COMPANIES AND SECURITIES LAW REVIEW COMMITTEE

DISCUSSION PAPER NO. 11

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

JULY 1990

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PREFACE

Membership and Functions of the Committee

The Companies and Securities Law Review Committee was established late in 1983 by the Ministerial Council for Companies and Securities pursuant to the inter-governmental agreement between the Commonwealth and the States of 22 December 1978.

The Committee's function is to assist the Ministerial Council by carrying out research and advising on law reform in relation to legislation concerning companies and the regulation of the securities industry.

The Committee consists of five part-time members, namely:

Mr Geoffrey W Charlton
Mr David A Crawford
Professor H A J Ford (Chairman)
Mr Anthony B Greenwood
Mr Donald R Magarey

The full-time director is Mr Colin Sayer.

The Committee's office is at the office of:

National Companies and Securities Commission
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31 Queen Street
MELBOURNE VIC 3000

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General Aims of the Committee

To develop improvements of substance and form in such parts of companies and securities law as are referred to the Committee by the Ministerial Council and for that purpose to develop proposals for laws:

* which are practical in the field of company law and securities regulation;

* which facilitate, consistently with the public interest, the activities of persons who operate companies, invest in companies or deal with companies and of persons who have dealings in securities; and

* which do not increase regulation beyond the level needed for the proper protection of persons who have dealings with companies or in relation to securities.

In the identification of defects and the development of proposals the Committee is required to have regard to the need for appropriate consultation with interested persons, organisations and governments.

The Reference from the Ministerial Council

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

(a) standards relating to their conduct and performance

(b) ..... and

(c) any related matter."

Responses Invited

The Committee invites written submissions on the issues listed in the latter part of this discussion paper.

The Committee will assume that it is free to publish any submission, in whole or in part, unless the respondent indicates that the submission is confidential. All respondents will, in any event, be listed in any report made by the Committee to the Ministerial Council.

Submissions should be sent to:

Companies and Securities Law Review Committee
6PO Box 5179AA
MELBOURNE VIC 3001

BY 12 SEPTEMBER 1990.

SCOPE OF THIS PAPER

[1] There are grounds for believing that the existing law about civil enforcement of duties on behalf of a company is unsatisfactory. The conditions under which a member of a company (whether a shareholder in a company with share capital or a member of a company without share capital)(1) can bring proceedings on behalf of the company against a delinquent director or executive officer are thought, in some quarters, to be too restrictive.

[2] A change by which it would become easier for a member to take proceedings on behalf of the company might serve a useful purpose in the general scheme of regulation of corporate activity in the interests of investors and creditors. Civil proceedings brought by members might provide enforcement in cases which the regulatory authorities are unable to prosecute because of competing demands on limited resources.

[3] In several of its previous reports(2) the Committee has recommended particular changes to the law in order to provide better definition of the legal duties owed by a director or executive officer to the company. Other bodies have also conducted inquiries and made recommendations about redefining duties,(3) Improved formulation of those duties will confer only limited benefit on the public unless the means of enforcement are also improved.

[4] Civil proceedings by a company to enforce the duties owed to it by its directors or officers, whether initiated as a result of a resolution of the board of directors, by the vote of the company in general meeting or decision of a liquidator, do not(4) ordinarily involve any greater initial

(1) And, possibly, creditors of the company and directors or officers who are not also members of the company; see respectively paras. [79] and [87] below.

(2) Report No. 8 on Nominee Directors and Alternate Directors (March 1989);
Report No. 9 on Director's Statutory Duty to Disclose Interest and Loans to Directors (November 1989);
Report No. 10 on Indemnification, Relief and Insurance in Relation to Company Directors and Officers (May 1990).

(3) For example, Senate Standing Committee on Legal and Constitutional Affairs, "Report on the Social and Fiduciary Duties and Obligations of Company Directors", November 1989; New Zealand

Law Commission Report No. 9 "Company Law Reform and Restatement" June 1989

(4) With the exception of some additional requirements eg. a company is unable to initiate proceedings or be represented by anyone other than a legal practitioner; Re Education Pty Ltd [1963] NSWR 1340; Hubbard Association of Scientologists International v. Anderson & Just [1971] VR 788; [1972] VR 340; a further

procedural difficulty nor carry more onerous requirements for the conduct of the action than would be expected of general litigation undertaken by a natural person.

[5] Such proceedings, which in many cases are undertaken only after a change in control of a company (either through variation in the composition of the board of directors or appointment of a liquidator), may seek to enjoin some proposed action of the directors, recover the amount of loss suffered by the company as a result of an alleged breach of duty or claim some other relief. That such action is rare in the case of a solvent company in the absence of a change in control is hardly surprising, unless only a minority of directors is claimed to have breached some duty owed by them to the company.

[6] This paper is not concerned with action taken directly by a company against its directors or officers, the law or procedure in respect of which would not appear to require substantial reform.

[7] This paper is not predominantly concerned with proceedings that members can take to vindicate their personal rights(5) - such as their rights to vote at company meetings - arising out of the company's constituent documents(6) or under the general law,(7) nor the enforcement by a member of a liability imposed on a director directly to investors(8) and members.(9) This paper does not examine such proceedings, whether they are brought by a member on his or her behalf alone or in a representative capacity suing also on behalf of all other wronged members. It may be that there is a need to review the conditions under which such proceedings may be taken but it may not be seen as an urgent need.

[8] What is addressed below is the question of the conditions under which a member - and, possibly, a director or officer who is not also a member or even a creditor - should be able, as surrogate for the company itself, to

example is that a company can be in a different position on the question of providing security for costs; Pacific Acceptance Corp Ltd v Forsyth (No 2) [1967] 2 NSWR 482.

(5) A specific exception to the rule in Foss v Harbottle - see para [10] below.

(6) Which have contractual force by virtue of section 78 Companies Act 1981 (Cwlth). Cf Corporations Act 1989 (Cwlth) section 180.

