Chapter 9

Remedies and Enforcement of Directors' Duties

Simple knowledge of the directors' duties of care and loyalty is not enough. The value of such duties depends on who can enforce them, their chances of success, and the sanctions and remedies available. This chapter considers the enforcement of statutory duties (for which there are civil remedies, such as damages and compensation, or criminal sanctions, such as fines and imprisonment); the ability of members to enforce these duties in civil actions; and the specific remedies available.

Investigations under section 291 into a corporation's affairs

Under s 291, the Commission may investigate companies.¹ The Minister may direct the Commission to investigate the affairs, or particular affairs, of a corporation, where it appears to the Minister that it is in the public interest or the national interest to do so.² The Ministerial Council may also direct an investigation.³ The inspectors so appointed have considerable discovery and inquisitorial powers. Such investigations can be requested by, inter alia, not less than 100 members or members holding not less than one-twentieth of the issued shares or paid-up capital.⁴

Although it has a vital role in the control of delinquent companies, the Commission may, for reasons of costs, insufficient personnel, lack of evidence, or the existence of a suitable alternative remedy, not pursue an investigation where one would appear to be warranted. This problem is not confined to Australia. The English Board of Trade refused on 15 occasions to take action over the dubious activities which led to Wallersteiner v Moir.⁵

Who may seek statutory remedies?

Criminal proceedings

Most jurisdictions use criminal sanctions to control directors and controllers. Australia is no exception. The Companies Code includes many

2. Section 291(1) and (2).
3. Section 291(3).
offences for which there are criminal law penalties of imprisonment and fines. The offence provisions appear in substantive sections of the Code and in Div 2 of Part XIV (ss 552–575). However, not everyone can bring criminal proceedings. Such action can be taken only by the Commission, its delegates (that is, various Corporate Affairs Commissions) and persons authorised by those delegates, or by the Ministerial Council.6

Criminal remedies are valuable in corporate law. But they are by no means the only means of controlling misbehaviour by officers and controllers. Enforcement is far from certain. The threat of fines or even of imprisonment is often a puny deterrent and the criminal standard of proof — beyond reasonable doubt — is hard to satisfy. Aggrieved persons may prefer the return of money or other property as compensation for loss or damage — civil remedies — rather than or in addition to criminal remedies.

Civil proceedings under the Code

The Code also specifies persons who may seek civil remedies for damages or compensation against officers who have breached statutory duties. For example, s 229(7) says that the corporation may ‘recover from [the wrongdoer] as a debt due to the corporation by action’ any profit made by the wrongdoer or compensation for loss or damage suffered by the corporation as a result of the wrongdoing. Another example is the liquidator’s right to recover company money under s 453.

The Code occasionally gives members the right to seek remedies (as in ss 227A, 259, 320 and 574). But, generally, the individual shareholder’s ability to control directors’ misconduct has been inhibited by the rules of law, which discourage actions on behalf of companies by members.

The expanded s 320 — the oppression provision — has increased significantly members’ rights of action. It is especially useful to members of small or ‘close’ companies, as well as being useful to control wrongs against the company. Under s 320(2)(g), the court may, on the application of a member (or the Commission), make ‘an order directing the company to institute, prosecute ... specified proceedings, or authorizing a member or members of the company to institute, prosecute ... specified proceedings in the name of and on behalf of the company’.7

Who may enforce civil law remedies for breaches of general law duties?

The board

Because the fiduciary duties and the duties of care, skill and diligence are owed to the company, the company is the proper party to enforce those

6. See s 36 of the Companies and Securities (Interpretation and Miscellaneous Provisions) Act 1980. Cf s 381(1) of the UCA. Section 36 can be superseded by specific provisions in an Act. Section 34 adds that proceedings for an offence must be started within five years of the offence. Only with the Ministerial Council’s consent can they start at some later time. Section 382(2) of the UCA had set the limit at three years.

7. This provision is discussed in detail in Ch 12.
duties and to seek compensation for their breach. The board of directors ‘is’ the company when it makes managerial decisions. There is no difficulty in law if, in the company’s name, the board sues the party in breach of duty. Then the company is taking the action. Similarly, a liquidator can sue on the company’s behalf because upon appointment he assumes the powers of the board.

The general meeting

But what if the directors refuse to pursue an officer over, say, a breach of fiduciary duty? Such inaction, after all, would not be entirely unexpected. Can the majority at a general meeting step in and initiate proceedings? Under reg 66(1) of Table A, the company vests managerial power in its directors. Many companies’ articles will also have an article expressly vesting the power to sue on behalf of the company in the directors. For example:

The directors shall have the power to commence and carry on or defend, and to abandon and compromise any legal proceedings whatsoever by or against the company or its officers or otherwise concerning the affairs of the company.

Where there is no such specific article, companies invariably have reg 66(1) or its predecessors or a very similar article. The power to sue a director (over a breach of duty, for example) is a management power; such powers usually cannot be interfered with or usurped by the shareholders. As discussed in Chapter 3, the courts have accepted that the power to sue is not exclusive to the board; it is a power that the general meeting can also exercise in certain circumstances (even though articles such as reg 66(1) of Table A and reg 70 of the UK Table A vest management power in the board). The courts assume that the general meeting retains a residual power to initiate suits for the company, even against the wishes of the directors. Further, the shareholders in sufficient numbers can simply alter the articles and give the power to sue to the general meeting.

The minority shareholder

Corporate litigation may in some cases be initiated by the minority shareholder. His voting power is usually negligible. But in some circumstances he has the power to enforce duties owed the company. Shareholders may bring actions for breaches of personal rights (discussed below), such as the right to seek payment of dividends or to receive notice of meetings. These may be given under statute, the articles, the memorandum, some

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9. See Ahmed, (1976) 1 UNSWLJ 264 at 269–270. See also Ch 3.
10. See Wedderburn, [1957] CLJ 194. See also discussion of control of corporate litigation in Ch 3. See also Afterman, Company Directors and Controllers at 137–138; Wedderburn, ‘The Rule in Foss v Harbottle’ [1957] CLJ 194 at 200–203 (quoted below); 1967 Ontario Interim Report of the Select Committee on Company Law (the Lawrence Committee Report) at paras 7.3.4–7.3.6; Bamford v Bamford [1969] 1 All ER 969 at 976, per Russell L J.
separate agreement, or general law. In such a case, it is an individual rather than the company taking the action. As such, he will be asserting a personal right, not a company grievance.\textsuperscript{11} Therefore standing to sue will not be a problem.

Often the board and the general meeting may refuse for good business reasons to act over corporate (as distinct from personal) wrongs. Legal proceedings may promise insufficient returns to cover costs, or may lead to bad publicity or labour relations problems. Inactivity may be in the best interests of the company.

But does the control of the power to sue by the board and/or the majority at a general meeting mean that the minority shareholder is powerless, even when faced with a major breach of duty owed to the company? He can do little about the composition of the board, because he usually lacks the votes. In a large public company, he will rarely know even a handful of the thousands of other members. Unless he is very persuasive and can influence the proxy vote, he will be unable to carry a majority at a general meeting and so force action by that means. When in doubt, uninformed shareholders will usually support the management. Does being a drop in the corporate pond mean that a minority shareholder cannot ensure that the company's rights are upheld?

At first blush it seems that the minority shareholder, if spurned by the board and the general meeting, has no right to enforce the company's rights. The Rule in \textit{Foss v Harbottle} — that only the company can sue for wrongs done to it — remains effective in Australia, as in the United Kingdom and New Zealand. Exceptions to the Rule have evolved through necessity. (For example, a director who was also a majority shareholder might otherwise be able to rob the company.\textsuperscript{12}) The development of these exceptions has, however, been haphazard and confusing. North American and European legislative solutions to the problem, which are considered later, have not as yet been adopted.

\textbf{Practical difficulties of proceeding against company officers}

Ironically the board, which invariably controls the company's power to sue, is made up of the very persons against whom breach of duty actions might be brought. The board has considerable power under articles such as reg 66(1) of Table A. It is unlikely to be brought to account for breaches of duty because of the so-called Rule in \textit{Foss v Harbottle} (discussed below) and the difficulties which an individual shareholder may encounter in getting information from a truculent management. The board often controls the information needed by the plaintiff shareholder, and the extraction of such information under the rules of discovery may be

\textsuperscript{11} \textit{Edwards v Halliwell} [1950] 2 All ER 1064 at 1067; \textit{Kraus v J G Lloyd Pty Ltd} [1965] VR 232 at 236.

\textsuperscript{12} See Lord Denning M R in \textit{Wallersteiner v Moir (No 2)} [1975] QB 373 at 390 for a good summary of the minority shareholder's difficult position.
cumbensome and incomplete. The trauma of court action and the difficulties involved in fighting directors, who can rely on the company’s funds to mount their defence, may also deter action. Apparent inactivity by shareholders is therefore understandable.

Funding suits against directors

Even when a breach of duty action is successful, a shareholder usually stands to gain very little from the enforcement of company rights. Lord Denning discussed the problem in *Wallersteiner v Moir (No 2)*:

Suppose there is good ground for thinking that those in control of a company have been plundering its assets for their own benefit. They should be brought to book. But how is it done and by whom? By raising it at a meeting of shareholders? Only to be voted down. By reporting it to the Board of Trade? Only to be put off, as Mr. Moir was. At present there is nothing effective except an action by a minority shareholder. But can a minority shareholder be really expected to take it? He has nothing to gain, but much to lose. He feels strongly that a wrong has been done — and that it should be righted. But he does not feel able to undertake it himself. Faced with an estimate of costs, he will say: ‘I’m not going to throw away good money after bad.’ Some wrongdoers know this and take advantage of it. They loot the company’s funds knowing there is little risk of an action being brought against them.13

Like any other litigant, the plaintiff shareholder in a derivative or corporate action prima facie is personally liable to his own lawyer for costs (and possibly to the defendant for his costs), even though he is suing on the company’s behalf. The costs of court action can be prohibitive. In *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*,14 for example, it was estimated that the damage suffered by the allegedly wronged company may have been about £440,000; but the legal costs of the trial stage only were about £750,000.15

Concerned about the problem, the English Court of Appeal in *Wallersteiner v Moir (No 2)*16 suggested that an order could be made indemnifying a shareholder against costs incurred in initiating a derivative action. If he wins,

\[\ldots\] it is only just that the minority shareholder should be indemnified against the costs he incurs on its [the company’s] behalf \ldots the wrong-doing director will be ordered to pay the costs: but if they are not recovered from him, they should be paid by the company. And all the additional costs (over and above party and party costs) should be taxed on a common fund basis and paid by the company.

13. Ibid at 395. See also Buckley L J at 399.
16. Above n 12.
Lord Denning M R added that, in the event that the plaintiff loses, if the action was 'reasonable and prudent', the company should pay the costs of the defendants,

... because [the plaintiff shareholder] was acting for [the company] and not for himself. In addition, he should himself be indemnified by the company in respect of his own costs. ... It is a well-known maxim of the law that he who would take the benefit of a venture if it succeeds ought also to bear the burden if it fails.\textsuperscript{17}

Such an approach is possible in jurisdictions where legislation governs the bringing of suits on behalf of the company. In British Columbia, for example, s 225(5) of the \textit{Company Act 1979} says that the court may order an unsuccessful plaintiff to pay the solicitor-client costs of the company and of the director-defendants.\textsuperscript{18} Given the safeguard that the plaintiff must be acting reasonably and prudently in the company's best interests, Lord Denning's approach is attractive. Some scope for action by minority shareholders is an important bulwark against managerial incompetence and self-dealing. This indemnity is also justified in terms of a broad trustee-trust analogy: like the trustee, the plaintiff shareholder is entitled to an indemnity for costs and expenses incurred in conducting business or fulfilling 'duties'.

Lord Denning (opposed by the other two members of the Court) thought, further, that it would be acceptable to allow such actions to continue on a \textit{contingency fee} basis — that is, where counsel charge fees only when the client is successful, the fees being usually a handsome percentage of the damages awarded. From the point of view of the shareholder, this would be even better than the indemnity, which may be worthless if the individual shareholder loses the action and the company is or becomes insolvent. Traditionally, though, the English, Australian and New Zealand judiciary have opposed contingency fee arrangements as being contrary to public policy.\textsuperscript{19}

\textbf{The Rule in Foss v Harbottle}

The Rule derives from \textit{Foss v Harbottle}\textsuperscript{20} and \textit{Mozley v Alston}.\textsuperscript{21} The first principle of the Rule, as summarised by Lord Davey in \textit{Burland v Earle}, is:

(a) ... the court will not interfere with the internal management of companies acting within their powers, and in fact has no jurisdiction to do so.\textsuperscript{22}

\textsuperscript{17} Above n 12 at 391–392.
\textsuperscript{18} See also s 233(d) of the \textit{Canada Business Corporations Act 1974} and s 246(c) of the \textit{Ontario Business Corporations Act 1982}.
\textsuperscript{19} See Scarman L J, above n 12 at 407–408; Buckley L J at 401–403.
\textsuperscript{20} [1843] 2 Hare 461; 67 ER 189.
\textsuperscript{21} (1847) 1 Ph 790; 41 ER 833.
\textsuperscript{22} [1902] AC 83 at 93 (PC).
This is termed the 'internal management principle'. Broadly, it means that the company's management and other internal problems should be solved internally; that minority shareholders cannot come to court with mere irregularities or informalities in the internal affairs of the company (that is, 'internal irregularities'), if those irregularities can be remedied by a majority vote in general meeting. But the courts are unclear as to what a mere or ratifiable irregularity is. Is a breach of the articles, for example, merely an internal irregularity?

