RESEARCH REPORT

LITIGATION BY SHAREHOLDERS AND DIRECTORS: AN EMPIRICAL STUDY OF THE STATUTORY DERIVATIVE ACTION

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I Introduction

A statutory derivative action has been proposed for the United Kingdom and is contained in Part 11 of the *Company Law Reform Bill.* Australia has had a statutory derivative action for approximately 6 years. This article outlines the results of the first empirical study of the Australian statutory derivative action. The study provides insights into the way Australian courts have interpreted and applied this remedy.

Part 2F.1A of the *Corporations Act 2001 (Cth)* ("the Act") came into operation on 13 March 2000.[1] Part 2F.1A enables current and former members and officers of a company to bring an action on behalf of the company, or intervene in proceedings to which the company is a party. This action, known as the statutory derivative action, was introduced to rectify the perceived inadequacies of the common law derivative action, on the recommendation of several government reports.[2] These reports perceived the statutory derivative action as an important remedy available to minority shareholders to enforce their rights. However, the statutory derivative action has not been uniformly welcomed. Some commentators have criticised Part 2F.1A, claiming that it does not significantly improve the position of shareholders.

The aim of this study is to examine the effectiveness of the Australian statutory derivative action during the 6 years it has been in operation. In particular, we evaluate Part 2F.1A in light of the reasons for its introduction, and assess whether it has made a significant improvement on the common law position.

Part II outlines the rationale for the introduction of Part 2F.1A, and includes a discussion of the common law position, the rule in *Foss v Harbottle* and its exceptions. An overview of the operation of Part 2F.1A is provided in Part III. Part IV details the empirical study and results. Part V is the conclusion.

II The Introduction of Part 2F.1A

The Role of Shareholder Litigation in Corporate Governance

Opinion on the utility of shareholder litigation differs widely. One author has argued from an economic analysis that a litigious model of corporate governance is difficult to support.[3] However, many other commentators have suggested that – despite its limitations – shareholder litigation has an important role to play in effective corporate governance. Giving

[1] The provisions were enacted by the *Corporate Law Economic Reform Program Act 1999 (Cth)* ("CLERP").

[2] See the Explanatory Memorandum to the *Corporate Law Economic Reform Program Bill 1999 (Cth)* at [6.11]-[6.13]. The reports were: Companies and Securities Law Review Committee, *Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action* (Discussion Paper 11, July 1990); Companies and Securities Law Review Committee, *Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action* (Report No 12, November 1990); Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (November 1991); Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action* (July 1993); CLERP Proposals for Reform, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors* (Paper No 3, 1997). These are collectively referred to throughout as "the government reports".

[3] Michael J Whincop, 'The Role of the Shareholder in Corporate Governance: A Theoretical Approach' (2001) 25 *Melbourne University Law Review* 418 at 432-8.

shareholders effective remedies maintains investor confidence,[4] by punishing improper corporate conduct.[5]

Coffee and Schwartz argue that the derivative action plays an important role in deterring directors from breaching their duties and punishing breaches.[6] Others have argued that derivative litigation is a useful deterrent to management dishonesty.[7] This is echoed in the discussion of another author who argues that, although there is a concern as to how much justice is received from a derivative suit, derivative actions play a useful role in deterring directors and officers from wrongful behaviour.[8] In deterring managerial misconduct, the derivative action helps to align the interests of the managers with those of the company,[9] and can be a 'key element in reducing the agency costs inherent in the management of public companies'.[10]

This divergence of opinion is reflected in debates in several countries.[11] The United States Supreme Court has stated that the derivative action has long been 'the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests'.[12] Others believe that derivative actions are 'expensive, hazardous and clumsy' and do not provide adequate protection for minority shareholders.[13] The lack of a derivative action in China is said to be a serious deficiency in the remedies available to shareholders.[14]

The derivative action must provide a balance between giving an effective remedy to shareholders while at the same time allowing the directors of a company reasonable freedom from shareholder interference. This is based on the principle that, generally speaking, shareholders should have little say in the ordinary management of a corporation.[15] As a consequence:

> [t]he ideal derivative suit statute would balance precisely the public concern for management accountability and the corporation's concern in avoiding frivolous and unfounded claims,

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[4] Michael J Duffy, 'Procedural Dilemmas for Contemporary Shareholder Remedies – Derivative Action or Class Action?' (2004) 22 *Company & Securities Law Journal* 46 at 47.

[5] William Kaplan and Bruce Elwood, 'The Derivative Action: A Shareholder's "Bleak House"?' (2003) 36 *University of British Columbia Law Review* 443 at 451, 481.

[6] John C Coffee and Donald E Schwartz, 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform' (1981) 81 *Columbia Law Review* 261 at 302-9.

[7] Oliver C Schreiner, 'The Shareholder's Derivative Action – A Comparative Study of Procedures' (1979) 96 *South African Law Journal* 203 at 211.

[8] Thomas P Kinney, 'Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers' (1994) 78 *Marquette Law Review* 172 at 174-5.

[9] Kristina de Vere Stevens, 'Should We Toss Foss?: Toward an Australian Statutory Derivative Action' (1997) 25 *Australian Business Law Review* 127 at 130.

[10] Ian Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 *University of New South Wales Law Journal* 149 at 156.

[11] See, for example, Klaus J Hopt, 'Shareholder Rights and Remedies: A View from Germany and the Continent' (1997) 2 *Company, Financial and Insolvency Law Review* 261.

[12] *Cohen v Beneficial Industrial Loan Corp* 337 US 541, 548 (1949). See also Thomas M Jones, 'An Empirical Examination of the Resolution of Shareholder Derivative and Class Action Lawsuits' (1980) 60 *Boston University Law Review* 542.

[13] George T Washington, 'Stockholders' Derivative Suits: The Company's Role, and a Suggestion' (1940) 25 *Cornell Law Quarterly* 361 at 375.