(7) For a recent example see Residues Treatment & Trading Co Ltd v Southern Resources Ltd (1988) 6 ACLC 1160.

(8) Such as the liability for an untrue statement or an improper non-disclosure in a prospectus: Companies Act 1981 (Cwlth) section 107. Cf Corporations Act 1989 (Cwlth) sections 96, 1005-1012 .

(9) Such as the liability for a mis-statement in a Part B statement or a Part D statement : Companies (Acquisition of Shares) Act 1981 (Cwlth) section 44. Cf Corporations- Act 1989 (Cwlth) section 704.

bring proceedings to enforce the duties of directors and officers when the company is unwilling or unable to do so.

THE EXISTING POSITION

[9] The focus of this paper has resulted from recognition of a widespread assessment(10) that due to the restrictive nature of the rule in Foss v Harbottle,(11) existing law does not provide adequate means for the enforcement of the duties of directors and officers where the company improperly refuses or fails to take action.

[10] The rule in Foss v Harbottle has two elements; the first dictates that the Court will not interfere where the matter complained of is capable of being forgiven or ratified by a simple majority of the company in general meeting; the second element states that prima facie the company is the only proper plaintiff in respect of wrongs done to the company.

[11] Exceptions to the rule have developed; in addition to enforcement of personal rights, an individual member has been able to take action where the company has acted ultra vires,(12) where there has been an attempt to approve by ordinary resolution what may only lawfully be effected by special resolution, and where actions within the company constitute a "fraud on the minority" of members. The status of a claimed further exception, that proceedings may be initiated where the "interests of justice" require action, is far from clear.(13)

(10) See for example Gower, Final Report of the Commission of Enquiry into the Company Law of Ghana at page 152 and Sealy, "Company Law and Commercial Reality" (1984) Sweet & Maxwell, pp 52 to 55.

(11) (1843) 2 Hare 461, 67 ER 189.

(12) The doctrine of ultra vires has been abolished by current legislation in Australia. But the memorandum of association or articles of association of a company may contain an express restriction on, or an express prohibition of, the exercise by the company of a power of the company and the memorandum of association may contain a provision stating limited objects of the company; Companies Act 1981 (Cwlth) section 68. Cf Corporations Act 1989 (Cwlth) section 162. Where a restriction, prohibition or objects clause is not observed the fact of non-observance may be asserted only in the proceedings listed in section 68(6), which expressly gives standing to a member of a company to sue in some proceedings. See sections 68(6)(g) and (h). The only other proceedings which a member might properly bring are an application under section 320

which confers standing on a member (section 68(6)(e)) or an application for an injunction under section 574 to restrain the company from entering into an agreement (section 68(6)(f). As to proceedings generally under section 320 and' a member's standing under section 574 see paras. [15] to [19] and [22] to [24] of this Discussion Paper.

(13) See Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] 1 All ER 354.

[12] Application of these exceptions has not always been consistent nor necessarily achieved a satisfactory result. Even in a case of serious misconduct involving misappropriation of company assets, the individual member may face great difficulty in taking remedial action; see the comments of Lord Denning MR in Wallersteiner v Moir (No 2).(14)

Menders' existing remedies against maladministration

[13] Existing law provides members with standing to seek some remedies against maladministration of their company. But those remedies are primarily directed to terminating the maladministration rather than enforcement of duties of directors and officers. As will be noted in the following discussion, existing provisions dealing with actions for breach of duty on the part of directors and officers allow members to proceed on behalf of a company only in limited circumstances. Those provisions do not specifically provide for action on behalf of a company by creditors of the company nor any of its directors and officers who are not also members of the company. It seems to the Committee appropriate to include as part of this examination the question of the range of persons who should be permitted to bring action on behalf of a company for breach of duty on the part of its directors or officers.

[14] One approach to the problem addressed in this paper could be to enact a new provision to enable members (and, possibly, creditors and directors or officers who are not also members) to take action in the face of a breach of duty on behalf of the company. An alternative view might be that the same result could be achieved by amending existing legislation.

[15] Applications under Companies Act 1981 (Cwlth) section 320.(15) Section 320(1) gives standing to apply to the Court to a member (and, in a more limited way, to the Commission) who believes that the 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, or in a manner that is contrary to the interests of the members as a whole" or that some act or omission, or proposed act or omission, by or on behalf of the company or a resolution or proposed resolution of a class of members would result in such oppression, unfair prejudice or unfair discrimination.

[16] On a successful application one of the orders that the Court may make (under section 320(2)(g)) is an order that the company institute, prosecute, defend or discontinue specified proceedings. The Court also has, power to authorize a member to take similar action in the name and on behalf of the company.

[17] Conduct which results in the kind of adverse effect on a member or members specified in section 320(1) may not necessarily involve any breach by directors or officers of duties owed to a company alone.

(14) [1975] QB 373 at 390.

(15) Cf Corporations Act 1989 (Cwlth) section 260.

[18] As Corkery notes(16) the ability of a member to take the kind of derivative action contemplated by section 320(2)(g) would depend on the existence of facts showing both injustice to a member or members and harm to the company. As well, the statutory provision for standing to be granted to a member in these circumstances does not necessarily overcome in every case the traditional reluctance of the Courts to intervene in the affairs of a company.(17)

[19'] Section 320 does not provide for authorization to take action to be granted to any creditor of the company. Later in this paper the Committee discusses the position of creditors; see para [79]ff.

[20] Application under Companies Act 1981 (Cwlth) section 364(18) for a winding up order. A member can apply to the Court for a winding up order on the ground that:

(a) "directors have acted in the affairs of the company in their own interests rather than in the interests of the members as a whole, or in any other manner whatsoever that appears to be unfair or unjust to other members"; section 364(1)(f);

(b) "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"; section 364(1)(fa);

(c) "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 of the company, was or would be oppressive or unfairly discriminatory against, a member or members or was or would be contrary to the interests of the members as a whole"; section 364(1)(fb); or

(d) "the Court is of opinion that it is just and equitable that the company be wound up"; section 364(1)(j).