Wedderburn argues, contrary to views expressed in many cases, that:

... prima facie no breach of the articles is open to ratification; that only a few such 'irregularities' are within the power of the majority; that the limits of ratification [by ordinary majority vote] and, therefore, of the Rule in Foss v Harbottle, may be much more narrowly defined than is sometimes believed. 23

Such analysis helps sanctify the s 78 statutory contract between the members and the company. One breach of the articles that apparently qualified as a ratifiable breach or 'internal irregularity' arose in MacDougall v Gardiner. 24 The articles said that a poll should be held at the request of five members. The court held, however, that the Rule in Foss v Harbottle prohibited action by the minority when the chairman refused to observe that article. According to the Court of Appeal, it was an internal matter for the decision of the majority, and not a matter for litigation.

Ross J in Clark v Workman 25 thought that questions of internal management which the court could not deal with (that is, those that were internal irregularities) included those relating to 'how much is to be distributed in dividends, or how much is to be added to the reserve account; what contracts for material are to be accepted, what remuneration is to be paid to their employees, and such like'. But, 'if it turns out that there was a breach of trust, that could never be a question of internal management'. A serious wrongdoing, especially fraud, cannot be classified as a mere matter of internal management, but drawing a line between serious wrongdoings and mere irregularities in company procedures is not always easy.

Internal irregularities in the conduct of the company's affairs should also be distinguished from illegals. 26 Illegals cannot be ratified because they are contrary to public policy and are, per se, in bad faith, even if they benefit the corporation.

The second principle of the Foss v Harbottle Rule, as summarised by Lord Davey, is:

(b) ... 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. 27

23. Above n 10 at 199.
24. (1875) 1 Ch D 13.
26. Prudential Assurance Co Ltd v Newman Industries (No 2) [1982] 1 All ER 354 at 357.
27. Above n 22 at 93.
This is the ‘corporate-plaintiff principle’, which says that not individual members, but the company — that is, the party injured by any breach of duty — has the right to decide whether or not such breaches should go before the courts. This exclusive right to decide generally applies only to actions that the company, by majority, has the right to ratify or forgive. Nevertheless, some actions cannot be ratified by even an overwhelming majority.

**Reasons for the Rule in Foss v Harbottle**

Majority-rule notions are derived from 19th century partnership principles. Most partnerships and companies at that time were small ('close' or closely-held). Many argue that it is unfair to minority shareholders that the courts have clung as tenaciously as they have to these principles laid down in a time when shareholder democracy was attainable. Nevertheless, tradition dies hard.

The reasons for these majority-rule based principles, applied in *Foss* and *Mozley*, are well known. Invariably, it is only the wronged party who can take action in civil litigation. If there were no such principles, it is argued, there would be a costly multiplicity of actions over breaches of duty. Or, as the applicants’ counsel in *Pavlides v Jensen* said, easy access to the courts for minority shareholders might 'open the doors wide for polite blackmailing actions by minority shareholders who disagreed on certain questions of company policy'. Because the duties are owed to the company, should not the company, it is argued, expressing itself through the majority of members, be able also to forgive wrongs done to it and to waive legal action? Or, more fundamentally, is there anything to sue about if the majority ratifies? Ownership of shares in a company implies acceptance of the prevailing will of the majority. The English Court of Appeal noted in *Prudential Assurance*:

... when the shareholder acquires a share, he accepts the fact that the value of his investment follows the fortunes of the company and that he can only exercise his influence over the fortune of the company by the exercise of his voting right in general meetings.

Furthermore, courts, especially in the United States, sometimes mention the ‘business judgment rule’. This rule says that courts will be reluctant to interfere in and to evaluate business judgments of directors and managers that are made in good faith. This reluctance springs from a recognition that the judiciary will often be ill-equipped to make such judgments and a belief that objective analysis of corporate decision-

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29. [1956] 1 Ch 565 at 569.
making is difficult.\textsuperscript{32} Few judgments are purely business, however, and the company, while at law an independent 'person', is not like natural persons. Behind the legal fiction are shareholders and creditors whose money the company uses and risks. An injury to the company is in reality an injury to the investment of its shareholders and creditors. When the company is managed or controlled by wrongdoers, should shareholders and creditors not be able to seek the court's help? The reality behind the corporate facade creates the difficulties in this area of law.

Some argue that the costs to the company (and thus to the non-complaining members) outweigh the benefits of actions initiated by small shareholders, some of whom have only a small number of shares. Most authorities disagree. These derivative actions have often been the most effective way of halting managerial mischief and restoring assets to the company. There are too many obstacles that hinder minority shareholder actions; the legislature should ease and clarify the rules of standing and procedure that govern such actions.

The majority of shares in major public companies are often owned by a relatively small group of institutional investors and by wealthy individuals.\textsuperscript{33} These groups provide some check on management. But for one reason or another — such as misguided collegiality, fear of the wrong sort of publicity, conflict of interest problems, disinterest, or the costs of litigation — major shareholders may be unwilling to assert the company's best interests and call management to task.\textsuperscript{34} Although institutional shareholders (such as insurance companies, investment trust companies and pension funds) may be large shareholders, they are generally reluctant to enforce the company's rights. Little real power rests with the other minority shareholders. In the larger public companies, shareholder democracy is a myth.\textsuperscript{35} Allowing energetic minority shareholders relatively free access to the courts in order to correct corporate wrongs is one way to help maintain management standards and corporate morality.

When the court applies the Rule in \textit{Foss v Harbottle}, it invariably knows the mind of the majority — for example, that the majority does not want the suit to go ahead. Where this is not known with certainty, the court may (as it did in \textit{Hogg v Cramphorn})\textsuperscript{36} give the parties time to ascertain the views of the majority. If the majority is ultimately entitled to sanction an action, even though it may be a breach of duty (for example, the board issues shares not in the company's best interests), there is usually little use in having litigation over it at the instance of a minority shareholder for, in the end, the majority may simply forgive or ratify that action.

\begin{itemize}
\item \textsuperscript{32} See discussions of this rule or doctrine by the Court of Appeals of New York in \textit{Auerbach v Bennett} 47 NY 2d 619; 393 NE 2d 994 (1979); see also \textit{Burks v Lasker} 441 US 471; 60 L Ed 2d 404 (1979); cf \textit{Maldonado v Flynn} 597 F 2d 789 (2d Cir 1979).
\item \textsuperscript{34} Farrar and Russell, ibid at 109–110.
\item \textsuperscript{35} Cf (1958) 67 Yale L J 1477 at 1489.
\item \textsuperscript{36} [1967] Ch 254.
\end{itemize}
However, such arguments should not obscure the fact that on some occasions action, even by a minority shareholder, is sorely needed. At present, the company controllers are undoubtedly in a strong position, despite the enactment of the revised oppression provision (s 320 of the Code). 

**Foss v Harbottle and Mozley v Alston: origins of the Rule**

The Rule may be better understood after looking at the facts of the two seminal decisions. The first involved a breach of fiduciary duty; the second concerned 'internal irregularities'. In *Foss v Harbottle*, the two shareholder/plaintiffs, acting on behalf of themselves and the other shareholders (except, of course, the alleged wrongdoers) alleged, inter alia, that the directors had sold their own property to the company at exorbitant prices. The court ruled that the alleged wrong was a wrong to the company and that the plaintiffs had no standing to sue on the company's behalf. The members had not actually deliberated on the issue. But the court pointed out that the company in general meeting could simply confirm or forgive the breach. The court therefore refused to rule on the alleged breach; it was an internal matter for the majority to decide:

... it cannot be competent to individual corporators to sue in the manner proposed by the Plaintiffs on the present record. ... Whilst the Court may be declaring the acts complained of to be void at the suit of the present Plaintiffs, who in fact may be the only proprietors who disapprove of them, the governing body of proprietors may defeat the decree by lawfully resolving upon the confirmation of the very acts which are the subject of the suit. The very fact that the governing body of proprietors assembled at the special general meeting may so bind even a reluctant minority is decisive to show that the frame of this suit cannot be sustained whilst that body retains its functions. In order then that this suit may be sustained it must be shown either that there is no such power as I have supposed remaining in the proprietors, or, at least, that all means have been resorted to and found ineffectual to set that body in motion. ... there is no suggestion that an attempt has been made by any proprietor to set the body of proprietors in motion, or to procure a meeting to be convened for the purpose of revoking the acts complained of.  

In *Mozley v Alston*, two shareholders sought a declaration that the board were holding office illegally. The statute incorporating the company required one-third of the board to retire each year. This had not

37. Discussed in Ch 12.  
38. Above n 20.  
39. As we have seen, such a contract with one's own company is voidable at the company's election.  
40. Above n 20 at 494–495; 203–204, per Sir James Wigram V-C.  
41. Above n 21.
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whichever is appropriate) in the following circumstances:

• where there is an ultra vires act by the company;
• where the company has broken a provision of the Code or its own rules (as expressed in the articles usually) by doing something without a special resolution which could under the Code or the articles only be done by a special resolution;
• where a member’s personal rights have been ignored or overridden;
or
• where there has been a ‘fraud on the minority’ and the fraudsters control the company.

Some speculate about a fifth exception: that an individual shareholder can bring an action where ‘the justice of the case’ requires a right to action. Such an exception finds support from, amongst others, Jenkins L J in Edwards v Halliwell\(^{45}\) and Jessel M R in Russell v Wakefield Waterworks Co.\(^{46}\) The English Court of Appeal in Prudential Assurance was ‘not convinced that this is a practical test’,\(^{47}\) however. Such an exception would embrace the others anyway. The so-called ‘justice’ exception has been the ‘root principle’ of the minority suit.\(^{48}\) It could be said that it is the reason for the exceptions, rather than a description of the exceptions. It was also the guiding principle in Foss v Harbottle, where Wigram VC spoke of the ‘general principle of justice and convenience’ when talking of the Rule.

42. It has since been suggested that, because the plaintiffs had a personal right to have the internal government of the company carried out in accordance with the articles and memorandum, they did in fact have standing to sue. See discussion below.
43. See Hurley v BGH Nominees Pty Ltd (1982) 1 ACLC 387 at 394–395, per White J.
44. See Megarry V-C in Estmanco (Kilner House) Ltd v Greater London Council [1982] 1 All ER 437 at 443.
45. [1950] 2 All ER 1064 at 1067.
46. (1815) LR 20 Eq 474 at 480.
47. [1982] 1 All ER 354 at 366; Estmanco, above n 44 at 444.
itself, and of the 'claims of justice' when talking of exceptions.\textsuperscript{49} As Gregory\textsuperscript{50} concludes, 'In company law, "Justice" is the great general principle to which all exceptions owe their existence'.

\textbf{Ratifiability test}

The exceptions to the Rule can be reduced to one general test — the \textit{ratifiability test}. White J adverted to this test in \textit{Hurley v BGH Nominees Pty Ltd}:

The exception in favour of minority (or deadlocked) shareholders to bring action on behalf of a company is based upon the propositions that a fraudulent irregularity or illegality is incapable of cure by the passing of an ordinary resolution in general meeting and that there would be a failure of justice if the company remained powerless to remedy it.\textsuperscript{51}

The ratifiability test says that the shareholder can take judicial action where the directors or controllers commit fraudulent breaches of duty — acts that the majority of shareholders cannot lawfully confirm or endorse by ordinary resolution. If, on the other hand, the shareholders can sanction the act, the individual shareholder almost invariably cannot object, 'his only remedy being by the action of a general meeting'.\textsuperscript{52}

[He] cannot have a larger right to relief than the company itself would have if it were plaintiff, and cannot complain of acts which are valid if done with the approval of the shareholders, or are capable of being confirmed by the majority.\textsuperscript{53}

The mere \textit{possibility} of ratification by the general meeting prevents members from complaining of wrongs to the company.

However, there are exceptions to the ratifiability rule. In both \textit{Hogg v Cramphorn}\textsuperscript{54} and \textit{Bamford v Bamford},\textsuperscript{55} the conduct complained of (that is, improper but not mala fide issues of shares) \textit{was} open to corporate ratification. Yet the minority shareholders were allowed to commence what were really corporate or derivative actions (although in both cases the members were permitted to proceed on the basis that they were asserting personal actions). In \textit{Hogg v Cramphorn},\textsuperscript{56} Buckley J ordered a meeting to test the company's opinion regarding ratification of the share issue. At the meeting, the shareholders ratified and adopted the directors' acts. Without this, the minority action would presumably have gone ahead. Thus, some breaches, even though they may be open to majority

\textsuperscript{49} (1843) 2 Hare 461 at 492; 67 ER 189 at 202–203.
\textsuperscript{50} Above n 48 at 585, citing Cotter v Seamen's Union [1929] 2 Ch 58 at 69.
\textsuperscript{51} Above n 43 at 392.
\textsuperscript{52} Sir W Page-Wood V C in Taunton v Royal Insurance Co (1864) 2 H & M 135 at 140; 71 ER 413 at 415.
\textsuperscript{53} Burland v Earle [1902] AC 83 at 93, per Lord Davey.
\textsuperscript{54} [1967] Ch 254.
\textsuperscript{55} [1969] 2 WLR 1107.
\textsuperscript{56} Above n 54.
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49. As the leading case, Foss v. Harbottle is fundamental to the principles of derivative actions.

