

# THE DERIVATIVE ACTION IN AUSTRALIA AND NEW ZEALAND: WILL THE STATUTORY PROVISIONS IMPROVE SHAREHOLDERS' ENFORCEMENT RIGHTS?

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## Introduction

The rule in *Foss v Harbottle*<sup>1</sup> has long been seen as a significant barrier to effective shareholder enforcement action, particularly in cases of wrongdoing by a company's own directors.<sup>2</sup> In response to the uncertainties associated with the common law, sections 165-168 of the *Companies Act 1993* (NZ) were enacted with effect from July 1994, introducing for the first time into New Zealand's company law a statutory 'derivative action'. This followed a recommendation by the New Zealand Law Commission in 1989<sup>3</sup> that such a remedy be included in revised companies legislation. In Australia, the recently introduced *Corporate Law Economic Reform Bill 1998* includes a proposal that similar provisions be added to the *Corporations Law* to address the inadequacies of the common law action.<sup>4</sup>

A derivative action is an action brought by a shareholder or director of a company in the name and on behalf of that company. Such an action is 'derivative' in the sense that the right to sue belongs not to the party actually bringing the action, but is 'derived' from that of the company. Its purpose is to achieve relief in situations where a wrong has been done to the company, rather than to its shareholders personally. Normally, the decision to take action on the company's behalf lies with the directors, as they generally have the responsibility of managing the company.<sup>5</sup> However, in some cases it is necessary that the shareholders be given the right to commence action on the company's behalf, usually because some or all of the board are themselves responsible for the wrong that has been committed.

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1 (1843) 2 Hare 461.

2 Beck A and Borrowdale A, *Guidebook to New Zealand Companies and Securities Law* (4th ed.), CCH (NZ) Ltd (1990), 232 state that 'the [common law] derivative action is universally recognised to be completely inadequate as a procedure for protecting the interests of minority shareholders.'

3 See The Law Commission, *Company Law Reform and Restatement*, NZLC R9 (1989), para. 564-571, and ss 127-130 of the Law Commission's draft *Companies Act*.

4 *Corporate Law Economic Reform Bill 1998*, proposed new Part 2F 1A - 'Proceedings on Behalf of a Company and Others'; Explanatory Memorandum to the Bill paragraphs 6.11-6.70. See also Corporate Law Economic Reform Program, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors, Proposals for Reform: Paper No 3*, Australian Government Publishing Service (1997), 29-40; McDonough D, 'Proposed New Statutory Derivative Action - Does It Go far Enough?' (1996) 8 Bond LR 47; and de Vere Stevens K, 'Should We Toss *Foss*?: Towards an Australian Statutory Derivative Action' (1997) 25 ABLR 127.

5 See sec 128 of the *Companies Act 1993* (NZ); *Corporations Law* sec 226A.

This article discusses both the common law derivative action and the new statutory provision, including the application of sec 165 in the first cases to be brought since it was enacted.<sup>6</sup> It seeks to answer the question: Has the New Zealand provision conferred any significant advantage on minority shareholders, in terms of their access to the courts and the remedies available to them, compared to the previous situation at common law and under existing statutory remedies, and should Australia follow New Zealand's lead and enact its own statutory derivative as is proposed?

It is concluded that, although the rule in *Foss v Harbottle* may historically have prevented effective shareholder discipline over errant directors in many cases, the liberalisation of the common law derivative action in more recent years, and the development of alternative remedies such as the statutory oppression remedy, have largely neutralised the limitations of the rule.

This being the case, the introduction of the statutory derivative action will probably not in itself serve to place significantly greater enforcement power in the hands of minority shareholders. What it has the potential to do, however, is add certainty to the law, in the sense that it specifies much more clearly and logically the situations in which an aggrieved shareholder may pursue a remedy for a wrong done to the company. The provision diverts attention away from the extraneous matters which encumbered the common law action, such as the level of 'fraud' required before proceedings could be brought, and the vexed question of whether or not the 'interests of justice' were sufficient in themselves to attract relief; and instead focuses the court's decision squarely on the more relevant questions of whether or not the company itself intends to take action to right the wrong done to it, and the company's interests in having the proceedings controlled by someone other than its directors or a majority of shareholders. If the statutory derivative action is approached in line with the legislative intent evident in the provision, it should prove to be a much more attractive option for shareholder control over directors' wrongdoing than its common law equivalent.

## The Common Law Derivative Action

Under the common law, a derivative action was generally possible only if the applicant could invoke one of the 'exceptions to the rule in *Foss v Harbottle*'.

### The Rule in *Foss v Harbottle*

The rule, as set out by Sir James Wigram VC in *Foss v Harbottle*, simply stated that in respect of wrongs to the company, '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>7</sup>

Thus, if an action did not have the support either of the directors of the company, in whom the power to bring proceedings on the company's behalf generally rests, or of a majority of shareholders,<sup>8</sup> it could not proceed.

6 *Vrij v Boyle* [1995] 3 NZLR 763, *Techflow (NZ) Ltd v Techflow Pty. Ltd* (1996) 7 NZCLC 261, 138, *MacFarlane v Barlow* (1997) 8 NZCLC 261, 470 and *Thorrington v McCann* (1998) 8 NZCLC 261, 564.

7 (1843) 2 Hare 461, 491.

8 Generally, the management of a company is vested in its board of directors. Thus it is usually only the board

This principle was later expanded to also state that if the alleged wrong is ratifiable by a majority of the company's shareholders, the minority may not sue. Mellish LJ in *MacDougall v Gardiner* emphasised the practical advantage of the rule in avoiding futile litigation when he said:

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 ... there can be no use in having a 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>9</sup>

Consequently, when reference is made to the 'rule in *Foss v Harbottle*', it is generally this broader set of principles which is being referred to, rather than just the locus standi rule referred to by Sir James Wigram in *Foss v Harbottle* itself.

There is disagreement as to whether the rule is in fact a single rule incorporating these two components - the 'proper plaintiff' component and the 'internal management' or 'majority rule' component - or two separate but related rules. The former interpretation postulates a single rule, based in broad terms on the majority rule principle,<sup>10</sup> and stating that, where a company has a cause of action, that company is the proper party to bring proceedings, provided that an individual shareholder or director may take action on the company's behalf if the conduct complained of cannot be properly ratified by an ordinary resolution of shareholders.

The source of the confusion appears to lie in the descriptions of the rule in *Foss v Harbottle* given in later cases, such as that by Lord Davey in *Burland v Earle*:

It is an elementary principle of the law relating to joint stock companies that the court will not interfere with the internal management of companies acting within their powers, and in fact has no jurisdiction to do so. Again, it is clear law that in order to redress a wrong done to the company or to recover moneys or damages alleged to be due to the company, the action should prima facie be brought by the company itself.<sup>11</sup>

Depending on one's interpretation of this passage and others like it, either of the conclusions discussed above is tenable. Willcocks,<sup>12</sup> citing Ford<sup>13</sup> and Gower<sup>14</sup> in

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which has the right to initiate proceedings in the company's name, and a board cannot be compelled to comply with a resolution of shareholders: *Automatic Self-Cleansing Filter Syndicate Co. Ltd v Cuninghame* [1906] 2 Ch 34, 45; *John Shaw & Sons (Salford) Ltd v Shaw* [1935] 2 KB 113, 134; and *Breckland Group Holdings Ltd v London & Suffolk Properties Ltd* [1989] BCLC 100, 104-105. However, in practice, and as noted in the above cases, a majority of shareholders will control the composition of the board, and may vote to remove directors if their wishes are not followed.

9 (1875) 1 ChD 13, 25. See also *Mozley v Alston* (1847) 1 Ph 790 for the original formulation of this component of the rule.

10 Wedderburn K, 'Shareholders' Rights and the Rule in *Foss v Harbottle*' [1957] CLJ 194, 198 states that 'it is ... 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'.

11 [1902] AC 83, 93.

12 *Shareholders' Rights and Remedies*, The Federation Press (1991), 74.

13 See *Ford & Austin's Principles of Corporations Law* (7th ed), Butterworths (1995), 444.

14 *Gower's Principles of Modern Company Law* (4th ed), Stevens (1979), 645. In his 5th edition, Gower seems to

support, concludes that the general consensus of opinion is towards there being a single rule, comprising two interlocking components. This interpretation does appear to be the most logical, given that the conduct complained of had to effectively satisfy both components before the *exceptions* to the rule - which are the real focus of any case dealing with an application to commence derivative proceedings - could come into play. The wrong had to be both:

- Properly subject to action by the company only, rather than a member personally; but
- Not acted on by the company, either through a refusal on the part of the board of the company to use the corporate machinery to take action on the company's behalf or, in the case of wrongdoing by controlling shareholders, through the use of improper means to prevent such action being taken. This could be done, for example, by the wrongdoers using their own voting power (and that which they otherwise controlled through the use of nominee shareholders and proxy votes) to procure ratification of the wrongful act by a majority of shareholders, or by purporting to obtain the board's approval for their conduct when the board had no power to grant such approval.<sup>15</sup>

If either of these did not apply, the issue of an action by a shareholder in the company's name did not arise. The combining of these two principles to make up a single 'rule' also appears to be the interpretation favoured in the early case law dealing with this issue. For example, in *MacDougall v Gardiner*,<sup>16</sup> the *majority rule* principle was described as emanating from both *Mozley v Alston* and *Foss v Harbottle*, and in *Gray v Lewis*, James LJ said:

It is very important, in order to avoid oppressive litigation, to adhere to the rule laid down in *Mozley v Alston* and *Foss v Harbottle* ... that where there is a corporate body capable of filing a bill for itself ..., that corporate body is the *proper plaintiff* and the only proper plaintiff.<sup>17</sup>

### Background to the Rule

The rationale for the rule in *Foss v Harbottle* is best understood by considering the original case itself, and the context within which it was decided.