An order for winding up will not of itself mean that directors or officers will be made liable for breaches of duty.

[21] Application under Securities Industry Act 1980 (Cwlth) section 42(19) for order enforcing listing rules. Where a rule in the listing rules of a securities exchange (such as the Australian Stock Exchange Limited) imposes a duty on a director of a listed company to conduct himself or herself in a

(16) "Directors' Powers & Duties" (1987 Longman) at page 258.

(17) For example, see the comments of Brooking J in Zephyr Holdings Pty Ltd v Jack Chia (Australia) Ltd & Ors (1989) 7 ACLC 239 at p 246.

(18) Cf Corporations Act 1989 (Cwlth)' section 461.

(19) Cf Corporations Act 1989 (Cwlth) section 777.

certain way when administering the company's affairs, there is some possibility that a member may have standing as a "person aggrieved" within section 42 to seek from the Court an order giving directions to the director "concerning compliance with, observance or enforcement of, or the giving effect to" the listing rule.

[22] Application under Companies Act 1981 (Cwlth) section 574. (20) Section 574 provides that where a person has engaged, is engaging or proposing to engage in any conduct constituting a contravention of the Act or has refused or failed to do an act or thing required of him' or her by the Act, the Commission or "any person whose interests have been, are or would be affected by the conduct" may apply to the Court for an injunction restraining the relevant conduct or requiring the act or thing to be done.

[23] At least one commentator(21) considers that, as many of the duties of directors and officers recognized under the general law are given statutory recognition in provisions such as Companies Act 1981 (Cwlth) section 229, the proper application of section 574 should eliminate many of the procedural problems resulting from the rule in Foss v Harbottle. (22)

[24] However, there could be a possibility that the Courts are not prepared to hold that every action which constitutes a breach of duty to a company also adversely affects the interests of that company's members so as to afford standing to a member as such. In cases other than those such as Residues Treatment & Trading Co Ltd v Southern Resources Ltd,(23) where the exercise by directors of a power for an improper purpose also effected an infringement of the rights of members, proving concordance of interests may be difficult, if not impossible.

[25] Complaint under Companies Act 1981 (Cwlth) section 420(24) about conduct of official manager or liquidator. By force of section 420 (and in the case of an official manager, section 351(4)) a member has standing to complain to the Court or the Commission with respect to the conduct of a liquidator, or official manager, in connection with the performance of his or her duties.

[26] Application under Companies Act 1981 (Cwlth) section 542.(25) Section 542 provides that if, on the application of an official manager, liquidator, provisional liquidator or person authorized by the Commission, the Court is satisfied that a person is guilty of "fraud, negligence, default, breach of trust or breach of duty" in relation to a corporation and that as a result the corporation has suffered, or is likely to suffer, loss or damage, the

(20) Cf Corporations Act 1989 (Cwlth) section 1324.

(21) Baxt, "Will section 574 of the Companies Code please stand up!" (1989) 7 Companies and Securities Law Journal, 388.

(22) (1843) 2 Hare 461, 67 ER 189.

(23) (1988) 6 ACLC 976.

(24) Cf Corporations Act 1989 (Cwlth) section 536.

(25) Cf Corporations Act 1989 (Cwlth) section 598.

Court may make appropriate orders against, or in relation to, that person. Under section 542(4), the orders that may be made include an order directing the person to pay money or transfer property to the corporation or an order that the person pay to the corporation the amount of such loss or damage.

[27] Section 542 is, like its predecessor (section 367B "uniform" Companies Act 1961), basically a procedural provision which allows for recovery on behalf of a company by way of summary action without the necessity of instituting proceedings in the usual way by issue of a writ of summons.

[28] The provision from which section 367B/542 was derived (section 305 Companies Act 1961) was often referred to as a "misfeasance" provision, covering wrongful acts of directors or officers which were in the nature of a breach of trust and which caused actual loss to a company. It is not at all clear whether, apart from the reference in section 542(2)(b) to likely loss on the part of a company as well as actual loss, the different wording of section 542 has necessarily widened the scope of the earlier provisions.(26)

[29] A member of a company, unless authorized by the Commission, does not have standing under section 542 to take action over a breach by directors or officers of a duty owed to the company; the necessity for a member to obtain authorization from the Commission could be seen as an inhibiting factor in urgent cases.

[30] There is also a question, having regard to the nature of the functions undertaken by those granted specific standing by section 542, .as to the applicability of the provision where the solvency of a company is not in question. There could be uncertainty over the validity of any authorization by the Commission to a member of a company where the relevant company is a going concern.

[31] Section 542 is a specific procedural provision; it may be open to question whether the section, even in some amended form, is a suitable means of achieving the access for members of a company with which this paper is concerned. If some other general provision for the taking of derivative action is thought to be warranted, would there be merit in amending section 542 to make it clear that members and creditors of a company have standing to undertake the summary procedure provided by the section? Should section 542 also be amended to make it clear that it covers solvent companies?

[32] Later in this discussion paper (at para [60]) the Committee discusses the question of the liability for costs of an unsuccessful applicant under section 542.

[33] Examination under Companies Act 1981 (Cwlth) section 541.[27] Section 541 provides that where it appears to the Commission or a "prescribed person" (official manager, liquidator, provisional liquidator or person authorized by the Commission) that a person who has taken part or been concerned in the promotion, formation, management, administration or winding

(26) See McPherson, "The Law of Company Liquidation" 3rd edition (1987) Ed. O'Donovan pp 353 to 364.

(27) Cf Corporations Act 1989 (Cwlth) section 597.

up of, or has otherwise taken part or been concerned in affairs of, a corporation has been or may have been guilty of fraud, negligence, default, breach of trust, breach of duty or other misconduct in relation to the corporation, or a person may be capable of giving information relating to such promotion etc. of the corporation, the Commission or the prescribed person may apply to the Court for orders in relation to that person.