50. The Ratification Rule requires shareholders to ratify actions that have been taken incurring liability to third parties, which would otherwise not be covered by the company.

51. The ratification test is characterized by the requirement that shareholders must take deliberate action to ratify a transaction, usually by a vote or formal resolution.

52. The uncertainty surrounding the ratifiability rule, and the injustice that may result from its rigid application, lie at the root of the widespread dissatisfaction with the Rule in Foss v. Harbottle. The view of the majority of shareholders is important. But it should not be a major hurdle to shareholder action. The legislative relegation of the ratifiability test to a persuasive, rather than what is now a potentially decisive role, is appropriate.

The four established exceptions to the Rule are discussed in more detail below.

- **Ultra vires acts**

The first exception to the Rule says that Foss v. Harbottle does not apply where the act complained of is illegal or ultra vires. An example of an ultra vires-based action, brought by a minority shareholder, is *Atherton v The Plane Creek Central Mill Co Ltd*. The plaintiff, acting on behalf of himself and all other shareholders, gained a declaration that certain payments which the directors had authorised were ultra vires the powers of the company as expressed in the articles. The plaintiff was successful, even though the majority of shareholders approved of the payments. Even the unanimous approval of the shareholders could not validate or ratify an ultra vires act.

Although the ultra vires doctrine has effectively been abolished in Australia at least since 1985, a minority shareholder can bring an action against directors (and the company) where the directors have caused the company to act outside the powers of the company (providing that the rules of the company set out the powers of the company). This right of action is recognised in s 68(6)(g) of the Code, whereby the company's lack of capacity or power can be relied on in 'proceedings by the company, or by a member of the company, against the present and former officers of the company'. Ultra vires acts can still arise in Australia if companies elect to limit their powers or capacity in their articles or memoranda. However, third parties can no longer suffer from these ultra vires acts. Ultra vires is now only an issue between the company, the members and its officers and, as s 68(6) says, it can be relied on in s 227A, s 320, s 574, as well as in winding up and other listed proceedings.

By s 68(6)(g), ultra vires allegations or involvement could also be used


58. This has happened in Canada. See *Re Northwest Forest Products Ltd* [1975] 4 WWR 724 for an application of s 225(7) of the 1979 Company Act of British Columbia, for example.


61. See Act 192 of 1985 (Cth), ss 47ff.
against officers — for example, in negligence actions or proceedings alleging breaches of the duty to act in the company’s best interests. And because ultra vires acts are one of the exceptions to the Rule in *Foss v Harbottle*, minority shareholders could bring these ultra vires-based proceedings on behalf of the company.

- **Actions done or approved by ordinary majority where a special majority is required under the Code or the articles or memorandum**

Minority shareholders can also bring actions when the company, usually acting through its directors, has 'broken its own regulations by doing something without a special resolution which could only be done validly by a special resolution' 62 The Code itself, the articles or memorandum, may require a special resolution or a special majority for certain matters. For example, the articles may require that the directors' remuneration be settled by special resolution, or that the rights attaching to a particular class of shares should be altered only after a 75% majority resolution of the class members, and then if the general meeting approves the alterations. By this requirement of a special majority, and certain procedures to gain that special majority validly, the company or the legislature has shown that it thinks some decisions are especially important. If the required procedure is waived or ignored, the minority shareholder may complain to the courts. 63

The most commonly cited examples of this category of exception are *Baillie v Oriental Telephone Co* 64 and *Edwards v Halliwell*. 65 In *Baillie*, a circular accompanying the notice of meeting to pass special resolutions was misleading or ‘tricky’, as Lord Cozens Hardy M R described it. The resolutions were therefore invalid. They concerned, inter alia, the receipt by the directors of significant remuneration for their services as directors of a subsidiary company. The rules required that such resolutions should be validly passed by a three-quarters majority. It appeared that, despite the invalidity of the resolutions, the company was not prepared to rectify the situation. In effect, the company proposed (by its inactivity) to allow the bare majority to do what could only be done validly by a special resolution (namely, to sanction the directors' receipt of the remuneration and to change the articles). This would have meant that, by the control of a bare majority, the wrongdoers could indirectly, or 'by a side wind as it were', 66 get around the requirements of the rules. The court upheld the plaintiff's right to pursue the action for declarations, injunctions and orders.

63. Some may question the logic of allowing derivative actions for irregularities that only a special resolution can put right and refusing them for irregularities that an ordinary resolution can put right. See Barak, ‘A Comparative Look at Protection of the Shareholders’ Interest: Variations on the Derivative Suit’ (1971) 20 ICLQ 22 at 31-33.
64. [1915] 1 Ch 503.
65. [1950] 2 All ER 1064.
66. Swinfen Eady L J, above n 64 at 518.
In Edwards v Halliwell, a rule of the defendant trade union stated that no change could be made to the subscriptions of members ‘until a ballot vote of the members has been taken and a two-thirds majority obtained’. A meeting of only the union’s delegates simply resolved to increase the subscriptions. Two union members successfully brought actions against two members of the executive committee and the union itself. The Court of Appeal thought that this was more than a case of mere internal irregularity and that Foss v Harbottle should not prevent the individual member from suing.67

Other examples in this category include the wrongful variation of class rights cases. In Crumpton v Morrine Hall Pty Ltd,68 a minority shareholder initiated proceedings against the company to prevent it giving effect to certain special resolutions modifying the rights attached to Crumpton’s shares. The articles said that Crumpton had to give her written consent to such modifications. She had not given it. So the special majority required to change the articles had not been gained validly and Crumpton thus had legal standing. Class rights cases also fall into the third exception category in that they involve the infringement of the personal rights of shareholders.

* Personal rights

Ownership of shares carries with it personal rights (sometimes called individual rights). Shareholders can bring actions for a breach of these personal rights. They usually seek declarations and injunctions, rather than damages.69 Every shareholder, whatever his voting power in the company, has the right to ask the courts to enforce or protect his personal right as a shareholder. The restrictive rule in Foss v Harbottle is irrelevant to such actions;70 personal not corporate rights are at issue.

Personal rights include the right to vote as a member, to inspect the company’s records, to receive proper notices of meetings, to use proxies, to stop an ultra vires act (on the ground that such a wrong is a breach of contract and is thus a wrong to the member personally by the company), to prevent dilution of one’s own votes by the counting of improper votes, to prevent such alteration to the articles as constitutes a ‘fraud on the minority’ (see below) and to seek dissolution of the company. These rights arise from the Code itself. Most arise from the articles and memorandum of association (which, under s 78 of the Code, constitute a statutory contract between the members and the company). Some of the rights arise even from separate contracts entered by the shareholder with the company.71

67. See Jenkins L J, above n 65 at 1067–1068.
68. [1965] 82 WN (NSW) 456.
71. As to the statutory or s 78 contract see Allen v Gold Reefs of West Africa [1900] 1 Ch 656 at 671–673.
There are many other examples of true personal rights of shareholders. They may enforce personal rights to have pre-emptive share rights observed; to enforce payment by the company of declared but unpaid dividends; to vote and have that vote recorded in accordance with the articles; to stop directors holding or remaining in office in breach of the articles; and to have accurate information passed down from management. As noted above, class rights enforcement cases also fall into this category of exception. In *Crumpton v Morrine Hall Pty Ltd*, Jacobs J noted that the minority shareholder was entitled to seek her injunction in order to prevent modification of her class rights because ‘particular rights are attempted to be taken away from the holder of particular shares’.

This personal rights category includes wrongful dismissal — that is, where shareholders who are directors and whose appointments, terms and removals are governed by, or embodied in, the articles enforce their personal contractual rights and seek damages from the company when they are improperly removed as directors. Such cases are not ideal examples because directors are enforcing their rights qua directors and not their rights as shareholders. By s 78(1) of the Code, the articles constitute a contract between each member and the company, and between the company and each officer. For example, a member who is also managing director can use s 78(1)(b) to bring a personal action to enforce powers or rights given by the articles to him as managing director.

The precise ambit of this personal rights exception is uncertain. It is not always clear, even after close analysis of certain cases, whether the action has been brought by shareholders and allowed by the courts as a personal action, or as a derivative action, or as both. Unfortunately, the exception’s limits are determined for the time being by random precedents rather than by clear statements of legal principle.

The English Court of Appeal in *Prudential Assurance* thought that a shareholder does not suffer any breach of his personal rights when the company’s profits diminish because of a wrong done to the company. Nor do the cases uniformly extend the exception to all infringements of the ‘contractual’ terms of the shareholder’s relationship. In *MacDougall v*  

72. See *Godfrey Phillips Ltd v Investment Trust Ltd* [1953] Ch 449 at 457.
73. See *Pender v Luckington* (1877) 6 Ch D 70 at 81.
74. *Catesby v Burnett* [1916] 2 Ch 325; *Kraus v J G Lloyd Pty Ltd* [1965] VR 232.
76. Above n 68 at 460.
77. See an example in *Salmon v Quin & Axtens Ltd* [1909] 1 Ch 311; affd [1909] AC 442. See also *Rayfield v Hands* [1958] 2 All ER 194 (s 78(1)(b) of the Code would now cover the facts of this case).
79. See Ahmed, (1976) 1 UNSWLJ 264. The distinction is of crucial importance under Canadian legislation: see Beck, ibid.
Gardiner,\(^81\) for example, James L J said that members did not have the right to complain of internal irregularities, even where those irregularities were infringements of the articles (specifically, of an article entitling members to demand a poll in a general meeting). Yet in Baillie and Pender v Lushington, for example, in contrast to MacDougall and other cases,\(^82\) the shareholders were allowed to complain to the courts of what were, in essence, internal irregularities. Other authorities suggest that every shareholder has the right to stop the company allowing persons to act as directors in breach of the articles. But it has also been said that members, by ordinary resolution, can ratify directors' breaches of procedure as laid down in the articles.

As Wedderburn pointed out,\(^83\) with reference to personal rights arising from the articles, those articles a breach of which cannot be ratified cannot easily be separated from those a breach of which can be ratified by an ordinary resolution:

It is, therefore, suggested that matters of 'internal management' ought to be confined to matters already covered by judicial pronouncements. This, at best, will leave anomalies ... but this does not mean that the mere fact that a breach of the articles can be expressed as an 'internal irregularity' is not a reason, without more, for saying that the wrong has been 'done to the corporation' alone and for denying to the individual member a personal right of action in respect of the wrong. The question which the court should ask itself is: 'Was this an irregularity such that we should allow an ordinary majority to put it right?'

**Personal, derivative and representative actions defined.** Most personal rights are pursued as representative actions (called 'class' actions in the United States) by the shareholder(s). This is because the rights at issue will be common to other shareholders. Thus, the aggrieved shareholder may sue on behalf of himself and all other shareholders having the same personal interest. Although each is asserting his personal rights, it is more efficient to act together. Such concerted actions are described as being in representative form. One or a few shareholders represent all shareholders (except, of course, the defendants). The defendants in such actions will be the directors, or the majority shareholders, and/or the company, depending on who are perceived to be the wrongdoers and what remedies are sought.

The personal action differs from the derivative action,\(^84\) but, as with personal actions, the aggrieved shareholder bringing a derivative suit usually sues in a representative form. Lord Denning M R said in Wallersteiner v Moir (No 2): 'The form of the action is "A.B. (a minority shareholder) on behalf of himself and all other shareholders of the company"

\(^{81}\) (1875) 1 Ch D 13 at 22-23.
\(^{82}\) For example, Cotter v National Union of Seamen [1929] 2 Ch 58.
\(^{84}\) Discussed below.
against the wrongdoing directors and the company. This form should not confuse us. The true nature of a derivative suit is that the wrongs for which the plaintiff shareholder sues will not be personal wrongs but wrongs done to the company. Naturally the company would itself sue as principal, but since this is impossible, the minority shareholders sue on its behalf, naming the company as defendant. Thus, the company is the proper plaintiff. Any benefit from a judgment goes to the company, and the fact that it is a nominal defendant does not affect this.

High authority dictates that a minority shareholder is not entitled to proceed in a representative action [on behalf of the company] if he is unable to show when challenged that he has exhausted every effort to secure the joinder of the company as plaintiff and has failed. If the company's controllers refuse to act, however, the company in a sense is not able to look after its own interests. Then the minority shareholder may be able to step in.

We call such actions 'derivative' because the minority shareholder gets his right to action from the company and enforces the rights of the company. The gravamen of the matter is injury to the company; theoretically, the company is the aggrieved party. While most derivative suits are over breaches of duties owed the company by directors and controlling shareholders, they can also be brought for other wrongs against the company. There may, for instance, be corporate claims against third parties for defective merchandise or negligence, matters which do not necessarily involve misbehaviour of the board or by a controller.

Company as 'defendant'. When the minority shareholder brings a derivative action in a representative capacity, all shareholders and the company are bound by the court's decision because all shareholders are committed to the action as plaintiffs. The company — also a 'plaintiff' in the sense that the minority are suing on its behalf (because the board and the majority of members refuse to initiate a suit) — is, paradoxically, also joined as nominal defendant.

