CHAPTER 11

SHAREHOLDER REMEDIES

11.1 The duties of directors are owed to the company rather than to individual shareholders. It is perhaps ironic that the general power to sue in the company's name, whether to enforce directors' duties or otherwise, lies in the first instance with the directors. Where the board declines to sue, the general meeting may be able to do so. In limited circumstances, an individual may take action which will benefit the company.

Minority shareholders

11.2 The company is generally identified with the majority of shareholders measured by value of shareholding. It is the majority which controls the general meeting. Accordingly, the majority will exercise the power vested in the general meeting.

11.3 Shareholders are neither trustees for one another nor in a fiduciary relationship with each other. Any rights, including the right to vote attached to their shares, are for the shareholders' personal advantage.[1]

11.4 The majority's control is not unfettered. It is bound to act bona fide in the interests of the company as a whole. If it does not, it perpetrates 'fraud on the minority'. In relation to an alteration of articles, it was said of the power of the majority that

> like all other powers, [it must] be exercised subject to those general principles of law and equity which are applicable to all powers

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1. *Peters' American Delicacy Company Ltd v Heath (1939) 61 CLR 457 at 504 per Dixon J.*

> conferred on majorities and enabling them to bind minorities. It must be exercised, not only in the manner required by law, but also bona fide for the benefit of the company as a whole, and it must not be exceeded.[2]

11.5 The nature of the relationship between majority and minority shareholders is different in public and private companies. Shares in a public company can, at least in theory, be readily sold on the stock exchange. This gives a minority shareholder an escape route.

11.6 The marketplace is not available to shareholders in a private company. The companies legislation itself places a restriction on the right to transfer shares in a proprietary company and prohibits invitations to the public to subscribe for shares or debentures. The right to transfer shares may also be restricted.[3]

11.7 The limits to majority power are unclear. The problem lies in distinguishing decisions of the majority which may cause unhappiness or discontent, but which are otherwise legitimate exercises of power, from decisions that are unfair and an abuse of majority power. It is the latter which are of concern here.

11.8 Majorities can exploit minorities in a number of ways, for example, by withholding dividends, by making distributions which are inadequate, by making disproportionate share allotments, by withholding information, or by excluding the minority from management. In these ways, the majority is in a position to stop shareholders participating in companies they partially own.

11.9 The minority can also suffer from inaction of the majority. This may occur where it is within the power of the

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2. *Allen v Gold Reefs of West Africa, Ltd [1900] 1 Ch 656 at 671 per Lindley MR.*
3. *Section 34 (Corporations Act, s116).*

majority to bring a legal action in the name of the company (for example, to redress action taken by a director) but where it refuses to do so. In these circumstances it seems that the members in general meeting can decide to sue[4] as long as the articles do not prevent them from doing so. The clearest case of abuse occurs if the board and/or the majority commits a wrong against the company and refuses to allow the company to sue. The court will permit a derivative action to be brought by a minority shareholder on behalf of the company in these circumstances.[5] (The Foss v Harbottle principle will not apply. See below.)

The rule in Foss v Harbottle

11.10 If a wrong is done to a company, the company is the proper person to sue for the damage. Professor Finn told the Committee that

> because the [director's] duty is owed to the company, the company is the complainant. Obviously, because directors control the company and it is their conduct that is in issue, you are looking, practically, to shareholders having to bring an action in the name of the company. So the courts have had to evolve a set of criteria which would indicate when it would be proper for shareholders to be able to bring an action in the name of the company and when it would not be proper. ... it has ... been a view that historically the particular categories that the courts have evolved have been much too narrow.[6]

11.11 The 'set of criteria' referred to by Professor Finn is known as the 'rule in Foss v Harbottle'. In Foss v Harbottle,[7] two shareholders in a company sued its directors for fraudulent misapplication of the company's funds, arguing that the directors

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4. *Marshall's Valve Gear Company Ltd v Manning, Wardle & Co. Ltd [1909] 1 Ch 267.*
5. *Dutton v Gorton (1917) 23 CLR 362.*
6. *Evidence, p 170.*
7. *(1843) 2 Hare 461.*

should compensate the company. The suit was brought on behalf of all of the shareholders except the directors. It was held that the shareholders could not succeed, because the proper plaintiff was the company to whom the wrong had been done. This 'proper plaintiff' concept is the first of two recognised aspects of the rule.