*Foss v Harbottle* involved an action by two shareholders of a company, nominally on behalf of themselves and all other shareholders (with the exception of the defendants), against the company's directors. It was established by Sir James Wigram in the Court of Chancery that it was not appropriate for the plaintiffs to sue in a personal (although representative) capacity, as the conduct with which the defendants were charged was

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favour the division of the rule into two distinct parts. He says, at 646, that 'it seems questionable whether it can be correct to treat the rule as a single, albeit two-part, rule subject to a single list of exceptions ... There seems to be two distinct rules: (i) The original rule in *Foss v Harbottle* and (ii) What might better be called the rule in *Mozley v Alston* or in *MacDougall v Gardiner*, each with its own exceptions.'

15 Except by way of a derivative action, a company cannot be made a plaintiff if neither the board or the general meeting have consented to this: *Spokes v Grosvenor Hotel Co* [1897] 2 QB 124, 130, per Chitty LJ; *Beattie v E & F Beattie Ltd* [1938] Ch 708, 718, per Sir Wilfrid Greene MR.

16 (1875) 1 ChD 13, 21 & 25, per James and Mellish LJJ.

17 (1873) LR 8 Ch App 1035, 1050-1051 (emphasis added).

‘an injury not to the plaintiffs ... [but] to the whole corporation.’<sup>18</sup> Therefore, the Vice Chancellor held that the action could only be brought by the company itself or, if ‘reasons of a very urgent character’ could be shown to exist, by the plaintiffs acting on the company’s behalf.<sup>19</sup>

The complaint itself alleged that the directors had fraudulently misapplied the company’s funds by causing the company to purchase a piece of land from them at an excessive price, and that the board had raised money in a manner not authorised by the private Act of Parliament under which the company had been incorporated.

The decision not to allow the plaintiffs to bring the action seems to have been based primarily upon a desire to uphold contemporary norms of company management and ownership.<sup>20</sup> This desire is understandable if we consider that *Foss v Harbottle* was decided at the height of the industrial revolution, with incorporation not yet being freely available and limited liability still twelve years away.<sup>21</sup> It was noted by the judge that ‘corporations like this [incorporated by individual private statute] ... are in truth little more than private partnerships’,<sup>22</sup> suggesting that he was relying on partnership principles, with their connotations of mutual trust and good faith between individual business people, and presupposing mechanisms of consultation, and genuinely universal and equal suffrage among members, as a justification to suppress individual members’ wishes in favour of the will of the majority. It was considered necessary that corporate managers be shielded from undue shareholder interference, to encourage risk taking and entrepreneurship. The Act which provided for the company’s incorporation clearly placed its management in the hands of the directors, subject only to challenge by all shareholders in general meeting,<sup>23</sup> and thus:

It would be the very antithesis of the statutory control structure to allow shareholders to make, in essence, a management decision. Injustice, we are to assume, is not a problem because individual shareholders contract into this arrangement upon entering the company and therefore should be aware of the consequences.<sup>24</sup>

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18 (1843) 2 Hare 461, 490.

19 Ibid at 492.

20 Maloney M, ‘Whither the Statutory Derivative Action?’ (1986) 64 Can Bar Rev 309, 312-313. Prunty B, ‘The Shareholders’ Derivative Suit: Notes on its Derivation’ (1957) 32 NYULR 980, 983-984 notes that the right of a shareholder to sue management on the company’s behalf had been recognised prior to *Foss v Harbottle*, in cases like *Hichens v Congreve* (1828) 1 Russ & M 150 and *Preston v The Grand Collier Dock Co* (1840) 11 Sim 237 but that, by 1843, ‘the prospect of an avalanche of disgruntled or querulous shareholders’ seems to have led the courts to the conclusion that judicial restraint on such action was required. See also *Lord v The Copper Miners’ Co* (1848) 1 H & Tw 85, 99, a judgment made soon after *Foss v Harbottle*, where it was held that: ‘If a court of equity were to assume jurisdiction in such a case, could it do so without opening its doors to all parties interested in corporations ... who, although a small minority of the body to which they belong, may wish to interfere with the conduct of the majority? This cannot be done; and the attempt to introduce such a remedy ought to be checked for the benefit of the community.’

21 These two characteristics, now central to the utility of the corporate form in modern business, were introduced by the *Joint Stock Companies Registration and Regulation Act 1844* and the *Limited Liability Act 1855* respectively. The *Chartered Companies Act 1837*, in force when the case was decided, permitted incorporation only by the granting of letters patent upon regal or ministerial approval: see above n13, at 39-42.

22 (1843) 2 Hare 461, 491.

23 Ibid at 492.

24 Above n20, at 313.

Bottomley<sup>25</sup> states that the predominant attitude of the courts at that time towards shareholders' rights was that the 'best interests of the company' (as determined by the wishes of the majority) should necessarily prevail over the interests of any individual shareholder, thus effectively separating the process by which decisions were made from the issue of the decision-making competence of the majority, including a consideration of the nature and effect of the questions which were voted on. Bottomley describes this principle as fitting within the 'formalist model' of corporate law,<sup>26</sup> in that it provided a mechanism by which decisions could be justified in an entirely objective way:

The resulting action (or, in the context of *Foss v Harbottle*, inaction) of the corporation is justified simply on the grounds that it is what most of the constituents wanted. As one judge<sup>27</sup> has put it, 'Even if the minority is profoundly convinced that a decision not to sue is wrong, the minority is still a minority and not the majority'.<sup>28</sup>

This attitude towards corporate management, although understandable and even perhaps justifiable in the circumstances in which *Foss v Harbottle* was decided, was never appropriate as an absolute standard. In *Foss v Harbottle* itself, Sir James Wigram referred to the possibility of the rule being relaxed in situations where 'no adequate remedy remained except that of a suit by individual corporators' or where 'the claims of justice' required such relaxation.<sup>29</sup>

Since then, developments in the business environment and in the characteristics of the corporate form itself have prompted a shift away from treating majority rule as the principle which will prima facie be followed by the courts in shareholder disputes, and towards a more balanced view of the rights of minorities in relation to those of the majority.

Bottomley<sup>30</sup> notes that the corporate group, rather than what Sir James Wigram described as the 'private partnership', has become 'the quintessential model of corporate business activity in the late twentieth century'. He claims that in this context corporate activity (and in particular the exercising of directors' discretion in business decision-making) has become more of a 'public' concern, which should therefore be subject to greater judicial scrutiny in order to protect individual members' rights.

Thus, in the case of larger companies at least, the liberalisation of shareholder remedies is a recognition that the individual members of such companies do not normally have the means to control errant directors without judicial interference. However, the same liberalisation is also evident in cases involving smaller, closely held, companies which, although relatively less significant in economic terms, still make up the vast majority of companies (and thus also the majority of companies involved in litigation arising from intra-corporate disputes).<sup>31</sup> This appears to be based

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25 'Shareholders' Derivative Actions and Public Interest Suits: Two Versions of the Same Story?' (1992) 15 *UNSWLJ* 127, 138.

26 A term coined by Frug G, 'The Ideology of Bureaucracy in American Law' (1984) 97 *Harvard LR* 1277, 1282.

27 Sir Robert Megarry in *Estmanco (Kilner House) Ltd v Greater London Council* [1982] 1 WLR 2, 10.

28 Above n25, at 138.

29 (1843) 2 Hare 461, 492.

30 Above n25, at 141-142.

31 See The Law Commission, *Company Law: A Discussion Paper*, NZLC PP5 (1987), para 46-47.

on a realisation by the courts that, although these companies may in practical terms be little more than incorporated partnerships, there are certain characteristics of the corporate form (such as the majority rule principle, the presumption that management power will reside solely with the directors rather than shareholders, and the existence of a written constitution which may purport to exhaustively define members' rights and duties) which can result in a member's legitimate expectations regarding his or her role within the company being frustrated.

The trend towards greater recognition of minority enforcement rights is evident from the introduction of several exceptions to the rule in *Foss v Harbottle* in the years following the judgment, and from the broadening of the scope of these exceptions which has occurred in more recent times. It is proposed to now consider these exceptions, their development in response to the above changes, and the advent of alternative statutory remedies designed to overcome the obstacles placed in the way of minorities by the common law. Chief among these provisions is the 'oppression' remedy.

