddell C.J. did. not refer to the decision of *Wayde v. New South Wales Rugby League*.

<sup>43</sup> (1987) 5 A.C.L.C. 184.

price substantially higher than the competitor's tender. As a result of this, Panizza formed two other companies which became sub-contractors to Transfield. While the other directors acknowledged the advantages of using these sub-contractors, it left open the possibility that Panizza would be subject to a conflict of interest. Inevitably, disputes arose because of the profits made by these companies. These disputes led to the removal of Panizza as managing director of Transfield. Prior to the removal of Panizza the co-directors had used their majority on the board to control the company for their own advantage. Alpine Ltd, representing the interests of Panizza sought a winding up order against Norvabron Pty Ltd on the ground of oppression or alternatively an order that its share in Norvabron be bought by the respondents. The respondents argued that the application was directed at Norvabron, whereas the conduct complained of was limited to the affairs of Transfield. The directors of Norvabron had not been shown to be at fault in the affairs of that company.

Derrington J. in the Supreme Court of Queensland, held that the applicant's share was to be purchased by the respondents. His Honour found that the directors of Norvabron knew what was happening in respect of Transfield, as they were one and the same. Their omission to take action as directors of Norvabron to prevent their own conduct as directors of Transfield constituted unfairly prejudicial and/or oppressive conduct, for which an order would be made for the purchase of the appellant's share by the respondents.



*Wayde v. New South Wales Rugby League Ltd* was quoted by Derrington J. in *Re Norvabron* though little use was required to be made of this decision. The facts were, as in *Sandford v. Sandford*, presented in such a manner as to leave no alternative to the court. The decision however, does again indicate how a minority shareholder may, in a closely held company force those in control to adopt a more reasonable attitude.

The next decision to consider is that of *Shears & Anor v. Phosphate Co-operative Co. of Aust. Ltd.*<sup>44</sup> In this case, the appellant Shears was the beneficial owner of the appellant company Cityfarm. Cityfarm had entered into contracts to purchase shares in the respondent company. However, Cityfarm did not become the registered holder of those shares. Each contract by which Cityfarm agreed to purchase shares in the respondent company contained a clause, whereby Cityfarm was appointed the attorney of the holder of the shares, allowing Cityfarm to attend and vote, and generally to exercise all the rights as the holder of the shares in the respondent company. By this stratagem, Shears planned to bypass restrictions in the respondent company's articles prescribing the maximum number of shares and the number of votes to which a shareholder was entitled. In response article 5A was adopted by the members of the respondent company. Article 5A was as follows:

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<sup>44</sup> [1989] 14 A.C.L.R. 747 - Special leave to appeal this decision to the High Court was refused, (1989) 7 A.C.L.C. 1225.

For the purposes of these articles a person shall be deemed to hold a share if he has a relevant interest in the share for the purposes of s.9 of the *Companies (Acquisition of Shares) (Vic) Code*. The directors may at any time and from time to time require a shareholder to furnish to the company satisfactory evidence that no other person has a relevant interest in the shares held by him and in the absence of such evidence the shareholder shall not be entitled to vote in respect of the shares held by him.

This Article was used to deny voting rights to shares acquired by Cityfarm. The appellants appealed to the Full Court of the Supreme Court of Victoria against declarations to the effect that the operation of Article 5A was valid.

One of the bases for allowing the appeal was that Article 5A was invalidated by the predecessor of s.260 of the *Corporations Law*; the article was unfairly prejudicial and oppressive by reason of the width of the definition of relevant interest in the *Acquisition of Shares Code*.<sup>45</sup> In reaching this conclusion their Honours followed *Wayde v. New South Wales Rugby League Ltd*; and in particular the judgment of Brennan J. Article 5A imposed upon a member a burden which according to the

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<sup>45</sup> See now Chapter 6 of the *Corporations Law*.

ordinary standards of reasonableness and fair dealing was unfair.<sup>46</sup>

The decisions subsequent to *Wayde*, where s.260 was not successfully used may indicate a more restrictive interpretation of the scope of s.260 than the decision of *Sandford v. Sandford*.

In *Re Terri Co Pty. Ltd.*<sup>47</sup> a shareholder sought an order restraining a scheme administrator from disbursing payment to certain alleged creditors. The scheme administrator of Terri Co Pty Ltd had stepped in following a provisional liquidation. Under the scheme the scheme administrator was obliged to list the creditors and then determine the amount of each creditor's claim. The applicant shareholder claimed to be oppressed and sought to rely on the oppression section.

The application was dismissed, there being no element of wrongdoing, lack of probity or fair dealing. Importantly His Honour Martin J. considered that matters of business judgment cannot constitute grounds for relief under section 320. Thus, in this case we see a reaffirmation of the traditional rule that the

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<sup>46</sup> The other basis for the decision was that the alteration of the articles could not be considered 'bona fide for the benefit of the company as a whole.'

<sup>47</sup> (1988) 6 A.C.L.C. p.402 There was no discussion of the High Court decision of *Wayde v. N.S.W. Rugby League*.

courts will not substitute their own judgment for that of the business community.

This line of thought was reinforced in *Zephyr Holdings Pty Ltd v. Jack Chia Ltd*.<sup>48</sup> Jack Chia Ltd was a public company which had issued two series of options exercisable in 1990 and 1991. There was no reasonable prospect of the options being exercised. Resolutions were passed eliminating the existing options and offering new more attractive options. The applicant sought an injunction restraining the issue on the options on the bases, first, of a breach of s.260 of the Code and secondly, a breach of the Stock Exchange Listing Rules. The injunction was granted on the basis that there had been a breach of the Listing Rules though the Court held that there was no breach of the then equivalent of s.260 of the *Corporations Law*. Interestingly, the Court stated that it:

...must take care that it does not too readily intervene in the affairs of a company under [s.260] ... It is only stating the obvious to say that under [s.260], the Court does not sit as an appellate tribunal to review the decisions of the organs of a company or of a class of its members on the footing that the court will, as it were, automatically reverse the decision if it disagrees with it.<sup>49</sup>

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<sup>48</sup> [1988] 14 A.C.L.R. 30. *Wayde v. N.S.W. Rugby League* was mentioned though there was no detailed discussion of the decision.

<sup>49</sup> *Id.* at p.37.

Having adopted that statement Brooking J. held that while there were doubts as to whether the proposed course was in the interests of members, it could not be said that no board of directors, acting reasonably, could have decided that the proposed issue was in the interests of members as a whole.<sup>50</sup>

### The Effect of the Decision of *Wayde v. N.S.W. Rugby League*

In summary the decision of *Wayde v. New South Wales Rugby League Ltd.* can be considered a restrictive interpretation of the legislation. The High Court reinforced the traditional view that the judiciary should not interfere with the decisions of the business community. They also failed to recognise that in certain corporate structures such as the incorporated partnership, the type, history and nature of the company should be relevant. The decisions subsequent to *Wayde*, such as *Sandford v. Sandford*, *Re Norvabron* and *Shears and Anor. v. Phosphate Co.* where s.260 was successfully invoked,<sup>51</sup> were not so

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<sup>50</sup> Section 260 was also unsuccessfully alleged in *Re Dernacourt Investments Pty. Ltd.* [1940] 2 A.C.S.R. 553 where a failure to allow a member to inspect financial records was held not to be oppressive. *Wayde v. N.S.W. Rugby League* was followed.

<sup>51</sup> Section 260 was also successfully invoked in *Parker v. N.R.M.A* (1990) 1 A.C.S.R. 227 where a persistent failure by executives of a company to investigate or pursue complaints made by a director was held to be oppressive within the meaning of s.260. The section was again successfully utilised in *Re Spargos Mining N.L.* (1990) 3 A.C.S.R. 1. See also *J.D. Hamer v. M.J.H. Pty. Ltd* [1992] 7 A.C.S.R. 8, *Jenkins v. Enterprise Gold Mines* (1992) 6 A.C.S.R. 539, *Re Quests Exploration Pty. Ltd.* (1992) 6 A.C.S.R. 659 and *Starr v. Andrew* (1991) 9 A.C.L.C. 1372.

much an extension of the law, but an example of factual situations where a violation of s.260 was readily apparent. Indeed this area of the law may be like so many other areas of the law; the evidence led being of more significance than the interpretation of the law.

It is now appropriate to discuss alternative interpretations of s.260 which may provide it with a greater remedial role than the High Court presently gives it. Shapira comments that the formula for establishing unfair prejudice should be as follows:

The court should seek to balance protection of the minority's interest against the policy of preserving freedom of action for management and the right of the members to back up their investment by their vote. The fair view of the majority should carry considerable weight, but should not be critically important. The history, nature and structure of the company, the essential nature of the association, the type of rights affected and general company practice should all be material. More concretely, the test of unfair prejudice should encompass the following considerations: the protection of underlying expectation of shareholders in closely held companies; and the detriment to the members proprietary interests as a shareholder.<sup>52</sup>

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<sup>52</sup> G. Shapira, "Minority Shareholders Protection - Recent Developments" [1982] 10 *N.Z.U.L.R.* 134 at p.145-6.

This test of Shapira goes further than the test adopted by the High Court in *Wayde v. New South Wales Rugby League Ltd.* Shapira's test, in particular, looks at the history and the structure of the company. He thus recognises that s.260 will be of particular use in the closely-held company, the incorporated or quasi-partnership. In this context Shapira recognises the importance of the decision of *Ebrahimi v. Westbourne Galleries Ltd.*<sup>53</sup> In this case Nazar and Ebrahimi operated a business of dealing in carpets as equal partners. They decided to incorporate the business. On incorporation they each subscribed for 500 shares and were appointed directors. Later, Nazar's son was made a director, and the other two transferred 100 shares to him. No dividends were ever paid. The profits were distributed as directors remuneration. Eleven years after incorporation, the two Nazar's passed a resolution to remove Ebrahimi from office as director. Ebrahimi petitioned for a winding up of the company on the just and equitable ground. At first instance the order was made but this was set aside by the Court of Appeal. Ebrahimi appealed and the House of Lords allowed the appeal.

Importantly, Lord Wilberforce recognised that in the incorporated partnership there may be circumstances where the history and structure of the company dictate that the rights and

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<sup>53</sup> [1973] A.C. 360.

obligations of the members are not submerged in the incorporation of the business. His Honour states:

There is room in company law for recognition of the fact that behind it, or amongst it, there are individuals, with rights, expectations and obligations inter se which are not necessarily submerged in the company structure.<sup>54</sup>

This statement was made in the context of a discussion of the just and equitable ground of winding up, nevertheless there is no reason to suggest his comments are not applicable to s.260. Importantly, they have been adopted in the context of the Canadian equivalent of s.260. In *Diligenti v. R.W.M.D. Operations Ltd.*<sup>55</sup> the British Columbia Supreme Court was considering the then recently introduced oppression and unfairly prejudicial section. Diligenti was one of four founding member directors of two companies. He was employed by the companies as managing director of two restaurants. Differences of opinion arose between himself and the other three directors. The other three then removed Diligenti from his position as director of the two companies. A management contract in respect of the two restaurants was then awarded to another company, the only members of this third company were the other three directors. His Honour Fulton, J. conceded that

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<sup>54</sup> *Id.* at p.379.

<sup>55</sup> [1976] 1 B.C.L.R. 36.



the conduct was not oppressive, however, he did find the conduct unfairly prejudicial to Diligenti:

Although his fellow members may be entitled as a matter of strict law to remove him as director, for them to do so is unjust and inequitable, and is a breach of equitable rights which he in fact possesses as a member ... such unjust and inequitable denial of his rights and expectations is undoubtedly 'unfairly prejudicial' to him in his status as a member.<sup>56</sup>

The High Court decision in *Wayde v. N.S.W. Rugby League* can be criticised on the basis that it made no reference to the previous structure of the business or the need to impose equitable considerations upon the operation of the separate legal entity, the company. In the closely held company minority shareholders are vulnerable to a number of injustices that have no counterpart in the listed public company. These include exclusion from management, refusal to register a share transfer, refusal to purchase the shares at a price that reflects the commercial value of those shares, refusal to declare a dividend and disloyalty to the company by favouring another business entity, which quite often they control. The shareholder in the listed public company will generally have no role to play in management and has the remedy of selling his shareholding on

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<sup>56</sup> *Id.* at p.51.

the open market. The minority shareholder in the closely-held company, the incorporated partnership for example, will usually be locked-in, unless the majority shareholders are willing to allow a transfer of his shares to another party. It is because of this reason that the minority shareholder in the closely-held company needs special protection, and that in giving protection the courts must go behind the corporate entity, and consider its previous form together with the reasons for incorporation. Because of these criticisms of the High Court judgment the analysis by Shapira does offer more assistance to the minority shareholder. In essence he is prepared to impose equitable considerations on the operation of s.260. In contrast the High Court made no mention of this, and added the caveat that the court should be reluctant to intervene in the commercial decision making process.

Another approach to the interpretation of s.260 has been suggested by Wishart.<sup>57</sup> He considers that *Wayde v. New South Wales Rugby League Ltd.* is a restrictive interpretation of the legislation and that:

In summary, courts have failed to develop a means of ascertaining the standard by which the conduct of a company's affairs are to be measured. Indeed:

‘unfairness’ seems to have added to their confusions and

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<sup>57</sup> D. Wishart, "A Fresh Approach to s.320" [1987] 17 W.A.L.R. 94.

forced a retreat behind the walls of managerial discretion.<sup>58</sup>

Wishart, then puts forward his criteria for the operation of s.260, "[the] standard of unfair discrimination or prejudice should be a test something like: Could this member be taken to have acquiesced on joining the company to this decision or inaction? If not, then the decision or failure to decide is unfair to the member".<sup>59</sup> The test proposed by Wishart does not derogate from the freedom that the company needs to make rational decisions, as s.260 in his opinion allows the enforcement of the limits imposed upon decision making, to which the members upon joining the company have agreed.

There are some difficulties with Wishart's approach. He is submitting that all the shareholders choose to incorporate, or join, a company to maximise their own economic interests. While this may be the case with the listed public company, the situation involving the closely-held company can often be radically different. *Re G. Jeffrey (Mens Store) Pty Ltd.*<sup>60</sup> and *Thomas v. H.W. Thomas Ltd.*<sup>61</sup> are examples of this. The minority shareholder in both cases obtained his interest in the company by way of inheritance, they did not in any way choose

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<sup>58</sup> *Id.* at p.108.

<sup>59</sup> *Id.* at p.127.

<sup>60</sup> (1984) 9 A.C.L.R. 193.

<sup>61</sup> (1984) 2 A.C.L.C. 610.

that particular structure. Further the minority shareholder, 'was factually, if not legally, "locked-in", unable to recover the real value of his inheritance'.<sup>62</sup> The minority shareholder was not in a position to choose any particular form of investment. Further, the business may have been incorporated to obtain the benefits of limited liability and legal personality, rather than seeing the corporate form as the vehicle most likely to maximise the economic interests of the partner.

Overall, the most positive approach to an interpretation of s.260 is that of Shapira. He emphasises the need to balance the interests of the minority against the judicial policy of not interfering in commercial decisions but recognises that equitable considerations deriving from the history, nature and structure of the business can be superimposed on the corporate shell. He also recognises that management should not be unduly inhibited in the decision making process but that their decisions are not sacrosanct and that the judiciary should be prepared to re-examine their decisions. The High Court in *Wayde* were reluctant to take this step and failed to consider the remedial nature of the legislation. They still reiterated the judicial reluctance to intervene in corporate affairs and didn't inquire into the previous nature of the corporation in question.

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<sup>62</sup> S.S. Berns, "The Structure of Minority Remedies" unpublished, University of Tasmania, 1988 at p.20.

They did however cite the New Zealand decision of *Thomas v. Thomas* and it may be possible for a differently constituted High Court bench to adopt the reasoning of the New Zealand Court of appeal, and accept that equitable considerations could be imposed upon the corporate shell.<sup>63</sup>

Having discussed how the judiciary should interpret s.260 in a overall sense I will now discuss some of the particular issues that can arise in respect of s.260.

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<sup>63</sup> The High Court only used *Thomas v. Thomas* as a point of comparison.

## CHAPTER 4

### SPECIFIC PROBLEMS WITH THE OPPRESSION SECTION

The oppression section was introduced and amended to overcome the problems associated with the common law and in particular with the rule in *Foss v. Harbottle*.<sup>1</sup> However, the section has created some difficulties of its own. Firstly, the definition of 'affairs of the company' may not include the acts of nominee directors appointed to a subsidiary. This would be unusual considering the widespread use of groups of companies. The second problem that may occur is that there is authority to suggest that a resolution of the general meeting is not an act by or on behalf of the company. If this is the case then the problems associated with the fraud on the minority exception to the rule in *Foss v. Harbottle* may not have been overcome. The third problem to be considered is, whether conduct can be said to be unfairly prejudicial or unfairly discriminatory if it affects all members the same. It is necessary to address the term contrary to the interests of members as a whole, and consider whether this requires the conduct in question to be contrary to each and every member of the corporation. Discussion will also be made as to whether s.260 can be used where there is a specific statutory provision governing the conduct in question, or where members could have their claims in contract in tort. Further a number of issues

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<sup>1</sup> [1843] 2 Ha. 461; 67 E.R. 189.

arise in respect of the interaction of s.260 with the general law remedies available to the minority shareholder. Problems associated with the remedies available to the successful minority shareholder will be raised as will the utilisation of s.1324 as a statutory remedy. Finally, the question of whether the Courts should interfere in matters of business judgment, will be examined.

### The Definition of 'Affairs of the Company'

Section 260 of the Code refers to the situation where the affairs of the company are being conducted in an oppressive, unfairly prejudicial, unfairly discriminatory, or in a manner that is contrary to the interests of the members as a whole. Section 53 defines the affairs of a body corporate:<sup>2</sup>

53 For the purposes of section 260... the affairs of a body corporate include:

- (a) the promotion, formation, membership, control, business, trading, transactions and dealings  
(whether alone or jointly with another person or

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<sup>2</sup> It should be noted that s.260 refers to a company whereas 53 refers to a body corporate. This is probably of no consequence, but such looseness of terminology should have been avoided.

other persons and including transactions and dealings as agent, bailee or trustee), property (whether held alone or jointly with another person or other persons and including property held as agent, bailee or trustee), liabilities (including liabilities owed jointly with another person or other persons and liabilities as trustee), profits and other income, receipts, losses, outgoings and expenditure of the body;

- (b) in the case of a body corporate (not being an authorised trustee corporation) that is a trustee (but without limiting the generality of paragraph (a)) - matters concerned with the ascertainment of the identity of the persons who are beneficiaries under the trust, their rights under the trust and any payments that they have received, or are entitled to receive, under the terms of the trust;
- (c) the internal management and proceedings of the corporation;
- (d) any act or thing done (including any contract made and any transaction entered into) by or on behalf of the body, or to or in relation to the body or its business or property, at a time when -



(i) a receiver, or a receiver and manager, is in possession of, or has control over, property of the body;

(ii) the body is under official management;

(iii) a compromise or arrangement made between the body and another person or other persons is being administered; or

(iv) the body is being wound up,

and, without limiting the generality of the foregoing, any conduct of such a receiver or such a receiver and manager, of any official manager or deputy official manager of the body, of any person administering such a compromise or arrangement or of any liquidator or provisional liquidator of the body;

(e) the ownership of shares in, debentures of, and prescribed interests made available by, the body;

- (f) the power of persons to exercise, or to control the exercise of, the rights to vote attached to shares in the body or to dispose of, or to exercise control over the disposal of, such shares;
- (g) matters concerned with the ascertainment of the persons who are to have been financially interested in the success or failure, or apparent success or failure, of the body or are or have been able to control or materially to influence the policy of the body;
- (h) the circumstances under which a person acquired or disposed of, or became entitled to acquire or dispose of, shares in, debentures of, or prescribed interests made available by, the body;
- (j) where the body has made available prescribed interests - any matters concerning the financial or business undertaking, scheme, common enterprise or investment contract to which the interests relate; and
- (k) matters relating to or arising out of the audit of, or working papers or reports of an auditor concerning,

any matters referred to in any of the preceding paragraphs.

As can be seen from the section, the definition is widely drafted. However, a number of problems still arise in respect of the definition. The first problem is that of nominee directors. In *Morgan v. 45 Fleurs Avenue Pty. Ltd.*<sup>3</sup> Company A held 45% of the equity of Company B. Company A appointed a nominee director to the Board of Company B. The plaintiff, a shareholder in Company A, claimed that conduct of the nominee director was oppressive and unfair to him. The Supreme Court of New South Wales dismissed the suit on the basis that the complaint referred to the affairs of Company B, and not to Company A. The plaintiff had no shareholding in Company B; thus he did not have standing to pursue the matter.