11.12 The second aspect is known as the 'internal management' principle. In brief, if the action complained of is something which the majority is entitled to do, then only the majority can complain that it has not been done properly.[8]

11.13 The rule in Foss v Harbottle can impede individual shareholders seeking to enforce their rights against directors. Directors' duties are owed to the company, and a breach of those duties is a wrong against the company for which it alone can sue. In many cases it is lawful for a general meeting to forgive a breach of duty and decide not to sue a director. If a shareholder cannot persuade a general meeting to sue the transgressing director, the rule in Foss v Harbottle will generally prevent the individual shareholder bringing an action, no matter what loss he or she may suffer. It may be difficult for the shareholder to secure the support of a majority, particularly if the directors control most of the voting shares.

11.14 The courts have established exceptions to the rule in Foss v Harbottle. Likewise the legislature has mitigated its effects.

Derivative action (fraud on the minority)

11.15 In Foss v Harbottle, the court recognised that there would have to be exceptions to the 'proper plaintiff' concept in

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8. *MacDougall v Gardiner (1875) 1 Ch D 13 at 25 per Mellish LJ. See also Australian Coal & Shale Employees' Federation v Smith (1937) 38 SR (NSW) 48 at 54-6.*

some cases where an injury to the company would otherwise go unremedied. So, in limited circumstances, where the board and the general meeting decide the company will not sue, individual shareholders have been allowed by the courts to bring an action for a wrong done to the company.[9]

11.16 The shareholder sues on behalf of the company and not in a personal capacity. These suits are called 'derivative suits'. The term emphasises that the individual member is suing on behalf of the company to enforce a right derived from the company.[10] The benefits of a successful suit are entirely those of the corporation[11] and the individual shareholder gains only through any enhancement to his or her shareholding, unless the company is ordered to reimburse the shareholder for any legal costs not otherwise recovered.

11.17 Unless a majority resolution not to sue is unlawful or beyond the power of the majority, two conditions must be present before a shareholder can bring a derivative action. First, the wrongdoers (eg directors in breach of duty) must have been fraudulent, and secondly, they must have had the power to control a general meeting and, in this way, excuse themselves from liability.

11.18 Fraud in this context does not equate with deceit but rather with improper conduct.[12] A clear example of conduct giving rise to a derivative action is appropriation of company property.[13] Other breaches of fiduciary duty may do so if they

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9. *Eg in Prudential Assurance Co Ltd v Newman Industries Ltd [1981] Ch 229 a derivative suit was brought against directors and their companies for damages.*
10. *See Gower, LCB, Gower's Principles of Modern Company Law (4th ed), Stevens & Sons, London, 1979, pp 647-53; Wallersteiner v Moir (No 2) [1975] QB 373 at 391 per Lord Denning MR.*
11. *Spokes v Grosvenor and West End Railway Terminus Hotel Co, Ltd [1897] 2 QB 124.*
12. *See, eg, Ford, HAJ, Principles of Company Law (4th ed), Butterworths, Sydney, 1986, p 491.*
13. *Eg Burland v Earle [1902] AC 83 at 93.*

involve an element of bad faith.[14] Mere negligence by directors, even if it is gross, will not normally be sufficient.[15] However, in at least one English case a shareholder has been allowed to bring a derivative action against directors where no fraud on their part was alleged but where the directors had profited from their wrong actions.[16] Justice Templeman said in that case:

> To put up with foolish directors is one thing; to put up with directors who are so foolish that they make a profit ... at the expense of the company is something entirely different.[17]

11.19 Another English judge has said that the 'fraud' lies not in the wrong to the company but in the majority's use of its voting power to misappropriate a right (the right to sue) which is in a sense the property of the company.[18] If this line of reasoning were followed, the courts would not need to rely on making fine distinctions between categories of breach of duty as they presently do.