### **Exceptions to the Rule**

There are four generally accepted exceptions to the rule. These were set out by Jenkins LJ in *Edwards v Halliwell*,<sup>32</sup> and may be summarised as follows:

#### **1 The 'special majority' exception**

This applied when a corporate action had been approved by an ordinary resolution (ie. one approved by a simple majority), when a higher majority had been prescribed by statute or the company's constitution. It was held in cases such as *Baillie v Oriental Telephone Co Ltd*<sup>33</sup> and *Cotter v National Union of Seamen*<sup>34</sup> that to allow a company to invoke the rule in such circumstances would be to effectively let the company breach its constitution or the statute, with no opportunity of redress for the disadvantaged minority.

#### **2 The 'illegal or ultra vires acts' exception**

If the action complained of was illegal,<sup>35</sup> or wholly ultra vires the company,<sup>36</sup> then the rule could not apply because a majority of members cannot validly confirm such a transaction.

#### **3 The 'personal rights' exception**

This 'exception' stated that when the action complained of was a breach of a shareholder's personal rights, and therefore could be remedied by a personal action by

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32 [1950] 2 All ER 1064, 1067, in what has been described as 'by far the most classic definition of the rule in *Foss v Harbottle*': Osunbor O, 'A Critical Appraisal of the 'Interests of Justice' as an Exception to the Rule in *Foss v Harbottle*' (1987) 36 *ICLQ* 1.

33 [1915] 1 Ch 503.

34 [1929] 2 Ch 58.

35 *Northwest Transportation Co Ltd v Beatty* (1887) 12 App Cas 589.

36 See *Hutton v West Cork Railway Ltd* (1883) 23 ChD 65, and more recently *Devlin v Slough Estate Ltd* [1983] BCLC 497.

the complaining shareholder, the derivative action did not apply. This rather obvious conclusion was not really an exception as such, but rather, as emphasised by Jenkins LJ in *Edwards v Halliwell*, a circumstance where the rule simply had no application. Any member who wished to sue in such a case was free to do so, 'not in the right of the company but in their own right, to protect from invasion their individual rights as members.'<sup>37</sup>

The fact that this was ever framed as an exception to the rule may be indicative of the confusion shown periodically by the judiciary regarding the true nature of the derivative action,<sup>38</sup> or perhaps rather of the historical uncertainty regarding the lines of demarcation between personal and corporate rights.<sup>39</sup>

#### 4 *The true exception: 'fraud on the minority'*

This has been described as 'the only true exception' to the rule in *Foss v Harbottle*,<sup>40</sup> a fair description when it is considered that the others are really self-evident and, strictly speaking, not even within the ambit of the rule. It is also the broadest exception and thus the one most often invoked by complaining minorities. The exception included two components: Those against whom relief was sought had to *control* the company, thereby preventing an action being brought against them in the company's name; and the conduct complained of must, in the view of the court, have constituted a *fraud*.

In early cases, control was equated only with actual control of voting rights,<sup>41</sup> but more recently the courts have held the control requirement to be fulfilled not only in cases where the defendants themselves have held the majority of voting rights, but also in any other case where the company has in fact been controlled by the wrongdoers. Such cases included those where a majority of shares were held by nominees, bound to vote in accordance with the defendants' instructions; those where shareholders were offered inducements to vote in favour of the wrongdoers,<sup>42</sup> or where the defendants were able to determine the outcome of a resolution in their own favour by the use of proxy votes.<sup>43</sup>

As noted by Russell,<sup>44</sup> the extension of the interpretation of 'control' to include de facto as well as actual voting control was plainly 'good sense', since it would have

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37 [1950] 2 All ER 1064, 1067.

38 See *Gower's Principles of Modern Company Law* (5th ed), Sweet & Maxwell (1992) 647, and *Wallersteiner v Moir* (No 2) [1975] QB 373, 391, where Lord Denning adopted Gower's words to the effect that the commonly used form of action - 'the plaintiff on behalf of himself and all the other shareholders' - gave a misleading impression of what really occurs in a derivative action: 'The plaintiff shareholder is not acting as a representative of the other shareholders, but as a representative of the company.' For this reason, he approved the discarding of the usual formula.

39 See Hanrahan P, 'Distinguishing Corporate and Personal Claims in Australian Company Litigation' (1997) 15 C&SLJ 21, 41-43, which refers to the 'somewhat ad hoc approach to the question' adopted by the Australian courts.

40 See above n20, at 311; and *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257, 323.

41 *Burland v Earle* [1902] AC 83, 93.

42 An extension to the 'control' requirement which was actually accepted as early as 1867, in *Atwool v Merryweather* (1867) LR 5 Eq 464.

43 An example suggested by Vinelott J in *Prudential Assurance Co. Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257, 324.

44 'Liberalising the Derivative Action' [1982] NZLJ 180, 181.

been absurd to require voting control in instances where de facto control could be achieved with less than a majority shareholding.

In a similar fashion, the 'fraud' requirement was interpreted in earlier cases, such as *Cook v Deeks*<sup>45</sup> and *Pavlides v Jensen*,<sup>46</sup> to include only actual fraud, ie. dishonesty. Negligence (even gross negligence) was not sufficient. In *Pavlides v Jensen*, the directors approved the sale of a mine belonging to the company for £182,000 when it was actually worth about £1000,000. The minority shareholders complained, alleging fraud and gross mismanagement. The court held that a minority shareholder could **not** sue on behalf of the company in these circumstances, as only negligence, and no actual fraud, could be proven. As a majority of shareholders can ratify acts that are merely negligent (ie. in breach of the directors' duty of care), the applicant had no standing to bring the action.

Later cases gradually extended this rather restrictive interpretation of the exception. A more liberal approach was first applied in the case of *Daniels v Daniels*.<sup>47</sup> In that case, the company's only directors, Mr and Mrs Daniels, also held a majority of the company's shares. A piece of land was sold by the company to Mrs Daniels for £4,250 - a gross undervalue considering that she was able to resell the property four years later for £120,000. Another shareholder attempted to sue the directors on the company's behalf. Despite no allegation of actual fraud, Templeman J held that negligence or a breach of duty which not only harmed the company but also resulted in a profit to a director did amount to a fraud on the minority.

The defendants relied heavily on the decision in *Pavlides v Jensen* in their submission that 'mere gross negligence' was not actionable, to which Templeman J replied:

To put up with foolish directors is one thing; to put up with directors who are so foolish that they make a profit of £115,000 odd at the expense of the company is something entirely different.<sup>48</sup>

While conceding in his judgment that *Pavlides v Jensen* seemed to be in line with current authorities on the subject (including *Cook v Deeks*,<sup>49</sup> *Alexander v Automatic Telephone Co Ltd*<sup>50</sup> and *Turquand v Marshall*<sup>51</sup>) Templeman J actually broadened the fraud on the minority exception significantly, by effectively removing the requirement for bad faith on the part of the defendants. He concluded that:

A minority shareholder who has no other remedy may sue where directors use their powers, intentionally or unintentionally, fraudulently or negligently, in a manner which benefits themselves at the expense of the company.<sup>52</sup>

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45 [1916] 1 AC 554.

46 [1956] Ch 565.

47 [1978] Ch 406.

48 Ibid at 414.

49 [1916] 1 AC 554.

50 [1900] 2 Ch 56.

51 (1869) LR 4 Ch App 376, 386, where Lord Hatherley said that the trust given by shareholders to directors extended to conduct done 'merely by default of judgement ... However ridiculous and absurd their conduct might seem, it was the misfortune of the company that they chose such unwise directors.'

52 [1978] Ch 406, 414.

This passage, although representing a breakthrough for minority shareholders seeking to enforce corporate interests, appears to retain the previous requirement that an intention (albeit bona fide) on the part of the defendant to benefit from the conduct had to be shown.

However, in the next case on the fraud requirement to come before the English courts, *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*,<sup>53</sup> Vinelott J concluded that it was not necessary for the plaintiff to allege and prove that a defendant, in breaching a duty to the company, acted 'with a view' to benefiting him or herself at the company's expense. In fact, he expressed doubt as to whether the requirement for some benefit on the defendant's part was a valid one at all:

The exception does not apply if all that is alleged is that the directors who control the company are liable to the company ..., it not being shown that the transaction was one in which they were interested or that they have in fact obtained any benefit from it. It is not easy to see precisely where the line between these cases is to be drawn ... [or] to see what principle underlies the distinction ... It may be said, in a perfectly intelligible sense, to be a fraud on the minority that those against whom the claim would be brought are in a position to procure and, if the derivative claim is not brought will procure, that the company's claim, however strong it may appear to be, will not be enforced.<sup>54</sup>

In a more recent English case, *Barrett v Duckett*,<sup>55</sup> the grounds for allowing a derivative action seem to have been reduced to only two, namely that the company is entitled to the relief sought, and that no other remedy is available. References to such matters as the meaning of 'fraud' and the need for bad faith or some benefit to the defendant, are conspicuous by their absence.