It is of course true that a person who is what might be called a nominee director, may legitimately exercise his votes on a board in the interests of the person who appointed him without being in breach of a fiduciary duty to the company on whose board he sits. However, I do not consider that this state of affairs is sufficient for one to conclude that when so taking part in a board meeting of a

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<sup>3</sup> (1987) 5 A.C.L.C. 222.

company one is acting in the affairs of the appointor company.<sup>4</sup>

As Redmond comments, "[t]he outcome is anomalous in view of the widespread adoption of the group of companies as a model of business organisation. The Morgan decision effectively denies shareholders in the parent company a right of complaint concerning the conduct of nominees appointed to the board of a subsidiary company."<sup>5</sup>

The solution to this problem may be in expanding the definition of the affairs of the company to include that of a nominee director appointed to the board of another company. This would have the advantage of allowing judicial intervention where appropriate, but if there was no legitimate shareholder interest the court could still deny a remedy, as it did in Morgan.

Prentice states that:

...where activities are carried out in group form, the economic reality of group activity should be recognised and the manner in which the affairs of one member of the

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<sup>4</sup> *Id.* at p. 234.

<sup>5</sup> P. Redmond, "Nominee Directors" [1987] 10 *UNSWLJ* 194.

group are conducted should, in most circumstances, be treated as part of the affairs of other group members.<sup>6</sup>

What constitutes an act/omission by or on behalf of the company?

Section 260 requires that the unfairly prejudicial, unfairly discriminatory, oppressive conduct be related to the affairs of the company, or alternatively that the act or omission or resolution etc. be by or on behalf of the company. "This description can hardly cover acts of sheer misfeasance, such as the misapplication of the company's funds, where the company is the victim and not the agent".<sup>7</sup>

If an act such as the misappropriation of company funds does not come within the terms of the section the minority shareholder may still have to rely on an exception to the Rule in *Foss v. Harbottle*,<sup>8</sup> or seek a winding up order on the just and equitable ground.<sup>9</sup> In this writer's view it would be unusual if s.260 was interpreted in such a legalistic manner. Section 260 was introduced and then amended to amplify the remedies

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<sup>6</sup> D.D. Prentice, "The Theory of the Firm: Minority Shareholders Oppression: Sections 459-461 of the Companies Act 1985" [1988] 8 *Oxford J. of Legal Stud.* 55.

<sup>7</sup> R. Instone, "Unfair Prejudice to Shareholders" [1981] *NLJ* 1316.

<sup>8</sup> [1843] 2 Ha. 461, 67 E.R. 189.

<sup>9</sup> See 460-461 of the *Corporations Law*.

available to the minority shareholder, and it would be inconsistent with the philosophy of the section if it did not provide a remedy where there was a misapplication of company funds by a director.<sup>10</sup>

In addition to the preceding problems there is doubt that the passing of a resolution by the general meeting can be considered an act by or on behalf of the company. BurrIDGE submits that, "there are many acts or omissions which may very well unfairly prejudice the interests of members but which are not acts or omissions of the company or acts or omissions performed or omitted to be performed on its behalf".<sup>11</sup> Authority for this proposition is *Northern Counties Securities Ltd. v. Jackson and Steeple Ltd.*<sup>12</sup> In this case, the directors of the defendant company summoned a meeting of shareholders to obtain approval for certain matters which would allow the company to comply with an order for specific performance made in favour of the plaintiff. One of the issues before Walton J. was whether the specific performance order made against the company was binding on the shareholders. His Honour held that it was not:

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<sup>10</sup> Similar questions could arise with a director passing on corporate information. This could hardly be considered an act by or on behalf of the company.

<sup>11</sup> S. BurrIDGE, "Wrongful Rights Issues" [1981] 44 *MLR* 40.

<sup>12</sup> [1974] 1 *WLR* 1133.

...although it is perfectly true that the acts of the members, in passing certain special types of resolutions, binds the company, their acts are not the acts of the company.

There would ... be no real doubt about this, were it not for the use of the curious expression 'the company in general meeting' which in a sense drags in the name of the company unnecessarily, what the phrase really means [counsel submitted] is 'the members (or corporators) of the company assembled in general meeting', and that if the phrase is written out full in this manner, it becomes quite clear that the decisions taken at such a meeting, and the resolutions passed there at, are decisions taken by, and resolutions passed by, the members of the company, and not by the company itself.<sup>13</sup>

The view of Burridge, that a resolution of the general meeting may not be an act by or on behalf of the company has been criticised by Prentice,<sup>14</sup> and Shapira.<sup>15</sup> Shapira considers that the decision of *Northern Counties* is an isolated, first instance decision decided in an exceptional context and that it is a thin base,<sup>16</sup> from which to argue that the legislation has failed in its objective to overcome the problems associated with the fraud on the minority exception to the rule in *Foss v. Harbottle*.

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<sup>13</sup> *Id.* at p.1144.

<sup>14</sup> D. Prentice, *op. cit.* at p.71-72.

<sup>15</sup> G. Shapira, "Minority Shareholders Protection - Recent Developments" [1982] 10 *NZULR* 134.

<sup>16</sup> *Id.* at p.140.

Prentice comments that, "[a]lthough the decisions of shareholders may not necessarily be those of the company so as to affect the company's relationships with a third party, they will be binding on the shareholders *inter se* and affect the shareholders' interest and it is this dimension to their operation that brings them within the ambit of section [260]".<sup>17</sup> The submissions of Prentice and Shapira are preferable, especially when one considers the remedial nature of the legislation, and the intention of the legislature to overcome the problems associated with the common law the judiciary is unlikely to follow *Northern Counties*.

In any event, a small amendment to our legislation would overcome any problems. Section 260 already refers to a resolution or proposed resolution of a class of members. This can be compared to the equivalent section of the *Malaysia Companies Act* s.181(1)(b) which refers to a resolution of the members, holders of debentures or any class of them. Therefore to remove any doubt about the effectiveness of s.260, the section could be amended to read "...a resolution, or a proposed resolution, of the members or of a class of members..."

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<sup>17</sup> D.D. Prentice, *op. cit.* at p.72.



Is the conduct unfairly prejudicial or unfairly discriminatory if it affects all members the same?

One issue that arises in respect of the terms unfairly prejudicial and unfairly discriminatory is whether the conduct in question can be said to be unfairly prejudicial or unfairly discriminatory if it affects all members equally. Corkery comments that:

...while an action - the non-payment of dividends, for instance - may apply to all shareholders equally, it may still unfairly prejudice some of them and not others. For example, some shareholders may rely entirely on income from their investments; others who are well paid executives of the company may not. In *Re Overton Holdings Pty. Ltd.* the defendants unsuccessfully argued that s.[260](a)(i) and (ii) did not apply because the actions complained of affected all members the same. Rowland J., without conceding that the words "prejudicial" and "discriminatory" call for evidence of unequal treatment of members, focussed on the word "oppression".

Oppression was made out:

"The fact that a loss if suffered by Overton [Pty. Ltd.] will eventually also be borne equally by the other shareholders does not make the conduct any less oppressive to the petitioner."

Similar things cannot be said of "prejudice" and "discrimination". Unequal treatment of members is at the heart of those words.<sup>18</sup>

This view of Corkery that unequal treatment is at the heart of these terms is supported by a decision, emanating from England. In *Re Carrington Vijella*,<sup>19</sup> a minority shareholder complained that the board of directors had entered into a disadvantageous service contract with its chief executive. Vinelott J. held that this was a breach which would affect all shareholders equally, and to succeed the complainant had to show the conduct was unfairly prejudicial to part of the members. Support for Vinelott J.'s view can be found in the particular wording of the English legislation. Section 459 of the *Companies Act 1985* U.K. requires conduct which is "unfairly prejudicial to the interests of some part of the members" (emphasis added). There is no such wording in s.260. Austin questions the Vinelott J. reasoning that unfairly prejudicial and unfairly discriminatory are restricted to situations involving inequality of treatment between shareholders.<sup>20</sup> The term "oppressive" did not require inequality of treatment between

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<sup>18</sup> J.F. Corkery, "Oppression or Unfairness by Controllers - What can a shareholder do about it? An Analysis of s.320 of the Companies code." (1988) 9 *Adel. Law Review* 437 at p.447.

<sup>19</sup> (1983) 1 B.C.C. 98, 951 ; noted (1983) 4 *Co. Lawyer* 164 (L. Sealy).

<sup>20</sup> R.P. Austin, "Protection of Minority Shareholders: Changes to Section 320" *Committee for Postgraduate Studies in the Department of Law*, University of Sydney, 102 at p.122.

shareholders<sup>21</sup> and it would be unusual if the new terms were interpreted in a more restrictive manner than the old legislation.

If the legislation is interpreted to mean inequality of treatment, the term "contrary to the interests of members as a whole" will assume particular importance.<sup>22</sup>

#### Contrary to the Interests of Members as a Whole.

This ground for relief contained in s.260 will generally cover those breaches of fiduciary duty which directors owe to the company:

Negligence and breaches of fiduciary duty by directors, even though those duties are owed to the company and not the shareholders, are indirectly contrary to the interests of members as a whole. If the company suffers then the members' investment is hurt.<sup>23</sup>

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<sup>21</sup> *Scottish Co-operative Wholesale Society Ltd. v. Meyer* [1959] AC 324.

<sup>22</sup> It should be noted that the Court of Appeal in New Zealand in *Re H.W. Thomas Ltd.* (1983) 1 A.C.L.C. 1256 at p.1262 indicated in *obiter* comments that conduct could be unfairly prejudicial or unfairly discriminatory even if it does affect all the members equally.

<sup>23</sup> J.F. Corkery, *op. cit.* at p.447-8.

One concern in respect of this term is what interpretation the judiciary will give to members as a whole. This ground for relief will be of little use if the conduct or act in question must be contrary to each and every individual member:

The controllers' interests as members may well be served by their selfish manner of acting. Thus not all members would be disadvantaged. More likely those words mean that, where controllers act in their own interests only, they will be seen to be acting contrary to the interests of members as a whole. Even if the controllers act in the majority's interests they will not, under this interpretation, be acting in the interests of members as a whole.<sup>24</sup>

It is submitted given the remedial nature of the legislation that the court should accept this view.

Can Section 260 be used where there is a specific statutory provision concerning the conduct in question or where the claim could be based in contract or tort

Section 260 has the potential to be utilised where the conduct in question is governed by a specific statutory provision. Does

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<sup>24</sup> *Id.* at p.448.

the existence of a specific statutory provision bar a remedy pursuant to s.260? Austin suggests not. He comments that:

The mere fact that there is another more specific statutory provision is surely no automatic bar to relief under the oppression section. Nevertheless, it is inconceivable that s.260 will be allowed to replace the more specific regimes. The key to a partial reconciliation, I suggest, is to remember that the cardinal utility of s.260 is that it makes available a much more extensive range of remedies than the more specific areas of law.<sup>25</sup>

One area of possible conflict that could occur is between s.260 and s.1002 of the *Corporations Law*. Section 1002 provides for a "Prohibition of Dealings in Securities by Insiders." In particular s.1002(G) provides for possible prosecution if a person with information not generally available, (and that person knows, or ought to know, that that information might have a material effect on the value of securities) utilises that information to buy or sell securities.

If one of the elements of s.1002(G) is not made out should the court still provide relief under s.260. Austin argues that s.260 should not be used where the section in question, such as the

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<sup>25</sup> R.P. Austin, *op. cit.* at p.114-5.

insider trading provisions, create a criminal offence. "There is a major issue of maintaining certainty and predicability."<sup>26</sup> The issue of the interaction of s.260 will also arise with respect to the rights of holders of classes of shares,<sup>27</sup> together with questions concerning acquisition of shares.<sup>28</sup> The Court when approaching these issues should proceed on a case by case basis without adopting general principles that cannot be justified for particular sections. I would agree with Austin,<sup>29</sup> that if the specific statutory provision provides for criminal penalties then s.260 should not be invoked. Other than that each case should depend on its own circumstances.<sup>30</sup>

Questions will also arise concerning the interaction of the law of contract and tort with the oppression section. Shapira provides the following example:

Assume that A and B own and manage a manufacturing company. X is prepared to invest in the company, provided he is awarded exclusive rights to market a range of the company's products. The agreement may be embodied in the company's articles, in a separate contract,

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<sup>26</sup> *Id.* at p.115.

<sup>27</sup> See ss.197-199 of the *Corporations Law*.

<sup>28</sup> See ss. 732-736 of the *Corporations Law*.

<sup>29</sup> *op. cit.*

<sup>30</sup> In *Re Zephyr Holdings* [1988] 14 ACLR 30, the precursor to s.260 was argued as was a breach of the Stock Exchange Listing Rules - there was however no question of criminal sanctions.

or in both. X takes a minority share and operates as the company's marketing agent. Eventually A and B vote resolutions cancelling X's agency, leading to its ruin. X, whom we may further assume has invested all his savings in the company and in his franchise, brings proceedings under [s.260], alleging that he had been unfairly prejudiced in his capacity as the company's marketing agent.<sup>31</sup>

X in this hypothetical case has a possible remedy for breach of contract or wrongful dismissal. Should X also be able to invoke s.260? I would submit that X, in this case, should be able to invoke s.260. His "rights, expectations and obligations are not necessarily submerged in the company structure".<sup>32</sup>

"The test should be whether the particular capacity in which the member has been prejudiced was, in part or in whole, the *raison d'être* for his subscribing to, or remaining a member of, the company."<sup>33</sup> If, however, the obligation sought to be enforced is only incidental to the incorporation relationship and not the principal reason for incorporation, then remedies pursuant to the Companies Code should not be utilised.

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<sup>31</sup> G. Shapira, *op. cit.* at p.155.

<sup>32</sup> See *Ebrahimi v. Westbourne Galleries Ltd.* [1973] A.C. 360 at p. 379.

<sup>33</sup> *Ibid.*

The Nature of Relief Available to a Minority Shareholder -  
Section 260(2)(g).

Section 260(2) provides a number of orders that the court can make if it is satisfied that injustice has been made out. The remedy that has attracted the most attention is s.260(2)(g). This provides for an order:

... directing the company to institute, prosecute, defend or discontinue specified proceedings, or authorising a member or members of the company to institute, prosecute, defend or discontinue specified proceedings in the name and on behalf of the company.

This order derives from the recommendations of the Jenkins Committee<sup>34</sup> and is designed to overcome the "legendary" problems associated with the rule in *Foss v. Harbottle*.<sup>35</sup>

Some writers, however, see some difficulties with this subsection. Section 260 was originally designed to protect shareholders' interests, but this order introduces a wider sphere of complaints - that of complaints about wrongs done to the company. Shapira comments that this "indicates the legislature's disregard for the fundamental distinction between

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<sup>34</sup> Cmnd 1749 at paras. 206-207 and 212(e).

<sup>35</sup> See the comments made by J.F. Corkery, *op. cit.* at p. 458.



the corporate cause of action and the member's personal rights."<sup>36</sup> He further comments that [s.260(2)(g)] is ill-conceived. It makes s.[260] blow hot and cold on the distinction between corporate rights and shareholders' interests."<sup>37</sup>

Corkery, however, considers that "any confusion would probably only be of academic concern".<sup>38</sup> The distinction:

...should not be a problem if the courts accept that actions that hurt the company also prejudice or hurt the members' interests in the company. Injury to the company - through misappropriation of assets, improper use of powers and negligence, for example - depreciates the value of its shares and thereby hurts members. Indirectly the company's property is the shareholders' property ... It is almost too much to hope that paragraph (g) will sweep away the troubles of *Foss v. Harbottle*. But applied liberally it could do just that.<sup>39</sup>

I would accept Corkery's comment that s.260(2)(g) has the potential to sweep away the troubles of *Foss v. Harbottle*, but I

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<sup>36</sup> G. Shapira, *op. cit.* at p.159.

<sup>37</sup> *Ibid.*

<sup>38</sup> J.F. Corkery, *op. cit.* at p. 461.

<sup>39</sup> J.F. Corkery, *op. cit.* at p. 460.

would submit that Shapira is right when criticising the introduction of a corporate remedy for a provision designed primarily for the remedy of personal injuries. This remedy does bring into question the issue of ratification and it is submitted that the preferable approach would be to introduce the statutory derivative action which would allow s.260 to be used for the remedy of personal wrongs and the statutory derivative action for the remedy of corporate wrongs.<sup>40</sup>

Section 260(2)(g) was used by Rowlands J. in *Re Overton Holdings Pty. Ltd.*<sup>41</sup> His Honour was satisfied by establishment of a prima facie case of oppression, the defendant having "chosen to remain silent". The applicant supported his allegations by affidavit, the company then failed to provide answering affidavits. This case offers some hope that applications to bring derivative proceedings can be brought expeditiously.

Hannigan suggests that this remedy, "calls into question the whole issue of ratification. If ratification of a ratifiable wrong is 'unfairly prejudicial' ... entitling the minority shareholder to a litigation order, does the rule in *Foss v. Harbottle* still exist?"<sup>42</sup>

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<sup>40</sup> I will consider the introduction of the statutory derivative action in chapter 5.

<sup>41</sup> (1984) 2 A.C.L.C. 777.

<sup>42</sup> B.M. Hannigan, "Statutory Protection for Minority Shareholders - Section 75 of the Companies Act 1980" (1982) 11 *Anglo-Am.L.Rev.* 20 at p. 32.

It is submitted that if the court is not likely to award a litigation order if the conduct in question is ratifiable, particularly in light of their desire not to interfere in the decisions of the business community.

It would appear that the court faces three options. Firstly, ratification by an independent majority, reaching a bona fide decision can never come within "unfairly prejudicial". Secondly, they could decide that ratification, regardless of *bona fides*, amounts to unfairly prejudicial conduct and grant a litigation order. Finally, the court could decide that ratification may, in certain circumstances, amount to unfairly prejudicial conduct, but the proper remedy is compensation rather than a litigation order. The chances of getting a litigation order then seem slim, nor is it indeed clear that minority shareholders will resort to [s.260] in an attempt to circumvent the rule in *Foss v. Harbottle*.<sup>43</sup>

Hannigan further considers, that it is "most unsatisfactory" that the problems surrounding the rule in *Foss v. Harbottle* have been imported into the new statutory regime, and that the s.260(2)(g) order is a convoluted way to deal with the problems of *Foss v. Harbottle*.<sup>44</sup>

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<sup>43</sup> *Id.* at p. 33.

<sup>44</sup> Hannigan, *op. cit.* at p.33.

In conclusion, I would agree with Corkery that the litigation order does have the potential to sweep away the problems surrounding the rule in *Foss v. Harbottle*. "[T]he complexities of proving fraud, dealing with the potential absurdities of ratification, and showing control by the wrongdoers - the problems that have dogged derivative suit proceedings in the past"<sup>45</sup> could all be of historical interest if the judiciary apply s.260(2)(g) liberally. However, my argument would be that a more acceptable way to overcome the problems associated with the rule in *Foss v. Harbottle* and to maintain a clear distinction between personal and corporate rights, would be to retain s.260 as the remedial provision for personal injuries, and to introduce a statutory derivative action for the remedy of corporate wrongs. This would have the advantage of resolving the issue of ratification<sup>46</sup> and maintaining the separation between corporate and personal rights.<sup>47</sup>

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<sup>45</sup> J.F. Corkery, *Directors' Powers and Duties*, Longman Professional, 1987, at p.259.

<sup>46</sup> See the discussion of the statutory derivative action in chapter 5.

<sup>47</sup> Another provision which would allow the minority shareholder to overcome the rule in *Foss v. Harbottle* is s.1324. This section provides:

**1324(1) [Court may grant injunction restraining]** Where a person has engaged, is engaging or is proposing to engage in any conduct that constituted, constitutes or would constitute:

(a) a contravention of this Law;

the court may grant an injunction restraining the first-mentioned person from engaging in the conduct and, if in the opinion of the Court it is desirable to do so, requiring that person to do any act or thing.

In certain circumstances an injunction obtained pursuant to s.1324 will provide a quicker and less complex remedy for the minority shareholder.

Should the Courts interfere in matters of Business Judgment.

The courts have recently reiterated that they should not interfere in matters of business judgment. His Honour Martin J. in *Re Terri Co. Ltd.*<sup>48</sup> considered that matters of business judgment cannot constitute grounds for relief under s.260. In a similar fashion, Brooking J. in the Supreme Court of Victoria in *Zephyr Holdings v. Jack Chia*<sup>49</sup> commented that:

Whereas in the present case, bad faith is not established and where, as in the present case, the allegation is that the proposed course of action is detrimental to the members as a whole, the court must take care that it does not too readily intervene in the affairs of a company under s.[260] ... It is only stating the obvious to say that, under s.[260], the court does not sit as an appellate tribunal to review the decisions of the organs of a company, or of a class of its members on the footing that the court will, as it

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The main limitation on the section, however, is that it only applies to breaches of the Corporation Law. Examples of the types of applications that come within the ambit of s.1324 are breaches of statutory duty under s.232, breach of a duty to disclose interests in contracts under s.231 or a breach of a duty to convene a general meeting pursuant to s.246.