11.20 The degree of control needed is not clear. 'Control' does not necessarily entail the wrongdoers being the owners of a majority of the company's shares.[19] It might be enough if, for example, the wrongdoers controlled another company and it owned shares in the company to which the wrong had been done which, combined with shares actually owned by the wrongdoers, amounted to a majority. Another example of de facto control might be where shares are held by nominees of the wrongdoers:

> [I]t must be admissible in certain cases to go behind the apparent ownership of shares in order to discover whether a company is in fact

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14. *Cook v Deeks [1916] 1 AC 554.*
15. *Pavlides v Jensen [1956] Ch 565.*
16. *Daniels v Daniels [1978] Ch 406.*
17. *[1978] Ch 406 at 414.*
18. *Prudential Assurance Co Ltd v Newman Industries Ltd [1981] Ch 229 at 307 per Vinelott J.*
19. *Prudential Assurance Co Ltd v Newman Industries Ltd [1981] Ch 229 at 323-4 per Vinelott J.*

> controlled by wrongdoers...[20]

11.21 Mr Charles Williams, Deputy Chairman of the NCSC, has suggested that it might be timely to consider examining the scope of the civil law and the availability of the shareholder's derivative action. He referred to legislation in Canada which allows derivative actions and to changes in the United States and New Zealand which recognise the position of shareholders as distinct from, but with interests in, a corporation when there was an issue of insider trading, and said:

> These developments are straws in the wind which suggest that a campaign to replace some of the strictures of the criminal law with greater access to civil remedies might well be successful.[21]

11.22 He cautioned that the shareholder's derivative action tended to be used too often in the United States, probably because of the operation of contingency fees in that country.[22]

Personal action

11.23 A shareholder may bring a personal action where the shareholder, personally, rather than the corporate body, has suffered a wrong. The memorandum and articles of a company form a contract between the company and its members, between the company and its officers, and between each and every member of the company. ('Officer' includes directors.)[23] Like any other contract, this arrangement creates individual legal rights in the parties which can be enforced in the courts. A breach of duty by a director which amounts to a breach of the 'statutory contract' constituted by the articles will be actionable by an individual

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20. *Pavlides v Jensen [1956] Ch 565 at 577 per Danckwerts J.*
21. *'Directors - How to Sort Out the Professionals from the Others', speech given to the Institute of Directors in Australia, Victorian Branch, Melbourne, 31 May 1989.*
22. *Ibid.*
23. *Companies Code, s78 (Corporations Act, s180).*

shareholder.[24] Strictly speaking, this is not an exception to the rule in Foss v Harbottle. Rather, the rule has no application in these circumstances. The wrong has been done to the individual and the company is therefore not the 'proper plaintiff'.

Rectification of the register

11.24 Section 259 of the Companies Code (Corporations Act, s212) provides that a person aggrieved by entries in a share register, or any member of the company, may apply to the court for rectification of the register. The court may order the payment by the company of damages sustained by any party to the application for rectification.

11.25 Rectification of the register can provide a remedy for individual shareholders if the directors' power to allot shares has been used improperly, for example, to qualify certain persons as directors[25] or if directors have acted in breach of duty.[26] An improper allotment of shares (and thus potentially of dividends and future voting power) is seen as a wrong against individual shareholders rather than the company.