[14] Daniel T L Lam, 'The Derivative Action: The Only Option for Minority Shareholders in PRC Companies?' (2000) 12 *Australian Journal of Corporate Law* 123.

[15] Whincop, above n 3, at 438-40.

> while maintaining the derivative action as a viable method of enforcing accountability in the modern corporation.[16]

In summary, shareholder litigation can play a valuable role in corporate governance, by deterring managerial misconduct, but must balance the need for accountability with the need for managers to have freedom to run their company. This is the view taken by the government reports. The 1993 Companies and Securities Advisory Committee *Report on a Statutory Derivative Action* stated:

> A key objective of shareholder litigation is that of achieving managerial accountability. … Consequently, shareholder litigation can be seen as a mechanism for maintaining investor confidence. … At the same time however it is clear that management needs to be protected against vexatious and hostile minority shareholders who, when commencing litigation, are not acting in the interests of the company. Therefore, any proposal for law reform in this area must contain mechanisms which operate to prevent needless and harmful shareholder litigation.[17]

Foss v Harbottle and its Exceptions

Although now abolished by s 236(3) of the Act,[18] it is important to understand the common law position in order to properly understand the rationale for the enactment of Part 2F.1A.[19] The common law is encapsulated in what is known as the rule in *Foss v Harbottle*, although there is some debate as to whether the rule is one rule with two limbs or two related rules.[20] The weight of authority favours the view that it is a single rule, comprising two related components.[21] In *Foss v Harbottle*, Sir James Wigram VC stated that in respect of wrongs done to the company, 'the corporation should sue in its own name and in its corporate character, or in the name of someone whom the law has appointed to be its representative'.[22] However, the classic statement of the rule was not in the case itself, but by Jenkins LJ in *Edwards v Halliwell*:

> The rule in *Foss v Harbottle*, as I understand it, comes to no more than this. First, the proper plaintiff in an action in respect of a wrong alleged to be done to a company or association of persons is *prima facie* the company or the association of persons itself. Secondly, where the alleged wrong is a transaction which might be made binding on the company or association and on all its members by a simple majority of the members, no individual member of the company is allowed to maintain an action in respect of that matter for the simple reason that, if a mere majority of the members of the company or association is in favour of what has been done, then *cadit quaestio*.[23]

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[16] Lawrence A Larose, 'Suing in the Right of the Corporation: A Commentary and Proposal for Legislative Reform' (1986) 19 *University of Michigan Journal of Law Reform* 499 at 503.

[17] Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action* (July 1993) at 4. See also CLERP Proposals for Reform, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors* (Paper No 3, 1997) at 9-11.

[18] Section 236(3) provides: 'The right of a person at general law to bring, or intervene in, proceedings on behalf of a company is abolished'.

[19] See generally H A J Ford, R P Austin & I M Ramsay, *Ford's Principles of Corporations Law* (Looseleaf, Butterworths) at [11.300].

[20] K W Wedderburn, 'Shareholders' Rights and the Rule in Foss v. Harbottle' [1957] *Cambridge Law Journal* 194 at 198.

[21] Matthew Berkahn, 'The Derivative Action in Australia and New Zealand: Will the Statutory Provisions Improve Shareholders' Enforcement Rights?' (1998) 10 *Bond Law Review* 74 at 76.

[22] *Foss v Harbottle* (1843) 2 Hare 461, 491; 67 ER 189.

[23] [1950] 2 All ER 1064 at 1066.

The rule in *Foss v Harbottle*, then, comprises two principles. The first limb is known as the "proper plaintiff" rule and is based upon the principle that a company is a separate legal entity, distinct from its shareholders.[24] A wrong done to the company is not a wrong done to the shareholders, and should be redressed by the company itself, taking action in its own name.[25] The second limb is known as the "internal management" principle. The courts will not interfere with the internal management of companies where those acting in management do so acting within their powers.[26]

Although based on sound corporate law principles,[27] the rule can lead to manifest injustices. As a consequence, a number of exceptions to the rule in *Foss v Harbottle* were developed:[28]

(a) The illegal or ultra vires act exception

Where an action was illegal or ultra vires the company, a shareholder could sue to restrain the action, because the majority could not ratify acts ultra vires the company.[29]

(b) The special majority exception

Where an action was taken in breach of a requirement in the constitution requiring a special majority to authorise the action, a member could sue to challenge the validity of the resolution.[30]

(c) The personal rights exception

Where the personal rights of the shareholder had been infringed, the rule in *Foss v Harbottle* did not apply, for the shareholder could sue in their own name to protect their personal rights.[31] Although a simple concept in theory, distinguishing in practice between personal and corporate rights can be a difficult task.[32]

(d) The fraud on the minority exception

Where the action amounted to a fraud on the minority and the wrongdoers were in control of the company, the minority shareholders were permitted to bring an action against the wrongdoers on behalf of the company.[33] Whereas any right of action under the first three

[24] *Salomon v Salomon & Co* [1897] AC 22, 29.
[25] Robert M Dick, 'A Reconsideration of the "Justice" Exception to the Rule in *Foss v. Harbottle*' (1964-6) 2 *University of British Columbia Law Review* 547 at 548-9.
[26] *Burland v Earle* [1902] AC 83 at 93.
[27] S Chumir, 'Challenging Directors and the Rule in Foss v. Harbottle' (1965) 4 *Alberta Law Review* 96.
[28] Note that there is debate as to whether they are exceptions to the rule or merely instances in which the rule does not apply. See especially Wedderburn, above n 20 at 203. The exceptions are based on Jenkins LJ's formulation in *Edwards v Halliwell* [1950] 2 All ER 1064 at 1067.
[29] Wedderburn, above n 20 at 204-5.
[30] Peter Lawrence Black, *The Rule in Foss v. Harbottle, Corporate Governance and the Derivative Action* (LLM Thesis, University of Melbourne, 1983) at 7-8.
[31] Berkahn, above n 21 at 80-1.
[32] See especially Pamela F Hanrahan, 'Distinguishing Corporate and Personal Claims in Australian Company Litigation' (1997) 15 *Company & Securities Law Journal* 21.
[33] Stefan Lo, 'The Continuing Role of Equity in Restraining Majority Shareholder Power' (2004) 16 *Australian Journal of Corporate Law* 96 at 105.