Section 1324 has substantial potential and it may well serve as a useful adjunct to s.260. Indeed Baxt comments that s.1324 on its own "may well overcome the strictness of the rule in *Foss v. Harbottle*" (R. Baxt, "Intervention by Members and N.C.S.C. in Statutory Breaches" (1980) 8 *A. Bus. L. Rev.* 406 at p. 412; see also R. Baxt, "Will s.1324 of the Companies Code Please Stand Up" (1989) 7 *Company and Sec. L.J.* 388).

<sup>48</sup> (1988) 6 A.C.L.C. 402.

<sup>49</sup> (1988) 14 A.C.L.R. 30.

were, automatically reverse the decision if it disagrees with it.<sup>50</sup>

The difficulty with this approach is that the judiciary have never adequately explained why they refuse to intervene in the internal management of corporations. It has generally been explained by academics on the grounds of economic efficiency. The firm is generally seen as more efficient "for the simple reason that it could in certain circumstances reduce the costs of contracting."<sup>51</sup> This reduction in the cost of contracting occurs because of a number of reasons including:

- (i) the firm is able to reduce the possibility of default;
- (ii) the firm is more able to adjust to unforeseen circumstances;
- (iii) the firm provides a mechanism for regulating the terms and conditions on which labour is supplied and rewarded.<sup>52</sup>

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<sup>50</sup> *Id.* at p. 37.

<sup>51</sup> D.D. Prentice, *op. cit.* at p.56.

<sup>52</sup> See the discussion by D.D. Prentice, *op. cit.* at p. 56-58.

Nevertheless, this efficiency will be largely eroded should the courts intervene in the internal management of companies. The efficient use of the capital of the company requires that the courts do not interfere. It is obviously not practicable to have the unanimous agreement of all the shareholders before a decision is made by the company. "The motivating rationale for the internal management rule is just as valid now as it was in the nineteenth century. Economic efficiency requires freedom to make rational decisions and the courts should not derogate from this freedom."<sup>53</sup>

This theory fails to consider that a clear distinction has to be drawn between a publicly listed company and an incorporated partnership. With a company listed on the Stock Exchange the opportunity for oppression is substantially reduced. The minority shareholder being able to freely transfer his shareholding can, "therefore expeditiously liquidate his investment."<sup>54</sup> This opportunity is not available to the minority shareholder in the incorporated or quasi-partnership as there is no market for such shares. Accordingly, it is submitted that the courts should not adopt an inflexible approach as to when they should interfere. In particular the court should adopt a positive role in the regulation of the incorporated partnership. As Prentice comments:

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<sup>53</sup> D. Wishart, "A Fresh Approach to Section 320" [1987] 17 *WALR* 94 at p. 127.

<sup>54</sup> D.D. Prentice, *op. cit.* at p.60.

The interests of a member in an incorporated partnership will be broadly as follows: (i) the right to participate in the affairs of the company so as to guarantee some return on his investment; (ii) the right to protect his investment in the company which will often take the form of the investment of skills and labour; (iii) the ability to monitor the conduct of his co-venturers. The response of the law should be to protect these interests as the law will then be doing for the parties what they would have done for themselves.<sup>55</sup>

Another reason for the courts refusing to intervene in intra-corporate disputes is the problem of escalating costs:

As with all civil actions, the costs of derivative suits have skyrocketed. In fact, the legal expenses incurred by a corporation are often especially onerous, not only because many of these actions are complex but because the corporation typically is called upon to pay for several separate teams of lawyers in the same action ... Expense is not the only burden imposed upon the corporation by the derivative suit. Typically these cases seriously disrupt corporate business, as top management personnel are divested from their normal pursuits and assume the role of

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<sup>55</sup> *Op. cit.* at p.61.



witness; and the corporation may also be damaged by bad publicity generated by the suit... Moreover, even where the derivative suit does have some merit, often the relief sought, even if obtained, would not justify the costs incurred in obtaining it.<sup>56</sup>

It is submitted that the introduction, and reform of the oppression section was to provide a more active role for the courts, particularly in disputes involving the close corporation or the incorporated partnership. As Shapira concludes:

If the price of meaningful minority protection is increased judicial involvement, so be it. Lack of business expertise of the judiciary has never been a convincing argument. After all, laying down fair standards of corporate practice and ethics is no more intractable than, say, formulating standards of liability in complex negligence cases. The courts conduct this type of inquiry every day.<sup>57</sup>

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<sup>56</sup> G. Shapira, *op. cit.* at p.160; Shapira was quoting from a summary of the American experience with derivative suits.

<sup>57</sup> *Id.* at p.163: In the area of fiduciary obligations there are similar questions being asked as were discussed in the preceding paragraphs. Some commentators suggest that the courts should not impose strict standards of fiduciary obligations as this inhibits economic efficiency. The contrary argument is that by imposing strict standards the courts have helped to legitimise corporate managerial power. For an excellent discussion of this area see M. Chesterman and G. Moffatt, *Trust Law: Text and Materials*, London, Weidenfeld Publishers, 1988 at p.603-604.

I would support the conclusions of Shapira. The legislature introduced s.260 to give the judiciary a more interventionist role in corporate decision making. When the original oppression remedy failed to achieve satisfactory protection the legislative amendments were introduced to cover a wider range of conduct. The courts should no longer hide behind the veil of non-interference in matters of business judgment. These questions are no less difficult than the myriad of issues that the courts face regularly.

## CHAPTER 5

### MINORITY SHAREHOLDER REMEDIES IN ENGLAND, CANADA AND THE UNITED STATES OF AMERICA

The existing statutory remedies have not resolved all of the problems for the minority shareholder who seeks to remedy a wrong done to the company. In particular s.260 has not been interpreted as broadly as perhaps the law reform committees who proposed its introduction would have hoped, and there are still problems associated with its relationship between personal rights and corporate rights. In addition the legislation has not resolved the problems surrounding ratification and it is certainly not appropriate to state that the legislation has rid corporate law of the rule in *Foss v. Harbottle*.<sup>1</sup> Overseas jurisdictions have adopted a different approach to the problem of minority shareholder complaints, and this chapter will be considering the options given to the minority shareholder in the England, Canada and the United States.

#### England

The English equivalent to our s.260 is contained in ss.459-461 of the *Companies Act* 1985. Section 459 provides:

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<sup>1</sup> See *Scarel Pty. Ltd. v. City Loan and Credit Corporation Pty. Ltd.* (1988) 79 A.L.R. 483 and *Smith v. Croft (No. 2)* [1987] 3 W.L.R. 405.

A member of a company may apply to the court by petition for an order under this Part on the ground that the company's affairs are being or have been conducted in a manner which is unfairly prejudicial to the interests of some part of the members (including at least himself) or that any actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial.

The first point of comparison is that Australia has a number of additional terms, these being oppression, unfairly discriminatory and contrary to the interests of members as a whole. The English legislation only contains the term unfairly prejudicial. It is arguable therefore that Australia is attempting by the use of the additional terms to cover a wider range of conduct than that prohibited by the English legislation.

One issue that arises from the English legislation, due to the more restrictive wording, is whether some aspect of discrimination is required to establish unfairly prejudicial conduct. In *Re Carrington Viyella plc.*,<sup>2</sup> Vinelott J. considered that if the directors had acted in breach of their fiduciary duty, this would affect all shareholders equally, and as such would not come within the ambit of the English legislation. This

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<sup>2</sup> (1983) 1 BCC 98,951.

conclusion of *Vinelott J.* has been questioned in a number of decisions.<sup>3</sup> The Australian legislation indicates that discrimination is not necessarily an element of prejudice by providing the additional terms.<sup>4</sup> In particular the words "contrary to the interests of members as a whole" would appear to be wide enough to cover breaches of fiduciary duty, which presumably affect all shareholders equally. Further support for an argument that the *Vinelott* interpretation is incorrect is the fact that the English legislation allows for the awarding of a court order requiring the company to institute civil proceedings.<sup>5</sup> Presumably this type of order will be used where a wrong has been done to the company, such as a breach of fiduciary duty and where the impugned conduct has affected all shareholders equally. *MacIntosh*, recognises this problem in the English legislation and states:

It may simply be better to recognise that the legislation as currently drafted (as least, if the *Carrington* Interpretation of the statute is sound), presents the court with a legal impossibility. The court cannot allow an action to proceed in the name and on behalf of the company (that is, in a situation where all shareholders are affected equally) if to do so would violate the requirement that only some part of

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<sup>3</sup> See *Re Cumana Ltd.* [1986] BCLC 430 and *Re London School of Electronics Ltd.* [1986] Ch. 211.

<sup>4</sup> This is also supported by the New Zealand legislation, s.209 of the *Companies Act 1955*, is drafted in similar terms to the Australian legislation.

<sup>5</sup> See s.461 of the *Companies Act 1985*.

the members be affected. But that is precisely what the statute authorises the court to do. A statutory amendment to resolve the ambiguity is clearly indicated.<sup>6</sup>

As Farrar points out:

The lesson seems to have been learnt here for s.27 of the *Insolvency Act* 1986 (which provides an unfairly prejudicial remedy for creditors and members when an administration order is in force) states that such a petitioner may apply on the grounds that:

...the company's affairs, business and property are being or have been managed by the administrator in a manner which is unfairly prejudicial to the interests of its creditors or members generally or some part of its creditors or members.

For the avoidance of doubt s.459 should be similarly reworded at the earliest opportunity.<sup>7</sup>

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<sup>6</sup> J.G. MacIntosh, "The Oppression Remedy: Personal or Derivative" (1991) 70 *Can. B. R.* 29 at p.41.

<sup>7</sup> J.H. Farrar, N.E. Furey and B.M. Hannigan, *Farrar's Company Law*, Butterworths, London and Edinburgh, 1988 at p.401.

### Origins of English legislation

The English legislation emanates from the recommendations of the Cohen Committee,<sup>8</sup> which gave two instances of oppressive conduct. The instances being the taking of excessive remuneration by directors and the refusal of directors to register transfers on the death of shareholders.<sup>9</sup>

The report led to the introduction of s.210 of the *Companies Act* 1948. This allowed a member to petition the Court if the affairs of the company were conducted in an oppressive manner:

Unfortunately, in summarising this recommendation in para 153 of the report [the Cohen Committee] used language which evidently misled the Department of Trade into supposing that the Committee intended the new jurisdiction of the Court to be coextensive with its power to make a winding-up order. It is this limitation (embodied in s.210(2)(b) of the 1948 Act) which long ago gave rise to a general recognition that the section was inadequate.<sup>10</sup>

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<sup>8</sup> Report of the Committee on Company Law Amendment, United Kingdom, Cmd. 6659 (1945). See Chapter 2.

<sup>9</sup> *Id.* at paras. 58-60. The Committee noted at paragraph 60 that these were only illustrations of a general problem.

<sup>10</sup> R. Instone, "Unfair Prejudice to Shareholders" (1981) *N.L.J.* 1316; Section 210(2)(b) states that:

Not surprisingly, the oppression remedy was seen as underutilised by the Jenkins Committee.<sup>11</sup> The Jenkins Committee therefore recommended that the legislation be amended by the introduction of the term unfairly prejudicial, and by the removal of the requirement that the remedy be linked to facts justifying a winding up.<sup>12</sup> The Jenkins Committee also considered that the available remedies should be altered to allow an order that the company institute legal proceedings.<sup>13</sup>

### Unfair prejudice

The concept of unfair prejudice has been variously described as opaque and elusive; but it has never caused practitioners or the courts any difficulty. Prejudice denotes detriment of some kind; but because it must also qualify as unfair it must be a form of detriment which would strike a man of business as unjust or inequitable. The role of the non-controlling shareholder is that of an

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"If on any such petition the Court is of the opinion that to wind up the company would unfairly prejudice that part of the members, but otherwise the facts would justify the making of a winding-up order on the ground that it was just and equitable that the company should be wound up, the Court may, with a view to bringing to an end the matters complained of, make such order as it thinks fit, "

<sup>11</sup> Report of the Company Law Committee, United Kingdom, Cmnd. 1749 (1962). See Chapter 2.

<sup>12</sup> The recommendations of the Jenkins committee were originally included in s.75 of the *Companies Act* 1980 and are now contained in ss.459-461 of the *Companies Act* 1985.

<sup>13</sup> Jenkins Report, at paras. 205-207.



investor, however he acquired his holding; and the standpoint from which the statutory criterion must be judged is plainly that of the average investor-the man on the Throgmorton Street omnibus.<sup>14</sup>

To satisfy this test of unfair prejudice, four elements are needed. It is required to be established that: (1) the interests of, (2) some part of the members have been, (3) prejudiced, (4) unfairly. Obviously as the Australian legislation includes the term "unfairly prejudicial," much can be learnt by a consideration of the English legislation.

### (1) Interests

Under the previous English legislation the oppression had to be suffered by the member in his capacity as a member.<sup>15</sup> This is no longer the case.<sup>16</sup> This now mirrors the Australian legislation which does not require the member to be affected in his capacity as a member.<sup>17</sup>

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<sup>14</sup> R. Instone, "Unfair Prejudice: An Interim Report" (1988) *Journal of Business Law* 20 at p.21.

<sup>15</sup> R Hollington, *Minority Shareholder Rights*, Sweet and Maxwell 1990, at p.56.

<sup>16</sup> See the comments of Lord Hoffmann in *Re A Company* (No. 00477 of 1986) [1986] B.C.L.C 376 at p.378-379.

<sup>17</sup> See s.260(4) of the *Corporations Law*.

(2)Parts of the members

This aspect was previously discussed in the context of whether discrimination was an element of unfair prejudice. The view of Vinelott J. in *Re Carrington Viyella* has support in the decision of Harman J. in *Re A Company (No. 00370 of 1987)*,<sup>18</sup> where his honour stated:

It may be regrettable but, in my view, the statute providing a statutory remedy, although in wide terms in part, does contain the essential provision that the conduct complained of must be conduct unfairly prejudicial to some part of the members, and that cannot possibly mean unfairly prejudicial to all of the members.<sup>19</sup>

There is no doubt that the English legislation is narrower in this context than Australia. The additional terms in Australia allows a wider range of conduct to be impugned. Nevertheless, as noted previously, the *Insolvency Act* 1986 of England has amended the equivalent remedy in their legislation and it may be that an amendment to the *Companies Act* 1985 may follow suit.

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<sup>18</sup> (1988) B.C.C. 507.

<sup>19</sup> Contrast the judgment of Gibson J. in *Re Sam Weller & Sons Ltd* (1989) 5 B.C.C. 810.

### (3) Prejudice

"The variety of ways in which prejudice may be suffered by members is almost unlimited."<sup>20</sup> Common examples include, exclusion from management, lack of dividends, coupled with excessive remuneration for the controllers, competition with the company and refusal to register a transfer of shares.<sup>21</sup>

### (4) Unfairness

Under the English legislation, and the Australian legislation, it is necessary to show both prejudicial conduct and that the conduct is unfair:

The manner in which these two requirements interrelate is not particularly clear. Obviously something may be prejudicial but not unfair. For example, if a company retains its earnings for expansion purposes, this would be prejudicial to shareholders who did not have an

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<sup>20</sup> R.Hollington, *op. cit.* at p.61.

<sup>21</sup> See D.D. Prentice "The Theory of the Firm: Minority Shareholder Oppression: Sections 459-461 of the Companies Act 1985" (1988) *Oxford Journal of Legal Studies* 55 at p.77ff for a discussion of the various types of prejudice. See also R. Hollington, *op. cit.* at p.62ff.

employment relationship with the company but not necessarily unfair.<sup>22</sup>

This test of unfairness is extremely wide<sup>23</sup> and allows the court considerable flexibility in determining what sort of conduct should be challenged.

#### The Remedies Available Under the English Legislation

Section 461 of the *Companies Act* 1985 does not offer the range of remedies that Australia does under s.260 of the *Corporations Law*. In England the judiciary can make orders regulating the conduct of the company's affairs, require the company to do, or to refrain from doing certain acts, to authorise the company to institute civil proceedings and to order the purchase of the petitioner's shares. With Australia offering a greater range of remedies,<sup>24</sup> this may again demonstrate that we are considering a wider operation for our legislation than our English counterparts. This distinction may be more illusory than real, as both sets of legislation provide that the remedies listed are without prejudice to the generality of the court's power.

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<sup>22</sup> D.D. Prentice, *op. cit.* at p.79.

<sup>23</sup> See the comments by R.Hollington, *op. cit.* at p.62.

<sup>24</sup> See s.260(2) of the *Corporations Law*.

Australia's injustice remedy has been modelled on the English legislation. However with the additional terms, Australia has attempted to provide a greater potential for use by minority shareholders. It would be my submission that the differences are more cosmetic than of substance. As indicated by the amendments to the English *Insolvency Act*, the intent of the parliament in England was to entrap the same breadth of conduct as Australia.

## **Canada**

The trend in Canada, like Australia, has been a move away from majority rule to protection of minority rights. Anisman states:

The direction in Canada, primarily in the last 20 years, has been toward greater egalitarianism, emphasising notions of fairness to minority shareholders in determining the balance to be drawn between majority and minority interests....It has affected the standards applicable to the conduct of majority shareholders in carrying on their corporation's affairs and the remedies available to minority

shareholders for enforcing those standards in the event of a conflict.<sup>25</sup>

Canada has differed from England, the United States and Australia by its enactment of a virtual "bill of remedies."<sup>26</sup> The result of this is that remedies for minority shareholders are more expansive than the equivalent Australia shareholder. The remedies available in Canada include the statutory derivative action, oppression remedy, various restraining orders, an appraisal remedy, and a remedy allowing for a just and equitable winding up.

#### Statutory Derivative Action

Canada has (unlike Australia,<sup>27</sup> New Zealand and England) enacted a statutory derivative action for the use of minority shareholders. This was adopted in Canada following the recommendations of various law reform committees such as the

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<sup>25</sup> P. Anisman, "Majority-Minority Relations in Canadian Corporation Law: An Overview" (1986-1987) 12 *Can. Bus.L.J.* 473 at p.474.

<sup>26</sup> See the comments by Palmer E.E. & Welling B.L., *Canadian Company Law - Cases, Notes and Materials*, 3rd. ed. 1986, Butterworths, Toronto and Vancouver at p.7-42.

<sup>27</sup> In Australia the Companies and Securities Law Review Committee have released (July 1990), discussion paper No. 11 which is titled "Enforcement of the Duties of Directors and Officers of a Company by means of a Statutory Derivative Action". New Zealand is also considering the introduction of the statutory derivative action, see 1989 draft *Companies Act*, s.127.

Lawrence Committee<sup>28</sup> and the Dickerson Committee.<sup>29</sup> In the words of the Dickerson Committee, the new statutory provision:

...requires a shareholder who seeks to bring a derivative action to obtain a court order before commencing legal proceedings. At one stroke, this provision circumvents most of the procedural barriers that surround the present right to bring a derivative action and, incidentally, minimises the possible abuse of "strike suits" that might otherwise be instituted as a device to blackmail management into a costly settlement at the expense of the corporation....In effect this provision abrogates the notorious rule in *Foss v. Harbottle* and substitutes for that rule a new regime to govern the conduct of derivative actions. In the preface (page v) to the second edition of this text, *Modern Company Law* Professor Gower states that "...an attempt has been made to elucidate the mysteries of the rule in *Foss v. Harbottle*. I believe that I now understand this rule, but have little confidence that readers will share this belief". We have been so persuaded by Professor Gower's elucidation of these "mysteries" that we have relegated the rule to legal limbo without compunction, convinced that the alternative system recommended is preferable to the uncertainties -

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<sup>28</sup> Interim Report of the Select Committee on Company Law, Ontario, 1967. See Chapter 2.

<sup>29</sup> Proposals for a New Business Corporations Law for Canada, Information Canada, Ottawa, 1971. See Chapter 2.

and obvious injustices - engendered by that infamous doctrine.<sup>30</sup>

In this section I will examine the judiciary's involvement in the interpretation of the new section to determine if the optimism of the Dickerson Committee was justified.

The *Canada Business Corporation Act* (C.B.C.A.) introduced the statutory derivative action in 1974. The section reads:

232(1) Subject to subsection (2) a complainant may apply to a court for leave to bring an action in the name and on behalf of the corporation or any of its subsidiaries, or intervene in an action to which any such body corporate is a party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate.

(2) No action may be brought and no intervention in an action may be made under subsection (1) unless the court is satisfied that:

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<sup>30</sup> *Id.* at para.482.



- (a) the complainant has given reasonable notice to the directors of the corporation or its subsidiary of his intention to apply to the court under subsection(1) if the directors of the corporation or its subsidiary do not bring, diligently prosecute or defend or discontinue the action;
- (b) the complainant is acting in good faith; and
- (c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.<sup>31</sup>

(a) Is the Statutory Derivative Action Personal or Derivative

Beck states that:

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<sup>31</sup> Many of the provinces of Canada have statutory derivative action which are similar to the Federal provisions: see *Alberta Business Corporations Act* 1981, s.232; *Manitoba Business Corporations Act* 1976, s.232; *New Brunswick Corporations Act* 1981, s.164; *Ontario Business Corporations Act* 1981, s.245; *Saskatchewan Business Corporations Act* 1978, s.232 and *British Columbia Company Act* 1979, s.225.