[34] On granting an application, the Court is empowered to order that a person attend before the Court and give evidence on oath or affirmation as to the relevant matters to do with the corporation; section 541(3). The Court is, amongst other matters, empowered to order that person to produce any books in his or her possession or under his or her control relevant to the matters the subject of the examination; section 541(9).

[35] Section 541 is, like section 542 of the same Act,(28) primarily a procedural provision, in this case the predecessors of the section having been designed to assist those charged with the responsibility for orderly liquidation of a company in obtaining greater information in relation to what may be broadly termed fraudulent conduct in the running of a company than could be obtained by way of private examination.(29)

[36] In the context of the remedies available to a member of a company to take action to enforce duties owed by directors and officers to that company, limitations similar to those which might be anticipated in relation to section 542 (see paras [29] to [32] above) could apply in the case of an application by a member under section 541 for an examination to be conducted. Having regard to the underlying purpose of the provision, authorization to a member of a company by the Commission might be seen as a matter of policy to be inappropriate, even in the case of a company in the course of liquidation. In the absence of amending legislation, there may well be a view that generally the examination procedure should not be available in the case of a solvent company.

[37] Is it desirable to retain section 541 as another specific procedural provision rather than to treat it as one which may be amenable to amendment to provide greater possibilities for enforcement action by members of a company generally? If so, would it be appropriate (as may also be suggested in the case of section 542; see para. [31] above) to amend section 541 to make it clear that the examination procedure is available on the application of members and creditors and is available in the case of a solvent company?

[38] Need for limitations on member's right to assert company's right of action.

Even if there is a valid view that the rule in Foss v Harbottle is too restrictive, there is unlikely to be dissent from an assertion that management needs to be protected against unreasonable interruption of its functions through litigation which may be actuated by nothing more than the strategic imperatives of a hostile minority or which may be undertaken by a member having unreasonable expectations as to his or her ability to

(28) See above para [26].

(29) See McPherson, "The Law of Company Liquidation" 3rd edition (1987) Ed. O'Donovan pp 430 to 432.

influence the orderly administration of the company's affairs.

ONE OVERSEAS SOLUTION: ONTARIO

[39] The solution favoured in some jurisdictions overseas is to require a person who seeks to sue on behalf of the company to apply to the Court for leave to bring proceedings in the name and on behalf of the company. An exemplar of this approach is section 245 of the Ontario Business Corporations Act, 1982[30]: section 245 and other relevant provisions are reproduced in Appendix 1. Under that provision standing to seek leave to commence a derivative action is granted to a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security (which includes a share or debt obligation) of the corporation or any of its affiliates, the tests for affiliate status being similar to those set out in Companies Act 1981 (Cwlth) section 7(5) to determine whether corporations are related for the purposes of Australian law. Standing is also afforded to any director or officer, or former director or officer of the corporation or any affiliate of the corporation and "any other person who, in the discretion of the court, is a proper person to make an application..." (section 244(a)(iii)).

[40] Leave may be granted to bring an action in the name and on behalf of the corporation or any subsidiary, or to intervene in any proceeding, for the purpose of prosecuting, defending or discontinuing the action. As an alternative to the practice in Ontario an action could proceed in the name of the applicant with the company being joined as a nominal defendant, the "true" defendants being the alleged wrongdoers.[31]

[41] Unless the complainant can establish that it is not expedient to do so, in which case the application may be heard ex parte and interim orders made pending notification, it is necessary that 14 days' notice of intention to make an application has been given to the directors of the corporation or of the subsidiary. Before granting an application, the Court must be satisfied that:

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

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

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

[42] The Court may at any time in connection with an action brought or intervened in under section 245, make an order

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

(30) A similar approach is found in the New Zealand Law Commission's draft Companies Act section 127 (June 1989).

(31) Regardless of the approach preferred, the company must be joined as a party to ensure that it is bound by the terms of any judgment obtained.

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

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

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

[43] A complainant is not required to give security for costs in respect of an application under section 245; section 248(3). The Court is empowered at any time in relation to such an application, or consequent action brought or intervened in, to order the corporation or affiliate to pay to the complainant interim costs, including legal fees and disbursements, which upon disposition of the application or action which is adverse to the complainant the complainant may be ordered to pay to the corporation or its affiliate. The question of indemnity for costs is discussed further below.

[44] The Ontario provisions restrict the ability of a complainant to discontinue or settle an application made under section 245 or consequent action brought or intervened in. The leave of the Court must be obtained. Approval may be granted on such terms as the Court thinks fit, including notice to any complainant whose interests the Court considers may be "substantially affected", presumably detrimentally, by the discontinuance or settlement - section 248(4). This provision would appear to be designed to provide greater control over unmeritorious proceedings commenced with a view to favourable settlement or to prevent collusion between the complainant and the defendants.(32)

ISSUES INVOLVED IN A STATUTORY DERIVATIVE ACTION

[45] **Refusal of board or general meeting to take action.**

One of the preconditions that an applicant must satisfy under the Ontario legislation is the production of evidence that the directors of the corporation or its subsidiary "will not bring, diligently prosecute or defend or discontinue" the relevant action.

[46] In any action based on the "fraud on the minority" exception to the rule in Foss v Harbottle(33) there must be established control of the conduct of the company's affairs on the part of the alleged wrongdoers - in many cases this has been evidenced by showing that a demand on the part of a member that action be taken

has been resisted as a consequence of the adverse vote of the wrong-doers at a meeting of the board or general meeting.

(32) See "Ontario Corporations Law Guide" CCH p 7547; the incorporation into English law of such a provision has been supported by at least one commentator – see Gower, "Principles of Modern Company Law" 4th edition at page 653.

(33) (1843) 2 Hare 461, 67 ER 189.