exceptions was personal, an action brought under the fraud on the minority exception was derivative,[34] and it has thus been described as 'the only true exception' to the rule in *Foss v Harbottle*.[35] In order to bring a common law derivative action, the plaintiff had to bring evidence that 'the defendants were in a position of control within the company and had perpetrated a fraud on the minority'.[36] Due to the ambiguity of these terms, proving fraud and control was by no means an easy task.[37] English courts adopted a conservative approach to control, usually requiring that the defendants control a majority of the voting shares,[38] which made derivative actions difficult to bring except in small private companies,[39] and anything less than expropriation of corporate assets would be unlikely to be considered fraud.[40] As a consequence, it was difficult to bring an action under this exception.[41]

(e) The interests of justice exception

There has been debate as to whether a fifth exception existed based on the "interests of justice". That is, the courts would permit a shareholder to bring an action despite the rule in *Foss v Harbottle* when the interests of justice required it. Boyle has succinctly stated the position:

> There has … been a thin but steady stream of *obiter dicta* … which adopt a more flexible approach to *Foss v Harbottle*. They are to the effect that a minority action will be allowed by exception to the rule whenever justice requires it in the circumstances of the case, even though the requirements of one of the established exceptions cannot be met.[42]

Sealy argued that the interests of justice was not so much an exception but 'the very foundation of the court's willingness to lend its aid to a minority member who seeks redress for a corporate wrong'.[43] Another commentator argued that the "interests of justice" was not an exception to the rule as it was 'too nebulous, vague and infinitely elastic'.[44]

The Rationale for the Introduction of Part 2F.1A

The Inadequacy of the Common Law

Although *Foss v Harbottle* does have its advantages, for example by reducing a multiplicity of shareholder legal actions, leaving significant decisions in the hands of management who

[34] F H Buckley, 'Ratification and the Derivative Action under the Ontario Business Corporations Act' (1976) 22 *McGill Law Journal* 167 at 179.
[35] M Maloney, 'Whither the Statutory Derivative Action?' (1986) 64 *Canadian Bar Review* 309 at 311.
[36] G R Sullivan, 'Restating the Scope of the Derivative Action' (1985) 44 *Cambridge Law Journal* 236 at 239.
[37] Leslie Kosmin, 'Minority Shareholders' Remedies: Practitioner's Perspective' (1997) 2 *Company, Financial and Insolvency Law Review* 211 at 212.
[38] K W Wedderburn, 'Derivative Actions and Foss v. Harbottle' (1981) 44 *Modern Law Review* 202 at 205.
[39] A J Boyle, *Minority Shareholders' Remedies* (Cambridge University Press, 2002) at 29.
[40] Stanley M Beck, 'The Shareholders' Derivative Action' (1974) 52 *Canadian Bar Review* 159 at 168.
[41] Christopher Hale, 'What's *Right* with the Rule in *Foss v Harbottle*?' (1997) 2 *Company, Financial and Insolvency Law Review* 219.
[42] Anthony Boyle, 'A Liberal Approach to Foss v. Harbottle' (1964) 27 *Modern Law Review* 603 at 603.
[43] L S Sealy, 'Foss v. Harbottle – A Marathon Where Nobody Wins' (1981) 40 *Cambridge Law Journal* 29 at 32.
[44] O A Osunbor, 'A Critical Appraisal of "The Interests of Justice" as an Exception to the Rule in *Foss v. Harbottle*' (1987) 36 *International and Comparative Law Quarterly* 1 at 13.

are qualified to make those decisions, and reducing the scope for vexatious litigation,[45] the case has been the object of sustained criticism.

Described as 'complex and arcane',[46] and as '140 years' accumulation of procedural codswallop',[47] seeking redress under an exception to the rule in *Foss v Harbottle* was an 'onerous undertaking'.[48] The two limbs of the rule in *Foss v Harbottle* created 'considerable, sometimes insurmountable, barriers to any shareholder or interested party seeking to enforce a cause of action vested in the company',[49] and had a 'leaden impact' on shareholder litigation.[50] Ever since *Foss v Harbottle*, 'shareholders of companies have been fighting to widen the ambit of their rights to bring actions against directors and controlling shareholders'.[51]

> In short, the common law derivative action was complex in both legal theory and procedural hurdles. Not only were shareholders limited to the elusive exceptions to the rule in *Foss v Harbottle*, they also faced threshold tests, applications to strike, interlocutory appeals, an uncertain prospect of meaningful recovery, uncertain funding for their legal expenses, and a judiciary inclined to defer to the "corporate will".[52]

Criticisms of the common law situation highlighted, in particular, the following issues:

(a) The Cost of Litigation

In *Wallersteiner v Moir (No 2)*[53] Lord Denning held that a shareholder who brings a derivative action should be entitled to be indemnified by the company for all costs incurred in bringing the action, because if the action succeeds, the company will take the benefit.[54] Although considered by some to finally resolve the issue of costs,[55] subsequent cases limited its utility. In *Smith v Croft*[56] Holton J held that interim funding orders should not be made until after discovery, and only in cases of genuine need. The situation was similar in Australia.[57] The outcome was that minority shareholders could not rely on their costs being indemnified,[58] for although cases gave some comfort that costs would be paid, comprehensive indemnity rules were not developed.[59]