## 5 The 'interests of justice'?

It has been suggested at various times that there was a fifth exception to *Foss v Harbottle*, commonly described as the 'interests of justice' exception. This view can be traced back to the words of Sir James Wigram in *Foss v Harbottle* itself:

If a case should arise of injury to a corporation by some part of its members, for which no adequate remedy remains, except that of a suit by individual corporators ..., the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue.<sup>56</sup>

The English courts during the 1980s and 1990s avoided classifying the interests of justice as a distinct exception to the rule, claiming it was 'not a practical test',<sup>57</sup> preferring instead to extend the bounds of the existing 'fraud on the minority' exception to the point where 'injustice' could almost be said to have overtaken the original test.

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53 [1981] Ch 257, overruled in part by the Court of Appeal [1982] Ch 204.

54 Ibid at 316.

55 [1995] 1 BCLC 73, overruled by the Court of Appeal on other grounds [1995] 1 BCLC 243.

56 (1847) 2 Hare 461, 492.

57 *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204, 221.

In *Estmanco (Kilner House) Ltd v Greater London Council*, Sir Robert Megarry said: 'I do not think that it can simply be said that there is an exception from the rule whenever the justice of the case requires it.' He did, however, also hold that 'although the concept of justice is not the test, I think that it is nevertheless a reason, and an important one, for making exceptions to the rule'.<sup>58</sup>

Commentators such as Osunbor support the view that, although recent English cases show that

the courts are prepared to relax [the rule] where necessary to bring about justice in the circumstances presented to the court ..., the 'interests of justice' by themselves are not an exception to the rule as they are too nebulous, vague and infinitely elastic.<sup>59</sup>

Russell<sup>60</sup> has described decisions such as those in the *Prudential* and *Estmanco* cases as 'laudable' in the sense that they provided justice for the participants, but unhelpful in providing a sound basis of principle, from which accurate observations on the law could be made. Wedderburn makes similar comments in his consideration of the *Prudential* case, which he says left unanswered many fundamental questions.<sup>61</sup>

The approach taken recently by the Australian courts, and to a more limited extent those of New Zealand prior to the enactment of the statutory remedy, has also been a liberal one. As in the United Kingdom, the courts have generally shown a willingness to grant a shareholder standing where justice requires it but, unlike the English courts, they have also shown an inclination to effectively 'brush aside' the procedural barriers of *Foss v Harbottle* where they stand in the way of justice being served.

Case law on this point, and on the common law derivative action in general, was sparse in Australia prior to about 1990, and continued to be so in New Zealand right up until the statutory provision came into force in 1994. Sealy notes that between 1971 and 1989 *Foss v Harbottle* was mentioned a total of only 11 times in reported Australian cases, more often than not merely in passing, or to say that the rule had no application. He goes on to state, however, that the picture that consistently comes through from these cases is one of 'a willingness to get to the substantial issue, undistracted by any consideration of locus standi or procedure'.<sup>62</sup>

An example appears in *Bancorp Investments Ltd v Primac Holdings Ltd*.<sup>63</sup> This case concerned a matter of internal corporate procedure, one to which a court in the United Kingdom might well have applied Mellish LJ's remarks in *MacDougall v Gardiner*, that

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 ... there can be no use in having a litigation about

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58 [1982] 1 WLR 2, 10-11.

59 Above n32, at 13.

60 Above n44, at 182-183.

61 'Notes of Cases: Derivative Actions and *Foss v Harbottle*' (1981) 44 *MLR* 202, 207.

62 'The Rule in *Foss v Harbottle*: The Australian Experience' (1989) 10 *Co Law* 52.

63 (1984) 9 *ACLR* 263.

it, the ultimate end of which is only that a meeting has to be called, and then ultimately the majority gets its wishes.<sup>64</sup>

Instead, McPherson J granted leave to commence proceedings on the grounds that the proposed actions were in breach of

the fundamental right of shareholders, which is their right to vote using their shares at a meeting ... It is clear that a shareholder that apprehends that some wrong may be done to him ... is entitled to apply to the court for relief such as will ensure that the apprehended injustice or wrong is not done to him.<sup>65</sup>

Sealy describes the difference between the English and Australian approaches as 'the difference between 'Why should we?' and 'Why not?''.<sup>66</sup> This attitude has continued in the most recent Australian cases, with the most obvious point of contrast lying in the Australian courts' willingness to embrace the 'interests of justice' as an exception to *Foss v Harbottle* in its own right.

The judgment of Ipp J in the Supreme Court of Western Australia in *Biala Pty Ltd v Mallina Holdings Ltd*<sup>67</sup> is the leading Australian authority on the application of this 'fifth exception'.

In this case the defendant company, Mallina Holdings Ltd, had entered a joint venture with another company, Dempster Nominees Pty. Ltd, to tender for the right to carry out a feasibility study on the development of a petrochemical plant on behalf of the Western Australian State Government. The chairman and managing director of both companies, Mr Dempster, was described in the judgment as the 'dominant force' in relation to the joint venture's dealings with the government and others: 'The idea of the joint venture was conceived and implemented by Dempster alone', there being no written or oral agreement between Mallina and Dempster Nominees concerning the joint venture, and no resolution of directors to approve its formation.<sup>68</sup>

Without informing Mallina's shareholders, Mr Dempster arranged for the company to transfer its interest in the joint venture to another company, in which he held 50% of the shares. This company was eventually awarded an exclusive mandate to undertake the feasibility study for the project.

The plaintiff company, a minority shareholder in Mallina, brought derivative claims against both Mr Dempster and Dempster Nominees, alleging breaches of fiduciary duties owed to Mallina as a joint venture partner. On the issue of Biala's standing to take action on Mallina's behalf, the company relied on both the 'fraud on the minority' and the 'interests of justice' exceptions to *Foss v Harbottle*.

Ipp J held that this was not a case where the fraud on the minority exception applied. The plaintiffs could not establish that Dempster Nominees and Mr Dempster 'controlled' Mallina, in the sense that they could not show that more than 50% of the

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64 (1875) 1 ChD 13, 25.

65 (1984) 9 ACLR 263, 267.

66 Above n62, at 54.

67 (1993) 11 ACSR 785.

68 Ibid at 813.

company's shareholders would have voted against commencing or proceeding with the action at the date of the trial. In light of this finding, the issue of whether or not the defendants' failure to comply with their fiduciary duties to Mallina satisfied the 'fraud' requirement was left open.<sup>69</sup>

Failure to establish the elements of fraud on the minority did not, in the judge's opinion, necessarily detract from any arguments that could be raised based on the 'interests of justice', however. In upholding the existence of a fifth exception to *Foss v Harbottle*, his Honour referred to English authority stretching back to statements by Lord Cottenham in *Wallworth v Holt*,<sup>70</sup> and including *Hodgson v National & Local Government Officers' Association*,<sup>71</sup> a trade union case which, according to Ford and Austin, 'is thought to exemplify the fifth exception'.<sup>72</sup>

Ipp J then also considered the more recent *Prudential* and *Estmanco* cases where, as noted above, the existence of a fifth exception to *Foss v Harbottle* was rejected due to its impracticality. He noted, however, that the Court of Appeal in the *Prudential* case had described their findings on this point as 'merely a reflection of our own thoughts, without the benefit of sustained argument', and had further stated that 'it would be improper for us to express any concluded view on the proper scope of the exception or exceptions to the rule in *Foss v Harbottle*'.<sup>73</sup> With regard to the sentiments expressed by Sir Robert Megarry in *Estmanco*, Ipp J, in a similar fashion to Russell immediately after that case was decided,<sup>74</sup> concluded that:

His views equally justify the existence of a fifth exception so as to protect minority shareholders in those rare cases where they are unable to bring themselves within one of the recognised exceptions and where serious injustice would arise if they were precluded from pursuing a derivative action.<sup>75</sup>

The fifth exception to *Foss v Harbottle* was next considered in *Aloridge Pty Ltd v West Australian Gem Explorers Pty Ltd*,<sup>76</sup> where the plaintiff applied as a shareholder to have the defendant company wound up. In support of its application, Aloridge argued that the company's directors had breached a number of their duties. The application was unopposed, and a provisional liquidator was appointed.

After the winding up proceedings had commenced, Aloridge sought to amend its statement of claim to include further allegations against the company's board. The directors argued that these new claims depended upon a right of action belonging to the company, which could only be exercised by the provisional liquidator on the company's behalf.

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69 Ibid at 843-844.

70 (1841) 4 Myl & Cr 635, also cited by Sir James Wigram in *Foss v Harbottle* (1847) 2 Hare 461, 492 in support of his finding that the interests of justice should override any technical difficulties regarding a shareholder's right to sue on behalf of a company.

71 [1972] 1 WLR 130.

72 Above n13, 449.

73 [1982] 1 Ch 204, 220-221, cited at (1993) 11 ACSR 785, 845-846.

74 Above n44, at 182. See above under the heading *The true exception: fraud on the minority*.

75 (1993) 11 ACSR 785, 845-847.

76 (1995) 15 ACSR 645.

Burchett J granted the application at first instance and appointed Aloridge as receiver of the rights of action of the company, on the grounds that 'considerations of justice and convenience' favoured the plaintiff. He stated that 'a provisional liquidator's primary function is to maintain the status quo pending determination of the winding up process',<sup>77</sup> and that it was thus inappropriate for the court to authorise the provisional liquidator to pursue the matter when the plaintiff was ready to do so.