Why is the company cited as defendant when the minority shareholder, the formal plaintiff, derives his right to action from the company? [T]he company must be a party to the suit in order to be bound by the result of the action and to receive the money recovered in the action. Obviously, in such an action as this, no specific relief is asked against the company; and obviously, too, what is recovered

85. [1975] QB 373 at 390–391. See also Atwool v Merryweather (1868) LR 5 Eq 464 at 467–468. Cf Ansett v Butler Air Transport Ltd (1958) 75 WN (NSW) 299 at 305. In Peters' American Delicacy Co Ltd v Heath (1938–1939) 61 CLR 457, the action was brought 'by three shareholders on behalf of themselves and other shareholders in the company holding partly paid shares' (at 476). Partly paid shares formed about a quarter of the issued shares.
86. Hurley v BGH Nominees Pty Ltd (1982) 1 ACLC 387 at 392, per White J.
87. Ferguson v Wallbridge [1935] 3 DLR 66 at 83, per Lord Blanesburgh.
cannot be paid to the plaintiff representing the minority, but must go into the coffers of the company.\textsuperscript{89}

As the company, too, is bound by any judgment, all parties are precluded from bringing other suits on the same cause of action. Decisions become \textit{res judicata} as far as the company and the members are concerned. If control of the company changes at some later date, there can be no suits based on the same cause of action.\textsuperscript{90}

\textbf{Joining derivative and personal claims in the same action.} One set of facts may support both a personal and a derivative action. Generally, a personal (or direct) action is not precluded simply because the same facts could also found a derivative action. A derivative action can be combined or joined with a personal direct action in the same proceedings by the shareholder, providing that the claims arise out of the ‘same transaction or occurrence’.\textsuperscript{91} Similar joinder of claims for damages payable to shareholders personally (for example, for a fall in the value of shares) and actions on behalf of the company for breach of duty is allowed, for example, in Canada and France.\textsuperscript{92} Beck\textsuperscript{93} argues that an aggrieved shareholder should prefer a personal action to derivative proceedings ‘for reasons of procedural simplicity and remedial advantage’.

\section*{Fraud on the minority}

This is the most litigated exception to \textit{Foss v Harbottle}. Some (including the author) argue that it would be better named the ‘fraud on the company’ exception.\textsuperscript{94} Providing that he has standing, a shareholder sues on behalf of the corporation in order to stop or seek remedies for a fraud on the minority. This means, as noted earlier, that the company must be joined as a party to the action. The plaintiff almost invariably sues in a representative form. Only ‘derivative’ (or ‘corporate’) actions (not personal actions) can be brought under this heading.\textsuperscript{95} In \textit{Wallersteiner v Moir (No 2)},\textsuperscript{96} however, Moir sued in his own name when bringing his suit on behalf of the company.\textsuperscript{97}

The ‘fraud on the minority’ exception has two requirements. First, the wrong complained of must amount to a ‘fraud’ which cannot be validly waived by the company. Second, the alleged wrongdoers must be in

\begin{itemize}
  \item \textsuperscript{89} Chitty L J in \textit{Stokes v Grosvenor Hotel Co} [1897] 2 QB 124 at 128.
  \item \textsuperscript{90} See discussed in \textit{Gower’s Modern Company Law} (4th ed) at 651.
  \item \textsuperscript{91} \textit{Goldex Mines Ltd v Revill} (1974) 54 DLR (3d) 672 at 677; \textit{Prudential Assurance v Newman Industries (No 2)} [1980] 2 All ER 841 at 859–860.
  \item \textsuperscript{92} See Pennington, \textit{The Investor and the Law} (1968) at 491; Beck, ‘The Shareholders’ Derivative Action’ (1974) 52 Can Bar Rev 169 at 182ff and n 108; \textit{Goldex Mines Ltd v Revill}, ibid at 677 (where the Ontario Court of Appeal stressed the need for proper pleadings if personal and derivative claims were to be pursued together).
  \item \textsuperscript{93} Above n 78 at 169 and 195.
  \item \textsuperscript{94} Slutsky, (1976) 39 MLR 331 at 333; Wedderburn, [1958] CLJ 93 at 93–94.
  \item \textsuperscript{95} See \textit{Ferguson v Wallbridge} [1935] 3 DLR 66 at 81, 83 (PC).
  \item \textsuperscript{96} [1975] QB 373.
  \item \textsuperscript{97} See a good article by Schreiner, ‘The Shareholder’s Derivative Action — A Comparative Study of Procedures’ (1979) 96 South African LJ 203, esp at 212–218.
\end{itemize}
control of the company to the extent that they are able to prevent the company from suing.

Fraud. The meaning of 'fraud' in this context has been the subject of much comment; its meaning is wide. Megarry VC said, in Estmanco (Kilner House) Ltd v Greater London Council, that 'fraud' meant not just 'fraud at common law but also fraud in the wider equitable sense of that term, as in the equitable concept of fraud on a power'. 'Fraud on a power' means an abuse or misuse of power:

[It] does not necessarily denote any conduct on the part of the appointor amounting to fraud in the common law meaning of the term or any conduct which could be properly termed dishonest or immoral. It merely means that the power has been exercised for a purpose, or with an intention, beyond the scope of or not justified by the instrument creating the power.

In Ngurli v McCann, it was a 'fraud' for the controlling director to abuse the power to issue shares conferred on him by the articles. The director had issued shares at par (when a substantial premium would have been appropriate) to advance his own control. The power to issue was not used bona fide for a purpose that was for the benefit of the company as a whole.

The fraud is more culpable where directors use their powers to appropriate to themselves property which belongs to the company. Lord Davey confirmed that fraud arises 'where the majority are endeavouring directly or indirectly to appropriate to themselves money, property, or advantages which belong to the company, or in which other shareholders are entitled to participate'. (Cook v Deeks and Menier v Hoopers Telegraph Works are good examples.)

Wedderburn grapples with the definition of 'fraud'. He asserts two basic propositions: that not all breaches of fiduciary duty are 'fraud', and that some breaches of fiduciary duty can (and others cannot) be ratified by shareholders in general meeting. Those that cannot be ratified amount to fraud. Thus, if the general meeting may ratify, that is sufficient to prevent a minority shareholder from bringing a derivative action. Wedderburn further suggests that precedent dictates that those breaches

98. [1982] 1 All ER 437 at 445.
99. Vatcher v Paull [1915] AC 372 at 379, per Lord Parker. This passage was cited with approval by the High Court in Ngurli Ltd v McCann (1953) 90 CLR 425 at 438.
1. Ibid.
3. [1916] 1 AC 554.
4. (1874) 9 Ch App 350.
5. Making an incidental profit, as the directors did in Regal (Hastings), is arguably not a misappropriation of 'money, property, or advantages' and thus not 'fraud' in this context. As Sullivan comments in [1985] CLJ 236 at 240: 'The distinction is not attractive as a matter of law or policy. The exclusive ambit, respectively, of proprietary and non-proprietary claims to gains made in breach of fiduciary duty is uncertain.'
of fiduciary duty that do amount to fraud (that is, which cannot be ratified) arise either where the directors act in bad faith or where some legal or equitable property of the company has been misappropriated. In other words, neither mala fides nor misappropriation can be ratified. In Cook v Deeks, corporate property in the form of a contractual opportunity was diverted to or misappropriated by the directors themselves. In Menier’s case, the directors surreptitiously agreed amongst themselves to divert a telegraph cable-laying contract away from their company to the benefit of a third company.

The meaning of ‘bad faith’ defies accurate and comprehensive summary. Gower suggests that it is bad faith for directors to refuse to call a general meeting to consider a resolution that the company take action against them and thereby try to prevent such an action. His reasoning is that to refuse the meeting for their own selfish interests is a breach of good faith by the directors, irrespective of the nature of the actions complained of originally. Being in bad faith, such an act is then not open to ratification. But Gower goes on to comment that ‘when the directors appropriate the company’s property, it seems that their action can be authorized by a resolution of the company if it can be shown positively that this was passed bona fide in the interests of the company’. Gower concludes that only where there is expropriation as well as lack of bona fides can there be no ratification.9

Dishonesty is clearly fraud. But does fraud encompass negligent or reckless acts by directors? Broad dicta in Daniels v Daniels10 suggest that it does. An accusation of negligence by directors on the sale of the company’s land to one of their own number at a dramatic undervalue gave minority shareholders standing when the directors profited from the negligence and the company was harmed. The two directors were a married couple and also the majority shareholders. Acting as the board, they sold company land to the wife. Some four years later, the wife sold the same real estate for more than 28 times its cost price. Although the couple sought to use Foss v Harbottle to stifle the action against them, Templeman J ruled that:

... a minority shareholder who has no other remedy may sue where directors use their powers, intentionally or unintentionally, fraudu-

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9. We should keep in mind the judgment of Manson J in Canada Safeway Ltd v Thompson [1951] 3 DLR 295, where there was both expropriation and lack of bona fides. In a dictum at 321, his Honour suggested that unanimous resolution of the shareholders can excuse practically anything, even the expropriation and lack of bona fides at issue in the case. See brief and cryptic support for this power of all the corporators by Helsham J in Provident International Corporation [1969] 1 NSWR 424 at 441; Moss J A in Earle v Burland (1900) 27 OAR 540 at 561. See also discussion of power of unanimous shareholders in Ch 6.
11. See also Vinelott J at first instance in Prudential Assurance, above n 88. His Honour attempted a comprehensive examination of the meaning of ‘fraud’.
lently or negligently, in a manner which benefits themselves at the expense of the company.\(^\text{12}\)

It is difficult to disagree with Templeman J's observation that:

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.\(^\text{13}\)

Without doubt, the shareholder's complaint was justified.\(^\text{14}\) Denying the minority shareholders access to the court would have rewarded negligence.

Daniels should be compared to an earlier and much-criticised decision in Pavlides v Jensen.\(^\text{15}\) The plaintiff minority shareholder was denied access to the courts. He alleged that the defendant directors (a majority on the board) had sold an asbestos mine for £182,000 to another company when, he alleged, its true value was about £1,000,000. The plaintiff did not allege fraud or ultra vires; he alleged only gross negligence. Danckwerts J followed the advice of Lord Davey in Burland v Earle\(^\text{16}\) and refused to 'interfere with the internal management of companies acting within their powers'. Because such a breach of duty was ratifiable by a majority at general meeting, the action should, he said, prima facie be brought by the company itself.\(^\text{17}\) Negligence by itself did not, the court ruled, amount to fraud for the purposes of the Rule, despite the seeming affront to justice on the facts of the case. Prentice commented: 'After this decision a collective sigh of relief of hurricane-like proportions was no doubt emitted from British boardrooms.'\(^\text{18}\) Gower also was not impressed: 'Is it not, perhaps, time that the rule in Foss v Harbottle was decently interred?'\(^\text{19}\) Daniels, by contrast, was warmly received.\(^\text{20}\)

In Daniels v Daniels,\(^\text{21}\) Templeman J distinguished Pavlides on the ground that in the latter no benefit had accrued to the directors.\(^\text{22}\) This suggests that only if the negligence benefits the director himself can he be sued by a minority shareholder. Whilst moral culpability is important, the company can suffer the same damage from non-self-serving as from self-serving negligence. This distinction is rather thin.

These decisions raise other questions. As stated earlier, acts that can be ratified by the general meeting generally cannot support derivative actions by minority shareholders.\(^\text{23}\) But, most breaches of duty,
including negligence, are ratifiable. Templemen J in Daniels did not say whether or not the breach of duty alleged in that case — negligence — was ratifiable. We assume it was not. To fit Daniels into the case law, it must be accepted either that 'self-serving' negligence can amount to 'fraud' on the minority, or the case must simply be classified as an expropriation of corporate property case (as in Cook v Deeks). If the latter, the case would fall into a well-established category. However, Templeman J himself did not treat the case as one of expropriation. 24

Daniels suggests that the 'fraud on the minority' exception is expanding and not contracting, despite the retrenchment evident in the English Court of Appeal's dicta in Prudential Assurance. 25 Prentice suggests:

The net result of Daniels v Daniels is that the rule in Foss v Harbottle is confined to a very narrow compass to situations where a director's breach of duty does not result in any personal gain. 26

This debate over whether or not negligence amounts to fraud complicates unnecessarily this area of the law. Whilst s 320 of the Code has taken the urgency out of calls for legislative cures to the problems of derivative suits, it is time that the legislature rid us of the Foss v Harbottle corpus. It is instructive to read the incisive approach of the British Columbia Supreme Court to substantiated allegations of boardroom negligence when permitting a derivative action in Re Northwest Forest Products. 27

Wrongdoers in control. Before minority shareholders can use the fraud on the minority exception, they must set out in their statement of claim and show evidence that the wrongdoers or 'fraudsters' control the company. If the wrongdoers do control the company, the individual shareholder seeking to right some wrong can be in an impossible position. His action would never reach the courtroom. 29 If the wrongdoers do not control the board or the general meeting, it is reasoned that the matter should be thrashed out in the company and not in the courts.

Proving control was no problem in Estmanco Ltd v Greater London Council. 30 The alleged wrongdoer, the Council, held all the voting shares (although not all the shares) in the company. The Council voted that the directors discontinue a derivative action against the Council. The non-voting shareholders were held to have standing to bring the derivative action under the fraud on the minority exception.