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 plaintiffs 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 et al.*<sup>32</sup>

In *Farnham v. Fingold*<sup>33</sup> the minority shareholders sought to share in the premium that the controlling shareholders had received on the sale of their shares. The action was brought by a minority shareholder on behalf of himself and all other shareholders, except the defendants, alleging a breach of fiduciary duty owed by the majority to the minority. The defendants sought to strike out the action on the basis that the action was derivative and, therefore; it could only be brought pursuant to the legislative provision dealing with statutory derivative actions, and this required leave of the court.

The Ontario Court of Appeal held that the statement of claim was concerned with damage allegedly suffered by the corporation and therefore, leave should have been requested to bring a statutory derivative action, rather than the instituting of a personal action." It was clear in *Farnham* that the plaintiffs were

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<sup>32</sup> S.M. Beck, "The Shareholder's Derivative Action" (1974) 52 *Can. B.R.* 159 at 169.

<sup>33</sup> [1972] 3 O.R. 688, 33 D.L.R. (3d) 156 (Ont. C.A.).

not themselves sure as to whether their claim was personal or derivative and they tried to have it both ways."<sup>34</sup> The case is therefore important because it indicates that it is the responsibility of the plaintiff to correctly identify whether the cause of action is personal or derivative.

*Goldex Mines v. Revill* concerned a fight for control of Probes Mines Ltd. At issue was misconduct by the directors and defendant shareholders, including misleading proxy solicitation; however, it was not clearly stated whether the claim was personal or derivative. Leave to bring an action had not been sought. This was the central issue. Was leave required?

The Ontario Court of Appeal ultimately concluded that the endorsement was deficient as it failed to differentiate between personal claims and derivative claims. The case is, therefore authority for the proposition, that while derivative and personal actions may be joined in the one writ, it is necessary to distinguish each cause of action in the statement of claim.

These two cases establish that if a minority shareholder wants to seek redress for misconduct, it will be vitally important to determine whether the cause of action is personal or derivative and to correctly endorse the statement of claim. This will

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<sup>34</sup> Beck, *op. cit.* at p.181.

become of crucial importance if the statutory derivative action is introduced into Australia and stands alongside the oppression remedy.<sup>35</sup>

(b) Standing to Bring a Derivative Action.

Section 231 of the C.B.C.A. provides for an application for a statutory derivative action to be made by "complainants" This term includes past and present shareholders and creditors and anyone considered a "proper person" at the court's discretion. The term "proper person" was considered by Wallace J. in *Re Daon Development Corporation*.<sup>36</sup> His Honour stated:

...The section requires that the category ["proper person"] be composed of those persons who have a direct financial interest in how the company is being managed and are in a position - somewhat analogous to minority shareholders - where they have no legal right to influence or change what they see to be abuses of management or conduct contrary to the company interest.<sup>37</sup>

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<sup>35</sup> In Canada the right to bring a common law derivative action has been excluded by the legislation introducing the statutory derivative action. See *Shield Development Company Limited v. Snyder* [1976] 3 W.W.R. 44 (B.C.S.C) The distinction between personal and derivative actions also arises with the oppression remedy. See J.G. MacIntosh, "The Oppression Remedy: Personal or Derivative?" (1991) 70 *Can B.R.* 29.

<sup>36</sup> (1984) 54 B.C.L.R. 235.

<sup>37</sup> *Id.* at p.243.

Adopting this definition, Wallace J. refused to allow a debenture holder standing to bring a statutory derivative action. The view of Wallace J. has been criticised as being, "unnecessarily restrictive and one which it is hoped will not be followed by future courts".<sup>38</sup> In particular it is submitted that employees should have standing to bring a statutory derivative action. They stand to lose their livelihood through mismanagement, a consequence not likely to happen to an investor with a diversified portfolio.<sup>39</sup>

Finally and importantly, the category of applicants should not remain or become static. The changing face of capitalism and the role which corporations play in furthering its aims dictate the necessity of flexibility...Any fears regarding floodgate possibilities or limitless applicants can be dealt with by the other procedural or substantive requirements.<sup>40</sup>

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<sup>38</sup> M.A. Maloney, "Whether the Statutory Derivative Action?" [1986] 64 *Can. B.R.* 309 at p.318.

<sup>39</sup> *Id.* at p.318-319.

<sup>40</sup> *Id.* at 319.

(c) The Prerequisites for the Bringing of a Statutory Derivative Action

The prerequisites for the complainant to bring a statutory derivative action are (1) that the complainant give reasonable notice to the directors of the corporation, (2) that the complainant be acting in good faith and (3) that it is in the interests of the corporation that the action be brought.

(c)(i) Notice

The requirement of notice has been loosely interpreted. In *Armstrong v. Gardner*<sup>41</sup> letters sent to the managing director, detailing the minority shareholders complaint, but without any particularity, were held to be sufficient.<sup>42</sup>

(c)(ii) The Good Faith Requirement

Palmer and Welling, comment that this requirement, "probably does not mean much."<sup>43</sup> It could be used to disallow suits

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<sup>41</sup> (1978) 20 O.R. (2d) 648 (Ont. H.C.).

<sup>42</sup> See also *Bellman v. Western Approaches Ltd.* (1981) 33 B.C.L.R. 45.

<sup>43</sup> Palmer and Welling, *op. cit.* at p.7-65.

brought by disgruntled minority shareholders in the hope that the company will settle the matter quickly, rather than pursue litigation which is time-consuming and expensive. In this instance I would consider that the requirement does serve a useful purpose in discouraging the vexatious litigant. Maloney criticises this prerequisite. He states:

Indeed it is difficult to justify the need for the good faith requirement in any case. If a wrong has been committed and the other prerequisites fulfilled, it should make little, if any difference whether a plaintiff's motives are pure or not. This is all the more the case if the main reason for allowing statutory derivative actions is to ensure some watchdog role over corporate management which society cannot do or does not wish to undertake for administrative and expense reasons. The other procedural devices already deal adequately with malicious or unmeritorious actions.<sup>44</sup>

My submission would be as litigation is generally undesirable and costly, the vexatious litigant should be discouraged and only genuine grievances encouraged. The good faith requirement does serve as a useful safeguard and its abolition would, in my opinion, only lead to the tainting of the altruistic nature of the remedy.

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<sup>44</sup> M.A. Maloney, *op. cit.* at p.320.

(c)(iii) That the Interests of the Corporation would be Served  
by the Bringing of the Action.

The section requires that the court be satisfied that it is in the interests of the corporation that the action be brought, prosecuted, defended or discontinued. Does this allow a court to reject a valid cause of action if they consider that it is not in the interests of the company to continue the action? The English Court of Appeal in *Prudential Assurance v. Newman Industries*<sup>45</sup> was mindful that although there may exist a valid cause of action, the benefits of a successful action may be less than the detriment caused to the company. They comment:

...the board clearly doubted whether there were sufficient reasons for supposing that the company would at the end of the day be in a position to count its blessings, and clearly feared, as counsel said, that it might be killed by kindness.<sup>46</sup>

Further on, after noting that costs of the trial were in the region of three quarter of a million pounds, state:

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<sup>45</sup> [1982] 1 All E.R. 354.

<sup>46</sup> *Id.* at p.365.



The innocent shareholders.... may well wonder, whether this appeal succeeds or not, if there is not something to be said after all for the old fashioned rule in *Foss v. Harbottle*.<sup>47</sup>

In the Canadian context this issue was discussed in *Bellman v. Western Approaches Ltd.*<sup>48</sup> In this case the minority shareholders alleged that the directors had breached their fiduciary duty. The board of directors requested a law firm to investigate the allegations. The conclusion of the law firm was that there was no evidence to support the allegations. The minority shareholders sought leave to commence a derivative action.

The court held that the legal report was inconclusive as regards the substantive issues and that it could not be said that the resolution by the directors following this report was impartial. Accordingly it was in the interests of the company that the action be brought.

Maloney again criticises this requirement. He comments:

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<sup>47</sup> *Id.* at p.368.

<sup>48</sup> (1981) 33 B.C.L.R. 45, 130 D.L.R. (3d) 193 (B.C.C.A.).

It moves the derivative action increasingly away from a policy-oriented, macro-level to a micro-level measure designed to fit the individual circumstances of a company....Even from a fairly narrow perspective, the company must be viewed as a continuing concern which must encompass the interests of past, present and future shareholders, creditors and (one would hope) employees. From a broader perspective, given the major economic force of the modern corporation, it must also have an interest in society's needs and/or at least, economic concerns. Viewed in this light it is nearly impossible to delineate all the criteria and different needs of the various interest groups and then judge which, if any, is the appropriate course of action. Obviously a macro view of the corporate world is required.<sup>49</sup>

I would submit that in the case of the close corporation or the quasi-partnership, a macro view of the corporate world is not required. These types of corporations cannot be considered a major economic force, the number of employees is relatively small, as is the number of shareholders. To pursue every *prima facie* case of wrongdoing may be economic lunacy for the small corporation.

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<sup>49</sup> Maloney, *op. cit.* at p. 328.

### Ratification

Section 242 of the *Canadian Business Corporations Act* states that an action shall not be:

...stayed or dismissed by reason only that it is shown that an alleged breach of a right or duty owed to the corporation or its subsidiary has been or may be approved by the shareholders of such body corporate, but evidence of approval by the shareholders may be taken into account by the court in making an order...

This is, in my opinion, the best approach to ratification. In certain situations a majority of shareholders should be entitled to forgive a breach of duty by the directors, however, if the directors control the general meeting, ratification should only be treated as a piece of evidence, with the court giving it the appropriate weight for each individual case.<sup>50</sup>

By treating ratification as something to be taken into account, yet not be determinative of the matter, allows the premise of majority rule to remain yet gives the minority shareholder a remedy if his, "rights, expectations and obligations," have been

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<sup>50</sup> See the comments to this effect by S. Beck, *op. cit.* at p.198.

infringed. It will allow the judiciary flexibility and discretion in determining the boundaries of majority rule. Schreiner comments that:

...the courts will now have to formulate new criteria of permissible conduct on the part of directors, and set new limits to the extent to which they will intervene in the so-called internal affairs of companies...What is important to note here is that the mere fact of or potential for ratification will not automatically prevent a suit being heard.<sup>51</sup>

#### Conclusion on the Statutory Derivative Action.

There is no doubt that the statutory derivative action has an important role to play in the correction of abuses by directors:

The next decade may prove decisive for the fate of the statutory derivative action. It is only hoped that the courts will fully grasp its significance and role in society. As corporations become increasingly powerful, as management becomes increasingly isolated from criticism and accountability, the derivative action may be one of the

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<sup>51</sup> O.C. Shreiner, "The Shareholders Derivative Action: A comparative study of procedures" (1979) 96 *South African L.J.* 203 at p.235. See also the comments of the Dickerson Committee *op. cit.* at para.487.

few remaining methods of ensuring some accountability.

The courts, with the help of the legislature, should attempt to ensure that the derivative action plays the pivotal role for which it was designed.<sup>52</sup>

In Australia the introduction of the statutory derivative action would greatly increase the range of remedies for the minority shareholder. It could then play a pivotal role in correcting abuses of management. The statutory derivative action also has some advantages over the oppression remedy. To correct a wrong done to the company via s.260 requires proving some form of injustice to obtain an order that the company institute proceedings against the wrongdoers. In essence, you go to court to obtain an order for further litigation. It is obviously a circuitous route to correct wrongs to the company. In this sense the statutory derivative action provides a quicker and more efficient way to correct wrongs to the corporation.

### The Oppression Remedy

In addition to the statutory derivative action, Canada also possesses the oppression remedy. The legislation differs throughout Canadian provinces, but s.241 of the *Canadian*

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<sup>52</sup> Maloney, *op. cit.* at p.341.

*Business Corporations Act* is typical. A complainant may apply to the court if the:

...affairs of the corporation...have been conducted in a manner... that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditor, director, or officer, the court may make an order to rectify the matters complained of.

Illustrative of how this section has been interpreted in Canada is *Redekop v. Robco Construction Ltd.*<sup>53</sup> In this case the English principles as regards oppression were adopted. His honour considered that oppression indicated burdensome harsh or wrongful conduct, a lack of probity or of fair dealing.<sup>54</sup>

#### Personal and Derivative Actions Under the Oppression Remedy.

The presence in Canada of the statutory derivative action and the oppression remedy has led to the issue of whether both personal

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<sup>53</sup> (1978) 5 B.L.R. 58 (B.C.S.C.).

<sup>54</sup> The Canadian court quoting from the English decisions of *Re Harmer* [1958] 3 All E.R. 689, *Scottish Co-op Wholesale Society Ltd. v. Meyer* [1959] A.C. 324. See also the Canadian decision of *Diligenti v. RWMD Operations* (1976) 1 BCLR 36 which considered the words "unfairly prejudicial". Fulton J. found that actions of the board in removing one of the founding members of the company was unfairly prejudicial in that it was an unjust and inequitable denial of his rights and expectations. See (1976) 1 BCLR 36 at p.51 quoting from the decision of Lord Wilberforce in *Ebrahimi v. Westbourne Galleries Ltd.* [1973] A.C. 360.

and derivative actions are available under the oppression remedy. It could be submitted that the derivative actions should exclusively be available under the legislation pertaining to the statutory derivative action and that the oppression remedy should be linked solely to personal wrongs against minority shareholders. MacIntosh suggests that:

...the derivative action and the oppression remedy are two pieces of a puzzle that steadfastly refuse to fit together in a tractable fashion. An amendment to the statute will best succeed in salvaging order from potential chaos. In particular, I suggest that the statutory derivative action and oppression provisions ought to be combined into a single all-embracing provision. the new unified provision will ensure that all actions involving derivative wrongs are funnelled through the statutory leave procedure.<sup>55</sup>

The Dickerson Committee also commented on the relationship between the oppression remedy and derivative actions when recommending the adoption of the oppression remedy. They considered that the object of the statutory derivative action was to remedy wrongs to the corporation whereas the oppression remedy would generally be invoked by minority shareholders in close corporation. The committee also recognised that in some situations the actions may constitute a wrong to the corporation

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<sup>55</sup> MacIntosh, *op. cit.* at p.30.

and a wrong to minority shareholders. In this context they comment:

...but the payment of excessive salaries to dominant shareholders who appoint themselves officers is a borderline case: it may constitute a wrong to the corporation and, at the same time, may have as its specific goal the squeezing out of minority shareholders (at a low price reflecting the small dividends paid) whose investment is no longer required. In such a case the aggrieved person may select the remedy that will best resolve his problem...In sum, we think that the courts should have very broad discretion, applying general standards of fairness, to decide these cases on their merits.<sup>56</sup>

Despite the opinion of the Dickerson Committee that the relationship between the two provisions could work, MacIntosh considers that the interaction is unclear and confusing and that:

...a better alternative is to combine the derivative and oppression actions in a single provision, embracing all forms of action. A unified provision could funnel all derivative actions through a leave procedure, while

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<sup>56</sup> Dickerson Committee, *op. cit.* at para.484.



eliminating insupportable differences in matters of standing, procedure, remedies and substance as between derivative and oppression actions.<sup>57</sup>

MacIntosh does mount a powerful argument for the amendment of the legislation. I would submit that an equally valid alternative would be to allow personal actions under the oppression section, leaving corporate wrongs to be remedied under the statutory derivative action. If the matter was doubtful, either party could seek directions of the court as to the appropriate course to take. This solution would not represent such a radical reappraisal of the remedies of the minority shareholder, but would still give the minority shareholders appropriate avenues to pursue to correct abuses of management. Furthermore, in the case of corporate wrongs it is appropriate for the minority shareholder to seek leave of the court. The shareholder is seeking leave to institute proceedings on behalf of another entity, it is apposite that the judiciary be given an opportunity to consider if the claim is valid. However, in the case of personal wrongs, the shareholder is instituting proceedings on behalf of themselves and there is no reason for leave to be obtained. Ultimately, if the claim is found to be unjustified, the shareholder will suffer the penalty of having to pay the costs of the other party.

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<sup>57</sup> MacIntosh, *op. cit.* at p.68.

### The Appraisal Remedy

Canada also has available an appraisal remedy whereby minorities can force the corporation to purchase their shares at a mutually agreed price or at a "fair price". An example of the provisions found in this area is s.184 of the *Canadian Business Corporations Act*.

184(1) Right to dissent.- Subject to sections 185 and 234, a holder of shares of any class of a corporation may dissent if the corporation is subject to an order under paragraph 185.1(4)(d) that affects the holder or if the corporation resolves to

- (a) amend its articles under section 167 or 168 to add, change or remove any provisions restricting or constraining the issue, transfer or ownership of shares of that class;
- (b) amend its articles under section 167 to add, change or remove any restriction upon the business or businesses that the corporation may carry on;

- (c) amalgamate with another corporation,  
otherwise than under section 178;
- (d) be continued under the laws of another  
jurisdiction under section 182; or
- (e) sell, lease or exchange all or substantially all  
its property under subsection 183(2).

(3) Payment for shares.- In addition to any other right he may have, but subject to subsection (26), a shareholder who complies with this section is entitled, when the action approved by the resolution from which he dissents or an order made under subsection 185.1(4) becomes effective, to be paid by the corporation the fair value of the shares held by him in respect of which he dissents, determined as of the close of the business on the day before the resolution was adopted or the order was made.

This section has the potential to allow minorities dissenting from fundamental changes in corporate policy to exit the organisation. Nevertheless, the practice in Canada has shown that it will not be in contentious matters when the remedy is invoked.<sup>58</sup> As to

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<sup>58</sup> See the comments by Palmer and Welling, *op. cit.* at p.7-121.

what constitutes a fair value, *Re Montgomery and Shell Canada Ltd*<sup>59</sup> indicates that this will be interpreted as meaning the market value of the shares, despite their asset value being significantly higher.

### Conclusion

Canada provides a greater range of remedies for the minority shareholder than Australia. I would submit that Australia would benefit greatly from the introduction of the statutory derivative action. This would provide the minority shareholder with an appropriate remedy for the correction of derivative wrongs, leaving the oppression remedy for the recovery of personal wrongs. The Canadian approach with ratification also constitutes a significant improvement over the Australian position. By treating ratification as a piece of evidence, giving it due weight in the circumstances of the case, allows the court to treat ratification on its merits, preventing it from hindering the minority shareholder as it presently does in Australia. I would consider that the statutory derivative action would prove a quicker and more effective remedy for the minority shareholder (in preference to s.260 and requesting a s.260(2)(g) order), though s.260 has the potential to be interpreted as widely as the statutory derivative action. Nevertheless, the introduction of the

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<sup>59</sup> (1980) 11 D.L.R. (3d) 116 (Sask. Q.B.); for a fuller discussion of the appraisal remedy see Magnet "Shareholders' Appraisal Rights in Canada" (1979) 11 *Ottawa L. Rev.* 100.

statutory derivative action would provide a clearer picture of the relevant use of the provisions.

### **United States of America**

The substantive method of control of corporate mismanagement in the United States has been the shareholder's derivative suit. The United States minority shareholder, though primarily depending upon the derivative suit, can also utilise the oppression remedy and the notion of a fiduciary duty owing from majority to minority to correct any perceived injustices.

#### Derivative Suit

The United States equivalent to the decision of *Foss v. Harbottle*<sup>60</sup> is the case of *Hawes v. City of Oakland*.<sup>61</sup> The two decisions provide a contrast as to the approach of the judiciary to derivative suits by shareholders. While the Rule in *Foss v. Harbottle*<sup>62</sup> denies an action by a minority shareholder unless it comes within strict guidelines, the American decision

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<sup>60</sup> (1843) 2 Hare 461; 67 E.R. 189.

<sup>61</sup> 104 U.S. 450 (1882).

<sup>62</sup> See my earlier discussion of this aspect in chapter 2.

established the procedural requirements for the bringing of a shareholder suit. These requirements were as follows:

- 1) Before instituting the action, the complainant shareholders were required to make a demand on all the shareholders requesting that they resolve the matter.
- 2) The complainant shareholders were also required to make a demand on the directors, requesting that the grievance be pursued. This requirement was excused if the demand would be futile.
- 3) The complainant then had to specify with particularity the facts justifying the complaint and they also had to allege that there was no collusion between the parties so as to create federal rather than state jurisdiction.
- 4) The plaintiff was also required to own shares at the time of the alleged wrongdoing.

The decision of *Hawes v. City of Oakland* led to the enactment of Equity Rule 94 in 1881, which is reproduced today in Rule 23.1 of Federal Rules of Civil Procedure.<sup>63</sup>

23.1. In a derivative action brought by one or more shareholders to enforce a right of a corporation, the corporation having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder at the time of the transaction of which he complains or that his share devolved upon him thereafter by operation of law; (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors, and, if necessary, from the shareholders, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders similarly situated in enforcing the right of the corporation. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or

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<sup>63</sup> Obviously there are some differences from one state to another, however there is basic similarity with the federal procedure. See the comments by Shreiner, *op. cit.* at p.221.

compromise shall be given to shareholders in such manner as the court directs.