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[45] Brian R Cheffins, 'Reforming the Derivative Action: The Canadian Experience and British Prospects' (1997) 2 *Company, Financial and Insolvency Law Review* 227 at 229-231.
[46] Sarah Watkins, 'The Common Law Derivative Action: An Outmoded Relic?' (1999) 30 *Cambrian Law Review* 40.
[47] Sealy, above n 43 at 31.
[48] Dick, above n 25 at 556.
[49] John Kluver, 'Derivative Actions and the Rule in Foss v. Harbottle: Do We Need a Statutory Remedy?' (1993) 11 *Company and Securities Law Journal* 7 at 8.
[50] Stephen Bottomley, 'Shareholder Derivative Actions and Public Interest Suits: Two Versions of the Same Story?' (1992) 15 *University of New South Wales Law Journal* 127 at 137.
[51] Salah Uddin Ahmed, 'Disentanglement of Shareholders' Personal Action from Derivative Action – Recent Canadian Experience' (1976) 1 *University of New South Wales Law Journal* 264 at 264.
[52] Kaplan and Elwood, above n 5 at 450.
[53] [1975] QB 373.
[54] Ibid at 391-2 (Denning MR); see concurring statements by the other judges at 403-4 (Buckley LJ); 407 (Scarman LJ).
[55] See Schreiner, above n 7 at 215.
[56] [1986] 2 All ER 551.
[57] See, eg, *Parker v National Roads & Motorists Association* (1993) 11 ACSR 370 at 382.
[58] Watkins, above n 46 at 48.
[59] Kluver, above n 49, at 9, 23.

In addition to not being assured that their costs would be paid, plaintiff shareholders faced the prospect that any money recovered would accrue to the company,[60] giving the shareholder only a small pro-rata benefit.[61] The combination of these factors left potential plaintiff shareholders with a serious disincentive to commence litigation.[62] One commentator summarised the position:

> the main impediment to shareholders contemplating litigation is … a lack of incentive to commence litigation deriving from a number of factors including the cost of litigation and the fact that if the action is successful any recovery accrues to the company and not the plaintiff shareholder.[63]

The government reports also underlined the importance of the question of costs, describing it as 'possibly the greatest inhibitor to shareholder litigation'[64] and noting that the cost of litigation 'effectively prevents shareholders from pursuing the legal remedies open to them'.[65]

(b) Restrictive Standing Requirements

The restrictive standing requirements facing a potential plaintiff shareholder were also a significant barrier. In *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*[66] it was held that the question of standing had to be considered as a preliminary issue. Given that, as previously mentioned, proving fraud and control was a difficult process,[67] these preliminary hearings developed into long and expensive hearings.[68]

However, the courts in Australia took a different direction. King CJ in *Hurley v BGH Nominees Pty Ltd*[69] considered that the procedure set out in *Prudential* should not be followed in all situations, and other cases followed King CJ's approach.[70] Unlike English courts, Australian courts 'usually consider it inappropriate for the question of standing to be tried as a preliminary issue'.[71] As a result of this 'pragmatic and sympathetic approach to the question of standing':

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[60] Giora Shapira, 'Shareholder Personal Action in Respect of a Loss Suffered by the Company: The Problem of Overlapping Claims and "Reflective Loss" in English Company Law' (2003) 37 *International Lawyer* 137.
[61] Pearlie Koh Ming Choo, 'The Statutory Derivative Action in Singapore: a Critical and Comparative Examination' (2001) 13 *Bond Law Review* 64 at 89.
[62] James McConvill, 'Part 2F.1A of the Corporations Act: Insert a New s 242(2) or Give it the Boot?' (2002) 30 *Australian Business Law Review* 309 at 309.
[63] Ramsay, above n 10 at 150.
[64] Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action* (July 1993) at 8. See also CLERP Proposals for Reform, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors* (Paper No 3, 1997) at 31.
[65] Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (November 1991) at 190.
[66] [1982] 1 Ch D 204 at 221-2.
[67] Cf *Biala Pty Ltd v Mallina Holdings* (1993) 11 ACSR 785 at 840-4, where the plaintiff failed to satisfy the court.
[68] Kaplan and Elwood, above n 5 at 448. See the strident criticisms of *Prudential* in Sealy, above n 43.
[69] (1982) 1 ACLC 387 at 389.
[70] Cf *Aloridge Pty Ltd (prov liq apptd) v Western Australian Gem Explorers Pty Ltd* (1995) 127 ALR 410; *Dempster v Mallina Holdings Ltd* (1994) 15 ACSR 1.
[71] Elizabeth J Boros, *Minority Shareholders' Remedies* (Clarendon Press, 1995) at 190.

> [i]t is fair to conclude from these decisions that the courts are willing to overcome the procedural obstacles to the common-law derivative action, thus minimizing the impact of *Foss v Harbottle*.[72]

Stevens has stated that '[t]he major impetus for Australia's move toward adopting a statutory derivative suit is the very restrictive nature of the standing requirements at common law'.[73] Several statements in the government reports seem to support this statement.[74] However, given that standing has not proven to be as problematic in Australia as it has been in England, the validity of this reasoning is questionable.[75]

(c) Ratification

The law relating to ratification has been described as '[u]ndoubtedly the greatest legal difficulty with the existing derivative remedy'.[76] A derivative action could only be brought by a shareholder against a director for the director's breach of duty if the breach was unable to be ratified by the company.[77] Indeed, 'the mere *possibility* of ratification was sufficient to deprive a shareholder of the ability to bring a derivative action'.[78] There is conflicting authority as to what types of acts and omissions by directors are ratifiable by the company,[79] to such an extent that it has been described as a 'labyrinthine case-law'[80] and a 'legal quagmire'.[81] This 'uncleared minefield' could often lead to unjust outcomes.[82]

(d) Uncertainty of the Rule and Exceptions

Although the rule in *Foss v Harbottle* can be stated with 'disarming simplicity',[83] the simplicity ends there. 'Few areas of the law are more beleaguered by confusion and misconception than the rule in *Foss v Harbottle*'.[84] The law is 'complex and obscure',[85] with conflicting authority as to the exact scope of the exceptions to *Foss v Harbottle*,[86] making it