The plaintiff generally shows control by the wrongdoers by proving that the board and the general meeting have actually refused to bring

26. Above n 24 at 51.
30. [1982] 1 All ER 437.
proceedings and that the fraudsters' votes caused that refusal. This can be achieved by making a demand on the board to sue.\textsuperscript{31} Sometimes even a demand will be futile, and courts recognise this.\textsuperscript{32} Wrongdoers who control the board are most unlikely to initiate action against themselves. However, the control and demand requirements are well-founded; they staunch frivolous or ill-based derivative suits brought for reasons other than the good of the company. There seems to be a grey area as to whether or not the wrongdoers must be shown to be in control not only of the board but also of the general meeting. The time, cost and difficulty (especially in large public companies) of ascertaining the wrongdoers' power in general meeting can be great. Because of the tenuous nature of the general meeting's power to initiate suit, and because a request to it serves no useful purpose where a minority shareholder is prepared to sue, it is unlikely that wrongdoers' control of the general meeting is a vital prerequisite to a derivative suit.\textsuperscript{33}

'Control' meant holding a majority of votes in general meeting, according to James LJ in several cases in the 19th century.\textsuperscript{34} Given the realities of modern corporate power, that meaning is too limited. There may be de facto 'control', even where the wrongdoers or their nominees do not have a majority of votes.\textsuperscript{35} The English Court of Appeal in \textit{Prudential} suggested:

'control' . . . embraces a broad spectrum extending from an overall absolute majority of votes at one end to a majority of votes at the other end made up of those likely to be cast by the delinquent himself plus those voting with him as a result of influence or apathy.\textsuperscript{36}

Counting the votes that come through 'influence or apathy' will be difficult indeed. But the recognition of voting realities is to be welcomed. At first instance, Vinelott J had recognised the realities of control in large corporate structures. He pointed out that directors can manipulate proxy

\textsuperscript{31} See US and Canadian derivative suit procedures, discussed later, in which such a demand or at least notification of the proposed action is specifically required.

\textsuperscript{32} See US example in \textit{Barr v Wackman} 36 NY 2d 371; 329 NE 2d 180 (1975). In improper issues of shares cases, the element of 'control' is often central. For example, \textit{Hogg v Cramp horn} [1967] 1 Ch 254; \textit{Punt v Symons} [1903] 2 Ch 506; \textit{Piercy v S Mills & Co Ltd} [1920] 1 Ch 77. Through the improper issue itself, the alleged wrongdoers can gain enough votes to be in a majority: see \textit{Hogg}, ibid at 271, per Buckley L J; \textit{Piercy}, ibid at 84, per Peterson J; \textit{Punt}, ibid at 515–517, per Byrne J.

\textsuperscript{33} See criticism of a specific statutory requirement for demand on shareholders in \textit{Mayer v Adams} 37 Del Ch 298; 141 A 2d 458 (1958).

\textsuperscript{34} See \textit{MacDougall v Gardiner} (1875) 1 Ch 13 at 22; \textit{Menier v Hooper's Telegraph Works} (1874) 9 Ch App 350 at 353.

\textsuperscript{35} See \textit{Pavlides v Jensen} [1956] Ch 565 at 677. See also \textit{Pine Vale Investments Ltd v McDonnell & East Ltd} (1983) 8 ACLR 199 at 201, where a takeover offer was trying to achieve 42% of the issued share capital 'thereby conferring control of the company'. See also Pickering, 'Shareholders' Voting Rights and Company Control' (1965) 81 LQR 248; Sullivan, 'Restating the Scope of the Derivative Action' [1985] CLJ 236 at 246. See also Enstam and Kamen, 'Control and the Institutional Investor' (1968) 23 Bus Law 289 at 291–297, 315, where it is suggested that 10% or less of the votes can carry control.

\textsuperscript{36} Above n 72 at 364.
votes, and that large groups of shareholders (not necessarily amounting to an overall absolute majority) may attend particular meetings and determine the outcome of a motion. Vinelott J accepted a broad principle that the wrongdoers are in sufficient control,

[...wherever the persons against whom the action is sought to be brought on behalf of the company are shown to be able 'by any means of manipulation of their position in the company' to ensure that the action is not brought by the company.]

This dictum was crucial to the first instance decision in Prudential that the derivative action be allowed to proceed, because the alleged wrongdoers did not control a bare majority of the votes in general meeting. The Court of Appeal did not dispute Vinelott J's finding on this point.

Standing as a preliminary procedure. The courts themselves are moving to 'legislate for a simple procedure by which to determine the standing of a shareholder to bring a derivative suit. The English Court of Appeal in Prudential expressed strong opinions on the need to determine, as a preliminary issue, whether the plaintiff minority shareholder is entitled to sue on behalf of the company. The merits of the case should, it said, only be argued in full once the question of standing has been settled.

It cannot have been right to have subjected the company [Newman] to a 30-day action (as it was then estimated to be) in order to enable him [the judge at first instance] to decide whether the plaintiffs are entitled in law to subject the company to a 30-day action. Such an approach defeats the whole purpose of the rule in Foss v Harbottle and sanctions the very mischief that the rule is designed to prevent. By the time a derivative action is concluded, the rule in Foss v Harbottle can have little, if any, role to play.

The Court did not favour a 'full-dress trial' merely in order to establish the standing to bring a derivative action. Instead,

[...the plaintiff ought at least to be required before proceeding with his action to establish a prima facie case (i) that the company is entitled to the relief claimed and (ii) that the action falls within the proper boundaries of the exception to the rule in Foss v Harbottle. On the latter issue it may well be right for the judge trying the preliminary issue to grant a sufficient adjournment to enable a meeting of shareholders to be convened by the board, so that he can reach a conclusion in the light of the conduct of, and proceedings at, that meeting.]

37. [1980] 2 All ER 841 at 875.
38. The Rule in Foss v Harbottle was not relevant on appeal. The company had agreed that it would accept the benefit of the first instance order in its favour if the finding of fraud stood on appeal. It did, and that discouraged further discussion of any other requirements of the fraud exception: see [1982] 1 All ER at 365. The approach of the English Court of Appeal in Prudential Assurance has been criticised: see (1982) 98 LQR 179 at 180, for example.
40. Ibid at 366.
What, then, is a prima facie case? In this context, it is most unlikely that it means that the plaintiff must show it is more probable than not that he will succeed in the final trial. The test has, depending on the occasion or context, been variously described as requiring some probability of success, 'a chance of a microscopic fraction over 50% that the event in question will occur' or 'not frivolous or vexatious'. In Beecham Group Ltd v Bristol Laboratories Pty Ltd, the High Court accepted that something less than proof of probability of success was required. O'Leary J of the Ontario High Court thought that his only task was to see if there was a serious issue that could succeed. He resiled from any de facto trial of the action. A judicial or mathematical definition of 'prima facie' that demands probability and proof upon trial is too onerous; something less is called for if the spectre of Prudential Assurance is not to defeat justice-seeking shareholders too easily.

The line taken in Re Northwest Forest Products Ltd, a British Columbia case, may be helpful. The applicants had only to show that 'the action sought is prima facie in the interests of the company' and not to prove a prima facie case. The low standard set was because this was 'in the nature of an interlocutory application because it decides nothing more than that an action may or may not be commenced'. Also, in Bellman, Bell-Irving and Allarce Broadcasting Ltd v Western Approaches Ltd, Nemetz CJ only called for 'an arguable case' when affirming the lower court's grant of standing to bring a derivative suit pursuant to s 232 of the Canada Business Corporation Act 1974.

The cards are so consistently stacked against the shareholder with a well-founded cause that a fairly liberal policy on the granting of status is appropriate. In Hurley v BGH Nominees Pty Ltd, King CJ had reservations about the narrow interpretation that the dicta on standing in Prudential might receive.

In many such cases a hearing to determine whether there was a prima facie case would be almost as long as a full trial and a good deal less satisfactory. In such cases the only reasonable course may be to determine the issue of standing, if raised as a preliminary issue, on the assumption that the allegations in the statement of claim are correct. It seems to me that the procedure for the determination of the issue of locus standi ought to be determined in each individual case.

41. See Bray C J in Pizzey Ltd v Classic Toys Pty Ltd [1975] ACLC 28,011 at 28,014.
43. (1968) 118 CLR 618.
44. See also Spry, 'The Myth of the Prima Facie Case' (1981) 55 ALJ 784, commenting on Beecham and Cyanamid.
45. See Re Marc-Jay Investments Inc and Levy [1975] 5 OR (2d) 235 at 237. Section 99 of the Ontario Companies Act 1970 (the derivative suit provision) was at issue.
47. Ibid at 735.
48. Ibid.
according to what appears to be just and convenient in the circumstances of that case.\footnote{171}

Perhaps the simplest procedure was set out by Lord Denning MR in \textit{Wallersteiner v Moir (No 2)}, which dealt principally with the issue of costs for the litigants:

In a derivative action, I would suggest this procedure: the minority shareholder would apply \textit{ex parte} to the master for directions, supported by an opinion of counsel as to whether there is a reasonable case or not. The master may then, if he thinks fit, straightaway approve the continuance of the proceedings until close of pleadings, or until after discovery or until trial (rather as a legal aid committee does). The master need not, however, decide it \textit{ex parte}. He can, if he thinks fit, require notice to be given to one or two of the other shareholders as representatives of the rest — so as to see if there is any reasonable objection. . . . But this preliminary application should be simple and inexpensive. It should not be allowed to escalate into a minor trial. The master should simply ask himself: is there a reasonable case for the minority shareholder to bring at the expense (eventually) of the company? If there is, let it go ahead.\footnote{51}

In essence, Lord Denning proposes a ‘new’ test for deciding standing in derivative action cases: namely, is there a reasonable case to support an action by the minority shareholder or, as Buckley LJ suggests, ‘would it have been reasonable for an independent board of directors to bring [an action] in the company’s name?\footnote{52} Under this test, a shareholder may not have to fit himself first into one of the exceptions to the Rule in \textit{Foss v Harbottle}. Prentice notes that:

This test would probably be satisfied in all cases of directors’ breach of duty, except where the breach was trivial or perhaps where an independent board had decided not to take any action, or a meeting of independent shareholders had ratified the wrong.\footnote{53}

The plaintiffs must, however, be able to satisfy the court that they are the appropriate parties to bring the suit on behalf of the company and that the company itself will benefit.\footnote{54} Because leave to bring a derivative action is ‘a matter of grace’\footnote{55} the plaintiff’s own behaviour is material. Vindictiveness, or personal involvement in the breach, may compromise a would-be plaintiff.

\footnote{50} \textsuperscript{50} (1982) 1 ACLC 387 at 389–390. White J (at 396) cautioned that not every disputed standing case could be dealt with shortly: ‘it may often be necessary to embark upon some evidence before the foundation of the objection to standing is made clear.’
\footnote{51} [1975] 2 WLR 389 at 397. See also Buckley L J at 408–409. In \textit{Edney v Commodore Computer (NZ) Ltd} (1984) 2 NZCLC 99,167 a dismissed director, in interlocutory proceedings, was held to be entitled to bring an action on behalf of the company by way of derivative action. The plaintiff had ‘established that there are serious questions to be tried’ (99,177).
\footnote{52} Ibid at 407–408.
\footnote{53} (1976) 40 Conv 51 at 63.
\footnote{54} \textit{Nurcombe v Nurcombe} [1985] 1 All ER 65 at 70, per Lawton L J; \textit{Towers v African Tug Co} [1904] 1 Ch 558 at 567, per Williams L J.
Directors' Powers and Duties

The need for a legislative procedure

Despite judicial innovations, under the present law there are just too many hurdles to jump before bringing derivative suits. You must identify the wrongdoers, gather sufficient information, show there is fraud, prove the alleged wrongdoers control the company, and discover whether or not the acts complained of are ratifiable by a majority at a general meeting. Then you must somehow fund the action. In the face of all this and more, genuine grievances go unremedied.

As noted earlier, s 320 of the Code offers aggrieved shareholders remedies in situations that formerly had to be fought out in the mire of Foss v Harbottle. Although s 320's net of 'unfairness' or 'oppression' is wide, it may not cover all the ground of breaches of directors' duty. For example, the improper issue of shares for control purposes may not be seen as oppressive or unfair to a complaining shareholder and thus may still involve that shareholder in arguments over standing to bring a derivative suit. There is an essential difference: the oppression suit relies on a personal wrong to the shareholder; the derivative suit alleges a wrong to the company. The one wrongful action by directors will not always ground both a personal and a company grievance. The fact that wrongdoing by the directors adversely affects the company's share price does not necessarily mean that it is also a personal wrong to the members. A legislative clarification of the derivative suit's rules along the lines of the Canadian legislation would be welcome.

Legislative solutions to Foss v Harbottle problems

Canada

With the realisation that the common law was confusing and unreasonably stacked against the minority shareholder, the Ontario Lawrence Committee in its 1967 Interim Report opted to enlarge the shareholder's right of access to the courts to bring derivative actions. This led to s 99 of the Ontario Business Corporations Act 1970. Under s 99(2), the leave of the court must be gained before a minority shareholder can bring a derivative action on behalf of the company. The common law procedures have been replaced; the legislation now sets out the only procedure available. In Re Marc-Jay Investments Inc and Levy, O'Leary J noted that it was not the role of the judge hearing the standing application to try the action: Where the applicant is acting in good faith . . . and where the intended action does not appear frivolous or vexatious and could reasonably

56. This is borne out in the UK by Re a Company [1986] 2 All ER 253.
I too identify, tried to prove, neither through general nor this lens.

... the purpose of the provisions was to clear up the common law jungle of conflicting and confusing cases centring around the so-called 'derivative action' and the 'Rule on Foss v Harbottle'.

The Canadian experience with statutory control has been relatively free of problems. If vindication of the Canadian reforms was needed, the expensive Prudential Assurance saga provided it.