On appeal, the Full Federal Court overturned Burchett J's orders. The court did not, however, discount the application of a fifth exception in these circumstances, but rather stated that the vesting of the right to sue in a receiver 'was a case of departure from the general rule by way of an exception of necessity',<sup>78</sup> ie. it was necessary for the plaintiff to establish that there was no way in which the company itself, or the provisional liquidator on its behalf, would undertake the relevant proceedings, something Aloridge was unable to do in this case.

Subsequent discussion of the *Aloridge* case, both by commentators and in later judgments, emphasises the fact that the reversal of Burchett J's orders did not spell the end of the fifth exception to *Foss v Harbottle* in Australia. Baxt makes the point that although

the proponents of the statutory derivative action will argue that this is another example of why a statutory exception to *Foss v Harbottle* is needed ..., it would appear from the facts of this case that the court was dealing with a very special set of facts, and decided the matter on the facts rather than as a general principle of law.<sup>79</sup>

In a similar vein, Young J in *Mesenberg v Cord Industrial Recruiters Pty Ltd*, when presented with the argument that the Federal Court's decision showed that the fifth exception was 'now out of favour', said:

I do not think the case goes that far and even if it did, I would have thought that the authorities referred to above<sup>80</sup> meant that this court should continue to follow its previous decisions.<sup>81</sup>

The decision of the Supreme Court of Western Australia in *Cope v Butcher*<sup>82</sup> indicates the extent to which the 'interests of justice' exception is now accepted in Australia. While previous decisions speak of 'doubt as to whether this exception is part of the law' and judgments which merely 'conceive that it might exist',<sup>83</sup> in *Cope* even the *defendants* conceded that it was possible to invoke a fifth exception. Acting Master Johnston, however, in line with the Federal Court's decision in *Aloridge* and the

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77 Ibid at 650-651, citing *Re Obie Pty Ltd* (No 2) [1984] 1 QdR 371.

78 *Christianos v Aloridge Pty Ltd* (1995) 18 ACSR 272, 282.

79 'The Rule in *Foss v Harbottle* Rears its Ugly Head - The Case for a Statutory Derivative Action Gathers Strength' (1996) 14 *C&SLJ* 174, 175.

80 Including *Campbell v Kitchen & Sons Ltd* (1910) 12 CLR 513, *Hawkesbury Development Co Ltd v Landmark Finance Pty Ltd* [1969] 2 NSW 782 and other cases where the courts had given relief 'which can only be explained by this fifth or some other additional exception to the traditional four'.

81 (1996) 19 ACSR 483, 487.

82 (1996) 20 ACSR 37, 40.

83 See *Mesenberg v Cord Industrial Recruiters Pty Ltd* (1996) 19 ACSR 483, 486 and *Aloridge Pty Ltd v West Australian Gem Explorers Pty Ltd* (1995) 15 ACSR 645, 649-650.

current English position as set out in *Barrett v Duckett*,<sup>84</sup> held that, notwithstanding the applicability of the fifth exception to *Foss v Harbottle*, before a derivative action can be allowed by the court, it must be established that normal company procedures have failed to gain the justice sought to be achieved by such an action.

What Sealy describes as the ‘robust approach’ recently employed by the Australian courts in applying *Foss v Harbottle* seems to have also been favoured in New Zealand prior to the enactment of the statutory derivative action, although there has been little recent case law dealing directly with the rule and its exceptions. Instead, New Zealand judges preferred to simply ‘become embroiled in the substantive issue and see it resolved ..., brushing aside a *Foss v Harbottle* objection in a couple of sentences’ when such an objection arose as a potential obstacle.<sup>85</sup>

For example, in *Berlei Hestia (NZ) Ltd v Fernyhough*,<sup>86</sup> Mahon J was asked to rule on the validity of an alteration to the accounts of a joint venture. He quickly dealt with the issue of standing thus:

This is not a case to which the principle of *Foss v Harbottle* applies, because the claim is brought by a shareholder and its nominee directors against other directors and shareholders in respect of certain actions attributed to the directors and shareholders of the ... company, as well as to the company itself ... There can be no doubt that a shareholder in a company, while having no purely statutory right to enforce compliance by directors with their accounting duties, may yet rely on his proprietary rights to bring about the same result.<sup>87</sup>

The fact that so little was said in this case regarding the standing of the plaintiff to bring the action makes it somewhat difficult to ascertain the exact basis for Mahon J’s decision on this point. It appears to represent either a liberal interpretation of the ‘personal rights’ exception, or perhaps an application of the ‘interests of justice’ (in fact although not actually expressed).

In either case, the approach of Mahon J may be contrasted with that of Dillon J in *Devlin v Slough Estates Ltd*,<sup>88</sup> an English case decided shortly afterwards. On similar facts to the *Berlei Hestia* case, his Honour held that a shareholder did not have a personal right to insist on having accounts prepared in accordance with statutory requirements, and that a derivative action was not appropriate, as this was a matter of business judgment and ‘the court does not interfere with the business judgment of directors in the absence of allegations of mala fides’.<sup>89</sup>

More recent cases like *Mathias v Pearce*,<sup>90</sup> where Fisher J endorsed the findings of Pritchard J in *Baigent v DMcL Wallace Ltd*<sup>91</sup> that a plaintiff could pursue a derivative action if it could be established that the directors had breached their fiduciary

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84 [1995] 1 BCLC 243, 250. See above under the heading *The true exception: fraud on the minority*.

85 Above n62, at 53.

86 [1980] 2 NZLR 150.

87 Ibid at 155 & 158.

88 [1983] BCLC 497.

89 Ibid at 502.

90 (1992) 6 NZCLC 68,102, 68,109.

91 (1984) 2 NZCLC 99,122, 99,128-99,129.

obligations to the company, and that the directors would not initiate proceedings on the company's behalf, indicate that the courts of New Zealand favoured a liberal approach to the common law action. In fact, in its initial discussion paper on company law,<sup>92</sup> the New Zealand Law Commission expressed doubt as to whether the rule in *Foss v Harbottle* was, in practical terms, a substantial impediment to shareholders' rights of enforcement. In particular, the Commission pointed to the expansion of the oppression remedy in sec 209 of the *Companies Act 1955* (now sec 174 of the *Companies Act 1993*); and the apparent liberalisation of the common law derivative action, with the concept of 'unfairness', in line with the 'interests of justice' exception to *Foss v Harbottle*, largely supplanting the narrower 'fraud on the minority' exception.

However, by the time NZLC R9 was published, the Commission was of the opinion that the rule 'hampered' the effective enforcement of directors' duties.<sup>93</sup> No reason for this turnaround is given in the Report. One can only assume that submissions given in response to the Commission's preliminary paper were in favour of the statutory action. The business community appears, at least, to have had no problem with the provision - not one of the submissions made on the resulting *Companies Bill* even made mention of the proposed derivative action, suggesting that the provision was not seen as a threat to the ability of directors to make business decisions, or as an opening of the floodgates for disgruntled shareholders to enforce corporate rights.

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92 NZLC PP5, above n31, para 295-297.

93 NZLC R9, above n3, para 564.

### Corporate Action under the Oppression Remedy

The oppression remedy, now found in sec 174 of the *Companies Act 1993* (NZ) and sec 260 of the *Corporations Law*, is the broadest of all the remedies available to minority shareholders.<sup>94</sup> It provides that a shareholder who considers that the company's affairs are being conducted 'in a manner that is oppressive, unfairly discriminatory or unfairly prejudicial' to him or her may apply to the court for relief.

In the past, the provision has been interpreted very narrowly, and only a handful of successful actions were brought in New Zealand between 1955 and 1981.<sup>95</sup> However, amendments to both the New Zealand and Australian provisions in the early 1980s have resulted in a significant liberalisation of the courts' approach to the oppression remedy.

The increased scope of the amended oppression remedy was considered by the New Zealand Court of Appeal in *Thomas v HW Thomas Ltd*. Richardson J held that it was not necessary to show a lack of probity or want of good faith to invoke the remedy, and that:

The underlying concern of the subsection [is] that conduct of the company which is unjustly detrimental to any member of the company, whatever form it takes and whether it adversely affects all members alike or discriminates against some only, is a legitimate foundation for a complaint under sec 209 [of the *Companies Act 1955* (NZ)].<sup>96</sup>

The liberal approach currently favoured in the interpretation of the oppression remedy has made it a very useful remedial tool for minority shareholders. Uncertainty remains, however, regarding whether or not it may be used to remedy corporate (as opposed to personal) wrongs. The 1980 amendment to the 1955 New Zealand Act included the addition of paragraph (d) to the suggested orders set out in sec 209(2). Paragraph (d) provided that the court could make an order 'authorising a member or members of the company to institute, defend, or discontinue court proceedings in the name and on behalf of the company.'