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[72] Anil Hargovan, 'Under Judicial and Legislative Attack: The Rule in Foss v. Harbottle' (1996) 113 *South African Law Journal* 631 at 634, 636-7.
[73] Stevens, above n 9 at 135.
[74] CLERP Proposals for Reform, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors* (Paper No 3, 1997) at 31; Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (November 1991) at 191; Explanatory Memorandum, Corporate Law Economic Reform Program Bill 1999 (Cth) at [6.15].
[75] See Ramsay, above n 10 at 159-62.
[76] Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action* (July 1993) at 6.
[77] James Mayanja, 'Standing to Challenge the Implementation of Improper Defensive Measures' (1995) 5 *Australian Journal of Corporate Law* 66 at 69.
[78] Saul Fridman, 'Ratification of Directors' Breaches' (1992) 10 *Company and Securities Law Journal* 252 at 252.
[79] Lynne Taylor, 'Ratification and the Statutory Derivative action in the Companies Act 1993' (1998) 16 *Company & Securities Law Journal* 221 at 223. See also B H McPherson, 'Duties of Directors and the Powers of Shareholders' (1977) 51 *Australian Law Journal* 460 at 468-9.
[80] Kluver, above n 49 at 9.
[81] Hargovan, above n 72 at 646.
[82] Fridman, above n 78, 252, 255.
[83] D D Prentice, 'Another Exception to the Rule in Foss v. Harbottle' (1972) 35 *Modern Law Review* 318 at 318.
[84] Dick, above n 25 at 547.
[85] Cheffins, above n 45 at 233.
[86] Osunbor, above n 44, at 1. See also B A K Rider, 'Amiable Lunatics and the Rule in Foss v. Harbottle' (1978) 37 *Cambridge Law Journal* 270.

difficult to accurately state the law.[87] It is not surprising that the government reports recognised the uncertainty inherent in the common law derivative action as an area needing reform.[88]

(e) The Inadequacy of Alternative Remedies

A more controversial view is that existing remedies such as the oppression remedy did not furnish shareholders with adequate protection. This was the position held by CASAC in its 1993 report.[89] One author agreed that 'the oppression provision has not enjoyed great success as a response to *Foss v Harbottle*'.[90] However this view is by no means unanimous. One author argued that the 'liberal approach currently favoured in the interpretation of the oppression remedy has made it a very useful remedial tool for minority shareholders',[91] while another argued that due to its wide interpretation by the courts the oppression remedy 'has been used effectively by the courts to combat the rule in *Foss v Harbottle*'.[92] An empirical study of the use of the oppression remedy found there has been a 'significant a increase in the use of the oppression remedy'.[93]

Overcoming the Problems with the Common Law

The preceding discussion indicates the reasons for the introduction of Part 2F.1A. The government reports all highlighted the inadequacy of the common law and existing remedies in providing shareholders with adequate remedies. The Companies and Securities Law Review Committee said in its 1990 Discussion Paper:

> The focus of this paper has resulted from recognition of a widespread assessment that due to the restrictive nature of the rule in *Foss v Harbottle*, existing law does not provide adequate means for the enforcement of the duties of directors and officers where the company improperly refuses or fails to take action.[94]

The Companies and Securities Advisory Committee subsequently stated:

> Despite the existence of [the exceptions to the rule in *Foss v Harbottle*] there have been continued calls for reform of this area of law on the basis that the exceptions are too narrow and hinder shareholder litigation.[95]

The CLERP Proposals for Reform Paper contained a similar statement:

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[87] Berkahn, above n 21 at 98. Note the title of a journal article by R Gregory, 'What *Is* the Rule in Foss v. Harbottle?' (1982) 45 *Modern Law Review* 584. See also Wedderburn, above n 20 at 195, 199.

[88] CLERP Proposals for Reform, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors* (Paper No 3, 1997) at 32; Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action* (July 1993) at 6; Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (November 1991) at 193.

[89] Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action* (July 1993) at 5-10.

[90] Bottomley, above n 50 at 142.

[91] Berkahn, above n 21 at 89.

[92] Hargovan, above n 72 at 637.

[93] Ian M Ramsay, 'An Empirical Study of the Use of the Oppression Remedy (1999) 27 *Australian Business Law Review* 23 at 29.

[94] Companies and Securities Law Review Committee, *Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action* (Discussion Paper 11, July 1990) at [9] (citations omitted). See also Companies and Securities Law Review Committee, *Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action* (Report No 12, November 1990) at [6].

[95] Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action* (July 1993) at 2.

> The existing law is unsatisfactory both on the question of standing of a shareholder to take action and the disincentive to commence proceedings because of the potential costs which might be incurred.[96]

The reports recommended the enactment of a statutory derivative action to overcome the inadequacy of the common law: '[t]he main proposal to improve the ability of shareholders to take proceedings to enforce their rights is to implement a form of statutory derivative action'.[97] It was believed that a statutory derivative action would be 'a more effective avenue of enforcement than has previously been available' and the procedures 'would make a derivative action more feasible and practical than under the common law'.[98]

In particular, the statutory derivative action was enacted to overcome the common law problems with respect to ratification, the prohibitive cost of litigation, and the restrictive standing requirements confronting shareholders. The Explanatory Memorandum to the *Corporate Law Economic Reform Program Bill 1999* stated:

> The main difficulties associated with the common law action centre around:
>
> - the effect of ratification of the impugned conduct by the general meeting of shareholders;
> - the lack of access to company funds by shareholders to finance the proceedings; and
> - the strict criteria which need to be established before a Court may grant leave.