Canadian jurisdictions allow shareholders to bring derivative actions, even where the wrongdoing complained of does not amount to fraud. To get the court's approval before starting the action proper, the complainant must show that he is acting in good faith, that he has made reasonable efforts to get the directors to commence the action in the company's name, that the action is prima facie or 'appears to be' in the interests of the company and that he was a shareholder at the time of the alleged wrongdoing.

These standing criteria were traversed by the British Columbia Supreme Court in Re Northwest Forest Products Ltd. The applicants, alleging the sale of corporate assets at a price far below their true value, gained leave to commence an action. They produced sufficient evidence from land sale documents, a debenture, minutes of a general meeting, letters, and affidavits by the applicants to satisfy the requirements of the British Columbia provision.

Section 225(7) of the British Columbia Act says that action cannot be stopped on the sole ground that an alleged breach of duty, right or obligation owed to the company has been or could be approved by the general meeting (although it may be taken into account). In Re Northwest Forest Products Ltd, the court allowed the derivative action to go ahead,
even though the shareholders in general meeting had approved the directors' actions. The court was not satisfied that the votes had been independently cast.

Actual or potential ratification is a major hurdle for minority shareholder action in Australasian common law. Whilst the avoidance of needless litigation is a sound theoretical reason for the ratifiability test, the shareholders will not always be free of the directors' influence and well enough informed or motivated to assess the directors' conduct in the democratic manner that the rules presuppose. It is better to entrust the final word on the matter to the courts, the British Columbia and other legislatures have reasoned, even at the risk of more litigation. Such an attitude is also welcome because of the obscure distinction between ratifiable and non-ratifiable boardroom conduct.

Europe\textsuperscript{65}

In Germany and France, holders of a certain fraction of the issued capital (10% in Germany, 5% in France) can bring actions in the company's name for breaches of duty. The minimum issued capital requirement is to guard against the 'strike suits' (the practice of threatening suits to extract lucrative cash settlements) which bedevilled United States' corporate law. The plaintiff shareholder(s) must meet the costs should an action be unsuccessful. In both countries, shareholders can also sue officers and majority shareholders to recover personal loss suffered. For example, damages can usually be recovered if the plaintiff shareholder shows that illegal actions by the directors have depressed the value of the plaintiff's shares and caused him loss.

The United States

In the United States, there are relatively few statutory controls on company management. The derivative suit has therefore been popular and, whilst not without problems, has been easier to initiate than in England, Australia and New Zealand. Many American commentators see the derivative suit as a major control on managerial misbehaviour in large, public companies.\textsuperscript{66} Rule 23.1 of the \textit{Federal Rules of Civil Procedure} (USA) has been copied and adapted by most States.\textsuperscript{67} It provides:

In a derivative action brought by one or more shareholders to enforce a right of a corporation, the corporation having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder at the time of the transaction of which he complains or that his share devolved upon him thereafter by operation of law; (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would

\textsuperscript{65}. Pennington in \textit{The Investor and the Law} (1968, MacGibbon & Kee) at 491–492 extolled the virtues of French and German solutions to problems created by principles such as the Rule in \textit{Foss v Harbottle}.


\textsuperscript{67}. For example, \textit{California Corporation Code} s 800; \textit{New York Code} (BCL) s 626.
The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors, and, if necessary, from the shareholders, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders similarly situated in enforcing the right of the corporation. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders in such manner as the court directs.

This seems very wide — on the face of it, shareholders can enforce any right of the company. But the United States' courts examine the bona fides of the board or ratifying shareholders and, accepting realities, acknowledge that boards and majorities, acting bona fide, must make business decisions without excessive exposure to derivative suits.

The requirement that the plaintiff be a shareholder at the time of the wrongdoing is partly to prevent a by-product of the 'strike suit', called 'purchased litigation' — where someone buys shares in a company with the sole aim of initiating or threatening litigation. On balance, this requirement is unnecessary. The derivative suit is useful, not so much as a method by which shareholders can protect their investment, but so as to allow someone to step in and help police mismanagement and self-interested activity. Accordingly, 'vigorous use of the remedy is to be encouraged, not condemned'.

Two parts of Rule 23.1 of the United States’ Federal Rules of Civil Procedure are noteworthy. First, under Rule 23.1, the plaintiff is asked to show that he has tried to get the directors, and 'if necessary' the shareholders, to take action. Such a requirement is part of English common law. However, this demand requirement is rarely mentioned in judgments, although we often hear about the control-by-wrongdoers requirement. The two are closely linked. There is little use in asking controlling wrongdoers to initiate action against themselves; facts suggesting such futility are usually sufficient therefore to satisfy the statutory requirement in the United States. For example, the obvious inadequacy of price, where the directors have sold corporate assets, has led a United States' court to say that the demand to take action was not required:


The desirability of policing the conduct of corporate fiduciaries, and insuring they are made to disgorge illicit gains, far outweighs whatever interest there may be in discouraging the purchase of lawsuits.

69. See also s 99(2) of the Ontario Business Corporations Act 1970.

70. Lord Blanesburgh in Ferguson v Wallbridge [1935] 3 DLR 66 at 83 ruled that the plaintiff must be able to show that 'he has exhausted every effort to secure the joinder of the company as plaintiff and has failed'.

It is well-established that demand need not be made on the board if the majority of directors are interested, and this rule is normally extended to cases where nominally disinterested directors are under the ‘domination and control’ — or not independent — of interested directors.\(^{72}\)

Second, the court’s approval must be gained for a dismissal or compromise of a derivative action once it has started.\(^{73}\) Such a requirement gives other shareholders time to scrutinise the reasons for settlement and take up the suit themselves if dissatisfied. In English and Australasian law, it seems that the plaintiff shareholder can still settle such actions at whim (although this does not preclude another shareholder stepping into the breach). There have been reported instances of collusion and ‘buying off’ of plaintiff shareholders. In \textit{Clarke v Greenberg},\(^{74}\) for example, the plaintiff discontinued his action against the directors when he was promised $9000 for his stock which had a market value of only $51.88. However, the court ruled that the balance — $8948.12 — was held by the plaintiff shareholder on trust for the company.

Court approval for settlements would help eliminate the need for the lodgment by the plaintiff of a bond as security for court costs. Many state legislatures in the United States require plaintiffs to lodge security for litigation costs (including attorneys’ fees), ostensibly to prevent the danger of ‘strike suits’. This security bond requirement has been hotly criticised,\(^{75}\) and some legislation now actually forbids the court to require security for costs from derivative suit plaintiffs.\(^{76}\)

**Legislative control of derivative suits for Australia?**

It was argued earlier that a legislative solution to the ills that beset the derivative action procedure was needed in Australia. Clarification and simplification of the rules would be widely acclaimed. The United States', Canadian and Ghanaian legislatures have, in different ways, taken this step. Australian courts have tried to clarify the procedure and seem willing enough to allow minority shareholders access to the courtroom, but the lengthy and expensive litigation in \textit{Prudential Assurance} resurrects the fears that prompted legislative intervention overseas. The present law creates uncertainties and sometimes enormous costs; injustice may often be the result. The procedural hurdles could be replaced by a more rational and faster process.

If a judicial ‘filter’ process is adopted, which requires application to a

\(^{72}\) Cary & Eisenberg, \textit{above n 66} at 926.

\(^{73}\) Section 210(6) of the 1963 Ghanaian \textit{Companies Code} has a similar requirement.

\(^{74}\) 71 NE 2d 443 (1947).


\(^{76}\) See s 99(3) of the \textit{Ontario Business Corporations Act} 1970.
court for permission to initiate derivative suits, what lessons can be learned from overseas experience? Perhaps most important, those parts of overseas legislation should be avoided that reveal what Dykstra calls a 'general hostility to derivative suits or . . . an exaggerated fear of purchased litigation'.

Costs

A shareholder's lack of funds should not prevent him from bringing meritorious suits on behalf of the company. As emphasised above, a security for expenses requirement should not be imposed on plaintiffs. Such requirements have been almost universally condemned. They discriminate against the small shareholder, when the legislature's target should instead be the valueless claim. There is sufficient protection for the beleaguered company in a jurisdiction such as in Canada, where there must be an application to the court for standing in the first place. Ill-conceived suits can be filtered out at that stage.

To ensure the effectiveness of the derivative suit procedure, the findings on costs of the English Court of Appeal in Wallersteiner v Moir could be built into the legislation. There it was acknowledged that the company, being the potential beneficiary of any successful action, should bear the burden of all actions that are 'reasonable and prudent', and not just of those that it wins. Lord Denning advocated allowing for judicial discretion on costs. If standing to bring actions is to be liberally granted, then a discretion to award costs could, even in a system where the court's leave is required, be an extra safeguard against a flood of litigation, especially if a probability of success standard is not required of the plaintiff at the preliminary stage.

The company can, of course, help its directors by paying costs suffered by them in successfully defending derivative suits. A security for costs requirement should not be allowed to plague any legislation in this country. Such a safeguard should not be necessary to control unnecessary suits where, as the Ontario Lawrence Committee advocated in 1967, shareholders must first seek the court's leave to commence litigation on behalf of the company.

77. 116 Univ of Penn LR 74 at 97 (1967).
78. [1975] 2 WLR 389 at 397.
79. A judicial discretion is retained in s 49 of the 1979 draft of the US Model Business Corporation Act (drafted by the Committee on Corporate Laws of the American Bar Association). It says that the court, upon . . . a finding that the action was brought without reasonable cause, may require the plaintiff or plaintiffs to pay to the parties named as defendant the reasonable expenses, including fees of attorneys, incurred by them in the defense of such action. For an incisive discussion of the content and drafting of s 49 see Eisenberg, 'The Model Business Corporation Act and the Model Business Corporations Act Annotated' (1974) 29 The Business Lawyer 1407 at 1419–1425. The leave of the court is not required to initiate derivative suits in the United States.
80. As the Ontario Lawrence Committee advocated in Ch 7 of its Interim Report (1967).
**Contemporaneous ownership**

This rule, under variants of which the plaintiff often must show registered ownership from the time of the transaction complained of until judgment is entered, lacks real justification. It seems odd that persons who were not shareholders at the time of the wrong may benefit from a derivative suit and yet may not bring such a suit. In addition, ‘bought’ litigation, or strike suits, can generally be filtered out by the courts without requiring this sort of rule, if an application procedure is adopted. Again, such requirements have been ‘undermined’ by courts elsewhere. In the United States, beneficiaries of securities held in trust, shareholders upon whom shares have devolved by operation of law after the wrongdoing, and shareholders of parent companies have been held to be contemporaneous owners. Some legislation now requires that the shareholder be registered at the time of the alleged wrongdoing. Much of this could simply be left to the court’s discretion. If the company’s best interests and commercial morality are the chief beneficiaries of a derivative action, there seems little reason thus to restrict the range of shareholders who can complain.

**Demand on or notice to directors and shareholders**

As already noted, demand on or reasonable notice to the board is a useful rule that dovetails with the current requirement that the plaintiff prove control by the alleged wrongdoers. The requirement that the matter be put to the general meeting is hardly worthwhile, given the likely cost and delay, especially in larger companies. A prolonged and costly proxy contest could ensue. The general meeting's power to initiate suits is questionable in any case and, given the Wallersteiner v Moir approach to the payment of costs, the action may as well be initiated by a keen minority shareholder as by a general meeting. Approval of the suit by the general meeting would only mean substitution of the company’s name as plaintiff for that of the plaintiff shareholder; rejection of the suit would often simply confirm the control of the alleged wrongdoers.

An interesting debate has ensued in the United States over the rejection of derivative suits by sub-committees of the board. In some cases, boards, in reaction to a request for action on some alleged wrongdoing, have appointed special ‘independent’ litigation sub-committees to assess the merits of the proposed suit. In Auerbach v Bennett, the New York Court of Appeals gave one such independent committee great credence. A three-person litigation committee, appointed by the board, decided that the directors and their advisers had acted with good faith and due care, skill and diligence and that no proper interest of the corporation would be served by the continuation of the claim, bearing in mind the adverse publicity and costs of such action. The court inquired only into the inde-
pendence of the committee and the sufficiency of its procedures when judging whether it had acted in good faith and had made reasonable investigation; all else, it said, was denied the court because of the 'business judgment rule'. Court action was refused because the committee's composition and procedures were found to be satisfactory.

This appears to be a case of the mice being allowed to set their own trap. The decision implies that a sub-committee of the board can dictate to the court who shall bring derivative suits. Furthermore, should a principle (such as the 'business judgment rule') have great influence when usually only the board (or its trusted delegates) will have the information on which the appropriateness of the business judgment rule's application can be fully considered?

Maldonado v Flynn reasserted the court's power to decide whether or not a stockholder's derivative action has merit. A board or its committee, the Delaware Court of Chancery said, cannot compel the dismissal of a derivative suit and exclude a judicial scrutiny of the allegations of breach of fiduciary duty. The 'business judgment rule' is 'not an independent grant of authority to the directors to dismiss derivative suits'. This debate continues.

The distinction between personal and derivative actions

The Canadian experience has raised the problem of distinguishing between derivative and personal actions. This is easier said than done. In both Farnham v Fingold and Goldex Mines Ltd v Revill, the plaintiffs, probably uncertain as to whether the facts supported a personal or derivative suit, failed to get leave to bring the actions from the court. Because the statements of claim indicated derivative actions and appropriate leave had not been granted, the actions failed.