It has been noted that this provision did not fit neatly within sec 209. The oppression remedy is concerned with conduct of the company that adversely affects shareholders, rather than with wrongs done to the company itself.<sup>97</sup> This conclusion is supported by the fact that, during the period in which sec 209(2)(d) was in force (1 April 1981 - 30 June 1994), there were no reported New Zealand cases in which the court made such an order. The equivalent English and Australian provisions appear to have produced only one such order between them,<sup>98</sup> and the Australian Companies

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94 Wishart D, *Company Law in Context*, Oxford University Press (1994), 199-200.

95 Borrowdale A, 'Shareholder's Protection: The Section 209 remedy - A Survey' [1988] NZLJ 196. The only New Zealand cases where an application was granted during this period were *Re Anticorrosive Treatments Ltd* (1980) 1 BCR 238 and *Re Federated Fashions (NZ) Ltd* (1981) 1 BCR 297.

96 [1984] 1 NZLR 686, 693. See also *Lusk v Archive Security Ltd* [1991] MCLR 176 and, in Australia, *Wayde v New South Wales Rugby League Ltd* (1985) 59 ALJR 798 and *Jenkins v Enterprise Gold Mines NL* (1992) 6 ACSR 539.

97 See Shapira G, 'Minority Shareholders' Protection - Recent Developments' (1982) 10 NZULR 134, 159.

98 *Re Overton Holdings Pty Ltd* [1985] WAR 224. See Stapledon G, 'Use of the Oppression Provision in Listed Companies in Australia and the United Kingdom' (1993) 67 ALJ 575, 584-585.

and Securities Law Review Committee concluded in 1990 that the section did not, 'even on a wide interpretation, provide for anyone other than the company to seek to pursue a cause of action belonging to it, where the company itself improperly refuses or fails to take action'.<sup>99</sup>

Thus, while the current liberalisation of the courts' attitude to the oppression remedy has enhanced the rights of shareholders to remedy **personal** wrongs, its effect on shareholders' ability to enforce **corporate** causes of action was not significant. The uncertainty regarding a shareholder's standing to commence such proceedings remained.

## The Statutory Derivative Action

### The Nature of the Action, and the Power to Grant Leave

Section 165(1) of the 1993 New Zealand Act provides that the court must grant leave before a plaintiff may commence, or intervene in, proceedings 'in the name and on behalf of the company'.<sup>100</sup> This formulation identifies the nature of the derivative action, and distinguishes it from the personal and representative actions.

The statutory provision is potentially wider than the common law action - there is no requirement that the wrongdoers be in control of the company, it is not limited to certain types of action, and the applicant may be a director as well as a shareholder.

The justification for making an applicant apply for leave is to prevent trivial or malicious actions from proceeding, and also appears to be a recognition of the fact that to burden the company with the costs of bringing action, at the behest of someone with a relatively minor economic stake in the company, may outweigh the benefits, even if the claim has merit. Uncontrolled access to the remedy could also result in potential directors feeling so vulnerable to suit that they decline such positions, and in companies and their directors facing undeserved reputational and financial damage due to a proliferation of spurious actions.<sup>101</sup> The leave requirement is thus a 'process of balancing conflicting interests'.<sup>102</sup>

The model used by the New Zealand Law Commission for what eventually became ss 165-168 of the *Companies Act 1993* was based largely on existing North American provisions, particularly ss 239-240 of the *Canada Business Corporations Act*. Section 165(6), however, contains a provision not included in the Canadian legislation, that a derivative action may not be brought unless sec 165 has been complied with, ie. all actions by shareholders on behalf of companies must go through the statutory leave

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99 *Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action*, Report No 12 (1990) para 249.

100 See ss 236(1) and (2), and 237(1) of the draft amendments to the *Corporations Law* in the *Corporate Law Economic Reform Bill 1998*.

101 These possible pitfalls were identified by the Australian House of Representatives Standing Committee on Legal and Constitutional Affairs in its report on *Corporate Practice and the Rights of Shareholders*, (1991), para 6.3.30. Similar concerns were also expressed in Canada by the Dickerson Committee, *Proposals for a New Business Corporations Law for Canada*, Information Canada (1971), prior to the enactment of the statutory derivative action in Canada.

102 Above n20, at 316.

requirement of subsection (1), and the common law action is now excluded.<sup>103</sup> The intention seems to be to avoid the uncertainty on this point which has arisen in Canada on the issues of whether a derivative action may be brought under the oppression remedy as well as via the statutory leave procedure,<sup>104</sup> and whether the statutory leave requirement acts to the exclusion of actions under one of the exceptions to *Foss v Harbottle*. For example, it was held in *Rogers v Bank of Montreal*<sup>105</sup> that, despite the existence of a statutory leave procedure, a plaintiff may still rely on an exception to *Foss v Harbottle* as an alternative means of proceeding with a derivative action. The better view, however, appears to be that expressed in *Farnham v Fingold*, where Jessup J said:

In my opinion, the very broad language of sec 99(1) [of the *Ontario Business Corporations Act*] embraces all causes of action ... that a shareholder may sue for on behalf of a corporation ... and therefore subsection (2) (the requirement to seek leave of the court) applies to all such actions.<sup>106</sup>

This was the intention of the Dickerson Committee, whose recommendations culminated in the introduction of the statutory derivative action in Canada in 1975. The Committee's report refers to the 'abrogation' of the rule in *Foss v Harbottle*, and its 'substitution' with the new regime.<sup>107</sup>

Macintosh is of the opinion that '*Rogers* appears to be bad law, and ought not to be followed',<sup>108</sup> and Sutherland states that:

The codification of the [derivative] action embraces all causes of action that a shareholder may sue for on behalf of a corporation, and thus there no longer exists a common law [derivative] action. The statute must be complied with, and leave must be obtained from the court.<sup>109</sup>

Section 165(6) of the New Zealand Act, and sec 236(3) of the draft Australian provisions, reinforce the view that this was also intended to apply to the New Zealand and proposed Australian statutory derivative actions.

The nature and scope of the statutory derivative action were briefly discussed in *Vrij v Boyle*,<sup>110</sup> the first case to be brought in New Zealand under sec 165. The plaintiff and defendant in that case operated a plastics and outdoor lighting business by means of a company (Lite Plastics Ltd) and a partnership (Plaztech Trading). Boyle then set up a rival business without Vrij's knowledge. Upon discovering this, the plaintiff sought leave to commence a derivative action on the grounds that Boyle was effectively

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103 Section 236(3) of the proposed Australian provisions.

104 Macintosh J, 'The Oppression Remedy: Personal or Derivative?' (1991) 70 *Can Bar Rev* 29, 68 concludes that, despite the lack of a provision in the Canadian legislation that derivative actions must be commenced under the statutory leave procedure, 'common sense suggests that if the oppression provision embraces all forms of derivative action, the leave provision would be rendered nugatory'.

105 [1985] 5 WWR 193.

106 (1973) 33 DLR (3d) 156,159. See also *Goldex Mines Ltd v Revill* [1973] 3 OR 869 and *Shield Development Ltd v Snyder* [1976] 3 WWR 44.

107 *Proposals for a New Business Corporations Law for Canada*, above n101, para 482.

108 Above n104, at 67.

109 *Company Law of Canada* (6th ed), Carswell (1993), 717.

110 [1995] 3 NZLR 763.

diverting custom and other benefits from the original business. After granting leave for the plaintiff to commence proceedings, Fisher J said that there was 'no reason why the company should not also have an independent claim against the Boyles, which can be conducted at the same hearing as a derivative action'.<sup>111</sup> This seems an unusual statement, since a derivative action is itself an action on the *company's* behalf, ie. it is not separate from the company's claim; and one of the rules for granting leave in sec 165(3) (see below) is that the company does not intend to bring proceedings itself.

This apparent confusion as to whether the derivative action is an action on the shareholder's behalf, or on the company's, also seems to appear in the judgment of Kerr J in a later application by Boyle to strike out certain parts of Vrij's claim. His Honour stated that

the effect of *Foss v Harbottle* ... seems to be that ordinarily a wrong done to a ... company may, prima facie, only be sued on by the company itself. But if the wrong done amounts to a fraud on the minority ..., and the wrongdoers are in control of the company,<sup>112</sup> then the minority may bring an action *themselves* ... [Section 165(6)] restricts a member's ability to bring proceedings, but only 'in the name of and on behalf of the company', and not on a member's *own behalf*.<sup>113</sup>

He then briefly noted the possibility of a member bringing a personal action against the company or its directors for a breach of duties owed to members. If all of this means that an action by a member arising from a fraud on the minority belongs in the category of personal actions (as Kerr J appears, from the context, to be suggesting), then this defeats the purpose of sec 165(6), and indeed the statutory derivative action as a whole, by blurring the distinction, not only between personal and derivative actions, but also between the common law rule in *Foss v Harbottle* and the statutory provision of sec 165.