Restraining acts ultra vires the company

11.26 Any member of a company has a personal right to restrain directors from committing the company to a transaction which is beyond its powers.[27] Section 68 of the Companies Code (Corporations Act, s162) allows a company to restrict its objects or powers. Acting beyond the objects or powers will not necessarily be illegal of itself but can be relied upon by a

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24. *See, generally, Redmond, Paul, Companies and Securities Law - Commentary and Materials, Law Book Co Ltd, Sydney, 1988, pp 468-9, 487-94.*
25. *See Grant v John Grant & Sons Pty Ltd (1950) 82 CLR 1 at 31-2 per Williams J.*
26. *Ngurli Ltd v McCann (1953) 90 CLR 425.*
27. *Eg Simpson v Directors of the Westminster Palace Hotel Co and Wood (1860) 11 ER 608 at 610.*

member of the company taking action against the company's officers.[28]

'Where justice otherwise requires an exception'

11.27 The possibility of an exception to the general rule, where justice requires an exception, was raised in Foss v Harbottle itself:

> If a case should arise of injury to a corporation by some of its members, for which no adequate remedy remained, except that of a suit by individual corporators ... the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue.[29]

This exception does not appear to have been relied on in company law cases to date.[30]

The Australian attitude

11.28 The rule in Foss v Harbottle has not been as great a barrier to shareholder remedies in Australia as might have been expected.[31] Suits contesting directors' decisions have been commenced in non-representative form and the basis of the plaintiffs' standing to sue has gone substantially unquestioned. Australian courts have applied the established exceptions to the rule so as to accommodate a wide range of circumstances.[32]

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28. *Companies Code, s68(6) (Corporations Act, s162(7)).*
29. *(1843) 2 Hare 461 at 492 per Wigram VC.*
30. *Vinelott J referred to a similar notion in the Prudential Assurance case [1981] Ch 229 at 323, but used it as a rationale for relaxing the 'control' requirement for a derivative action (see above) rather than to establish a separate exception.*
31. *Evidence, pp 348-9 (Professor Baxt).*
32. *Redmond, Paul, Companies and Securities Law - Commentary and Materials, Law Book Co Ltd, Sydney, 1988, p 492.*

Statutory remedies

11.29 Although the common law gives shareholders a range of procedures to enforce directors' duties and obligations, its scope is far from clear. It is aimed at particular transactions rather than patterns of behaviour. Despite a recent tendency towards relaxation, the narrow rules of standing make it difficult for a shareholder to take legal action.[33] Moreover, the cost of litigation is a formidable barrier to shareholders contemplating action.

11.30 The legislature has enacted various provisions designed to facilitate shareholders' access to the courts. The Foss v Harbottle limitations are not relevant to statutory rights to take action. This development reflects an increasing public concern with the internal regulation of companies, an area the courts have been reluctant to enter.

11.31 Section 320 (Corporations Act, s260), 'the oppression remedy', allows a member of a company (or the NCSC) to apply to the court for an order winding the company up, regulating the company's affairs in some way or restraining a person from certain conduct. In general, orders may be applied for where the affairs or an act or omission of the company are being conducted in an oppressive, unfairly prejudicial, or unfairly discriminatory manner against a member, or in a manner that is contrary to the interests of members as a whole.

11.32 Section 574 (Corporations Act, s1324) provides for an injunction to be granted to restrain or prevent a person from engaging in conduct in contravention of the Companies Code or to force action that is required under the Code. Section 574 is couched in very wide terms[34] - the NCSC or 'any person whose interests have been, are or would be affected by the conduct' may

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33. *Evidence, pp 170, 180 (Professor Finn).*
34. *See Evidence, p 349 (Professor Baxt).*

seek an injunction.[35] This means that, to the extent that section 229 (Corporations Act, s232) covers the same ground as the obligations imposed on directors by the general law,[36] all shareholders have standing to restrain breaches of those duties or to insist that the duties be carried out.[37]

11.33 When the court is empowered to grant an injunction under section 574 to prevent or require certain action, it can order the injuncted person to pay damages to any other person, either in addition to or in substitution for the injunction.[38]