Make statute the only route

If common law actions are not replaced entirely by those based on statutory grounds, the law will not be simplified. A plaintiff who is unsuc-

84. Which says that the courts will not inquire into matters of business judgment because of their 'prudent recognition that courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments.' Ibid, 393 NE 2d 1000, per Jones J.
85. See the dissenting judgment of Cooke C J in Auerbach, above n 83, on this.
86. 597 F 2d 789 (1979); 413 A 2d 1251 (1980).
87. Ibid at 1263.
88. Ibid at 1262.
90. 1973] 2 OR 132; 33 DLR (3d) 156 (CA).
91. 7 OR (2d) 216; (1974) 54 DLR (3d) 672 (CA).
Directors' Powers and Duties

Successful under the statute can at present fall back on the common law, with all its uncertainties.

Lifting the corporate veil

The court should have power to lift the corporate veil and to order payments or compensation to members and former members of the company instead of to the company alone. At present, new shareholders might get unmerited bonuses, whereas former members might miss out.92

Discontinuance only on notice

Stays of proceedings, dismissals or settlements of derivative suits should be permitted only with court approval and notice to shareholders and the Commission. This permits judicial control of 'strike suits' and secret 'pay-offs' to plaintiffs. It also allows others to take up cudgels for the company.

Shareholder approval of breach not decisive

It would be wise to prevent the bugbear of the current Foss v Harbottle situation — the ratifiability test — from living on under a legislative procedure. The limitations of majority rule are the very reasons motivating any statutory solution. The 1979 British Columbia Act (s 225(7)) and the Canada Business Corporations Act (s 235(1)) say that shareholder approval or its possibility will not of itself stop a derivative suit. They are good precedents.

Creditors should also have standing

The Canadian federal statute protects this vulnerable group (who often have as much at risk as members) by extending the right to seek derivative suits to creditors as well as members.

Any reform in this area should aim for simplicity, clarity and the reduction of litigation delays and costs. At the same time, the harassment of boardrooms by overzealous or mischievous shareholders should be guarded against. Australia is fortunate in having many overseas examples to consider and, where appropriate, to imitate.

Remedies for breach of duty by directors

Remedies are, of course, vital to members, boards, liquidators and others seeking to bring wrongdoing directors to book for injury or wrongs done to the company. A range of remedies is available to the wronged company and individual members.

Where directors are in breach of their fiduciary obligations, they may

92. See Gower's discussion of this in his 1961 Final Report on the Ghanaian Code, para 210, p 153; see also s 233(c) of the Canada Business Corporations Act 1974.
be subject to equitable remedies (such as an accounting for profits made) asserted by the ‘person’ to whom the duties are owed — that is, the company. The company can also assert common law remedies (such as damages) where there is a breach of common law duties, such as the director’s duty of care. The aggrieved company, and other parties with standing, have a variety of remedies. Several remedies may be pursued in the same action. For example, a declaration that a resolution is invalid may be accompanied by an injunction restraining the company and the directors from acting on the resolution.

The possible remedies against delinquent directors and/or third parties implicated in a breach include:

- rescission of contracts;
- injunctions;
- declarations;
- statutory proceedings, such as those for misfeasance, oppression and winding up;
- the pecuniary remedies of compensation, damages and equitable damages;
- the pecuniary remedy of an account of profits;
- the proprietary remedy of restoration of property misapplied, including the remedy of tracing; and
- the proprietary remedy of constructive trusteeship.

Rescission of contracts

The court may sometimes order the setting aside of dispositions or contracts improperly procured. It does this in an effort to revive the former status quo — that is, to restore the plaintiff to his previous financial position. Unless the articles specifically permit, or there is proper disclosure to the general meeting, any contract entered into by a director with his own company is voidable. This means that the company has the option to rescind the contract. For example, the sale of a director’s property to the company or the purchase of company property by the director may be set aside, for fear of self-dealing. Until the company actually elects to rescind (that is, declares its intention not to be bound by the contract), the contract is normally said to be voidable. However, the company can lose this right to rescind or avoid. This may occur if restitution in toto is not possible, if third parties or outsiders have, in

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93. As in Crumpton v Morrine Hall Pty Ltd (1965) 82 WN (NSW) 456 (injunction restraining party from acting on a special resolution and declaration that rights attached to shares were not affected by a special resolution).
95. For example, see Transvaal Lands Co v New Belgium (Transvaal) Land and Development Co [1914] 2 Ch 488 (rescission of contracts with other company in which director held shares). See also North-West Transportation Co v Beatty (1887) 12 AC 589; Peninsular and Oriental Steam Navigation Co v Johnson (1937–1938) 60 CLR 189 at 212–213, 246; Burland v Earle [1902] AC 83.
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good faith, taken rights in the contract,96 or if the company delays unreasonably in electing to rescind.97

If directors do not exercise their powers bona fide in the best interests of the company they may enter voidable dispositions, transactions or contracts. For example, an allotment of shares not made bona fide in the best interests of the company is voidable (and not a nullity).98 Similarly, a lease entered into by the board, otherwise than for the benefit of the company as a whole, may be voidable.99

Injunctions

The injunction differs from damages, for example, in that it is a discretionary remedy. Its main use is to restrain the defendant by order from carrying out certain actions. A rapid remedy is available in the form of an interim or interlocutory injunction. These have been granted, for example, to restrain an improper allotment of shares;1 to restrain directors from holding a general meeting at which the votes of new shareholders, to whom shares were freshly issued, were to be used;2 to stop a merger on the ground that all relevant facts had not been revealed to the general meeting;3 to restrain a board from paying remuneration to directors in their capacity as directors of a subsidiary company;4 to stop a takeover bid where the price to be offered was alleged to be excessive and the bid was therefore not in the best interests of the members;5 to restrain a company from voting on shares held in another company;6 to prevent solicitation by directors of the company's customers or clients; and to protect trade secrets.

Where there is an offence against the Companies Code, an injunction under s 574 may be sought.7 On the application of the Commission or 'any person whose interests have been, are or would be affected by' any contravention of the Code, the Supreme Court may grant an injunction to stop the contravention under s 574. The Court can also grant an injunction where there is a failure or refusal, or proposed failure or refusal, to

97. For example, see Hely-Hutchison v Brayhead Ltd [1968] 1 QB 549. In Ansett v Butler Air Transport Ltd (1958) 75 WN (NSW) 299, plaintiffs were denied a declaration that shares were issued for an improper purpose because they did not 'come to the Court with that promptness which is required of them' (at 305). See generally, Pettit, Equity and the Law of Trusts (5th ed) at 564–565.
1. Ashburton Oil NL v Alpha Minerals NL (1971) 45 ALJR 162.
5. Re Australian Development Ltd (1973) 6 SASR 197.
6. Dinive Holdings Pty Ltd v Pancei Pty Ltd [1980] ACLC 34,239.
7. Discussed in Ch 12.
do an act or 'thing' that a person is required by the Act to do. Minority shareholders, providing that their interests are affected by the conduct, may therefore be able to use this injunction procedure to stop breaches of duties owed to the company. The Court may, either alternatively or in addition, award damages to the affected persons (s 574(8)). Thus, if, for example, the directors breach their duty of care (s 229(2)), or their duty to disclose interests in contracts (s 228), and directly or indirectly cause or threaten to cause the value of the minority shareholders' shares to fall, s 574 may provide an adequate and quick remedy.

Apart from their statutory power, the courts may also grant shareholders injunctions under their inherent jurisdiction in civil proceedings in order to prevent 'wrongdoing' and irregularities, such as breaches of the articles by the company and/or the directors8 or some threatened breaches of duty by directors or would-be directors.9 The usual remedy sought in 'personal actions' by shareholders is an injunction or declaration against the wrongdoers.10

Declarations

Declarations are statements of legal entitlement. Although they may not have binding force, they are nevertheless invariably observed when issued by the courts. Declarations may solve a variety of problems in the corporate context.11 For example, members or the company may bring proceedings for declarations as to the meaning or construction of the articles;12 as to whether a proposed action is ultra vires; as to the validity of the appointment of a director;13 as to the validity of meetings;14 and as to the validity of a share issue.15

8. Bray v Browne (1897) 41 Sols J 159 at 160, per Wright J.
10. For example, see Kraus v JG Lloyd Pty Ltd [1965] VR 232. See brief discussion in Smith, 'Minority Shareholders and Corporate Irregularities' (1978) 41 MLR 147 at 148-149. See also injunction and declaration authorities. Personal actions were discussed earlier in this chapter.
11. See Young, Declaratory Orders (2nd ed, 1984) at 198ff for a collection of corporate law cases involving declarations. See also Piercy v S Mills & Co [1920] 1 Ch 77 (declaration that issue of shares to convert minority into majority was void); Paul A Davies (Aust) Pty Ltd (in liq) v P A Davies (1983) 1 ACLC 1091 (declaration that business, goodwill and profits held on trust for the company); Howard Smith Ltd v Ampol Petroleum Ltd [1974] 1 All ER 1126 (declarations and orders to declare invalid and set aside the allotment and issue of shares and rectify register of members accordingly); Re Halt Garage (1964) Ltd [1982] 3 All ER 1016 (declarations and orders to declare invalid and set aside the allotment and issue of shares and rectify register of members accordingly); Re Halt Garage (1964) Ltd [1982] 3 All ER 1016 (declaration that excessive remuneration for holding office of director was disguised gift of capital or of payment of dividends and thus repayable to liquidator).
13. Grant v John Grant & Sons Pty Ltd (1950) 82 CLR 1; Barron v Potter [1914] 1 Ch 895.
15. Ngurli Ltd v McCann (1953) 90 CLR 425 (declaration that allotment of shares was invalid because of breach of duty); Clemens v Clemens Bros Ltd [1976] 2 All ER 268 (declaration that resolutions to increase share capital and issue new shares were oppressive and order setting the resolutions aside).
Proceedings under the Companies Code for misfeasance, oppression and winding up

Actions for oppression and winding up are available to shareholders under the Code. They are discussed in detail later.\(^{16}\) Also discussed later is a range of statutory measures aimed at defaulting directors,\(^ {17}\) including those who are liable for what used to be called misfeasance, a term that covers fraud, negligence, default and breaches of trust and duty.\(^ {18}\) The specific terms of these statutory provisions offer a wide variety of remedies.

Pecuniary remedies

Compensation, damages and equitable damages.\(^ {19}\) In awarding damages, the law tries to put the successful plaintiff into the position he would have been in had the breach not occurred. Damages can be awarded for a breach of the director’s common law duty of care,\(^ {20}\) although, as we have seen, successful actions for a breach of that duty are rare. There may also be punitive damages for a breach of fiduciary duty.\(^ {21}\)

If the company suffers loss through a breach of fiduciary duty, all directors in breach of duty may be jointly and severally liable for compensation (sometimes called equitable damages), the equitable remedy equivalent to common law damages.\(^ {22}\) Joint and several liability means that each individual director is liable for the whole amount. If he alone is made liable, he can seek contribution from other directors as appropriate. The fiduciary in breach makes restitution to or compensates the principal for the loss suffered.\(^ {23}\) The wronged principal will often prefer an accounting for profits, as the misbehaving fiduciary’s gain may well exceed the loss suffered by the principal.

Account of profits. The court can order an account of profits made or benefits received, or which ought to have been received, by the director

\(^{16}\) In Chs 12 and 13 respectively.

\(^{17}\) See Ch 11.

\(^{18}\) See discussion of s 542 of the Code in Ch 11.

\(^{19}\) See Markwell Bros Pty Ltd v CPN Diesels (Qld) Pty Ltd (1982) 7 ACLR 425 (equitable damages for breach of fiduciary duty to avoid conflict between interest and duty); Canadian Aero Service Ltd v O’Malley (1973) 40 DLR (3d) 371 (damages awarded for breach of fiduciary duty).

\(^{20}\) See Dorchester Finance Co Ltd v Stebbing, unreported 1977, Ch Div, Foster J; noted in (1980) 1 Co Law 38. See also Re Australasian Venezolana Pty Ltd [1962] 4 FLR 60.

\(^{21}\) See Parsons, ‘The Director’s Duty of Good Faith’ (1967) 5 Melb ULR 395 at 404ff. See also Lintas (SSC & B) NZ Ltd v Murphy (1986) Aust Torts Reports 67,534 (award of exemplary damages).

\(^{22}\) For the differences between awards of damages and compensation see Nucton v Lord Ashburnon [1914] AC 932 at 952, per Viscount Haldane; Re Dawson (decd) [1966] 2 NSWR 211 at 215–216. See also Davidson, ‘The Equitable Remedy of Compensation’ (1982) 13 Melb ULR 349 at 350–353.

\(^{23}\) Davidson, ibid at 353.
who breaches his fiduciary duty.\textsuperscript{24} This is the most popular money remedy for a breach of fiduciary duty. Whereas compensation and damages are supposed to indemnify the plaintiff for its loss, the remedy of an account of profits stops the wrongdoing director from retaining any advantage gained from his wrongdoing and takes away his profits.