The judgment of Elias J in *Techflow (NZ) Ltd v Techflow Pty Ltd*<sup>114</sup> perhaps indicates a better grasp of the true nature of the provision. In this case, the shareholders of Techflow (NZ) Ltd decided that the company should cease trading, and be wound up. At that stage debts owed by the company to its parent, Techflow Pty Ltd, totalled around \$17,000. There was some disagreement between two of the company's directors as to the arrangements for the paying of creditors, and one of them appears to have unilaterally arranged to have Techflow Pty Ltd paid the money owing to it out of Techflow (NZ) Ltd's account. The other brought this action under the sec 165 procedure, hoping to be able to recover costs pursuant to sec 166 (see below). Elias J held that:

The significant matters the court has to address in deciding whether to invoke the power under [sec 165] are whether the proceedings are in the *interests of the company*, whether they will be maintained by those in control of the company, and whether

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111 Ibid at 767.

112 The two elements of the 'fraud on the minority' exception to the rule in *Foss v Harbottle*, as set out in *Edwards v Halliwell* [1950] 2 All ER 1064, 1067.

113 Unreported, High Court Auckland, CP 31/94; 14 March 1996, 11-12 (emphasis added).

114 (1996) 7 NZCLC 261,138.

they are proceedings appropriately brought ... The advantage to [the plaintiff] as a shareholder ... seems to me at best a fringe concern.<sup>115</sup>

### **Matters to be Considered by the Court**

Under the New Zealand provision, in determining whether to grant leave, the court *must have regard* to:

- (a) The likelihood of the proceedings succeeding;
- (b) The costs of the proceedings in relation to likely relief ;
- (c) Any action already taken by the company to obtain relief; and
- (d) The ‘interests of the company’ in commencing or continuing the proceedings.<sup>116</sup>

In addition, the court *must be satisfied that* either:

- (a) The company does not intend to bring or continue proceedings itself; or
- (b) It is not in the company’s interests to leave the conduct of the proceedings to the directors or the shareholders as a whole.<sup>117</sup>

The Canadian provisions contain broadly similar ‘rules for granting leave’ as appear in subsection (3). The listing of matters to which the court must merely have regard seems to be unique to the New Zealand Act, but Canadian case law is probably still useful in interpreting subsection (2). Although matters such as the likelihood of success and action already taken are not particularly mentioned in the Canadian legislation, they are still relevant factors in the overall assessment of whether the action is in the company’s best interests, to which the Canadian Act does refer.

On the issue of the likelihood of the proceedings succeeding, it was held in *Re Marc-Jay Investments Inc and Levy* that:

It is obvious that a judge hearing an application for leave to commence an action cannot try the action. I believe that it is my function to deny the application if it appears that the intended action is frivolous or vexatious or is bound to be unsuccessful.<sup>118</sup>

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115 Ibid at 261,141 (emphasis added).

116 *Companies Act 1993* (NZ) sec 165(2). No directly comparable provision appears in the proposed Australian sections, although proposed sec 237(2) states that the court must grant leave if it is satisfied that, inter alia, it is in the company’s best interests that leave be granted, and that there is a serious question to be tried.

117 *Companies Act 1993* (NZ) sec 165(3); proposed Australian sec 237(2).

118 (1974) 50 DLR (3d) 45, 47.

A similar approach has also been employed in New Zealand, by Fisher J in *Vrij v Boyle*, where his Honour said that it was not for him 'to conduct an interim trial on the merits' of the claim,<sup>119</sup> and by Elias J in *Techflow (NZ) Ltd v Techflow Pty Ltd*.<sup>120</sup>

The Canadian Act requires the court to assess whether the proposed action 'appears to be in the interests of the corporation' under the equivalent of sec 165(3). Although this is something the court *must* be satisfied about, rather than merely have regard to, the use of the words 'appears to be' seems to place it in a similar category to sec 165(2)(d) of the New Zealand Act and sec 237(2)(c) of the Australian draft provisions. Nemetz CJ, in the British Columbian case of *Re Bellman and Western Approaches Ltd*, held that:

The section does not say that the court must be satisfied that it is in the best interests of the corporation. It says that no action may be brought unless the court is satisfied that it *appears* to be in the interests of the corporation to bring the suit. I take that to mean that what is sufficient at this stage is that an arguable case can be shown to subsist.<sup>121</sup>

The approach taken so far in New Zealand appears to be slightly more conservative. In the *Vrij* case Fisher J concluded that in relation to 'the likelihood of the proceedings succeeding' under sec 165(2), the appropriate test was that set out in *Smith v Croft*,<sup>122</sup> ie:

That which would be exercised by a prudent business person in the conduct of his or her own affairs when deciding whether to bring a claim. Such a decision requires one to consider such matters as the amount at stake, the apparent strength of the claim and the prospect of executing any judgment.<sup>123</sup>

Leave was granted on the grounds that 'it could hardly be contested' that the defendant owed fiduciary duties to the company, and the affidavit evidence presented would, if accepted, take the plaintiff's claim that these duties had been breached 'some distance'. Applying the same test, Elias J in *Techflow (NZ) Ltd v Techflow Pty Ltd* refused to grant leave, holding that the financial advantage to the plaintiff in using the sec 165 procedure would not have persuaded a 'prudent business person' to take action. In addition, the costs of the proposed litigation would have been disproportionate to the amount realistically at issue and, in any case, the derivative action was 'unnecessarily cumbersome and inappropriate', and a more convenient course of action would be the taking of accounts between the shareholders as part of the liquidation process.<sup>124</sup>

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119 [1995] 3 NZLR 763, 765.

120 (1996) 7 NZCLC 261,138, 261,141.

121 (1981) 130 DLR (3d) 193, 201. Interestingly, sec 237(3) of the proposed Australian provisions applies a sort of 'business judgment rule' to the issue of whether or not leave is in the company's best interests. It establishes a rebuttable presumption that leave is *not* in the company's best interests if all the directors who were involved in the company's decision not to bring action did so in good faith and for a proper purpose, were not interested in the subject matter of the case, were fully informed, and rationally believed that the decision was in the company's best interests

122 [1986] 1 WLR 580.

123 [1995] 3 NZLR 763, 765. See also *Techflow (NZ) Ltd v Techflow Pty Ltd* (1996) 7 NZCLC 261,138, 261,140-261,141; *MacFarlane v Barlow* (1997) 8 NZCLC 261,470, 261,473; and *Thorrington v McCann* (1998) 8 NZCLC 261,564, 261,569.

124 It had already been decided that *Techflow (NZ) Ltd* should cease trading and be wound up and the plaintiff, as a

This test has been criticised by Fitzsimons as too conservative, given that in New Zealand shareholders are left to enforce their own rights, rather than being able to rely on a strong state regulatory body as in Australia. If the provision is to serve its stated purpose of increasing shareholder protection, ‘the courts need to take a robust approach to applications’.<sup>125</sup> Fitzsimons also describes Fisher J’s comment that an interim trial of the case’s merits should not be conducted (see above) as inconsistent with the requirement of sec 165(2)(a) to consider the likelihood of success; and claims that his observation that the evidence presented ‘might be thought to take the claim some distance’ appears to use a lower threshold than a prudent business person might employ. Fitzsimons suggests that ‘an arguable case’ or ‘reasonable prospects’, in line with the Canadian and proposed Australian approaches,<sup>126</sup> would be a more suitable test.

A statement made by Fisher J in the course of his judgment that the broad discretion to grant leave conferred by sec 165(1) is ‘undiminished by the particular considerations referred to in later subsections’, ie. subsections (2) and (3),<sup>127</sup> seems to indicate a lack of familiarity with the provision or its objectives. While this is true of subsection (2), subsection (3) clearly states that leave may be granted *only* if the company itself does not intend to bring proceedings, or if it is not in the company’s interests to leave the conduct of the proceedings to the directors or the shareholders in general. Such comments are perhaps merely a symptom of the provision’s newness, but they could serve to defeat its purpose somewhat if followed in subsequent cases.

### **Costs to be met by Company**

Section 166 provides that, when an application is made, the court *must* order that the costs of the proceedings will be paid by the company, rather than the applicant personally, unless this would be ‘unjust or inequitable’. In contrast, sec 242 of the draft Australian provisions merely authorises the court to make ‘any orders it considers appropriate’ with regard to costs. Given that the common law action was itself based in equity, and that the awarding of costs was thus also regarded as an equitable issue,<sup>128</sup> the approach taken to sec 166 should not differ significantly from that traditionally employed by the courts.

This provision seems to be designed to overcome the disincentive to litigate stemming from the normal rule that the losing party will also pay the other side’s costs. Arguments have, however, been raised regarding the effectiveness of the provision in relieving this ‘deterrent effect’. For example, a comparison may be made between sec

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shareholder and director, could have made an application to the court for the appointment of a liquidator on ‘just and equitable’ grounds.

125 ‘Derivative Actions, Small Companies and Partnerships: The case of *Vrij v Boyle*’ [1995] *CSLB* 128, 129-130. See also ‘Statutory Derivative Actions in New Zealand’ (1996) 14 *C&SLJ* 184 for a redrafted version of this article.

126 Section 237(2)(d) of the draft provisions requires that there be ‘a serious question to be tried’ before leave will be granted.

127 *Vrij v Boyle* [1995] 3 *NZLR* 763, 767.