### Standing

To pursue a derivative action a plaintiff is required to be a shareholder at the time of the wrongdoing, and generally must remain a shareholder during the course of the action.<sup>64</sup> It has also been held that unregistered shareholding will qualify as does equitable ownership.<sup>65</sup> A shareholder in a parent corporation can bring a derivative action on behalf of a subsidiary,<sup>66</sup> and a creditor will have no right to bring a derivative action.<sup>67</sup> A shareholder will also be denied the right to bring an action 'if he consented to the wrong or explicitly ratified it; if he is guilty of laches, or even (under a few opinions) if he "acquiesced" in the wrong by failing to object. The theory of these cases is that the plaintiff is "estopped" to bring the action or lacks "clean hands."<sup>68</sup>

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<sup>64</sup> See *de Haas v. Empire Petroleum Co.*, 435 F.2d 1223 (1970); *Werfel v. Kramarsky* 61 F.R.D. 674 (1974); *Schilling v. Belcher* 582 F.2d 995 (1978) and *Tryforos v. Icarian Development Co.* 58 F.2d 1258 (1975).

<sup>65</sup> See the cases noted by W.L. Cary & M.A. Eisenberg, *Cases and Materials on Corporations* 6th ed., The Foundation Press Inc., New York 1988 at p. 936.

<sup>66</sup> *Ibid.*

<sup>67</sup> *Dodge v. First Wisconsin Trust Co.*, 394 F. Supp 1124 (1975).

<sup>68</sup> Cary and Eisenberg, *op. cit.* at 937.



The most controversial aspect of standing in America is the contemporaneous ownership rule. This requirement stems from the concern of the United States Supreme Court in *Hawes v. City of Oakland*, that shareholders would collude to create federal jurisdiction:

It appears to have been a well-established technique - particularly where a corporation itself desired the institution of litigation against persons who had injured it, but wished to remove the case from state jurisdiction - to sell a few shares to someone from out of the state of incorporation, who would then sue as a collusive plaintiff, federal jurisdiction existing on the basis of diversity of citizenship. This requirement, then, and that of an assertion that the plaintiff was not in collusion with the defendant to create federal jurisdiction, are based squarely on circumstances peculiar to the federal courts.<sup>69</sup>

There is no requirement in Australia that there be share-ownership at both the time of the wrongdoing and the bringing of the action:

Rejection of the contemporaneous-ownership doctrine is demanded by logic, since the shareholder sues in the right

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<sup>69</sup> Shreiner, *op. cit* at p.223.

of the corporation, and the corporation's right should not be affected by the date on which shares were acquired by the individual who sets the judicial machinery in motion.<sup>70</sup>

I would submit that the Australian position is preferable to the United States. The altruistic nature of the derivative suit should be encouraged rather than hampered, and accordingly the rejection of the contemporaneous-ownership requirement is a salutary feature of the Australian derivative action.

#### Requirement of Demand on the Board of Directors.

The courts in the United States have accepted that demand not be made on the board of directors if this demand would be futile. This will obviously be the case where the alleged wrongdoers control the board or where the directors have a material interest in the matter. Demand will also not be required where the board is under the dominion and control of interested directors.<sup>71</sup>

The minority shareholder in Australia, rather than showing that he/she has made a demand on the board, has to show that the

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<sup>70</sup> Shreiner, *op. cit* at p.224.

<sup>71</sup> *Papilsky v. Berndt* 59 F.R.D. 95 (1973).

wrongdoers are in control. This point reflects the different approaches of the judiciary of Australia and the United States. The United States approach is more expansive and permits the judge to examine the merits of the case, whereas in Australia, the judiciary has preferred to stay aloof from commercial decision making:

In the core cases - where the directors have committed a fraud on the minority and are in effective control, i.e. where there is no doubt that an action must be allowed - the United States formulation is preferable to the English, as it encourages a concentration on the question of effective rather than formal control.<sup>72</sup>

#### Requirement of Demand on Shareholders

The requirement of a demand on the shareholders does not have the degree of uniformity, as does the requirement of a demand on the board of directors. The law governing demand on the shareholders varies widely from state to state and to the federal jurisdiction. Some general points can be made:

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<sup>72</sup> Shreiner, *op. cit.* at p.225; See the discussion of the Australian aspect of control, in chapter 2.

- 1) Demand is not required where the wrongdoers hold a majority of the shareholding.<sup>73</sup>
- 2) Demand will also be excused where it would be futile.<sup>74</sup>
- 3) Demand may be excused where there is a large number of shareholders.<sup>75</sup>

#### Approval by the Court

Pursuant to the Federal rules of civil procedure, approval of the court is necessary for the settlement of any derivative action.

The aim of this requirement is to prevent any possibility of abuse by minority shareholders and the company. For example, a minority shareholder may bring an action with the intention to settle out of court, thus retaining the benefit for themselves rather than recovering on behalf of the corporation. The potential for abuse is shown by the decision of *Manufacturers'*

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<sup>73</sup> *Heilbrunn v. Hanover Equities Corp.* 259 F. Supp 936 (1966).

<sup>74</sup> *Pioche Mines Consolidated Inc. v. Dolman* 333 F.2d 257 (1964).

<sup>75</sup> Contrast the decision of *Weiss v. Sunasco Inc.* 316 F. Supp 1197 (1970) with *Quirke v. St. Louis-San Francisco Ry.* 277 F.2d 705 (1960).

*Mutual Fire Insurance Co. of Rhode Island v. Hopson*.<sup>76</sup> In this case the action was discontinued by the minority shareholder when his stock was purchased by the defendant corporation for seven times its market value.

It is obviously advantageous for the approval of the court to be required before any settlement. By allowing private settlements the aim of the derivative suit is defeated. The corporation is the intended recipient of the action, but as *Manufacturers' Mutual Fire Insurance* shows the minority shareholder is the principal beneficiary by a settlement out of court:

Moreover, the money for the settlement will usually come from company funds, so that the net result of the suit will be that the company has been milked twice - once to create the cause of action and once to pay off the discoverer of the wrong.<sup>77</sup>

In the United States, the rule in *Clarke v. Greenberg*<sup>78</sup> can be utilised to prevent a collusive settlement. In this case the plaintiff discontinued an action against the corporation after the corporation purchased his stock for \$9000. The market value of

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<sup>76</sup> 25 NYS 2d 502 (1940).

<sup>77</sup> Shreiner, *op. cit.* at p.225.

<sup>78</sup> 296 N.Y. 146 (1947).

the stock as \$51.88. The court held that the moneys received by the minority shareholder were held on trust for the corporation.

### Security for Costs

In the United States, one limitation on the use of derivative suits has emerged. In many jurisdictions the minority shareholder may be required to post security for reasonably anticipated expenses that the corporation or other defendants may incur. "Most of these statutes are by their terms inapplicable if the plaintiff owns more than a specified amount of stock."<sup>79</sup> In practice, these statutes do not provide a great impediment:

...because once the defendant moves to require that the security be posted, the court stays the action to permit the plaintiff to seek additional shareholders as plaintiff-intervenors so as to meet the requisite amount of shareownership to except the action from the statutory security requirement.<sup>80</sup>

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<sup>79</sup> D.A. DeMott, "Shareholder Litigation in Australia and the United States: Common Problems, Uncommon Solutions" (1987) 11 Sydney Law Review 529 at p.266.

<sup>80</sup> DeMott, *op. cit.* at p.267.

### Special Litigation Committees

At present in the United States the most controversial issue in derivative litigation concerns the use of "litigation committees". As this question is one controlled by state law, and only five state supreme courts have addressed the litigation committee device, further evolution of the law is inevitable.<sup>81</sup>

The first major authority to deal with litigation committees was *Auerbach v. Bennett*.<sup>82</sup> In this case the New York Court of Appeals held that the director's had the authority to appoint a committee of disinterested directors to determine if maintenance of the derivative suit was justified. Under this authority if the elected committee "utilise adequate and appropriate investigative procedures, and pursue the investigation in good faith, the committee's determination is shielded from judicial scrutiny."<sup>83</sup> In effect the court adopted the business judgment rule to the appointment of a litigation committee. This rule providing that if commercial decisions are made in good faith and in a reasonable manner the court will not interfere.

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<sup>81</sup> Demott, *op. cit.* at p.275.

<sup>82</sup> 419 N.Y.S. 2d 920 (1979); In *Alford v. Shaw* N.C. 349 S.E. 2d 41 (1986) the Supreme Court of North Carolina adopted *Auerbach*, but said, that if the independence of the directors is established as well as the investigation being deemed to be reasonable, the director's good faith will be presumed in the absence of evidence to the contrary.

<sup>83</sup> K.S. Williams, "Derivative Actions", (1987) 22 *Wake Forest Law Review* 127 at p.132.

A second approach to the appointment of litigation committees was considered by Delaware Supreme Court in *Zapata Corp. v. Maldonado*.<sup>84</sup> This court accepted the major elements of *Auerbach* with two amendments. Firstly, the burden of proof was shifted to the corporate defendant, and secondly, the courts were to exercise their own business judgment in determining whether the derivative suit should continue:

[T]he court's response to the use of litigation committees is grounded in practical reality: *Zapata Corp.* articulates the fear that committee members will so empathise with the plight of their fellow directors - the defendants - that they will be unable fairly to assess the merits of the suit.<sup>85</sup>

A third response to litigation committees was adopted by the Supreme Court of Iowa in *Miller v. Register and Tribune Syndicate, Inc.*<sup>86</sup> The court adopting what has become known as the "structural bias" theory.<sup>87</sup> This theory suggests that if the directors are not in a position to control litigation in the first place, (because of some conflict of interest); those same directors are disqualified from participating in the selection of

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<sup>84</sup> 430 A.2d 779 (Del. 1981).

<sup>85</sup> Demott, *op. cit.* at p.276.

<sup>86</sup> 336 N.W. 2d 709 (Iowa 1983).

<sup>87</sup> See the comments by Williams, *op. cit.* at p.133.



the litigation committee. Obviously this approach is the, "most critical of the motives and abilities of special litigation committees."<sup>88</sup>

The law in respect of litigation committees is still evolving, however:

The credibility of the institution, however, is called into question by the uniformity with which committees determine derivative actions not to be in the corporation's best interests. Surely in eight years some claims worth pursuing were raised derivatively. Indeed, in some reported cases, the committee's recommendation appears to have been at odds with the advice as to the merits of claims received from its counsel.<sup>89</sup>

With this background in mind it is very difficult to see the efficacy of special litigation committees.<sup>90</sup> While their use has been embraced by the American courts,<sup>91</sup> "the litigation

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<sup>88</sup> Williams, *op. cit.* at p.133.

<sup>89</sup> Demott, *op. cit.* at p.277.

<sup>90</sup> The problems created by litigation committees would be reduced by the adoption of a proposal from the American Law Institute's Project on Corporate Governance. This proposal, while endorsing the use of litigation committees, restricts their use where a director is personally benefiting from the dismissal of a derivative action. See the comments by Demott, *op. cit.* at p.278. See also Carey and Eisenberg *op. cit.* at p.1005.

<sup>91</sup> Demott, *op. cit.* at p.278-279 comments that this acceptance has resulted from the lack of judicial alternatives to dismiss a derivative claim

committee device ought not to commend itself to Australia or to the other commonwealth jurisdictions."<sup>92</sup>

[The] courts' acquiescence in the litigation committee as an instrument of the directors' "business judgment", ...may simply represent a transcendence of rhetoric over reality. The reality is a private non-judicial device to bring about the termination of litigation; the rhetoric is derived from a prudent judicial deference to decisions about the operation of business enterprises.<sup>93</sup>

### Oppression Remedy

In addition to the derivative action, many states of America also provide grounds for remedial action on the grounds of oppressive or unjust conduct. The legislation varies from state to state but an example of the United States provisions can be taken from the *Model Business Corporations Act* 1950.

s.97 The ...courts shall have full power to liquidate the assets and business of a corporation:

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summarily, and that the courts are sceptical of the minority shareholder's claim.

<sup>92</sup> Demott, *op. cit.* at p.279.

<sup>93</sup> Demott, *op. cit.* at p.279. See also *Growbow v. Peret* 539 A. 2d. 180 (1988).

- (a) In an action by a shareholder when it is established...
- (2) That the acts of the directors or those in control of the corporation are illegal, oppressive or fraudulent;  
or
- (4) That the corporate assets are being misapplied or wasted...

Oppression as a ground for the dissolution of a company was first included in the Illinois and Pennsylvania corporations acts of 1933 and in the *Model Business Corporation Act* 1950.

Approximately 37 states now have an oppression remedy (or something in similar terms) in their corporations legislation.

The section was analysed in the United States by the Supreme Court of Virginia in *White v. Perkins*.<sup>94</sup> The parties formed a company with White owing 55% and Perkins, 45% of the issued stock. The company was formed to act as a jobber for products of American Oil Company. The initial board consisted of Perkins, White and White's attorney. The company commenced operations in July 1967 with Perkins as the only

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<sup>94</sup> 213 Va. 129, 189 S.E. 2d 315 (1972).

full time employee. A dividend was never distributed by the company, White never agreeing to this course of action. During 1969 various disputes arose between White and Perkins, Perkins complaining about the lack of dividends, the alleged failure of White to honour certain agreements, and the refusal of White to grant Perkins a 50% equity in the company. In 1970 Perkins instituted legal proceedings to dissolve the corporation, arguing that the actions of White were illegal oppressive or fraudulent. The court found that the actions of White were oppressive and in coming to this conclusion quoted from the English decisions of *Elder v. Elder & Watson*<sup>95</sup> and *Scottish Co-op Wholesale Society v. Meyer*.<sup>96</sup> Accordingly oppression was held to constitute a visible departure from the standards of fair dealing, a violation of fair play and a lack of probity and fair dealing in the affairs of a company to the prejudice of its members.

As can be seen from this decision the United States courts have adopted an approach closely allied to the United Kingdom and thus integrally connected to the Australian position. Indeed many states in America now allow relief on the basis of unfair prejudice of persistent unfairness.<sup>97</sup>

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<sup>95</sup> (1952) Sess. Cas. 49 at p.55.

<sup>96</sup> [1958] 3 All. E.R. 66 at p.86.

<sup>97</sup> For a list of the applicable wording in each of the states see R.B. Thompson, "Corporate Dissolution and Shareholders' Reasonable Expectations" (1988) 66 *Wash. U.L.Q.* 193 at p.206-207, fn.57.

Recently the courts in America have tied its oppression remedy to the concept of what constitutes a minority shareholder's reasonable expectations. As Thompson states:

The highest courts in several states have adopted disappointment of reasonable expectations as the best guide to defining oppression, and this idea is now included in some state dissolution statutes.<sup>98</sup>

This idea of reasonable expectations guiding the content of the duty owed by the controllers to the minority mirrors the decision of the House of Lords in *Ebrahimi v. Westbourne Galleries*.<sup>99</sup> In this case the court ruled that the exercise by the majority of its legal power pursuant to the articles of association to remove a minority shareholder from management was sufficient to justify a winding up of the company on the basis that it was just and equitable.<sup>100</sup> Lord Wilberforce commented:

[A] limited company is more than a mere entity...there is room in company law for recognition of the fact that behind it, or amongst it, there are individuals, with rights,

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<sup>98</sup> Thompson, *op. cit.* at p.208.

<sup>99</sup> [1972] 2 All. E.R. 492.

<sup>100</sup> In Australia see s.461 of the *Corporations Law*.

expectations and obligations inter se which are not necessarily submerged in the company structure.<sup>101</sup>

This idea of reasonable expectations constituting the basis for injustice has been recognised in a number of jurisdictions in America<sup>102</sup> and as Thompson concludes:

...the reasonable expectation standard, provides an effective response to the problems of minority shareholders because they focus a court's attention on the ways in which the expectations of participants in a close corporation differ from the shareholder expectations reflected in the statutory norms and permits courts to provide relief consistent with those expectations in situations where advance private ordering would be inadequate.<sup>103</sup>

I would submit that Australia would benefit greatly from the introduction of a reasonable expectations standard within s.260 of the *Corporations Law*. This would allow the court to fully utilise the remedial nature of s.260 and permit the minority

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<sup>101</sup> [1972] 2 All. E.R. 492 at p.500.

<sup>102</sup> These jurisdictions and the authorities from those jurisdictions are discussed by Thompson, *op. cit.* at p.213.

<sup>103</sup> Thompson, *op. cit.* at p.237-238.

shareholder an appropriate avenue for the redress of unjust conduct by the controllers.

### A Fiduciary Duty Owed from the Majority Shareholders to the Minority

The United States courts have developed the notion of a fiduciary duty being owed by the majority shareholders of a corporation to the minority shareholders.<sup>104</sup> This idea was first given judicial support in the Massachusetts Supreme Judicial Court in *Donahue v. Rodd Electrottype Co. of New England Inc.*<sup>105</sup> Rodd was the principal founder of a family owned close corporation. He originally held 200 shares in the company which constituted an 80% interest. Rodd later brought two sons into management positions and made gifts of 39 shares to each of them. He also made a gift of 39 shares to another child. Rodd decided to retire and negotiated with the corporation to purchase 45 of his remaining shares. His eldest son, a director of the corporation, represented the company in these negotiations. Ultimately the corporation purchased his 45 shares for \$800 per share. Within 2 years he transferred the rest of his shareholding to his three children, increasing their interests to 52 shares each.

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<sup>104</sup> Thompson, *op. cit.* at p. 237 states that "It is not entirely surprising that the enhanced fiduciary duty doctrine seems to have added appeal to courts in states which have narrow dissolution remedies."

<sup>105</sup> 367 Mass. 578, 328 N.E.2d 505 (1975).

Donahue, a minority shareholder with 50 shares, alleged that the corporation's purchase of Rodd's shares constituted an unlawful distribution of corporate assets to the controlling shareholder and that this was in breach of the fiduciary duty owed by the majority to the minority. The company had offered Donahue, \$200 per share.

The Supreme Judicial Court of Massachusetts found in favour of Donahue. Donahue should have been given an equal opportunity to have the corporation purchase her stock at \$800 per share. The court stated:

...because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another. In our previous decisions, we have defined the standard of duty owed by partners to one another as the "utmost good faith and loyalty."...Stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict good faith standard. They may not act out of avarice, expediency or



self-interest in derogation of their duty of loyalty to the other stockholders and the corporation.<sup>106</sup>

This case was followed in the, "ground-breaking decision"<sup>107</sup> of *Wilkes v. Springside Nursing Home, Inc.*<sup>108</sup> Four parties, Wilkes, Riche, Pipkin and Quinn were the four shareholders of a corporation which owned and operated a nursing home. At the time of incorporation, each person understood that they would be a director of the company and actively participate in the management and decision making. It was also agreed that each would receive an equal amount of remuneration, provided they continued to play an active role in the company. Initially, the operation ran smoothly. However a dispute arose between Quinn and Wilkes and the other shareholders sided with Quinn.<sup>109</sup> Because of the strained relationship between the parties, Wilkes' salary was terminated and Quinn's remuneration increased. Subsequently, Wilkes was not re-elected as a director and he was informed that his services were no longer required. There was no allegation of misconduct or neglect by the majority shareholders as regards the conduct of Wilkes, they just wanted Wilkes to stop earning income from the corporation. Wilkes then instituted proceedings claiming

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<sup>106</sup> *Id.* at p.582, 328 N.E. 2d at p.511.

<sup>107</sup> See the comments by F.H. O'Neal, "Oppression of Minority Shareholders: Protecting Minority Rights" (1987) 35 *Clev. St. L. Rev.* 121 at p.127.

<sup>108</sup> 370 Mass. 842, 353 N.E. 2d 657 (1976).

<sup>109</sup> It should be noted that Pipkin was no longer a shareholder. In 1959 he sold his shareholding, with the knowledge of the other parties, to a Mr. Connor.

damages on the basis of the breach of fiduciary duty owing from the majority to the minority.

The court held that the removal of Wilkes had breached the fiduciary duties that the majority shareholders owed him and that Wilkes should be entitled to recover the salary to which he would have been entitled if he had remained a director of the corporation. They stated:

...the *Donahue* decision acknowledged, as a "natural outgrowth" of the case law of this Commonwealth, a strict obligation on the part of majority stockholders in a close corporation to deal with the minority with the utmost good faith and loyalty. On its face, this strict standard is applicable in the instant case. The distinction between the majority action in *Donahue* and the majority action in this case is more one of form than of substance....When an asserted business purpose for their action is advanced by the majority, however, we think it is open to minority stockholders to demonstrate that the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority's interest....applying this approach to the instant case it is apparent that the majority stockholders in Springside have not shown a legitimate business purpose for severing

Wilkes from the payroll of the corporation or for refusing to re-elect him as a salaried officer and director.<sup>110</sup>

There is no doubt that this notion of a fiduciary duty owed amongst the participants of a close corporation, greatly assists the minority shareholder to resist action which constitutes a violation of their expectations as a minority shareholder. In Anglo-Australian case law the decision which most closely reflects this idea of a fiduciary duty from the majority to the minority is the English decision of *Clemens v. Clemens Bros. Ltd.*<sup>111</sup> In this case Foster J. set aside resolutions of a general meeting which approved an increase in capital, the allotment of shares and the setting up of a trust for employees. The effect of these resolutions would be to reduce the plaintiff's shareholding from 45% to less than 25%, thus preventing her from blocking any special resolution. His honour, relying on the House of Lords decision in *Ebrahimi v. Westbourne Galleries*<sup>112</sup> held that the resolution were in breach of the expectations of the minority shareholder, and those expectations were not subsumed within the corporate structure.