If the director, as a result of his breach of duty, has benefited or made profits, they must be accounted for to the company as fruits of the trust property itself.\textsuperscript{25} Whether all profits made, or some measure greater or less than the actual profits, must be handed across is a complex matter.\textsuperscript{26} In general, all profits made must be accounted for, regardless of the damage suffered, the fairness of the bargain, or of any windfall gains to the company. The true measure of the fiduciary’s liability is, rather, that he is liable for so much of his gain — actual or presumed — as is attributable to the trust property misused.\textsuperscript{27}

If the directors take company money, in addition to returning it they are liable for interest on it or on account of profits, if any, made by using the money.\textsuperscript{28} These are personal rights of the company, as distinct from the proprietary rights (that is, rights in or to property). The company is entitled to ‘trace’ the money or its other property into someone else’s fund or property. Any profits earned on the money must be accounted for in addition to a return of the property traced.

\textit{Proprietary remedies}

\begin{quote}
Restoration or return of property held or misapplied. The directors, as fiduciaries, may be made to restore any company property taken or misappropriated (or to pay compensation in lieu). If the property still exists, the company has a claim \textit{in rem} to the property against the fiduciaries and anyone who has become legal owner of the property through the fiduciaries’ misuse of power — unless something intervenes, such as laches, a waiver, the limitation period lapses, the property becomes
\end{quote}

\textsuperscript{24} For examples, see \textit{Industrial Development Consultants Ltd v Cooley [1972]} 2 All ER 162 at 176 (‘an order for an account will be issued because the defendant made and will make his profit as a result of having allowed his interests and his duty to conflict’); \textit{Canada Safeway Ltd v Thompson [1951]} 3 DLR 295 (constructive trustees jointly and severally liable to account for profit on sale of shares); \textit{Burland v Earle [1902]} AC 83 (director liable to account for salary wrongly paid); \textit{Cook v Deeks [1916]} AC 554 (directors liable to account for profits from contract to which they were party); \textit{Furs Ltd v Tomkies [1936]} 54 CLR 583 (director accountable for undisclosed benefits); \textit{Regal (Hastings) Ltd v Gulliver [1942]} 1 All ER 378 (directors to pay over profit made on sale of shares); \textit{Redekop v Robco Construction Ltd [1979]} 39 DLR (3d) 507 (director liable to account to company for ‘secret profits’); \textit{Green & Clancy Pty Ltd v Bestobell Industries Pty Ltd [1982]} WAK 1 (director liable to account for benefit of contract usurped during course of a fiduciary relationship).

\textsuperscript{25} \textit{Docker v Somes [1834]} 2 My & K 655 at 664–665; 39 ER 1095 at 1098–1099.

\textsuperscript{26} See \textit{Phipps v Boardman [1965]} Ch 992 at 1018–1019; Finn, below n 27 at para 241; \textit{Christie & Co Ltd v Greer [1981]} 4 WWR 34 at 41–42; \textit{Paul A Davies (Aust) Pty Ltd v Davies [1983]} 7 ACLR 197; (1983) 1 ACLC 1091.

\textsuperscript{27} Finn, \textit{Fiduciary Obligations} (1977) at para 242.

\textsuperscript{28} \textit{Re Sharpe [1892]} 1 Ch 154 at 169–171.
untraceable, or the existence of a bona fide purchaser for value without notice of the company’s rights. In other words, the property must be given back, unless equity says otherwise.

The proprietary remedy of *tracing* can apply here. The wronged company may ‘trace’ its property in the hands of the wrongdoing fiduciary, and even into the hands of third parties who have no right to retain the property. It remains subject to the trust. The wronged company can reclaim the property (providing it can still be identified), except from a bona fide purchaser for value without notice. Having an interest in the property, the company is entitled to follow or trace it and to assert title. Property can be followed or traced at common law or in equity.

Tracing may be especially useful in liquidations because it allows the principal to reclaim specific property. He does not have to share in the often meagre assets to be divided up on liquidation amongst the creditors. The solvency of the defendants is of no concern if the specific property can be identified and traced. The proprietary remedy of tracing also has the advantage that a judgment carries interest from the date on which the property comes into the defendant’s hands, rather than from the date of judgment, as with claims in personam.

The right to chase the property is not ended by a change in its form, providing that it can still be identified. For example, real property may have been exchanged for money which was banked. If the defendants’ bank account still reflects that sum of money, it may be accessible to, or subject to a ‘charge’ by, the plaintiff who is ‘following’ his property. It makes no difference in reason or in law into what other form, different from the original, the change may have been made . . . for the product of or substitute for the original thing still follows the nature of the thing itself, as long as it can be ascertained to be such . . . .34 The claimant’s right to the trust property or its proceeds which he is able to trace is sometimes referred to as a lien. The problems associated with tracing

29. See, generally, Heydon, (1977) 51 ALJ 635; Sealy, ‘Some Principles of Fiduciary Obligation’ [1963] CLJ 119; Finn, above n 27 at 111–129. In *Re Sharpe*, ibid, a director who, with the others on the board, caused the company to act ultra vires (pay interest to shareholders out of capital when there were no profits) was liable to account for the misapplied money. His personal representatives had to pay it back, with interest.


32. See *Ford and Lee*, above n 30 at 731; *Hanbury and Maudsley*, ibid at 659.


34. *Taylor v Plumer* (1815) 3 M & S 562 at 575; 105 ER 721 at 726, per Lord Ellenborough C J. See also *Re Hallett's Estate* (1880) 13 Ch D 696 at 709, per Jessel M R: the beneficiary is entitled at his election either to take the property [purchased with trust money], or to have a charge on the property for the amount of the trust money’. As *Ford and Lee* comment, above n 30 at 734, the plaintiff is likely to seek the return of trust property if it, or its product, has increased in value.
when the company’s property is mixed with other property (money mixed into a bank account, for example) and where an innocent volunteer receives the company’s property and mixes it with his own are pursued in specialised treatments of these topics.\textsuperscript{35}

Constructive trust. Another proprietary remedy is constructive trusteeship. Constructive trusts may arise in a wide variety of circumstances concerning company directors. For example, if company property is misappropriated by a director, the court usually says that the director holds the property, or the proceeds of its use, as a constructive trustee. It is difficult to articulate clear rules on this broad and flexible equitable remedy. But a fiduciary in possession of ‘trust’ property — for example, a director holding the legal title to shares or a lease that belongs in equity to the company\textsuperscript{36} — may be said to be a ‘constructive trustee’ for those shares or that lease. By the operation of law, he holds it not for himself but for the benefit of the company, and must convey or ‘disgorge’ it to the company. In addition, the company will get any increase in value of the property which arises whilst the defendant has it.\textsuperscript{37}

The remedy of constructive trusteeship may have advantages over an accounting for profits when, for example, an accounting would be fruitless because the fiduciary is insolvent,\textsuperscript{38} or if the defendant fiduciary still has the property and the company wants specific recovery.

The distinction between the two remedies of accounting for profits and constructive trusteeship is not always made clear.\textsuperscript{39} The latter is a proprietary remedy; the former a pecuniary remedy. You must have company property vested in you to be a constructive trustee, the property being the subject of the trust. If the defendant has disposed of the property, he can no longer be a constructive trustee, although he can still be ‘accountable’ for any profits he has gained from the property. (The proprietary remedy of tracing may apply if there are any identifiable proceeds of the disposal of the property.) The courts often treat the defendant’s liability to account for a profit or benefit as naturally a consequence of, or flowing from, his position as a constructive trustee.\textsuperscript{40}

In other words, the courts see the profits earned through misuse of the company’s property as company ‘property’; accordingly, the defendant

\textsuperscript{35} See \textit{Re Diplock’s Estate} [1948] Ch 465; [1948] 2 All ER 318; \textit{Sinclair v Brougham} [1914] AC 398; \textit{Chase Manhattan Bank v Israel-British Bank (London) Ltd} [1979] 3 All ER 1025; Pettit, above n 31 at 446ff; Hanbury and Maudsley, above n 31 at 660ff; Ford and Lee, above n 30 at 731ff.

\textsuperscript{36} Like the defendant in \textit{Keech v Sandford} (1726) Sel Cas Ch 61; 25 ER 223.

\textsuperscript{37} See Gibbs J in \textit{Consul Development Pty Ltd} (1975) 132 CLR 373 at 395; 5 ALR 231 at 249.

\textsuperscript{38} See generally, McLay, ‘Multiple Directorates and Loss of Corporate Opportunity’ (1980) 10 VUWLR 429 at 448ff; Hanbury and Maudsley, above n 31 at 372.

\textsuperscript{39} Above n 37 at 395, per Gibbs J.

\textsuperscript{40} See Mason J in \textit{Hospital Products Ltd v US Surgical Corp} (1984) 55 ALR 417 at 462–464 for example.
becomes a constructive trustee of those profits and not merely liable to account personally.\(^{41}\)

In *Canada Safeway Ltd v Thompson*,\(^{42}\) strangers to the trust (but active participants in the breach of fiduciary duty) were held to be constructive trustees and liable to account to the company. Their liability to account was also joint and several. Where two or more trustees are liable for such a breach, therefore, each can be sued for the whole amount of the improper gains or the loss. Each trustee can, however, seek contribution from the other(s).\(^{43}\) Similarly, in *Boardman v Phipps*,\(^{44}\) there was a ‘dual’ finding of constructive trusteeship and liability to account for profits.\(^{45}\)

There are many other examples of the remedy of constructive trusteeship being applied. In *O’Brien & Anor v Walker*,\(^{46}\) a director used company money to buy a house in his own name. Kearney J held that there was a constructive trust in favour of the company (the property in equity belonged to the company). He was also prepared to find a resulting trust\(^{47}\) (that is, the property resulted or reverted to the real purchaser, the company, whose money was used to buy it). Although the property was in the name of the deceased director, the *cestui que trust* (the company) could follow or trace its misused money and claim it from the deceased or his estate.

Wootten J, at first instance, in *Queensland Mines Ltd v Hudson*,\(^{48}\) held that the exploration licences and profits therefrom were held on constructive trust in favour of Queensland Mines. This and other judgments suggest that any breach of fiduciary duty may give rise to a constructive trust. Such an approach has been criticised.\(^{49}\)

**Third parties may be constructive trustees**

Strangers or ‘outsiders’ may also be liable as constructive trustees if they intermeddle in a breach of fiduciary duty. Any outsider, including a company, who knows of the director’s breach of fiduciary duty may be liable as constructive trustee of the company’s property if it is in the outsider’s control, even though he is not a fiduciary of the company. An example may be where an outsider uses company secrets passed on to

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41. See Pettit, above n 31 at 146. Cf Hanbury and Maudsley, above n 31 at 372, 377, 604. Hanbury and Maudsley at 604 insist that it is ‘a fallacy’ to link the liability to account with the remedy of constructive trusteeship and say that a fiduciary who is required to account thereby becomes a constructive trustee. ‘A duty to account is a personal liability; a constructive trust is a proprietary remedy; the significance of the distinction ... appears where the fiduciary is bankrupt, and the question is whether the beneficiaries can claim ahead of the general creditors.’

42. [1951] 3 DLR 295 at 322–323.


44. [1966] 3 All ER 721.

45. See also *Industrial Development Consultants v Cooley* [1972] 2 All ER 162.


47. Ibid at 64–65.


him from a director, when the outsider knows the information is confidential.\(^50\) As Gibbs J found in *Consul Development Pty Ltd*:

\[
\text{on principle... a person who knowingly participates in a breach of fiduciary duty is liable to account to the person to whom the duty was owed for any benefit he has received as a result of such participation.}\(^51\)
\]

Constructive knowledge of the breach of fiduciary duty is enough.\(^52\) Shutting one’s eyes to the obvious (sometimes called ‘Nelsonian’ knowledge), failing to make inquiries, or other forms of knowledge and notice, will also suffice. Where ‘an ordinary reasonable man in his position’ ought to have known of the relevant breach, there can be a constructive trust.\(^53\) The stranger’s motives for intermeddling are irrelevant.

In *Green & Clara Pty Ltd v Bestobell*,\(^54\) Clara Pty Ltd, an ex-manager’s (Green’s) own company, obtained a tender in competition with his former employing company. Although not itself in a fiduciary position, Clara had to account to Bestobell because it ‘knowingly and for its own benefit participated in Green’s breach of duty owed to Bestobell’.\(^55\) In *International Sales and Agencies Ltd v Marcus*,\(^56\) registered moneylenders had actual notice that the money they received belonged to the two plaintiff companies, and that the controller was in breach of duty to those companies in paying out the money (by drawing cheques on the companies). They were held to be constructive trustees of the money so received and liable to account for it.

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50. *Canada Safeway Ltd v Thomson* [1951] 3 DLR 295; *Cradeleigh Precision Engineering Ltd v Bryant* [1965] 1 WLR 1293. The outsider could be liable to disgorge profits derived from the use of the secret information, and can be restrained by injunction from using it: see *Saltman Engineering Co Ltd v Campbell Engineering Co Ltd* [1963] 3 All ER 413. See, generally, Hanbury and Maudsley, above n 31 at 377 ff; Pettit, above n 31 at 146 ff; Harpum, ‘The Stranger as Constructive Trustee’ (1986) 102 LQR 114.

51. (1975) 5 ALR 231 at 251.

52. See Stephen J in *Consul Developments Pty Ltd*, above n 37 at 262–265. See also Heydon, above n 29 at 639–640; Harpum, above n 50 at 120ff.


54. [1982] WAR 1. Followed *Jones v Lipman* [1962] 1 All ER 442; *Cook v Deeks* [1916] 1 AC 554 at 565; and *Consul Development Pty Ltd*, above n 37.

55. Ibid at 12.

56. Above n 53.