11.34 Where directors have acted in their own interests or in an unfair or unjust way, or where the company's affairs have been conducted in an oppressive or unfairly discriminatory manner, compulsory liquidation under section 364 of the Companies Code (Corporations Act, s461) may be available.[39]

11.35 Mr Charles Williams, Deputy Chairman of the NCSC, has expressed the view that

> [s]omeone may once have believed that the remedies against oppression in section 320 and the injunctive procedure in section 574 of the Companies Code were adequate to protect shareholders, but only an inveterate optimist would think so now.[40]

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35. *Companies Code, s574(1)(b) (Corporations Act, s1324(1), (2b)).*
36. *Marchesi v Barnes [1970] VR 434, ruling on the Companies Act 1961 (Vic) equivalent to s229, and Callaway, FH, 'Commentary', in Finn, PD (ed), Equity and Commercial Relationships, Law Book Co Ltd, Sydney, 1987, pp 115-19, esp at p 117.*
37. *See Evidence, p 349 (Professor Baxt); Residues Treatment & Trading Co Ltd v Southern Resources Ltd (1988) 6 ACLC 976.*
38. *Companies Code, s574(8) (Corporations Act, s1324(10)).*
39. *Companies Code, s364(1)(f), (fa) (Corporations Act, s461(e), (f)).*
40. *'Directors - How to Sort Out the Professionals from the Others', speech delivered to the Institute of Directors in Australia, Victorian Branch, Melbourne, 31 May 1989.*

11.36 Mr Williams argued that

> [t]he fact that shareholders are relatively powerless against entrenched directors is the root cause ... for government having involved itself so much in the policing of directors' conduct by providing criminal sanctions.[41]

The cost of litigating

11.37 The great hurdle for most shareholders seeking remedies against directors is the cost of litigation. The statutory remedies have not overcome this hurdle. Funding problems affect both the NCSC and individuals who wish to bring an action. The corporation as a whole benefits from successful derivative action yet the individual shareholder who brings it is entitled to recoup no more than limited costs from the proceeds of the litigation, and then only upon an order from the court. An unsuccessful litigant will not get costs and may have to carry those of the opposing party. The English courts have approved a procedure of prior indemnification in derivative suits.[42] This has not been the case with personal actions although there appears to be no objection to it in principle where the suit would benefit a majority or a class of members.[43]

11.38 Professor Baxt said to the Committee:

> If we are to retain our current system of allowing persons to sue directors for breach of duty, then consideration should be given to providing incentives for persons to bring action against directors who are negligent or who do not carry out their obligations in an appropriate fashion. Consideration should be given to introducing legislation which would allow the award of multiple damages in

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41. *'Directors - How to Sort Out the Professionals from the Others', speech delivered to the Institute of Directors in Australia, Victorian Branch, Melbourne, 31 May 1989.*
42. *See Wallersteiner v Moir (No 2) [1975] QB 373.*
43. *See Redmond, Paul, Companies and Securities Law - Commentary and Materials, Law Book Co Ltd, Sydney, 1988, p 495.*

> appropriate circumstances (for example, where directors take advantage of a corporate opportunity, or allow a flagrant conflict of interest situation to arise). However, the more fundamental breaches - where directors make an honest mistake in trying to defeat a takeover - should not carry heavy penalties. The shareholders should be able to reverse the decisions taken by the company in such cases, but the directors should not be heavily penalised unless they have acted fraudulently.[44]

Contingency fees

11.39 Professor Baxt suggested that contingency fees might be a way of enabling shareholders to take action against recalcitrant directors.[45] A contingency fee is a payment for legal services based on results. It gives litigants the ability to take proceedings without the funds they would ordinarily need to do so. Legal representatives accept work on the basis of receiving an agreed fee or proportion of the proceeds where the litigation is successful. This gives them a personal financial stake in the successful outcome of the case.

11.40 Contingency fees are illegal in Australia. They are seen as a means of converting lawyers into entrepreneurs. They are blamed for causing an explosion in litigation and, as a consequence, in insurance costs. It should be noted that the United States, which allows contingency fees and which has been criticised for the operation of its contingency fee system, does not have a costs indemnity rule.