Numerous cases have described the rationale for the statutory derivative action in a similar way. In *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd*[99] Mullins J stated that '[t]he intention of the legislation was to overcome the practical and legal difficulties regarding what used to be called derivative actions, while maintaining appropriate checks and balances'. In *BL & GY International Co Ltd v Hypec Electronics Pty Ltd*[100] Einstein J stated:

> The matter that the legislature sought to address appears to have been the difficulties which had arisen when under the common law, a party sought to proceed on the basis of an exception to the rule in *Foss v Harbottle*.

The statutory derivative action is designed to overcome the problems with the common law derivative action and increase the effective remedies available to shareholders:

> It may be accepted that ss 236 and 237 were not intended to preserve the former law; but they should surely be approached as measures of reform designed to improve, rather than to place novel obstacles in the way of, such proceedings.[101]

The Purpose of the Statutory Derivative Action

As well as rectifying the defects inherent in the common law derivative action, the statutory derivative action has several significant purposes.

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[96] CLERP Proposals for Reform, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors* (Paper No 3, 1997) at 31.
[97] Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (November 1991) at 194.
[98] CLERP Proposals for Reform, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors* (Paper No 3, 1997) at 32, 34.
[99] [2001] QSC 324 at [11].
[100] (2001) 164 FLR 268; (2001) 19 ACLC 1622; [2001] NSWSC 705 at [70].
[101] *Metyor Inc (formerly Talisman Technologies Inc) v Queensland Electronic Switching Pty Ltd* [2002] QCA 269; [2003] 1 Qd R 186; (2002) 42 ACSR 398; (2002) 20 ACLC 1517 at [10].

Managerial Accountability

A key problem that confronts shareholders is that the division of management and ownership has the potential to encourage misuse of company resources by some directors for their own benefit[102] and this division can pose significant obstacles for shareholders seeking to bring an action against directors for breach of their duties.[103] If maintaining good corporate governance is essential to investor confidence, there must be effective ways of deterring managerial misconduct.[104] The primary purpose of the statutory derivative action is to enhance managerial accountability by deterring wrongful conduct:

> the statutory derivative action has primarily a deterrent objective – by empowering the shareholders and others, it serves to deter managerial misconduct by imposing the threat of liability.[105]

The government reports indicate that achieving managerial accountability is very much a key objective of the statutory derivative action:[106] '[a] statutory form of derivative action should provide strong encouragement for company managers to be accountable to shareholders'.[107] Stevens writes that the statutory derivative action was enacted from a 'desire for a more potent, accessible weapon to deter and punish managerial misconduct'.[108] Another author has spoken of the statutory derivative action allowing shareholders to act 'as some form of corporate watchdog, to pursue an action against a wrongdoer, when the board refuses to act'.[109]

This goal is reflected in the final form of Part 2F.1A. Section 237(3) establishes a rebuttable presumption that actions against third parties are not in the best interests of the company if the company has decided not to bring those proceedings and the directors made that decision reasonably and in good faith. The statutory derivative action is not designed to usurp the ordinary functioning of the board of directors, but to provide a remedy when the board has acted improperly.[110]

Compensating the Company

One author has posed the question: 'what does the derivative action accomplish – is it to deter corporate malfeasance or to provide some form of compensation?'[111] The CLERP

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[102] CLERP Proposals for Reform, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors* (Paper No 3, 1997) at 9.
[103] See Ben Saunders, 'Putting the Spoils of Litigation into the Shareholders' Pockets: When Can Shareholders Bring a Personal Action Against the Directors of Their Company?' (2004) 22 *Company & Securities Law Journal* 535 at 535.
[104] CLERP Proposals for Reform, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors* (Paper No 3, 1997) at 7-11.
[105] Choo, above n 61 at 69.
[106] Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action* (July 1993) at 4.
[107] CLERP Proposals for Reform, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors* (Paper No 3, 1997) at 40.
[108] Stevens, above n 9 at 127.
[109] Lynden Griggs, 'The Statutory Derivative Action: Lessons that May be Learnt from its Past!' (2002) 6 *University of Western Sydney Law Review* 63 at 64.
[110] See the Explanatory Memorandum to the *Corporate Law Economic Reform Program Bill 1999 (Cth)* at 22.
[111] Griggs, above n 109 at 94.

Proposals for Reform Paper states that 'the statutory action is not intended to be regulatory in nature but to facilitate private parties to enforce existing rights attaching to the company'.[112] The same view has been expressed by Heenan J:

> The action for relief …under the statutory derivative action [is a remedy] to vindicate an interest of the company as a whole, with consequent benefit to all current shareholders or members.[113]

However, it is appropriate to see these purposes as complementary. Deterrence is achieved through the means of the enforcement of company rights: 'private enforcement accomplished via shareholder litigation may be preferable to public enforcement'.[114] The statutory derivative action serves both purposes:

> it seeks to provide some level of deterrence against abuses of managerial or directorial authority, and it provides an avenue whereby, through shareholder activism in the absence of action by the board of directors, the corporation can recover damages or property belonging to the corporation.[115]

In giving shareholders an effective means of enforcing their rights and recovering money owed to the company, the goal of deterrence is achieved.