6[47] The actuality or possibility of the company in general meeting forgiving or ratifying the breach of duty complained of has been a significant, if not decisive, factor in many cases of members seeking to enforce duties owed to the company, even on occasions when what proceeded on the basis of an action to enforce personal member rights was in reality a derivative action.(34)

[48] If a provision such as that in the Ontario legislation were to be adopted, in practice an applicant member might, in all but the most urgent cases, need to show that a general meeting of the company has had an opportunity to express a view on the question whether action should be brought. The member might need to requisition a general meeting under Companies Act 1981 (Cwlth) section 241.

[49] One outcome of such a meeting could be endorsement of the member's actions. Another result could be that a properly informed majority, not associated with any person against whom a breach of duty is alleged, resolves that those against whom proceedings are contemplated should be released from liability. In that event the member would be unable to obtain leave and the action could not proceed; if the application or action had been commenced, any such resolution by the general meeting would not effect a discontinuance of the application or action without the leave of the Court.

[50] It might be considered that should the general meeting neither decide to endorse the actions of the member nor release those in breach from liability it should still be open to the member to persuade the Court that it is in the interests of the company that he or she should bring the action contemplated.

[51] In its Report No. 10 on Company Directors and Officers : Indemnification, Relief and Insurance (21 May 1990), this Committee, as part of the review of the ways in which a director or officer could be indemnified, recommended(35) an amendment of legislation to make it quite clear that a company should be able, by resolution of a properly informed and disinterested general meeting, to release a director or officer from liability to pay damages or compensation to the company in respect of wrongdoing that did not involve intent to deceive or defraud.

[52] The release by the general meeting would not preclude a derivative action to enjoin the directors or officers or to seek relief of any kind other than for payment by directors or officers of an amount of money by way of compensation or damages.

[53] It may be felt by some that once a breach of duty is apparent, the Court is the only proper forum for decision as to the consequences for the directors or officers of their breach, that

company members may too easily be influenced by those in control of the company's affairs. However, when preparing Report No. 10 the Committee saw justification for the view that an informed and disinterested majority of members may well be the best arbiters

(34) eg Hogg v Cramphorn Ltd [1967] Ch 254.

(35) In para. [106].

of whether there should be a release from liability for breach of a duty which is owed to the company alone. For whatever reason, the interests of a solvent company might dictate that action to redress a breach of duty should not proceed.

[54] **Conduct of an action on behalf of a subsidiary.**

Under the Ontario legislation an applicant may be granted leave to bring an action in the name and on behalf of a subsidiary of the corporation or to intervene in an action to which a subsidiary is a party. The draft Companies Act proposed by the New Zealand Law Commission in section 127 is to the same effect. There is a question whether any Australian provision for a statutory derivative action should extend to causes of action that belong to a subsidiary.

[55] Whether a member or creditor of a parent corporation should have standing to assert a cause of action of a subsidiary or to intervene could depend on the circumstances of the particular case. It may be thought that the most that can be done by legislation is to ensure that the Court hearing the application will have a discretion wide enough to allow an applicant to take action or to intervene on behalf of a subsidiary, whether it is fully or partly owned.

[56] **Court's power to make orders.**

It will have been noted that the Ontario legislation provides that the Court hearing the application to take derivative proceedings is empowered to make orders as to a number of matters including payment of costs, conduct of an action and the identity of any recipient of amounts ordered to be paid on final disposition of an action.

[57] Orders as to costs in a statutory derivative action. In relation to costs, there is a question whether there should be further provision by which an applicant could be granted indemnity for costs by the company (in the interests of which the action is being undertaken) at least until a specified stage of the proceedings. This was the approach adopted by the Court of Appeal in Wallersteiner v Moir (No 2).(36)

[58] In view of the matters under the Ontario legislation about which the Court must be satisfied before an application to commence derivative proceedings may be granted, it might seem logical that an applicant should not be exposed to the risk of personally having to meet not only his or her own costs, but those of the true defendants as well as the company as nominal defendant. This could add to the degree of control that the Court could exercise over

the conduct of an action; by granting indemnity to a specified stage of proceedings,[37] continuation of actions found to be without merit should be discouraged.

[59] Possibly, the costs indemnity, if granted to judgment, could apply regardless of the final outcome unless it transpired that the conduct or motivation of the applicant was in reality such that the original

(37) [1975] QB 373.

(38) For example, close of discovery as in Wallersteiner v Moir.

application should not have been granted, or that the proceedings should have been terminated at an identifiable time prior to completion. Later proof of unworthiness to have been granted an indemnity could found an action for recovery on the part of the company.

[60] Orders as to costs in applications under section 542. Even if there were support for the introduction of a statutory derivative action, there might also be a demand that the summary procedure provided by section 542 be clearly made available to members (or creditors) of a company that is a going concern; see para. [26]ff. If that change were made there could be a question in regard to the costs of a successful respondent.

[61] Under the existing law about applications under section 542 an unsuccessful liquidator is liable to have an order for costs made against him or her personally but with a right a indemnity out of the company's assets.(38)

[62] It may be that just as the Court might have a discretion as to costs of the kind referred to in paras. [57] to [59] in relation to actions, it should have a similar discretion under section 542. Compare the discretion given to the Court by section 541(18) in respect of costs of a person examined under section 541.

[63] Nature of the hearing of an application. What kind of case would have to be shown in order to obtain leave to bring derivative proceedings? It appears that in Ontario the applicant has only to establish that prima facie a breach of duty to the company has occurred.(39) In the ordinary course this could probably be done by way of affidavit. While there will undoubtedly be cases of greater complexity, it would seem undesirable that ordinarily an applicant for leave should have to anticipate conducting something approximating a full trial of the issues.

[64] Joinder of derivative and personal actions. The same set of facts can often afford grounds for personal actions as well as proceedings to enforce duties owed strictly to a company. In some cases there may be uncertainty as to whether an application to take derivative proceedings is warranted by the facts.