11.41 The Committee is presently inquiring into the cost of justice. It will consider the issue of contingency fees as part of that inquiry. It is premature for it to express an opinion at this time. It notes that the Law Institute of Victoria is now looking closely at the feasibility of introducing contingency

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44. *Submission, para 55 (Evidence, p 209).*
45. *Evidence, pp 350-1.*

fees in that State.

11.42 There is a lack of equity where some shareholders can afford to bring legal actions to protect their rights while others cannot. Any entitlement given to a security holder which he or she cannot enforce is a hollow one. These are issues the Committee will address when considering the cost of justice.

11.43 In the meantime it would be for the benefit of the corporate sector generally were the NCSC and the ASC to keep a vigilant watch over such shareholder interests as they are empowered to protect. Whether they should have greater powers to safeguard shareholders is a question to which such bodies could well give priority.

Obtaining information

11.44 Until recently, it has often been difficult for a shareholder to obtain the relevant information to enable him or her to launch legal action.[46] In 1985, amendments to the Companies Code empowered a court to order inspection of the books of a company by a registered auditor or legal practitioner on behalf of a member of the company.[47] This provision, section 265B (Corporations Act, s319), does not give a shareholder immediate access to the books or access as of right. A court order is necessary. The access is actually granted to an auditor or lawyer acting on the shareholder's behalf.

11.45 An inspection order under section 265B will only be granted if the application is made in good faith and inspection is sought for a proper purpose. In Unity APA Ltd v Humes Ltd (No 2),[48] Justice Beach found that it was a proper purpose to ascertain whether directors had breached their duties in relation

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46. *See, eg, Evidence, pp 176-7 (Professor Finn).*
47. *Companies Code, s265B, inserted by Act No 192 of 1985.*
48. *[1987] VR 474.*

to a takeover proposal and to help the shareholder decide whether or not to oppose the proposal.[49] Other proper purposes include ascertaining whether allegations of mismanagement have substance (for example, prior to taking action under section 229) and ascertaining a fair market value for shares in companies whose articles allow for pre-emption rights to share sales.[50]

11.46 Justice Brooking has recently emphasised the positive obligation on the plaintiff to show that he or she is acting in good faith and that the purpose is genuine. It will usually be sufficient if the shareholder shows that something has gone wrong in the company and, in the light of that, he or she wants to find out further facts to enable proceedings to be brought. It will then be up to the defendant to show that the plaintiff is not acting for an appropriate purpose.[51]

Forgiveness of breaches of duty

11.47 As a general rule, shareholders can forgive (or ratify) conduct of directors amounting to a breach of their duty to the company. In effect, this is a decision not to sue the directors.

11.48 It is open to question whether an exercise of the power to forgive a breach of duty can be challenged by a minority shareholder if it is infected with the same improper purposes as the directors' actions.[52] In the context of a shareholder's voting rights being diluted, a recent decision of the South Australian Supreme Court recognised the right of a minority shareholder to challenge a transaction where the action of the

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49. *[1987] VR 474 at 480-1.*
50. *Explanatory Memorandum, Companies and Securities Legislation (Miscellaneous Amendments) Bill 1985, p 107.*
51. *Knightswood Nominees Pty Ltd v Sherwin Pastoral Company Ltd (1989) 7 ACLC 536.*
52. *Ngurli v McCann (1953) 90 CLR 425 at 438; see also Winthrop Investments Ltd v Winns Ltd [1975] 2 NSWLR 666 at 702 per Mahoney JA.*

majority in ratifying it had been questionable.[53] The force of this decision is presently unclear. It would benefit minority shareholders were it to become established law. It is a trend to be encouraged.

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53. *Residues Treatment & Trading Co Ltd & Anor v Southern Resources Limited & Ors (1988) 6 ACLC 1160.*