Remedying Internal Disputes

The government reports recognised the 'clear need to protect directors and officers of companies from unreasonable interruption of their day to day affairs'.[116] The courts are also keen to exclude unwarranted interference with the internal management of companies.[117] However, sometimes interference by the courts is necessary in order to remedy internal disputes where those managing the company are unable to do so:

> Part 2F.1A is concerned with the domestic process by which a company makes decisions relevant to initiation and continuation of legal proceedings. The statutory provisions aim to counter the effects of inaction on the part of those who would normally decide such matters internally.[118]

The statutory derivative action is concerned with the internal decision-making process of a company. The objective is to ensure that members are not disadvantaged by the self-interested actions of other shareholders or the directors, and also to ensure they are able to bring an action to vindicate their rights. McPherson JA stated in *Metyor*:

> It is because one group of members are in control of the management or affairs of the company and refuse to permit it to take proceedings that there is a dispute between the two groups of shareholders or members here. It is only by permitting proceedings to be taken on behalf of the company that the dispute in question can be resolved at all and that the complaint of one set of members against the others can be remedied. Otherwise the majority

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[112] CLERP Proposals for Reform, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors* (Paper No 3, 1997) at 35.
[113] *Westgold Resources NL v Precious Metals Australia Ltd* [2002] WASC 221 at [21].
[114] Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action* (July 1993) at 4.
[115] Kaplan and Elwood, above n 5 at 455.
[116] Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (November 1991) at 196.
[117] Cf *Chapman v E-Sports Club Worldwide Ltd* (2000) 35 ACSR 462; [2000] VSC 403 at [10].
[118] *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 51 ACSR 245; [2004] NSWSC 973 at [16].

> will be able to prevent the minority and through them the company from obtaining redress against the actions of the majority.[119]

An example is *Braga v Braga* where Hamilton J stated:

> …it would appear from the correspondence that the plaintiff and the first defendant are ad idem that the company has valid claims for defalcation against these outside parties, but that the present state of disagreement between them cripples the company from taking those proceedings.[120]

Initial Appraisal of the Statutory Derivative Action

Although many commentators strongly criticised the common law situation, this was by no means unanimous, particularly in the Australian context. Some commentators argued that the development of corporate law by Australian judges minimised the problems arising from *Foss v Harbottle*. After examining the application of *Foss v Harbottle* by Australian courts, L S Sealy concluded in 1989:

> The picture that consistently comes through is one of a willingness to get at the substantial issue undistracted by any consideration of *locus standi* or procedure. Where a *Foss v Harbottle* point has in fact been taken, one frequently finds the judge putting the issue on one side.[121]

Prior to the introduction of Part 2F.1A, Australian courts took a much less restrictive approach to the question of standing than their English counterparts. They gave a broad interpretation of the interests of justice exception to the rule in *Foss v Harbottle,*[122] and expanded the personal rights category.[123] For these reasons, other commentators have followed Sealy's analysis, arguing that the implications of *Foss v Harbottle* were not as severe as they were made out to be.[124] It was also argued that there were adequate remedies under the pre-CLERP situation, because every action brought under Part 2F.1A could have been brought under s 1324[125] (which empowers the court to grant an injunction for breaches of the *Corporations Act*) or the oppression remedy.[126]

In consequence, some commentators considered that the statutory derivative action would have little impact. Thai argued that Part 2F.1A is 'no more than reformulation of the common

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[119] *Metyor Inc (formerly Talisman Technologies Inc) v Queensland Electronic Switching Pty Ltd* [2002] QCA 269; [2003] 1 Qd R 186; (2002) 42 ACSR 398; (2002) 20 ACLC 1517 at [11].
[120] *Braga v Braga Consolidated Pty Ltd* [2002] NSWSC 603 at [9].
[121] L S Sealy, 'The Rule in *Foss v Harbottle*: The Australian Experience' (1989) 10 *Company Lawyer* 52.
[122] *Biala Pty Ltd v Mallina Holdings* (1993) 11 ACSR 785; *Ruralcorp Consulting Pty Ltd v Pynery Pty Ltd* (1996) 21 ACSR 161; *Mesenberg v Cord Industrial Recruiters Pty Ltd* (1996) 19 ACSR 483 at 487; *Cope v Butcher* (1996) 20 ACSR 37; *Aloridge Pty Ltd (prov liq apptd) v Western Australian Gem Explorers Pty Ltd* (1995) 127 ALR 410 (although *Christianos v Aloridge Pty Ltd* (1995) 18 ACSR 272 overturned Burchett J's judgment, "the court was dealing with a very special set of facts and deciding the matter on the facts rather than as a general principle of law … the decision of the Full Court … adds no weight to the arguments that a statutory exception to the rule in *Foss v Harbottle* is needed": Robert Baxt, 'The Rule in Foss v Harbottle Rears its Ugly Head: The Case for a Statutory Derivative Action Gathers Strength' (1996) 14 *Company and Securities Law Journal* 174 at 175). See also Rosemary Teele, 'A Fifth Exception to the Rule in Foss v Harbottle?' (1995) 13 *Company and Securities Law Journal* 329.
[123] *Residues Treatment & Trading Co Ltd v Southern Resources Ltd (No 4)* (1988) 14 ACLR 569.
[124] Ramsay, above n 10 at 159-62, Berkahn, above n 21 at 75, 98, Choo, above n 61 at 68-9.
[125] Cf Robert Baxt, 'A Body Blow to Section 1324 of the Corporations Law? Will the Derivative Action Get a New Lease of Life?' (1996) 14 *Company and Securities Law Journal* 312.
[126] McConvill, above n 62 at 310.

law position'.[127] Griggs argued that 'a solution has been found to a problem for which there is arguably, little, if any demonstrated evidence' and that 'the available evidence suggests that the statutory derivative action will have little impact on shareholder litigation in Australia'.[128] Fitzsimons argued that the statutory derivative action has failed to make a major impact in Canada, and the Australian experience would prove to be similar.[129]

However, despite the expansive approach of the Australian courts, there were difficulties in the common law which needed to be overcome. As one commentator put it:

> …if there are difficulties in enforcing the duties of directors and officers as asserted by the CSLRC, this is not because of deficiencies in the common law resulting from *Foss v Harbottle*. … Rather, the reason why breaches of directors' duties may go unpunished is because of the lack of incentive to commence litigation.[130]

Corkery said, in an oft-quoted statement:

> 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.[131]

The cost of litigation was a significant hurdle to the bringing of common law derivative actions. Moreover, s 1324 did not occupy the prominent place in corporate law that some believed it should.[132]