[65] There is a question whether it would be preferable for a member, out of an abundance of caution, to take what should be relatively inexpensive action to learn that leave is not necessary rather than to be later met with a successful motion that proceedings be struck out on the basis that the required leave was not obtained when it becomes clear that the proceedings

(38) Re Buena Vista Motors Pty Ltd [1971] 1 NSWLR 72. In that case Street J observed at page 75 that the consequence could be to deter liquidators from invoking the procedurally simple form of litigating a misfeasance provided by section 305 "uniform" Companies Act 1961 from which section 542 is derived. See also Hamilton (1989) 7 Companies and Securities Law Journal at 310.

(39) Re Marc-Jay Investments Inc and Levy [1975] 5 OR (2d) 235: noted by Corkery op. clt. at page 259 n 83.

are based at least in part on claims of a derivative nature.(40)

[66] It might be thought that the possibility of an order for the costs of the company being made against an applicant could serve as a sufficient disincentive to applications being made for leave where the facts clearly indicate that only a personal or representative action is justified. As it would be anticipated that many cases would be borderline, it may be thought desirable not to disturb the discretionary nature of the Court's powers in respect of an award of costs.

[67] Should both personal and derivative actions be heard together? There could be a view that to allow such joinder could impose artificial procedural requirements on the conduct of the claim that personal rights of a member had been infringed. However, on the original application for leave to take derivative proceedings the Court could simply decline to make any order in relation to that part of the proceedings having a purely personal character. It could be thought that there may be some difficulty in apportionment of costs, although this might not prove to be an insuperable obstacle; the Courts regularly deal with cases involving a number of parties who experience differing degrees of success or failure in proceedings. The view might be taken that the same methods of costs apportionment could, with any necessary modification, be applied to any joined personal and derivative proceedings.

[68] Removal by the Court of directors or officers. The information disclosed on the hearing of an application to take derivative proceedings could in some instances demonstrate to the Court hearing the application that the acts or omissions of the directors or officers of the relevant company are of such a nature that the interests of the company require the immediate removal, even for a limited period, of all or some of those directors or officers.

[69] Notwithstanding the potential for citation for contempt, in some cases there may be grounds to believe that directors or officers may well use the financial or other administrative arrangements of the company or those of a related corporation to frustrate the conduct of the proceedings for which leave had been granted or in some other way to render the orders of the Court nugatory.

[70] French law provides for the appointment of an "administrateur provisoire", who takes over control of a company by order of the Court on the application of any shareholder, the directors, the creditors, the employees' works council or the auditors of a company.(41)

[71] While the circumstances justifying appointment of the temporary administrator have often involved a crisis in the management of a company, such as an absence of directors or a deadlock of the board or of the general meeting, it would appear that French Courts are now prepared to

(40) For an example see Hoskin v Price Waterhouse Ltd. 35 OR (2d) 350; 37 OR (2d) 464.

(41) See Redmond-Cooper, "Management Deficiencies and Judicial Intervention- A Comparative Analysis", The Company Lawyer, Volume 9 Number 8 page 169.

appoint an administrateur provisoire where there is an allegation that the decisions of a functioning management are not in the best interests of the company as a whole.(42) It may be open to question whether Australian Courts, having power to appoint a temporary administrator, would be prepared to take what might be viewed as such an interventionist approach. Regardless of the type of circumstances in question, there might be a valid view that removal of directors or officers should only be considered in the most serious cases.

[72] In the United Kingdom, the Insolvency Act, 1986 provides for the appointment of an administrator where it is established that a company is unable to pay its debts, or there is a likelihood of such an inability, and that the appointment would be likely to achieve one of the purposes set out in section 8(3). Those purposes include the survival of the company as a going concern and a more advantageous realisation of the company's assets than would be effected on a winding up.

[73] The application for appointment of an administrator may be made by the company or its directors, any creditor (including any contingent or prospective creditor) or by the clerk of a Magistrates' Court exercising powers under the provisions of another Act relating to the enforcement of fines imposed on companies.

[74] The effect of an administration order is that the management of the affairs, business and property of the company is placed under the control of the administrator; section 8(2).

[75] The circumstances giving rise to the appointment of an administrator under the United Kingdom legislation would not necessarily involve a breach of duty on the part of directors or officers; it may be open to question how suitable the provisions, even if amended to cover solvent companies, would be for inclusion in any Australian legislation relating to the taking of derivative proceedings.

[76] A further alternative which could be available to the Court when granting an application to take derivative action could be an order appointing what might be termed an "official observer". Such an observer could have all the rights of access to information and participation in board deliberations held by the existing members of the board and could be granted additional rights of veto in respect of any matter touching the acts or omissions constituting the breach of duty which originally gave rise to the application to take derivative proceedings.

[77] The observer could be an officer of the Court (with appropriate immunity) and could apply at any time for directions, to restrain some proposed act of the directors or seek other necessary orders. The period of appointment of the observer could be expressed to cease on the granting of the leave of the Court after final adjudication of the derivative proceedings.

[78] Appointment of such an observer could perhaps be seen as appropriate where it is not necessary or practical to take away from the board or management all relevant functions.

(42) ibid

[79] **Action by creditors.**

There is a view that creditors should have standing to interfere with the running of a company's business only where authorised by contract with the company or in certain limited circumstances apart from contract. There may be interference by obtaining a Mareva injunction, by realizing a security, by showing a case for the appointment of a receiver by the Court, by joining with other creditors to have an official manager appointed or by obtaining an order for winding up. In particular it is thought that a creditor has no right to take proceedings to enforce a right of action belonging to the company except under contract with the company.

[80] On the other hand, it is now accepted that in appropriate circumstances directors of a company should have regard to the interests of that company's creditors when taking decisions on the company's operations.(43) There is disagreement over whether that regard arises by way of a positive duty owed by directors to creditors or is necessary to properly safeguard the interests of the company itself, as disregard of the creditors' position can be said to rebound to the detriment of the company, even if in the longer term.