The Australian minority shareholder would significantly benefit from a common law development along the lines of a enhanced

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<sup>110</sup> 370 Mass. 842 at p.848 (1976).

<sup>111</sup> [1976] 2 All. E.R. 268.

<sup>112</sup> [1972] 2 All. E.R. 492.

fiduciary duty among the participants in a close corporation. However, there is the potential for s.260 to be interpreted in this expansive fashion and be able to achieve the same effect as the American decisions of *Donahue v. Rodd Electrottype Co. of New England* and *Wilkes v. Springside Nursing Home*.

### Conclusion

The United States, like Canada, has a greater range of remedies for the minority shareholder than does Australia. Nevertheless, as noted, a liberal interpretation of s.260 of the *Corporations Law* would provide the minority shareholder with much the same protection as offered to his or her North American counterpart. However, to improve the lot of the minority shareholder in this country, I would submit that the introduction of a procedural framework for the statutory derivative action is necessary. The oppression remedy could be used for the correction of abuses of a personal nature, leaving the statutory derivative action for the remedy of corporate wrongs.

## CHAPTER 6

### PERSONAL RIGHTS AND THE MINORITY SHAREHOLDER

The Rule in *Foss v. Harbottle*<sup>1</sup> established two principles. The first principle was that the corporation, being a separate legal entity, could only sue for wrongs done to it. The second principle was that the minority could not complain of an internal irregularity which the majority could put right. Beck explains the result of this case in the following terms:

The corporate pleasure was to be determined by the shareholders in general meeting and as the plaintiffs did not represent a majority, or allege that the will of the majority had been determined, they had no standing to sue in the name of the company... Moreover, the decision whether or not to bring suit in the company name belongs at common law to the general meeting where, once again, the majority rules.<sup>2</sup>

The two principles had the potential to trample minority interests to the benefit of majority shareholders:

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<sup>1</sup> [1843] 2 Ha. 461; 67 E.R. 189.

<sup>2</sup> S. Beck, "The Shareholders Derivative Action" [1974] 52 *Can.B.R.* 159 at p.164-5.

It is, then, plain that beneath the two parts of it there is, after all, one "Rule in *Foss v. Harbottle*" and the limits of that Rule lie along the boundaries of majority rule. At first sight, this is a terrifying prospect for the minority, since it has been asserted that the majority can ratify any act which is intra vires the corporation itself, even if it be an act in breach of the internal agreement, i.e. in the case of a company, the articles of association.<sup>3</sup>

Because of this possibility of majority abuse, the courts developed four exceptions to the Rule in *Foss v. Harbottle*.<sup>4</sup>

I have previously discussed the fraud on the minority exception but it is now appropriate to consider the personal rights exception, the reason being that this exception, as held in *Stanham v. National Trust of Australia*<sup>5</sup> has the potential to overcome many of the problems associated with the Rule in *Foss v. Harbottle*. The Supreme Court of New South Wales considered that if every matter in the articles of a company was elevated to the status of a contractual right vested in each and every member, the Rule in *Foss v. Harbottle* could be completely disregarded.

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<sup>3</sup> K.W. Wedderburn, "Shareholder Rights and the Rule in *Foss v. Harbottle*" [1957] *C.L.J.* 194 at p.198-9.

<sup>4</sup> For a list of those exceptions see Chapter 2.

The major difficulty with this exception however, is that the distinction between a personal action and a derivative action (that is an action brought by shareholders to recover on behalf of the company) is unclear and ill-defined. As Beck states:

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 which may well mean that his grievance will go unremedied ... The critical threshold question in shareholder litigation, therefore, is whether the action is personal or derivative.<sup>6</sup>

This chapter therefore aims to examine the personal rights exception to the rule, "a field which although perhaps best regarded as lying outside the ambit of the rule, has often become entangled with aspects of it and which, like the other exceptions, has many uncertain boundaries".<sup>7</sup>

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<sup>5</sup> (1989) 7 A.C.L.R. 628.

<sup>6</sup> S Beck, *op. cit.* at pp. 168-9.

<sup>7</sup> C. Baxter, "The Role of the Judge in Enforcing Shareholder Rights", (1983) 42 C.L.J. 96.

The first aspect to consider is the problem associated with distinguishing personal and corporate rights. Directors owe their fiduciary duties to the company.<sup>8</sup> Accordingly, any wrong committed by a director results in a cause of action arising in the corporation. Following from this, it has only been in the most limited circumstances where a shareholder's personal rights have been recognised.

Personal rights can arise from a number of sources. They can arise from the s.180 contract<sup>9</sup> or from some other source such as statute, independent service contract, the jurisdiction of equity or tortious principles.

Examples of personal rights which the courts have already accepted include:

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<sup>8</sup> *Percival v. Wright* [1902] Ch. 421.

<sup>9</sup> S. 180 of the *Corporation Law* states:

Subject to this Law, the Constitution of a company have the effect of a contract under seal -

- (a) between the company and each member;
- (b) between the company and each eligible officer; and
- (c) between a member and each other member

under which each of the above mentioned persons agrees to observe and perform the provisions of the constitution as in force for the time being so far as these provisions are applicable to that person.



1. The right to inspect the register of members.<sup>10</sup>
2. The right to vote at general meetings unless the articles deny that right.<sup>11</sup>
3. The right to protect preferential rights and class interests.<sup>12</sup>
4. The right to informative notice of meetings.<sup>13</sup>
5. The right to enforce a declared dividend as a legal debt.<sup>14</sup>
6. The right to have his or her voting rights protected or at least not diluted.<sup>15</sup>

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<sup>10</sup> *Mutter v. Eastern and Midlands Railway Co.* (1888) 38 Ch.D. 92 at p.104.

<sup>11</sup> *Pender v. Lushington* (1877) 6 Ch.D. 70 at p.81.

<sup>12</sup> *Greenhalge v. Arderne Cinemas* [1945] 2 All E.R. 719.

<sup>13</sup> *Kaye v. Croyden Tramways* [1898] 1 Ch. 358.

<sup>14</sup> *Godfrey Phillips Ltd. v. Investment Trust Ltd.* [1953] Ch. 449 at p.457.

<sup>15</sup> *Residues Treatment and Trading Co. Ltd. v. Southern Resources Ltd.* (1988) 14 A.C.L.R. 569.

7. The right under the *Corporations Law*, s.777 to seek enforcement of stock exchange listing rules against the company.

Beyond these accepted personal rights there has been three areas where the distinction between personal rights and corporate rights has caused difficult problems:

- (i) Internal Procedural Irregularities;
- (ii) Outsider Rights; and
- (iii) Issuing of Shares.

I will now discuss each of these in turn. I will then deal with the question of whether the general meeting can ratify a wrong done to an individual shareholder. In the next chapter, the minority shareholder's action in tort will also be considered.

#### Internal Procedural Irregularities

Drury comments that:

If a shareholder did have an unrestricted right to sue to force the company to adhere to every provision of the company contract, then he could always bring an action to set aside any resolution of the general meeting obtained where there had been some breach, however, trifling, of the provisions of the articles relating to notice, the appointment of the chairman or the like ... However company law does not grant to a member an unrestricted right to sue. The doctrine of majority rule enshrined in the decision of *Foss v. Harbottle* and subsequent cases appears to provide that, where the irregularity complained of relates to the internal management of the company, an individual shareholder cannot bring an action in his own name because the company itself is the proper plaintiff.<sup>16</sup>

Against this statement is a line of cases, where in certain circumstances a breach of a procedural matter has allowed a personal action for a shareholder.<sup>17</sup>

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<sup>16</sup> R.R. Drury, "The Relative Nature of a Shareholder's Right to Enforce the Company Contract", [1986] *C.L.J.* 219 at p.237.

<sup>17</sup> See for example the discussion by K.W. Wedderburn *op. cit.* at p.210-211 and in particular, *Spencer v. Kennedy* [1926] Ch. 125, *Henderson v. Bank of Australasia* (1890) 45 Ch.D. 330 and *Breay v. Browne* (1891) 41 S.J. 159 at p.160.

The difficulties in identifying where a personal action may lie can be seen by contrasting two decisions *Pender v. Lushington*<sup>18</sup> and *McDougall v. Gardiner (No. 2)*.<sup>19</sup>

In *Pender v. Lushington* a majority shareholder transferred his votes to nominees to overcome an article restricting each shareholder to a maximum of 100 votes irrespective of how many shares were held. The nominees were permitted under the articles to vote but their vote was disallowed by the chairman of the meeting. The Court held that the nominee did have standing to sue:

This is an action by Mr. Pender for himself. He is a member of the company and whether he votes with the majority or the minority he is entitled to have his vote recorded - an individual right in respect of which he has a right to sue. That has nothing to do with the question like that raised in *Foss v. Harbottle*.<sup>20</sup>

This case can be contrasted with *McDougall v. Gardiner (No. 2)* where a shareholder suing on behalf of himself and all other shareholders, except the directors, sought a declaration that decisions taken at a general meeting were invalid and an

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<sup>18</sup> (1877) 6 Ch.D. 70.

<sup>19</sup> (1875) 1 Ch.D. 13.

<sup>20</sup> (1877) 6 Ch.D. 70 at p.81.

injunction to restrain the implementation of the decisions. The articles provided for the taking of a poll at the general meeting if demanded by five shareholders. This was done, but the chairman declined to take a poll. The court refused relief on the basis that the irregularity was such that the general meeting could condone:

In my opinion, if the thing complained of is a thing which in substance the majority of the company are entitled to do or if something has been done irregularly which the majority of the company are entitled to do regularly, or if something has been done illegally which the majority of the company are entitled to do legally, there can be no use in having litigation about it, the ultimate end of which is only that a meeting has to be called, and then ultimately the majority gets its wishes.<sup>21</sup>

The effect of the decision of the Court was to postpone a vote on a matter which the plaintiffs considered important, and which it is probable that they would have won. In practical terms the Court denied the plaintiffs their vote, something which the Court in *Pender v. Lushington* said could not be done.

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<sup>21</sup> (1875) 1 Ch.D. 13 at p.25-6.

This issue has arisen in Australia in the decision of *Kraus v. Lloyd*.<sup>22</sup> In this case A. and B. had been directors of a proprietary company. It was agreed that upon the death of B, B.'s widow would be entitled to be a director. Upon B.'s death, A. appointed his own wife to be a director. She continued to act as director and A. refused to allow B.'s widow to become a director, or to appoint further directors as authorised by the articles. In addition to this there were allegations that A. had acted without a proper quorum. The Victorian Supreme Court held that B.'s widow was entitled to a declaration that A.'s wife was not entitled to be a director and an injunction to restrain A. and his wife from continuing their conduct in breach of the articles. The rights of B.'s widow that were being infringed were individual membership rights and to, "allow the majority to act as if the articles had been altered is to deprive the minority shareholders of their right to have the company run according to the rules by which the company and each of the members are contractually bound".<sup>23</sup>

Many attempts have been made at a reconciliation of these authorities<sup>24</sup> but it is Baxter,<sup>25</sup> who I would submit has provided the most satisfactory rationale:

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<sup>22</sup> [1965] V.R. 232.

<sup>23</sup> S. Beck, *op. cit.* at p.191.

<sup>24</sup> See the discussion by R.R. Drury, *op. cit.* at p.240 ff.

<sup>25</sup> C. Baxter, *op. cit.* at p.97-98.

The field has proved a happy hunting-ground for commentators wishing to choose distinctions. The general trend of opinion is to advance the cause of the somewhat more numerous Pender cases, saying variously that shareholders should always be able to sue for a breach of their company's constitution unless precluded by authority or policy, that the MacDougall authorities are unreliable in that most of them were decided before the Pender ideas were fully developed and that they have been so circumscribed as to present only an insignificant and unwarranted indentation in the Pender lines.<sup>26</sup>

Baxter then goes on to submit that the authorities can be reconciled by the principle that the court will intervene where:

- (1) [A] dispute situation has arisen in which it is impossible or impracticable for the members of the body to sort things out for themselves; and
- (2) there is something that the court can do about it.<sup>27</sup>

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<sup>26</sup> C. Baxter, *op. cit.* at p.97-98.

<sup>27</sup> C. Baxter, *op. cit.* at p.98.

In essence, the minority shareholder may be able to seek a remedy for a procedural irregularity utilising the s.180 contract where the matter is appropriate for judicial intervention. What must be identified is those cases appropriate for judicial intervention.

The first point to make is that the courts should not be concerned with procedural irregularity, unless the irregularity was such that the vote at the meeting may have been influenced.<sup>28</sup> Having ascertained this, the court should allow the individual shareholder to sue where on the given facts of that case the matter is inappropriate to refer that minority shareholder's claim to the decision of a simple majority in general meeting:

It is after all only a return to ancient principle to ask as "the first question" ... whether the general body of shareholders could not sanction such an act. If they could a single shareholder cannot object ... This was the principle of *Foss v. Harbottle*.<sup>29</sup>

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<sup>28</sup> See the comments by R.R. Drury, *op. cit.* at p.241 ff and C. Baxter, *op. cit.* at p.105 ff.

<sup>29</sup> K.W. Wedderburn, *op. cit.* at p.215. See Chapter 2.



### Outsider Rights

There is no doubt that s.180 of the *Corporations Law* establishes a binding contract between the company and each member.<sup>30</sup> However, to what extent does s. 180 allow a shareholder to enforce a right which affects that shareholder in a capacity other than as a member, for example, solicitor, accountant or governing director?<sup>31</sup>

There has been three views in this area. Lord Wedderburn's view is that, "a member can compel the company not to depart from the contract with him under the articles, even if that means indirectly the enforcement of 'outsider' - rights vested either in third parties or himself, so long as, but only so long as, he sues qua member and not qua 'outsider'".<sup>32</sup>

The opinion of Lord Wedderburn is supported by a line of cases best represented by *Quin and Axtens Ltd. v. Salmon*.<sup>33</sup> In *Quin and Axtens v. Salmon* the articles of association of a

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<sup>30</sup> *Hickman v. Kent or Romney Marsh Breeders Association* [1915] 1 Ch. 881.

<sup>31</sup> Throughout this paper I will use the term outsider right to denote "a right or power bestowed by the memorandum or articles on a person otherwise than in his capacity as a member of the company" - per G.A. Goldberg, "The Enforcement of outsider-Rights under Section 20(1) of the Companies Act 1948" (1972) 35 *M.L.R.* 362 at p.364; Goldberg was adopting the expression of Lord Wedderburn, *op. cit.* at p.208.

<sup>32</sup> K.W. Wedderburn, *Op. Cit.* at p.212-213.

<sup>33</sup> [1909] 1 Ch. 311; affd [1909] A.C. 442: other cases cited by Wedderburn, *op. cit.* at p.212 that support this view include *Edwards v. Halliwell* [1950] 2 All E.R. 1064; *Catesby v. Burnett* [1916] 2 Ch. 325 and *Wood v. Odessa Waterworks* (1990) 42 Ch. D. 636.

registered company delegated the management of the company to the directors. However, Article 80 provided that no resolution of the directors upon a number of matters should be valid unless notice had been given, "to each of the managing directors" (A. and S.) and neither had dissented. S. had dissented from a decision within the purview of Article 80. Nevertheless, a simple majority of shareholders passed a resolution confirming the decision of the directors. The English Court of Appeal held that S. had the right to obtain an injunction restraining the company from acting inconsistently with the articles of association. Importantly, Salmon sued in the representative form. Thus, the Court could see that Salmon was protecting a right which was common to all the members. "It is therefore obvious that Salmon enforced the right of a member to have the articles observed by the company."<sup>34</sup>

By contrast to Wedderburn's view, Professor Gower states:

... the memorandum and articles have no direct contractual effect in so far as they purport to confer rights or obligations on a member otherwise than in his capacity of a member ... <sup>35</sup>

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<sup>34</sup> K.W. Wedderburn, *op. cit.* at p.212.

<sup>35</sup> L.C.B. Gower, *The Principles of Modern Company Law*, 2nd ed. Stevens and Sons, 1957 at p.252.

A case illustrating this principle is *Eley v. Positive Government Security Life Assurance Co.*<sup>36</sup> In this case, Article 118 of the Articles of Association provided that the plaintiff should be the company's solicitor, transact all the company's legal business and be removed only for misconduct. The company, however, began to employ other solicitors in place of Eley despite there being no allegation of impropriety. Eley, who was also a member of the company sued for breach of the contract incorporated by the articles. He was unsuccessful, the court holding the memorandum and articles conferred no contractual effect in so far as they confer outsider-rights.<sup>37</sup>

As Goldberg states, "[o]bviously there could be no reconciliation of such contradictory opinions,"<sup>38</sup> and Wedderburn himself admits that his view is in conflict with cases such as *Eley v. Positive Life Assurance Co.*<sup>39</sup>

Goldberg submits that there is a middle way which will allow the cases to be reconciled:

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<sup>36</sup> (1875) 1 Ex. D. 20, affd. (1876) 1 Ex. D. 88.

<sup>37</sup> Other cases supporting this line of authority include *Browne v. La Trinidad* (1887) 37 Ch.D. 1; *Re Dale and Plant Ltd.* (1889) 61 L.T. 206 and *Beattie v. Beattie Ltd.* [1938] Ch. 708.

<sup>38</sup> G.D. Golding, *op. cit.* at p.362.

<sup>39</sup> K.W. Wedderburn, *op. cit.* at p.212-3.

A member of a company has under [s.180] of the Act a contractual right to have any of the affairs of the company conducted by the particular organ of the company specified in the Act or the company's memorandum or articles, even though the enforcement of that right ... may incidentally enforce also a right or power bestowed by the memorandum or articles on a person in a capacity otherwise than as a member of the company.<sup>40</sup>

Goldberg's view, while attractive in that the two lines of authorities can be reconciled, has attracted the criticism of Drury, who comments:

Now it may or may not be true that the rationes decidendi of the conflicting cases can be reconciled by the adoption of Goldberg's elegant reasoning, but it certainly is true that such a technical formulation was not present in the minds of the judges, and never formed part of the basis on which they made their decisions.<sup>41</sup>

Drury is able to resolve the authorities by an approach which I suggest, consistent with the cases but also sound on principle.

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<sup>40</sup> G.D. Goldberg, *op. cit.* at p.363.

<sup>41</sup> R.R. Drury, *op. cit.* at p.227-8.

He adopts a relational approach to outsider rights, and submits that:

[I]t becomes possible to suggest that a member does have a contractual right to have a particular provision in the company's memorandum or articles observed but that this right is equal to the rights of every other member to have alternative or inconsistent articles observed, or ultimately to seek a change in the articles.<sup>42</sup>

Thus under this approach the plaintiff will be able to enforce the company's articles, unless 75% of the shareholders of the company are able to solve the dispute by altering the articles, or another member is seeking to enforce an alternative or inconsistent article.

This approach by Drury recognises that the answers to the problems can be found by considering and contrasting the competing rights of the minority and majority shareholders to fit the particular circumstances of the case before the court rather than just an absolute enforcement of either the personal right of the minority shareholder, or the right of the majority to pass simple resolutions which would condone a breach of the articles.

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<sup>42</sup> R.R. Drury, *op. cit.* at p.229.

### Improper Issue of Shares

Many cases have arisen in relation to the issuing of shares by directors to forestall a takeover. If it is accepted that this is an improper purpose, can an individual shareholder bring a personal action to prevent the issuing of those shares? Or is it by necessity a derivative action, as the directors owe their fiduciary duties to the company and to the company alone?

The first case that I wish to consider is *Hogg v. Cramphorn*.<sup>43</sup> In this case the defendant company carried on a business which had previously been conducted in an unincorporated form by Cramphorn. Cramphorn was approached by Baxter who sought to obtain control of Cramphorn Ltd. Cramphorn considered that if Baxter obtained control there would be a harmful change in the nature of the company's business, and also that Baxter would have an unsettling effect on the company employees. Cramphorn informed his fellow directors of Baxter's intention. The directors issued 5,707 shares to three trustees, Cramphorn, the company accountant, and a representative of the staff. The trust was set up for the benefit of the employees. The voting rights attached to the shares ensured that the directors, their supporters and the trustees would have the major voting power in the company.

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<sup>43</sup> [1967] Ch. 254.

The directors then informed Baxter that they considered his offer to be inadequate. Baxter allowed his bid to lapse but an associate, Hogg, holding some 50 shares, challenged the issue of shares to the trustees on the basis of an improper exercise of power.