128 See *Wallersteiner v Moir* (No 2) [1975] *QB* 373, 391 & 403-404, where Lord Denning said that a prima facie right of indemnification by the company arose ‘on the plainest principles of equity’, whether the action was successful or not. Buckley LJ agreed: ‘Where a shareholder has in good faith and on reasonable grounds sued as plaintiff in a minority shareholders’ action, the benefit of which, if successful, will accrue to the company..., it would, I think, clearly be a proper exercise of judicial discretion to order the company to pay the plaintiff’s costs’.

166 and sec 18(5) of the *Securities Amendment Act 1988* (NZ), an apparently more generous provision which provides that in a derivative action for insider trading brought under that Act, the company will *always* be liable for the shareholder's costs, irrespective of the result.

It is unclear whether liability for costs under sec 166 proceeds on the same basis, ie. whether the section includes the defendant's costs, which the applicant may be responsible for if the action is unsuccessful. It could be argued that the policy arguments in favour of both provisions are similar, and that therefore it should, despite the more vague wording of sec 166.

Since the court is allowed some discretion in deciding whether or not to grant costs under sec 166 (a discretion which does not appear in the *Securities Amendment Act*), the applicant may only be awarded part of the costs of bringing the action. This occurred in the Canadian case of *Turner v Mailhot*,<sup>129</sup> where Reid J held that the presumption of entitlement to costs could be rebutted where the plaintiff could afford to pursue the action independently, or where he or she was likely to make a substantial personal gain if the action was successful. As a result he restricted the plaintiff's indemnity to only 50% of his total costs. It should be noted that the Ontario provision under which this case was decided gave the court more discretion with regard to costs than does sec 166, and was in fact more akin to the proposed Australian provision.<sup>130</sup>

If the courts do adopt a generous approach to sec 166, this may in fact work against an applicant's chances of being granted leave under sec 165. In *Re Wilson Neill Ltd*, a case brought under the *Securities Amendment Act 1988*, Heron J said:

It is no small matter to allow a free hand to a third party to undertake complex litigation at the expense of a public company containing many shareholders quite removed from this dispute ... The court should therefore act with considerable caution in exercising this discretion in favour of applicants for leave.<sup>131</sup>

Although comparisons with the derivative action under the *Securities Amendment Act* may provide some guidance as to the attitude which the courts will take in exercising their discretion under sec 166, the comments above of Heron J highlight one important difference between the two provisions. While an action for insider trading may concern a dispute from which most of the shareholders are removed, under sec 165 of the *Companies Act 1993* all shareholders (other than the wrongdoers) will, in principle, have the same interest. This factor should lead to a higher threshold before the cost to the company will dissuade a court from granting leave under sec 165.<sup>132</sup>

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129 (1985) 50 OR (2d) 561, 567.

130 Section 246 of the *Ontario Business Corporations Act* allowed the court to 'make any order it thinks fit including ... an order requiring the corporation ... to pay reasonable legal fees and any other costs reasonably incurred by the complainant in connection with the action'.

131 (1993) 6 NZCLC 68,336, 68,362.

132 In both *MacFarlane v Barlow* (1997) 8 NZCLC 261,470 and *Thorrington v McCann* (1998) 8 NZCLC 261,564, once the court had decided that the 'prudent business person' test set out in *Vrij v Boyle* was satisfied, the issue of costs was not seen as significant in determining that leave should be granted.

Fisher J's treatment of costs in *Vrij v Boyle*<sup>133</sup> seems to be in conflict with the wording and intent of sec 166 on a number of counts. He held that questions of costs and indemnity from the company should be:

- Reserved until after the substantive proceedings had been concluded, whereas sec 166 in fact requires that the applicant be indemnified at the time of the application for leave; and
- Decided on the basis of the outcome of the action on its merits, while sec 166 states that an order for costs must be given unless this would be 'unjust or inequitable'.

His Honour also ordered that the costs of the application for leave (as opposed to the substantive proceedings) were to be paid by the first defendant, Mr Boyle, rather than by the company. Section 166 refers to the company's liability for costs associated with 'the proceedings' only, which may be interpreted as referring to the trial itself but not to the application for leave. On its face, this is a reasonable interpretation (given that whenever the term 'the proceedings' is used in sec 165, it refers only to the substantive proceedings), although perhaps not one which was intended. There is arguably a certain injustice about absolving the company of those costs, but awarding them in respect of the substantive trial.

#### **Powers of Court where Leave Granted**

Section 167 of the New Zealand Act gives the court power to make whatever orders it thinks fit regarding the conduct of the proceedings, including matters such as the provision of information and assistance to the applicant by the company or its directors, and the direct payment of any amount awarded in the proceedings to shareholders rather than to the company itself. Section 241 of the Australian proposal is similarly broad, although no specific power to pay any amount awarded directly to shareholders is mentioned.

Such a provision appears to be 'a sensible mechanism for the proper resolution of the proceedings, including all attendant matters',<sup>134</sup> although Welling, referring to the equivalent Canadian provision, has criticised its open-endedness. He claims that it could be interpreted to go so far as to 'authorise judicial discretion to award damages to the plaintiff, notwithstanding his failure to prove his cause of action.'<sup>135</sup>

He admits that 'such an outcome is unlikely', and as noted by Desourdy:

This seems to be an overreaction. The court has been given similar powers elsewhere in New Zealand legislation without absurd consequences resulting. It can be expected that a trial court will exercise such powers prudently and, if it does not, the decision will be overturned on appeal.<sup>136</sup>

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133 [1995] 3 NZLR 763, 768.

134 Morgan M, *Derivative Actions Old and New: An Examination of the Development of the Law Concerning Derivative Actions in New Zealand*, Unpublished MBS Research Report, Department of Business Law, Massey University (1995), 45.

135 *Corporate Law in Canada: The Governing Principles* (2nd ed), Toronto (1991) 544.

136 *The Derivative Action in the Companies Act 1993*, Unpublished LLM Research Paper, Law Faculty, Victoria

### No Settlement without Court Approval

Once leave has been granted under sec 165, the proceedings may not be settled, compromised or discontinued without court approval.<sup>137</sup> This is designed to prevent the defendants paying off the applicants in return for discontinuing the action, and to discourage 'strike suits' by applicants who begin actions with such payoffs as their objective. Such court supervision may also have the effect of encouraging equitable settlement. In fact, most derivative actions in Canada to date have not actually proceeded to trial. Fair settlement has apparently been reached.<sup>138</sup>

Mediation, as an alternative to litigation, was suggested to the parties in *Vrij v Boyle* by Fisher J, on the grounds that 'the type of issues involved in this case [basically an intra-corporate dispute between business partners] and no doubt the desire of all parties to get on with more profitable activities than putting their time and energy and money into litigation, make that a particularly suitable course'.<sup>139</sup>

### Conclusions

The rule in *Foss v Harbottle* was initially a substantial barrier to a minority shareholder wishing to remedy a corporate wrong. Early emphasis on the rights of managers to conduct the affairs of companies without outside interference, and assumptions as to the appropriateness of the majority rule principle in all cases resulted in the courts building up complex procedural rules, often only tenuously linked to the central issues of the company's interests in having an action brought, and its ability to do so itself.

With the growing realisation that corporate activity had become more of a public concern, and the resulting trend towards greater recognition of individual shareholders' rights, the rule in *Foss v Harbottle* has, however, gradually been relaxed. By the 1990s this had reached the point where, in most cases, the rule had ceased to be much of a practical barrier to shareholder enforcement. With this more generous approach, however, the previously narrow set of exceptions have been replaced with the rather nebulous concept of the 'interests of justice', making accurate observations as to the state of the law somewhat difficult. Alternative remedies, particularly the oppression remedy, have also been liberalised to the point where a member may now complain if his or her 'legitimate expectations' have been breached. On occasion this has been interpreted widely enough to encompass derivative as well as purely personal causes of action. However, it must be conceded that, even with this blurring at times of the distinction between corporate and personal rights, a plaintiff cannot rely with any certainty on the oppression remedy as a means of exercising enforcement rights belonging purely to a company.

If a statutory derivative action is applied with the same liberal attitude to shareholder enforcement as has been recently shown under the common law, it should succeed in

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University of Wellington (1993) 47.

137 *Companies Act 1993* (NZ) sec 168; Australian draft provisions sec 240.

138 Above n135, at p537.

139 [1995] 3 NZLR 763, 768. Section 241(1)(b) of the proposed Australian provisions specifically includes an order 'requiring mediation' among the suggested orders and directions the court may make in relation to derivative proceedings.

its aim of providing a means for companies to take action for wrongs done to them when no other remedy is available. The statutory provision should also serve to redirect the courts' focus away from matters which are irrelevant to the issue at hand, and on to more appropriate considerations.

Being the first judicial consideration of the New Zealand section, Fisher J's judgment in *Vrij v Boyle* shows some uncertainty and inconsistency, as could perhaps be expected. Subsequent New Zealand cases appear to strike an acceptable balance between giving shareholders a reasonable opportunity to right corporate wrongs where necessary, and putting in place acceptable limits when more suitable alternatives are available. The proposed Australian statutory provision should also remedy the uncertainties associated with the common law action, although the less shareholder-friendly aspects of the proposal (on the issue of costs, for example) should perhaps be amended along the lines of the New Zealand provision.