[81] There is also uncertainty as to whether the necessity to take account of the interests of creditors only arises when a company is in a state of near-insolvency or should be recognized at some earlier stage, perhaps even when the solvency of the company is not in question.

[82] Section 245 of the Ontario Business Corporations Act, 1982 specifically gives standing to apply for leave to take derivative proceedings to any present or former holder of a "security" which under section 1(1) includes a share or debt obligation or a certificate evidencing such a share or debt obligation, whether secured or unsecured.

[83] The approach adopted by the New Zealand Law Commission(44) is to grant standing under the section of the Draft Companies Act relating to the seeking of injunctions, but not to allow creditors to take proceedings for damages while the company is solvent.(45)

[84] As noted,(46) it will often be the case that a creditor must rely on the contractual arrangements (if any) that are in place with a company for the purpose of preserving or realizing the interests of the creditor in the assets of the company; it may be thought that there is no harm in an unsecured creditor being in a less advantageous position for those purposes in the ordinary case. In the case of derivative proceedings, there may be a similar

view that only secured creditors should be able to approach the Court, and then only where it is clear that there is a real possibility of

(43) See generally Dabner, "Directors' Duties - The Schizoid Company" (1988) 6 Companies & Securities Law Journal 105.

(44) Report No. 9: "Company Law Reform and Restatement", June 1989.

(45) See the comment in para 215 of that report.

(46) Para. [79] above.

the company becoming insolvent. However, such an approach may prove difficult to encapsulate in a legislative provision and may in any event prove to be too restrictive in its application. In terms of policy, it may be questioned whether, in relation to enforcement of duties owed to a company, there is any good reason to draw a distinction between secured and unsecured creditors or between present and contingent creditors.

[85] If it is considered that there may be cases where the intervention of creditors generally might be justified in respect of a breach of duty on the part of directors or officers, the answer may be not to provide specifically for creditors, but rather to have a provision such as section 244(a)(iii) of the Ontario legislation which gives standing to apply to "any other person who, in the discretion of the Court, is a proper person to make an application under this Part".

[86] In practice such a provision may well in many cases restrict creditors to applying to enjoin directors or officers from taking some action rather than proceeding to claim damages or compensation.

[87] **Action by directors and officers who are not also members.** The possible need to consider whether directors and officers who are not also members should have specific standing to complain on behalf of the company could arise from a recognition that, notwithstanding the need in most cases for a board or the management of a company to act as an united deliberative body, there might well be occasions when any director or officer, in order to discharge properly his or her responsibilities to the company, could consider it essential to bring to the attention of either the Court or the general meeting a breach of duty on the part of other directors or officers which it is clear is not to be remedied at the instance of the board.

[88] In many cases it could be expected that any director or officer would have access to more information concerning the conduct of a company's affairs than would be anticipated in the case of any member of the company who is not also a director or officer, and consequently be in a better position to take action, particularly in cases requiring an urgent response.

[89] An alternative to granting specific standing to such directors and officers might be, as has been mentioned as a possibility in the case of creditors,[47] to give the Court a discretionary power in relation to standing of the type found in the Ontario legislation.

[90] **Inspection of a company's books.**

A member of a company who suspects that its affairs have not been properly administered can obtain access to the records of the company under section 265B of the Companies Act 1981 (Cwlth).

[91] Access under section 265B, which can only be obtained under an order of the Supreme Court, is undertaken by a registered company auditor or a duly qualified legal practitioner, acting on behalf of the member who seeks access.

(47) See para. [85] above.

[92] An aspect of section 265B which might need to be considered as calling for amendment is whether the present limitation that only registered company auditors and duly qualified legal practitioners can be authorised to inspect is too severe. Should the Court have power to authorize:

(i) the applicant-member or any suitable person including some other member nominated by the applicant; or

(ii) the Commission?

[93] Section 265B was considered by the New Zealand Law Commission(48) as a model for its investigations. That Commission recommended a measure(49) under which an application for inspection could be made by a shareholder, a creditor or the Attorney-General and under which the Court could make an order appointing "a suitable person" to inspect.

[94] Another question is whether section 265B needs amendment to show more precisely the kinds of company records in respect of which an order for inspection can be made. For example, should there be an express inclusion of records of meetings of the board and its committees?

[95] **Member's request for information.**

If a statutory derivative action by leave were to be introduced information could be needed by a member both before applying for leave and after leave had been granted. It might be considered that existing provisions may not be adequate for this purpose: for example, see discussion concerning Companies Act 1981 (Cwlth) section 541 at paras. [32] to [37] of this paper.

[96] Provisions for derivative action˜ to be taken by a member of a company which are canvassed in this discussion paper may be of little value where the methods available to a member to determine whether a breach of duty to the company has taken place are unduly restricted.

[97] In the Draft Companies Act proposed by the New Zealand Law Commission(50) section t38 provides for access to information. Section 138 is reproduced in Appendix 2. There is a question whether any legislation to introduce a statutory derivative action by leave should be accompanied by legislation similar to section 138.

ISSUES

[98] The following appear to be the principal issues arising for discussion out of the foregoing material:

(a) Is existing law adequate to enable a member of a company to take proceedings to enforce the duties owed by directors and officers to the company?

(48) Report No. 9 "Company Law Reform and Restatement", para. 581.

(49) Draft Companies Act section 139.

(50) Report No. 9 "Company Law Reform and Restatement" June 1989.

(b) If not, would a desirable amendment to the law be a provision in the Companies Act 1981 (Cwlth) of the kind in section 245 of the Ontario Business Corporations Act whereby a member may seek the leave of the court to take derivative proceedings, or would amendment of the existing provisions of the Companies Act such as section 574, section 320, section 542 and section 541 provide a sufficient remedy?

(c) If it is considered that neither a provision such as that in Ontario nor other amendment of the existing Companies Act would provide a suitable remedy, what should be the approach to this problem of enforcement?