Buckley J. ruled that the issue of shares was done for an improper purpose and was therefore liable to be set aside:

A majority of shareholders is entitled to pursue what course it chooses within the company's powers, however wrong-headed it may appear to others provided the majority do not unfairly oppress other members of the company. These considerations lead me to the conclusion that the issue of 5,707 shares, with the special voting rights which the directors purported to attach to them could not be justified by the view that the directors genuinely believed that it would benefit the company if they could command a majority of the votes in general meetings ... The power to issue shares was a fiduciary one and if, as I think, it was exercised for an improper motive, the issue of these shares is liable to be set aside.<sup>44</sup>

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<sup>44</sup> *Id.* at p.268-9.

Buckley J. also held that the allotment to the trustees could be ratified by the general meeting, provided that the disputed shares were not voted. The company accordingly ratified the issue of shares.

Buckley J. did not discuss the issue of the standing of Hogg. On the one hand as the directors owe their fiduciary duty to the company, the issue of shares was a wrong done to the company and the company alone had a right to seek redress.

Accordingly, for Hogg to sue, the action must have been derivative, and presumably there was a fraud on the minority.

On the other hand, it could be argued that if the directors do not act for a proper purpose, their actions are in breach of the statute and/or articles and memorandum of association, and thus Hogg had a personal right to bring the action. It is unclear from the judgment what was Hogg's capacity.<sup>45</sup>

The questions surrounding an allotment of shares to defeat a takeover bid were again raised in *Bamford v. Bamford*.<sup>46</sup> In this case the articles of Bamford Company vested the power to issue shares in the directors. In response to a takeover bid they issued a substantial block of shares. A general meeting of the company at which full and frank disclosure was made, and at which the contested shares were not voted resolved to ratify the

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<sup>45</sup> For alternate views as to whether it was derivative or personal, see Wedderburn (1967) 30 *M.L.R.* 80 and L.C.B. Gower, *The Principles of Modern Company Law*, 4th ed., Stevens and Sons, 1979 at p.655.

<sup>46</sup> [1969] 1 All E.R. 969.



allotment. The issue before the Court was not whether the directors had exceeded their powers, (it was assumed that they had) but whether the shareholders could ratify the issue. The action was brought as a representative suit with the plaintiff shareholders suing on behalf of themselves and all other shareholders apart from the defendant directors.

At first instance the action was treated as a personal action to enforce the contract in the articles between the members and the company created by s.20 of the *English Companies Act 1948*.<sup>47</sup>

The Court of Appeal also implicitly accepted that the action was personal,<sup>48</sup> and again the rule in *Foss v. Harbottle* was virtually ignored. Russell J.A., when discussing ratification stated:

The point before us is not an objection to the proceedings on *Foss v. Harbottle* grounds. But it seems to march in step with the principles that underlie the rule in that case.<sup>49</sup>

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<sup>47</sup> The English equivalent of our s.180 of the *Corporations Law*.

<sup>48</sup> See the comments by S.M. Beck, *op. cit.* at p.175.

<sup>49</sup> [1969] 1 All E.R. 969 at p.976.

Beck suggests that, "that the analogy,...to *Foss v. Harbottle* for the purpose of deciding the ratification point was unfortunate".<sup>50</sup>

In Australia the High Court has considered that an improper allotment of shares does give rise to a personal action. In *Ngurli v. McCann*<sup>51</sup> the High Court decided that the directors of the company had breached their fiduciary duty in issuing new shares without considering the interests of the company as a whole, and accordingly, "the plaintiffs have a clear right to sue in their own names to remedy the breach of trust".<sup>52</sup> The problem with the approach of the High Court is that they relied on the decisions of the Privy Council in *Burland v. Earle*<sup>53</sup> and *Cook v. Deeks*<sup>54</sup> and in both those actions, the suit by the shareholders was derivative.<sup>55</sup>

In addition to this case there has been a number of other Australian decisions in this area where the rule in *Foss v.*

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<sup>50</sup> S.M. Beck, *op. cit.* at p.175.

<sup>51</sup> (1954) 90 C.L.R. 425.

<sup>52</sup> *Id.* at p.447.

<sup>53</sup> [1902] A.C. 83.

<sup>54</sup> [1916] 1 A.C. 554.

<sup>55</sup> See the comments by S.M. Beck, *op. cit.* at p.176.

*Harbottle* has had little or no role to play in the judgment.<sup>56</sup> As

Baxt comments:

For many years that case, or rather the rule in that case, was hardly mentioned in the most often litigated area of corporate law involving directors - the charge that directors were using their powers for an improper purpose in issuing or allotting shares. It seemed "almost" that an agreement had been struck between lawyers on both sides of the cases, that it would be of little use to raise that procedural rule in this type of situation. If one looks at the classic cases involving the question of misuse of corporate power in the issue of shares, and indeed in other cases involving defensive tactics, there is hardly a mention of *Foss v. Harbottle*.<sup>57</sup>

In two recent Australian cases, the rule in *Foss v. Harbottle* has again been raised by counsel and discussed by the judiciary.<sup>58</sup>

The first of these decisions is *Eromanga Hydro Carbons N.L. v. Australian Mining N.L.*<sup>59</sup>. In that case:

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<sup>56</sup> See, for example, *Mills v. Mills* (1938) 60 C.L.R. 150, *Winthrop Investments Ltd. v. Winns* [1975] 2 N.S.W.L.R. 666 and *Whitehouse v. Carlton Hotel Pty. Ltd.* (1987) 162 C.L.R. 285.

<sup>57</sup> R. Baxt, "Is the Rule in *Foss v. Harbottle* dead and buried" (1987) 7 *Company. & Sec. L.J.* 199.

<sup>58</sup> The two decisions are *Residue Treatment v. Southern Resources Ltd.* (1988) 14 A.C.L.R. 569 and *Eromanga Hydrocarbons v. Australis Mining* (1988) 14 A.C.L.R. 486.

<sup>59</sup> (1988) 14 A.C.L.R. 486.

It was suggested obiter ... that the allotment by directors of shares for an improper purpose (such as to preserve their position on the board, by vesting effective control in a party or parties) may infringe a personal right of a minority shareholder.<sup>60</sup>

As stated by Malcolm C.J.:

In terms of that contract [created between the company and the members by the memorandum and articles of association] it has been suggested that if the directors acting as delegates of the company act otherwise than in good faith they render the company and themselves amenable to suit at the instance of an individual shareholder.<sup>61</sup>

However, in that case, Malcolm C.J. considered that the rule in *Foss v. Harbottle* was not to be applied despite the plaintiff not coming within any of the recognised exceptions to the rule in *Foss v. Harbottle*. Malcolm C.J. was not prepared to throw the plaintiff out of court at this stage - to do so would have required a detailed examination of facts in order to determine whether

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<sup>60</sup> P. Gillies, *The New Company Law*, Federation Press, 1989 at p. 234.

<sup>61</sup> (1988) 14 A.C.L.R. 486 at pp. 491-2.

there was standing. Malcolm C.J. was not prepared to do this at the preliminary stage.<sup>62</sup>

The second recent decision in this area, *Residues Treatment & Trading Co. Ltd. v. Southern Resources Ltd.*<sup>63</sup> has been described as being of "exceptional importance to the general law remedies of minority shareholders".<sup>64</sup>

Residues was a shareholder in the defendant company. They argued that the directors of Southern Resources had breached their duty to act in the best interests of the company, by issuing shares to defeat a takeover. The defendant company argued that as the matter was one which could be ratified,<sup>65</sup> the plaintiff therefore had no standing.

Residues, however, argued that if the shareholders in general meeting had the same improper purpose as the directors, then such ratification would not exclude the matter.

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<sup>62</sup> The approach of Malcolm C.J. echoed that undertaken by the Southern Australian Supreme Court in *Hurley v. B.G.H. Nominees Pty. Ltd.* (1982) 6 A.C.L.R. 791; cf. *Prudential Assurance v. Newman Industries* [1982] 1 Ch. 204; see Chapter 2.

<sup>63</sup> (1988) 14 A.C.L.R. 569.

<sup>64</sup> A.G. Diethelm, "Impugned Share Allotments and the Rule in *Foss v. Harbottle*" (1989) 5 *Australian Bar Review* 262.

<sup>65</sup> See for example *Hogg v. Cramphorn* [1967] Ch. 254 and *Bamford v. Bamford* [1970] Ch. 212.

The Full Court of the South Australian Supreme Court upheld the plaintiff's claim:

The case is authority for the proposition that a share allotment made by directors in breach of their fiduciary duty to exercise powers for proper purposes, and which has the effect of diluting a shareholder's voting power, is an infringement of a personal right vested in that shareholder; and that consequently the member has standing to bring proceedings to avoid the allotment or to restrain a threatened allotment notwithstanding the rule in *Foss v. Harbottle*.<sup>66</sup>

The importance of this decision is that the court held that the right to sue was based in equity, rather than the statutory contract embodied in s.180 of the Code. In the words of King C.J.:

The personal right of a shareholder to which I refer is founded, in my opinion, upon general equitable considerations ... arising out of membership of a body whose management is in the hands of directors having fiduciary obligations. It is fortified by the nature of the contract between the company and the members

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<sup>66</sup> A.G. Diethelm, *op. cit.* at p.262.

constituted by the Memorandum and Articles of Association and given statutory force by [s.180] of the [*Corporations Law*]. I do not mean that the relevant right of a shareholder is founded in contract or that his remedies for infringement are remedies for breach of contract. The shareholder's right is founded in equity and is a right to have the say in the company which accrues to him by virtue of the voting rights which are attached to his shares by his contract with the company, preserved against improper actions by the company or the directors who manage its affairs.<sup>67</sup>

The decision of the South Australian Supreme Court while not supported by authority<sup>68</sup> is consistent with principle. The articles of association will generally stipulate what powers the directors can undertake, but it will not stipulate the purposes for which the power can be employed. As such there is no breach of contract, the wrong is created by a breach of fiduciary obligations, that is by equity. "It is only because they are fiduciaries that they are bound to exercise that power in good faith for the purpose for which it was conferred, that is for the benefit of the company."<sup>69</sup>

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<sup>67</sup> (1989) 14 A.C.L.R. 569 at p.574.

<sup>68</sup> King C.J. noted that there were no authorities which were decisive on this point; *Ibid*.

<sup>69</sup> A.G. Diethelm, *op. cit.* at p.265.

The importance of this finding that the personal right is based in equity has the consequence that it can then be said that the directors' fiduciary duties include the duty not to issue shares for improper purposes which will result in a dilution of a shareholder's voting power. In essence the case recognises that directors can sometimes owe a fiduciary duty to individual shareholders.

#### Statutory Provisions Relevant to this Issue

The issues in these cases surrounding the allotment of shares may have been avoided by relying on s. 212 of the *Corporations Law*.

Section 212 of the *Corporations Law* provides *inter alia* that if;

(b) an entry is made in the register without sufficient cause;

(c) an entry wrongly exists in the register;

(d) there is an error or defect in an entry in the register;



a person aggrieved, a member of the company may apply to the court for rectification of the register.

The Court is given by s.212(2) a wide discretion to decide any matter with respect to rectification of the register.

As stated by Baxt s.212 is, "seldom used but can be a bargaining tool in the appropriate circumstances as was noted by King C.J. in the *Residue Treatments* case".<sup>70</sup>

There are possibly two major reasons why the section has not been used in this area; first, the majority view is that the section is procedural only and therefore does not confer any substantive rights, and is thus subject to the rule in *Foss v. Harbottle*<sup>71</sup> and second, in most of the cases that involved an improper issue of shares the action is brought to stop the issue and allotment, or to stop a general meeting brought to ratify the directors' decision to issue. These actions precede any entry onto the register, and thus s.212 will have no application.

Section 1324 of the *Corporations Law* may also be a useful provision in this area. Indeed Baxt comments that:

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<sup>70</sup> R. Baxt, "Will Section 574 of the Companies Code Please Stand Up!" (1989) 7 *Company. & Sec. L.J.* 388 at p.392.

<sup>71</sup> See the discussion by Diethelm, *op. cit.* at p.267.

If appropriate use is made of [s.1324] of the *Corporations Law* in the relevant case it is my view that the problems which may be thrown up by the operation of the rule in *Foss v. Harbottle* would be insignificant - indeed probably non-existent.<sup>72</sup>

The directors in issuing shares to defeat a takeover bid may be susceptible to allegations that their actions constitute a breach of duty by the directors on the basis that they are not acting in the best interests of the company. Section 232(1) of the *Corporations Law* requires that "An officer of a corporation shall at all times act honestly in the exercise of his powers and the discharge of the duties of his office". By s.232, an officer includes a director. The question to be raised is whether there is any nexus between this section and the fiduciary duty to act in the best interests of the company. In *Marchesi v. Barnes*, Gowans J. stated:

To act honestly refers to acting bona fide in the interests of the company in the performance of the functions attaching to the office of director. A breach of the obligation to act bona fide in the interests of the company involves a consciousness that what is being done is not in the

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<sup>72</sup> R. Baxt, "Will s.574 of the Companies Code Please Stand Up" (1989) 7 *Company and Sec. L.J.* 388.

interests of the company, and deliberate conduct in disregard of that knowledge.<sup>73</sup>

Further support for a correlation between the duty to act honestly and the duty to act in the best interests of the company stems from s. 232(11) which states that:

This section has effect in addition to, and not in derogation of, any rule of law relating to the duty or liability of a person by reason of his office or employment in relation to a corporation and does not prevent the institution of any civil proceeding in respect of a breach of such a duty or in respect of such a liability.

Therefore, the rule in *Foss v. Harbottle* could be disregarded in this area, if s.1324 was utilised by practitioners and then given a wide interpretation by the judiciary. "One would be surprised to see the section being ignored to the same extent in the next eight years"<sup>74</sup> (as it has been in the last eight years).

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<sup>73</sup> [1970] V.R. 434 at p.438.

<sup>74</sup> R. Baxt, "Will s.574 of the Companies Code Please Stand Up" at p. 398.

### Ratification

A further issue that arises here is the extent to which a personal action by a minority shareholder can be sustained where a majority of members has authorised, is, or is proposing to, authorise a breach of fiduciary duty by the directors. This question was raised, but not answered in *Winthrop v. Winns*.<sup>75</sup>

The question remains therefore whether it is open to the shareholders in general meeting to elect to affirm a transaction which is voidable because of the directors' collateral purpose, notwithstanding that, for example, the shareholders have the same collateral purpose, or whether a shareholders' resolution, that such a transaction be affirmed is, if passed for the purpose of defeating the takeover, ineffective as not being for the benefit of the company as a whole within the principles in *Ngurli Ltd. v. McCann*.<sup>76</sup>

This issue was also considered in *Residues Treatment v. Southern Resources Ltd.* Prior to the Full Court of South Australia hearing this matter the general meeting had passed resolutions to the effect that the allotment of shares be approved and ratified. The Full Court having decided that the plaintiffs had personal rights capable of being asserted raised the issue of

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<sup>75</sup> [1975] 2 N.S.W.L.R. 666.

<sup>76</sup> *Id.* at p.702.

whether such rights could be extinguished by the general meeting.

The Full Court resolved not to determine this question; King C.J. commenting that:

[I]t is by no means clear to me that the allotment in question, if made for an improper purpose alleged, is capable of ratification ... If it is correct that a shareholder has a personal right to have the voting power of his shares undiminished by an allotment of shares made for an improper purpose, there is to my mind a substantial argument that an exercise of the voting power of the majority to ratify such an allotment would be beyond the scope of the purpose for which that power exists. This is an issue which may have to be resolved at trial.<sup>77</sup>

However, if one approaches this question from principle then surely the matter is not capable of ratification. "Otherwise the very recognition of the personal equity is rendered nugatory ... The personal right makes no sense unless it is immune from destruction by the majority".<sup>78</sup>

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<sup>77</sup> (1989) 14 A.C.L.R. 569 at p.577.

<sup>78</sup> A.G. Diethelm, *op. cit.* at p.275-6.

Finally, I would note that if the minority shareholder brings an action via s.1324 of the *Corporations Law* then there could be no ratification of such a breach of duty. As Baxt comments:

Whilst ratification of common law breaches of duty is recognised, such a course of action could not apply to ratification of a breach of statutory duty. It would seem highly unlikely that the courts would recognise that the shareholders in general meeting, even if they were acting unanimously (apart from the complaining shareholder) could ratify a course of conduct which amounted to a breach of the statute.<sup>79</sup>

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<sup>79</sup> R. Baxt, "Will s.574 of the Companies Code Please Stand Up" at p.395.

## CHAPTER 7

### THE MINORITY SHAREHOLDER'S REMEDY IN TORT

Another avenue for the minority shareholder in attempting to recover on behalf of the company, while avoiding the problems associated with the fraud on the minority exception to the Rule in *Foss v. Harbottle* and s.260, is to attempt to bring a personal action in tort. The minority shareholder would be submitting that the wrong to the corporation has resulted in a wrong to him personally by way of an diminution in the value of his shareholding. The advantage of using a tortious remedy would be that the restrictive conditions of the exceptions to the Rule in *Foss v. Harbottle* and any problems associated with the statute would be negated as the minority shareholder would not be seeking to act on behalf of the company nor would he be seeking a remedy on their behalf but he would be attempting to obtain a personal remedy. Therefore, the minority shareholder is able to avoid the problem of establishing standing at common law and he will not be required to show control of the general meeting by the wrongdoers.

The major authority to consider this question is *Prudential Assurance Co. v. Newman Industries Ltd.*<sup>1</sup> In this case

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<sup>1</sup> [1980] 2 All E.R. 841 (Vinelott J. Trial Judge).

[1982] Ch. 204 (Court of Appeal).

Prudential Assurance had a small minority shareholding in Newman Industries. Prudential Assurance alleged that two directors of Newman Industries had conspired to sell the assets of a company known as T.P.G. (in which they had a substantial interest) to Newman Industries at an overvaluation. There were further allegations that misleading information had been distributed by the directors. Prudential Assurance in addition to a derivative action<sup>2</sup> brought a representative personal action seeking a declaration that an unlawful conspiracy had occurred, and an individual personal action claiming damages in respect of their own loss arising from the conspiracy.

Vinelott J., at first instance, allowed Prudential's claim for a declaration and ordered an inquiry into the damage suffered by Prudential. In His honour's opinion the conspiracy had resulted in Newman Industries paying 445,000 pounds more than the value of the assets that it had acquired:

Newman therefore lost the interest on 445,000 pounds and to the extent of that interest its profits were less than they would otherwise have been. That reduction in profit or net earnings must, in turn, have affected the prices at which shares of Newman changed hands and, therefore, the quoted price...the evidence adduced by the Prudential is in my judgment sufficient to show that it (and other

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<sup>2</sup> See the discussion of this action in Chapter 2.



shareholders) have suffered some damage in consequence of the conspiracy and that is sufficient to complete their cause of action, the amount of the damage, being, if necessary, referred to an inquiry.<sup>3</sup>

The Court of Appeal reversed this aspect of the judgment of Vinelott J. Three principal reasons emerged from the joint judgment of Cumming-Bruce, Templeman and Brightmann L.JJ. The first reason was that a shareholder had only a right of participation in the affairs of the company on the terms of the articles of association. Accordingly, the shareholder did not suffer any loss which was separate and distinct from the loss suffered by the company. The second reason adopted by the Court of Appeal follows on from the first. As the company was a separate legal entity, any wrong to the company meant that the company alone had a cause of action. The third reason was based on "intrinsic hostility":<sup>4</sup>

In our judgment the personal aim is misconceived. [The minority shareholder] cannot recover a sum equal to the diminution in the market value of his shares, or equal to the likely diminution in dividend, because such a loss is merely a reflection of the loss suffered by the company. The shareholder does not suffer any personal loss...The

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<sup>3</sup> [1981] 2 All E.R. 841 at p.859.

<sup>4</sup> M.J. Sterling, "The Theory and Policy of Shareholder Actions in Torts" (1987) 50 *M.L.R.* 468 at p.469.

plaintiffs in this action were never concerned to recover in the personal action, the plaintiffs were only interested in the personal action as a means of circumventing the rule in *Foss v. Harbottle*...A personal action would subvert the rule in *Foss v. Harbottle* and that rule is not merely a tiresome procedural obstacle placed in the path of a shareholder by a legalistic judiciary. The rule is the consequence of the fact that a corporation is a separate legal entity.<sup>5</sup>

Given this strong statement by the Court of Appeal in *Prudential* it could be said that no personal action in tort will lie for a diminution in value of shares resulting from a wrong done to the company. As Sterling comments; "This development would be acceptable only if the existing structure of remedies for the protection of minority shareholders is adequate. There are suggestions that it is not".<sup>6</sup>

#### Problems with the existing remedies for minority shareholders

I will now further examine some of the defects of the fraud on the minority exception to *Foss v. Harbottle* and an action

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<sup>5</sup> [1982] 1 All E.R. 354 at pp. 366-367.