(d) In any new legislation, what should be the provisions regarding:

(i) whether a director or executive officer of a company who is not also a member should have standing to bring an application (as in the Ontario legislation);

(ii) whether creditors and, if any, which creditors (contingent as well as present, secured as well as unsecured), should be given specific standing to make an application for leave to take derivative proceedings or whether the legislation should merely confer a discretion on the Court to allow standing to any person other than a member (or a director or officer who is not also a member);

(iii) whether holders of convertible notes should have standing to bring an application;

(iv) whether option-holders should have standing to bring an application;

(v) whether any of the foregoing should have standing to bring an application only in defined, and, if so, what circumstances; for example, should a creditor of a company not in liquidation only be able to sue to obtain an injunction to restrain action by persons controlling the company?

(vi) whether any other person should have standing to apply;

(vii) whether a member or other applicant should be able to obtain leave to take proceedings on behalf of a subsidiary and to intervene etc. in proceedings to which a subsidiary is a party;

(viii) whether there should be any requirement for notice to the company of intention to make an application;

(ix) whether an application should be permitted to proceed ex parte in urgent cases and what orders should be permitted in those circumstances;

(x) the degree of proof that the applicant should satisfy as to the existence of a breach of duty to the company;

(xi) whether an applicant should be required to give security for costs or, conversely, whether the court should be permitted to grant the applicant an indemnity for costs;

(xii) whether an applicant should be required to give an undertaking as to damages;

(xiii) if an indemnity for costs is to be granted in favour of an applicant, to what stage of proceedings should it run; should both leave to take action and the indemnity be capable of review at a specified stage of proceedings?

(xiv) whether derivative and personal actions should be able to be heard together and whether there needs to be any further provision to cover such joined actions;

(xv) what provision, if any, should be made by way of amendment to Companies Act section 265B {inspection of company records under Court order);

{xvi) what provision, if any, should there be in addition to section 265B in respect of inspection of records of a company and provision of information;

(xvii) in what name should the action be brought after leave is granted?

(xviii) who is to manage the action?

(xix) who is to 'have power to settle or discontinue the action and under what conditions?

(xx) whether the Court should have power to appoint a custodian or a panel of custodians to conduct the action in the interests of the company; whether those custodians should be members or other persons;

(xxi) whether the Court should have power, when granting an application to take derivative proceedings, to order the appointment of a temporary administrator to take over control of a company from alleged delinquent directors or officers and, if so, on what terms; should the Court have power, additionally or alternatively, to appoint an official observer and, if so, on what terms?

(xxii) whether the Court should have power to make an order for distribution of any amount recovered among:

(A) the company;

(B) present members;

(C) former members;

(D) present creditors;

(E) former creditors;

(F) any other persons;

(xxiii) whether the introduction of a statutory derivative action on the Ontario model should be accompanied by an amendment of Companies Act section 542 to make it clear that the summary procedure under section 542 is available to a member or a creditor, and is available where a company is solvent;

(xxiv) whether, if section 542 is to be amended in the manner indicated in (xxiii), some provision should be enacted about liability for the costs of a successful respondent;

(xxv) whether the introduction of a derivative action should be accompanied by an amendment of Companies Act section 541 to make it clear that the examination procedure in that section is available to a member or creditor, and is available where a company is solvent;

(xxvi) whether the enforcement provisions of the Companies Act, including sections 574, 320, 542 and 541, should all be placed in the one separate Division of the Act, perhaps entitled "Enforcement";

(xxvii) any other matter related to enforcement of the duties of directors and executive officers.

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APPENDIX 1

ONTARIO BUSINESS CORPORATIONS ACT, 1982: EXTRACTS

"Sec. 244

Interpretation.

In this Part,

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

(b) "complainant" means,

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

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

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

Sec. 245(1)

Derivative actions.

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

Sec. 245(2)

Idem.

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

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

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

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

Sec. 245(3)

Ex parte application.

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

Sec. 245(4)

Interim order.

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

Sec. 246

Court order.

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

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

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

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

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

Sec. 248(1)

Discontinuance and settlement.

'An application made or an action brought or intervened in under this Part shall not be stayed or dismissed by reason only that it is shown that an alleged breach of a right or duty owed to the corporation or its affiliate has been or may be approved by the shareholders of such body corporate, but evidence of approval by

the shareholders may be taken into account by the court in making an order under section 206, 246 or 247.

Sec. 248(2)

Idem.

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

Sec. 248(3)

Costs.

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

Sec. 248 (4)

Idem.

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

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APPENDIX 2

NEW ZEALAND LAW COMMISSION: DRAFT COMPANIES ACT (JUNE 1989): SECTION 138

"Inspection of records

138 Information for shareholders

(1) A shareholder may at any time make a written request to a company for information held by the company.

(2) The request must specify the information sought with sufficient particularity.

(3) Within 10 working days of receiving a request under sub-section (1), the company must either

(a) provide the information; or

(b) agree to provide the information within a specified period; or

(c) agree to provide the information within a specified period if the shareholder pays a specified charge to the company to meet the cost of providing the information, and explain how the specified charge is calculated; or

(d) refuse to provide the information, and give full reasons for the refusal.

(4) Where the company requires the shareholder to pay a charge for information, the shareholder may withdraw the request, and is deemed to have done so unless within 10 working days of receiving notification of the charge he or she informs the company that he or she will pay the charge.

(5) A shareholder aggrieved by the decision of a company in relation to a request for information may apply to the Court for relief on the grounds that

(a) the period specified for providing the information is manifestly unreasonable; or

(b) the charge set by the company is manifestly unreasonable; or

(c) the refusal to provide information is manifestly unreasonable;

and on an application under this sub-section the court may make such order as it thinks fit, including, without limiting the generality of this provision, an order

(d) as to the provision of the information; or

(e) as to the use that may be made of the information, and the persons to whom it may be disclosed; or

(f) as to the costs of the application."

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