<sup>6</sup> M.J. Sterling, *op. cit.* at p.479.

pursuant to s.260 to determine if a personal action in tort can alleviate these defects.<sup>7</sup>

The fraud on the minority exception is defective in that it is uncertain as to the meaning of the concept of control.

Obviously control can be established by less than 51% of the voting stock but there is no clear definition as to what type of control will be recognised by the courts. Vinelott J. in *Prudential Assurance v. Newman Industries* adopted a liberal position as to when control could be shown. A minority shareholder could bring an action against directors who may only hold a small shareholding if the directors were in a position to manipulate their position so that an action would not be brought by the company:

[I]n ascertaining the view of the majority whether it is in the interests of the company that the claim be pursued, the court will disregard votes cast by shareholders who have an interest which directly conflicts with the interests of the company...it applies wherever the persons against whom the action is sought to be brought on behalf of the company are shown to be able 'by any means of manipulation of their position in the company' to ensure that the action is not brought by the company.<sup>8</sup>

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<sup>7</sup> For further comment of the defects of the rule in *Foss v. Harbottle*, see Chapter 2.

<sup>8</sup> [1980] 2 All E.R. 841 at p.874-875.

However Vinelott J.'s statement of the concept of control may not represent the law. The Court of Appeal in *Prudential Assurance v. Newman Industries* saw the rule in *Foss v. Harbottle* as essentially a rule about standing. The minority shareholder seeking to bring a derivative action should be required at the outset to establish a *prima facie* case that the company is entitled to the relief claimed and that the action falls within the proper boundaries of an exception to the rule in *Foss v. Harbottle*. In determining this *prima facie* case the allegations of fraud and control were not to be treated as facts. Importantly, the Court of Appeal considered that if the directors seek to strike out the action at the initial stage, it will not be assumed that the director is guilty of fraud so as to disentitle the director from casting his votes at a general meeting.<sup>9</sup>

There are however problems with this approach by the Court of Appeal. If the minority shareholder establishes a *prima facie* case he will more than likely obtain an indemnity for his costs from the company.<sup>10</sup> What happens if at the conclusion of a full trial it was revealed that although there had been a *prima facie* case of fraud on the minority by those in control, the breaches of duty were able to be ratified. "Company money would then have been used to pursue an action which the

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<sup>9</sup> See the comments by the Court of Appeal [1982] 1 All E.R. 354 at p.362.

<sup>10</sup> *Wallersteiner v. Moir* (No. 2) [1975] Q.B. 373.

controllers could have prevented *ab initio*".<sup>11</sup> To overcome this problem the courts may require a fairly detailed *prima facie* case; the difficulty with this is that the *prima facie* hearing will then resemble a full trial, and thus the basis of the rule in *Foss v. Harbottle*, the need to prevent needless litigation, will be defeated.<sup>12</sup>

The statutory equivalent to the derivative action, the litigation order obtained pursuant to s.260(2)(g), may be beset with the same type of the problem associated with the derivative action. Presumably the court will not make a litigation order unless they are satisfied that there is at least a *prima facie* case, and in determining this the court will have to balance the respective interests of the minority shareholder in challenging the conduct in question, and of the company in ensuring that corporate funds are not used to impugn conduct which ultimately is shown to be reasonable. Another major problem with a s.260 action is that the minority shareholder must still be a member to bring his action. What happens where oppressive conduct occurs which results in a drop in the market value of his shares and the minority shareholder sells his shares at less than market value and then learns of the oppressive conduct? He has no remedy under s.260, or via a derivative action as he is no longer a member. However, the former member may be able to purchase shares to allow him to instigate the appropriate action.

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<sup>11</sup> M.J. Sterling, *op. cit.*, at p.481.

<sup>12</sup> See the comments by M.J. Sterling, *op. cit.* at p.480-481.

This course of action may not be available with a quasi-partnership where it is quite common for directors to have the right to refuse to register a transfer of shares.

It is therefore submitted that because of the problems associated with the derivative action, and the s.260 action, there is a place for the introduction of a personal action in tort. This will be particularly helpful where the aggrieved person is a former shareholder, or where it cannot be shown that the directors have control of the company.

Working on the assumption that there is a role for the personal action in tort the first matter that needs to be considered is whether that personal action should be confined to torts of intention (such as deceit, conspiracy etc.), or whether it should extend to torts of negligence.

Derivative actions have not been available for negligent acts by directors.<sup>13</sup> Further there are some good reasons for not allowing a personal action for the negligent acts of directors. Firstly, litigation is likely to be expensive and time consuming<sup>14</sup> and companies run by incompetent management are liable to be

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<sup>13</sup> *Pavlides v. Jensen* [1956] Ch. 565; See the discussion in Chapter 2.

<sup>14</sup> See the comments by M.J. Trebilcock, "Liability of Directors in Negligence" (1969) 32 *M.L.R.* 499 at p.512.

taken over by people who can run them more efficiently.<sup>15</sup>

This market regulation of companies may however not be applicable to the incorporated partnership, and it is this type of company where a personal action in negligence may provide an incentive for management to better its performance. "On the other hand, if the shareholder does have such an action, every fall in the value of shares becomes potentially actionable and competent management may suffer undue harassment from cantankerous minorities."<sup>16</sup> On balance an action in negligence should probably only lie where the negligence results in a benefit to the wrongdoers, as is the case with derivative actions.<sup>17</sup> To decide otherwise may constitute an unwarranted interference in the supervision and management of companies.

To allow a personal action in tort "would be unacceptable if it were likely to lead to multiplicity of suits, prejudice to creditors and double recovery but the extent to which it would be likely to do so is open to a certain amount of doubt."<sup>18</sup>

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<sup>15</sup> See D.R. Fischel, "Efficient Capital Market Theory, the Market for Corporate Control and the Regulation of Cash Tender Offers" (1978) 57 *Tex. L.R.* 1.

<sup>16</sup> M.J. Sterling, *op. cit.* at p.483.

<sup>17</sup> See *Daniels v. Daniels* [1978] 2 W.L.R. 73; See Chapter 2.

<sup>18</sup> M.J. Sterling, *op. cit.* at p.485.

### Multiplicity of Suits

The danger of multiplicity of suits was recognised in *Gray v. Lewis*<sup>19</sup> where Lord Justice James, expressed the following:

One object of incorporating bodies of this kind was, in my opinion, to avoid the multiplicity of suits which might have arisen where one shareholder was allowed to file a bill on behalf of himself and a great number of other shareholders. The shareholder who first filed a bill might dismiss it, and if he was a poor man the defendant would be unable to obtain his costs, then another shareholder might file a bill, and so on. It was also stated to us in the course of the argument that even after the plaintiff had dismissed his bill against a particular defendant a fresh bill might be filed against the defendant so dismissed. Therefore there might be as many bills as there are shareholders multiplied into the number of defendants. The result would be fearful, and I think the defendant has a right to have the case against him by the real body who are entitled to complain of what he has done.<sup>20</sup>

This problem of multiplicity of suits can be overcome by the courts. As Sterling comments. "The arguments which have been put forward to justify refusal of such an action -

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<sup>19</sup> (1873) L.R. 8 Ch. App. 1035.

<sup>20</sup> *Id.* at p.1050-51.



multiplicity of suit(s)... seem to have been overstated and underestimate the power of the court to prevent abuse of its proceedings".<sup>21</sup> A court has an inherent jurisdiction to control an abuse of its process, and furthermore the rules of court generally allow for a representative personal action. For example in Tasmania, Order 18 Rule 9 of the *Rules of the Supreme Court* 1965 provides:

In any case in which seven or more persons -

- (a) have the same or a common right against the same person or persons;
- (b) have the same or a common interest or the like rights in, to, or in respect of the same fund or other property; or
- (c) otherwise have a common interest in any subject-matter or controversy,

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<sup>21</sup> M.J. Sterling, *Op. Cit.* at p.490.

one or more of such persons may (either in a cause or a matter) sue on behalf or for the benefit of all persons having any such right or interest.

This provision makes representative personal actions highly attractive as the liability for costs can be shared and thus avoids the possibility of full personal liability for costs.

### Double Recovery

The second reason for not allowing a personal action is the danger of double recovery. That is if a personal action succeeds, the corporation being a separate entity can also bring an action thereby placing the wrongdoers in a position of double jeopardy.

This possibility was recognised in the English decision of *Nurcombe v. Nurcombe*.<sup>22</sup> In this case a husband and wife were the only shareholders in a company. The husband held 66% of the shares. The husband allowed options held by the company to lapse. These options were then acquired by a second company which was under the control of the husband

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<sup>22</sup> [1985] 1 All E.R. 65.

through his second wife. The property subject to these options was then resold, the profit being in the region of 293,000 pounds. In divorce proceedings the first wife received "compensation" for the diminution in the value of her shares; the diminution resulting from the husband profiting at the expense of the first company. The first wife then brought derivative proceedings to recover the loss suffered by the first company. There was no doubt that the husband's conduct amounted to a breach of fiduciary duty and was thus fraudulent. Similarly, the element of control was satisfied. However, the Court of Appeal refused to allow her standing to bring derivative proceedings. In essence the majority in the Court adopted the clean hands doctrine to deny the wife any remedy. She was not seeking to do justice to the company but rather to feather her own nest. However, while this may be the appropriate result in that case, the situation would have been far more complicated had there been a third shareholder involved. This person would not have received compensation via the matrimonial proceedings and accordingly should have been entitled to bring a derivative action. Assuming that person was so entitled the first wife would have had double recovery as there would have been a rise in the value of her shares, as well as receiving compensation via the matrimonial proceedings.<sup>23</sup>

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<sup>23</sup> Presumably if this scenario had occurred the husband could have gone back to the matrimonial court asking for a variation of the original order. Obviously this option will not always be available.

In English and Australian law it does not appear that this anomaly can be corrected. The company should not be denied the benefit of a derivative action because one of the shareholders has received compensation for the fall in the value of their shareholding. In this respect the benefits of the Canadian statutory derivative action can be seen. Section 233 of the *Canadian Business Corporations Act* 1975 allows for an order that the award of damages be paid to the security holders of the corporation instead of to the corporation itself. The section goes some way towards recognising that corporate and shareholder recovery may in certain circumstances be regarded as alternatives. Also there is no danger of double recovery as the shareholders are being allowed personal recovery in a corporate (i.e. derivative) action.

Another reason that double recovery is unlikely is that shareholders are probably more likely to initiate a corporate action, rather than a personal action. This is because with a corporate action the shareholder will normally be able to obtain a *Wallersteiner v. Moir* order.<sup>24</sup> This order gives the minority shareholder an indemnity for costs. With a personal action however, the liability for costs rests with the minority shareholder. It is fair to assume that most shareholders would prefer the company to bear the burden of costs. Overall, even though by allowing a personal action the possibility of double

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<sup>24</sup> [1975] Q.B. 373.

recovery exists; this problem should not on its own be used to deny a personal remedy:

There are some occasions on which personal recovery by the shareholders may seem fairer than recovery by the corporation because direct recovery ensures that the shareholders, who suffer most directly from the wrongdoing are directly compensated. If one shareholder is successful in a personal action there is no reason why a similar action should not be available to other shareholders. If so, it may be acceptable to dismiss the corporation action, in which case all the shareholders can be compensated through a personal action but none may recover twice.<sup>25</sup>

### Prejudice to Creditors

Another reason for disallowing a personal action in tort is the danger of prejudice to creditors. If personal action is allowed and a corporate action disallowed then there are fewer assets available to creditors on a liquidation of the company. Again to allow a derivative action as well as a personal action would place the wrongdoers in a position of double jeopardy. The position with creditors, though of concern, should not be a valid reason

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<sup>25</sup> M.J. Sterling, *op. cit.* at p.487.

for denying a shareholder a personal action in tort. The creditors will only be affected should the company go into insolvency, and if that is the position the court could thereby dismiss the personal action as an attempt to alter the normal rules of distribution of assets upon liquidation. It should be noted that s.195 of the *Corporations Law* allows a court to consider the objections of a creditor when considering a reduction of capital. Along similar lines the court could allow a creditor standing where the personal action would result in the capital of the company not being restored to its full value.

I would submit that an action in the intentional torts, such as deceit and conspiracy should be available to the minority shareholder where the controllers have acted together to harm the corporation and thus indirectly to affect the investment of the minority shareholder. This would provide another alternative to the minority shareholder and overcome some of the problems associated with the existing remedies available to the minority shareholder. In particular the standing of the minority shareholder would not be in issue as he is suing in a personal capacity and other restrictive elements such as control and ratification could not be used to block the member. The reason being is that as the member is suing in a personal capacity it would not be an option for the general meeting to condone the wrongdoing; the personal action being unable to be ratified.<sup>26</sup>

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<sup>26</sup> See the comments by A.G. Diethelm, "Impugned Share Allotments and the Rule in *Foss v. Harbottle*, (1989) 5 *Australian Bar Review* 262 at p.275-6.

In conclusion the personal action would fill the void left by the problems associated with the common law and statute, and thus would constitute a useful addition to the shareholders armoury.

## CHAPTER 8

### CONCLUSION

The main aim of this thesis has been to contrast the common law remedies for minority shareholders, particularly the rule in *Foss v. Harbottle* with the statutory remedies for minority shareholders; concentrating on the private company or, as it has been frequently referred to, the incorporated partnership.

The first observation that became apparent upon researching the common law was that there were obvious defects in the remedies available to the minority shareholders. At common law if you wished to establish the fraud on the minority exception to the rule in *Foss v. Harbottle* you were first required to prove standing. In light of the decision in *Prudential Assurance v. Newman Industries*<sup>1</sup> this required the minority shareholder to establish a prima facie case without being able to discount the voting power of the controllers. This obviously became a major impediment to the minority shareholder. Having established standing the minority shareholder was then required to overcome a restrictive definition of what constitutes fraudulent conduct, a definition of control which ignored the power of the directors to manipulate the general meeting by use of proxy machinery and nominee shareholding and also the complex issue of ratification. These elements individually were

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<sup>1</sup> [1982] Ch. 204.



difficult to prove, a composite of all the elements almost impossible. It was because of these difficulties for the minority shareholder that the remedial legislation, particularly s.260 was introduced. This legislation required the minority shareholder to prove that the affairs of the company were being conducted in a manner that was unfair to that member or to the members as a whole. The question raised by this thesis asks to what extent the statutory reforms have improved the position of the minority shareholder. As Shapira points out, "the whole point of the reform is to procure a more active role for the courts. If the price of meaningful minority protection is increased judicial involvement, so be it".<sup>2</sup>

My submission would be that the purpose and object of the statute has not been fulfilled. The High Court in *Wayde v. N.S.W. Rugby League*<sup>3</sup> placed a restrictive interpretation on the legislation and again reiterated that the judiciary should not become involved in matters of business judgment.

In particular the High Court of Australia required the minority shareholder to show that the decision was such that no reasonable board of directors could have made it, and that the Court was not to assume the responsibility for the management of the company. In effect the minority shareholder had a heavy

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<sup>2</sup> G. Shapira, "Minority Shareholder Protection - Recent Developments" [1982] 10 *N.Z.U.L.R.* 134 at p.163.

<sup>3</sup> (1985) 59 *A.L.J.R.* 798.

burden to prove if he wanted to establish commercial unfairness by the wrongdoers.

Corkery comments that:

Undoubtedly [s.260] and [s.1324] improve the minority shareholder's position markedly. There is now plenty of wag in the corporate tail. If the judiciary is receptive - and there is no reason for it not to be - then the minority shareholder will play an important monitoring role in corporate affairs in Australia.<sup>4</sup>

In addition to the restrictive interpretation of the legislation by the judiciary, the legislation has a number of defects which could be overcome by amendment. I would submit that the definition of "affairs of a body corporate" in s.53 should be amended to allow a shareholder in a parent company to complain of the conduct of a nominee director appointed to the board of a subsidiary, and furthermore the legislation should be amended to allow a shareholder to complain of a resolution of the members. These amendments would take into account the commercial reality of groups of companies as a form of business organisation, and also remove any argument that a resolution of

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<sup>4</sup> J.F. Corkery, "Oppression or Unfairness by Controllers - What Can a Shareholder do about it?: An analysis of s.320 of the *Companies Code*" (1985) 9 *Adel. Law Review* 437 at p.464.

members is not an act of the company.<sup>5</sup> The other statutory remedy for the minority shareholder is s.1324 and while it has great potential to overcome the problems of the rule in *Foss v. Harbottle* it has not been utilised to its full extent and accordingly, the redrafting of s.260 and an interpretation consistent with its remedial nature become paramount if any assistance to the minority shareholder is to be given.

The major amendment that I would submit Australia should adopt is the statutory derivative action.<sup>6</sup> The advantage of the statutory derivative action is that it would establish distinct statutory regimes to deal with both personal wrongs and corporate wrongs. Section 260 would be used to redress a personal wrong to the minority shareholder such as the refusal to declare dividends whereas the statutory derivative action would be utilised for those wrongs which run exclusively to the company; for example, the expropriation of corporate assets and the diversion of corporate profits. Those wrongs which can be seen both as a wrong to the shareholders and a wrong to the company such as the payment of excessive salaries to executives holding large shareholdings, the issue of shares to dominant shareholders on advantageous terms and the appointment of

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<sup>5</sup> This will overcome the problems surrounding the decision of *Northern Counties Securities Ltd. v. Jackson and Steeple Ltd.* [1974] 1 W.L.R. 1133; see Chapter 4.

<sup>6</sup> The Companies and Securities Law Review Committee has circulated a Discussion Paper (No. 11, July 1990), titled "Enforcement of the Duties of Directors and Officers of a Company By Means of a Statutory Derivative Action" which considers the introduction of the statutory derivative action.

dominant shareholders to executive positions within the company could be pursued under either provision.

If this two tiered system of protection for the minority shareholder is adopted the rule in *Foss v. Harbottle* may be relegated to historical interest only. The minority shareholder seeking to remedy the corporate wrongdoing would be required to bring his action via the statute - his standing established by his good faith and the fact that reasonable notice has been given to the directors of the corporation of his intention to apply to the court. The Court would then be in a position to determine if it was in the interests of the corporation that the action be continued. Ratification would be taken into the court but it would not necessarily be determinative of the matter. If this process was adopted the common law and in particular, the rule in *Foss v. Harbottle* would be transposed to "legal limbo".<sup>7</sup>

In Canada the statutory derivative action is seen as having a significant and important role to play. A role which could be adopted in Australia. If these improvements to the legislation are not made then the tortious remedy for minority shareholders will become more important and the need to overrule that aspect of the decision of *Prudential Assurance v. Newman Industries*<sup>8</sup>

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<sup>7</sup> See the Comments by the Dickerson Committee, Ottawa 1971 at p.161-162; see Chapter 2.

<sup>8</sup> [1982] Ch. 204.

which stated that the personal action cannot be used to overcome the rule in *Foss v. Harbottle* will become greater.

The personal rights exception to the rule in *Foss v. Harbottle* could provide an avenue for the minority shareholder to redress a wrong done to the company especially if the decision of *Residue Treatment v. Southern Resources Ltd.*<sup>9</sup> is adopted.

That decision which held that the right of the minority shareholder to sue in respect of an improper issue of shares is based not in contract but in equity has the potential to lead a court to hold that fiduciary obligations are owed by directors to individual shareholders in addition to the fiduciary duty owed to the company. The courts have so far resisted this.<sup>10</sup>

In conclusion the present state of authorities do not greatly assist the minority shareholder. It is important that this be redressed by the preceding amendments suggested. Section 260 should be amended to overcome any difficulties with its interpretation, and importantly, the statutory derivative action should be introduced to finally overcome the problems of the rule in *Foss v. Harbottle*. It is hoped that if these amendments were forthcoming the courts would recognise that the intent of the legislature was to give the judiciary a supervisory role over the

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<sup>9</sup> (1988) 14 A.C.L.R. 569.

<sup>10</sup> The genesis of the rule that fiduciary duties are owed exclusively to the company is *Percival v. Wright* [1902] 2 Ch. 421.

management of companies and therefore provide greater assistance for the minority shareholder:

In conclusion, one can see that a full examination of the case law does not unveil a recent trend of court interference with the internal workings of corporations. The corporate theory remains unmarred. Similar duties are being enforced today as were before the oppression remedies took their present form. One should be wary upon forming a closely held corporation on the basis of an agreement of participation in management decisions. ... Although minority shareholders are now in a better position to obtain direct relief, the question remains whether there is also a duty running to them, from the majority, to protect minority interest. It is suggested that the majority shareholder need not be unduly alarmed - as of yet. To date the courts have taken a conservative stance interpreting the scope of the oppression remedies. The years to come, however, may bring a comfort with the available remedies and a concomitant innovative approach to their implementation.<sup>11</sup>

It is submitted that the Australian judiciary has not brought an innovative approach to the interpretation of s.260 and therefore, it is paramount that legislation be put into place that will increase

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<sup>11</sup> L.M. Schaefer, "The Oppression Remedy for Minority Shareholders" (1985) 23 *Alberta Law Review* 512 at p.523.

the available remedies for the minority shareholder, and will provide the impetus for an innovative approach by the judiciary.

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