Some commentators have criticised the particular form in which the statutory derivative action is framed, arguing that it is a weakening of the position of shareholders as compared with their position under the common law. Clyne argued that the statutory derivative action puts significant hurdles in the path of minority shareholders, and will not assist them.[133] Prince argued that Part 2F.1A is 'harder to use than its New Zealand equivalent' and so the ultimate outcome from the shareholders' point of view is worse than under the common law.[134] Fletcher believes that '[e]nactment of subs 236(3) significantly weakened the legal position of minority shareholders', and that 'it is difficult not to conclude that shareholders have been short changed by these legislative developments'.[135]

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[127] Lang Thai, 'How Popular are Statutory Derivative Actions in Australia? Comparisons with United States, Canada and New Zealand' (2002) 30 *Australian Business Law Review* 118 at 135-6.
[128] Griggs, above n 109 at 90, 93.
[129] Peter Fitzsimons, 'Statutory Derivative Actions in New Zealand' (1996) 14 *Company and Securities Law Journal* 184.
[130] Ramsay, above n 10 at 162.
[131] J F Corkery, *Directors' Powers and Duties* (Longman Professional, 1987), 172.
[132] Baxt, above n 125.
[133] Shaun Clyne, 'Modern Corporate Governance' (2000) 11 *Australian Journal of Corporate Law* 276.
[134] Peter Prince, 'Australia's Statutory Derivative Action: Using the New Zealand Experience' (2000) 18 *Company and Securities Law Journal* 493 at 510-11.
[135] Keith Fletcher, 'CLERP and Minority Shareholder Rights' (2001) 13 *Australian Journal of Corporate Law* 290 at 295, 300. Note that he later argues that due to the 'likelihood that many actions that previously were brought under the "exceptions" to the rule in *Foss v Harbottle* will now be brought under' the oppression provision, 'it is difficult to assert that the CLERP changes have adversely affected minority shareholders' (at 303).

Others have assessed the impact of the statutory derivative action more positively. These authors have argued that the reforms are 'a vast improvement on the previous position',[136] and that 'the introduction of the statutory derivative action would greatly enhance the range of remedies available to the minority shareholder'.[137]

Summary

The statutory derivative action has displaced any potential recourse to any of the exceptions to the rule in *Foss v Harbottle*, so that, except where the company is a foreign company,[138] a derivative action must now be commenced under Part 2F.1A.[139]

As the statutory derivative action now covers the field,[140] it is important to compare the present situation with the pre-Part 2F.1A position. The government reports identified three key defects in the common law derivative action which were to be rectified by the statutory derivative action:

- ratification;
- the cost of litigation; and
- the restrictive standing requirements.

In our empirical study of the statutory derivative action, we pay particular attention to considering whether these problems have been rectified by Part 2F.1A.

III Outline of Part 2F.1A

Section 236(1) of the Act provides that:

- a member, former member, or person entitled to be registered as a member, of the company or of a related body corporate; or
- an officer or former officer of the company

may apply for leave to bring a derivative action.

The application may be to:

- bring proceedings on behalf of a company, or
- intervene in any proceedings to which the company is a party for the purpose of taking responsibility on behalf of the company for those proceedings, or for a particular step in those proceedings.

Proceedings brought on behalf of a company must be brought in the company's name (s 236(2)). The right to bring a derivative action at general law is abolished (s 236(3)).

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[136] James McConvill 'Ensuring Balance in Corporate Governance: Parts 2F.1 and 2F.1A of the Corporations Law' (2001) 12 *Australian Journal of Corporate Law* 293 at 296.
[137] Lynden Griggs and John P Lowry, 'Minority Shareholder Remedies: A Comparative View' (1994) *Journal of Business Law* 463 at 474.
[138] Section 236(3) does not apply to a foreign company, and so the general law still applies with respect to such companies: *Irawan v AWB Ltd* [2001] VSC 374 at [39]-[41].
[139] *Chapman v E-Sports Club Worldwide Ltd* (2000) 35 ACSR 462; [2000] VSC 403 at [2]; *Karam v Australia & New Zealand Banking Group Ltd* (2000) 34 ACSR 545; [2000] NSWSC 596 at 554; *Braga v Braga Consolidated Pty Ltd* [2002] NSWSC 603 at [2].
[140] Section 236(3); McConvill, above n 136 at 301.

Leave of the court must be obtained for the action to proceed. Pursuant to s 237(2), the court must grant the application if it is satisfied that:

(a) it is probable that the company will not itself bring the proceedings, or properly take responsibility for them, or for the steps in them; and
(b) the applicant is acting in good faith; and
(c) it is in the best interests of the company that the applicant be granted leave; and
(d) if the applicant is applying for leave to bring proceedings – there is a serious question to be tried; and
(e) either:
    (i) at least 14 days before making the application, the applicant gave written notice to the company of the intention to apply for leave and of the reasons for applying; or
    (ii) it is appropriate to grant leave even though subparagraph (i) is not satisfied.

All these criteria must be satisfied for leave to be granted, and leave must be granted if they are satisfied.

Section 237(3) establishes a rebuttable presumption that granting leave is not in the best interests of the company if it is established that:

- the proceedings are by the company against a third party or by a third party against the company; and
- the company has decided not to bring the proceedings or not to defend the proceedings or to discontinue, settle or compromise the proceedings; and
- all of the directors who participated in that decision:
    - acted in good faith for a proper purpose; and
    - did not have a material personal interest in the decision; and
    - informed themselves about the subject matter of the decision to the extent they reasonably believed to be appropriate; and
    - rationally believed the decision was in the best interests of the company.

The director's belief that the decision was in the best interests of the company is a rational one unless the belief is one that no reasonable person in their position would hold. The definition of a third party is in s 237(4). A person is a third party if:

- the company is a public company and the person is not a related party of the company; or
- the company is not a public company and the person would not be a related party of the company if the company were a public company.

Ratification of conduct by the members of a company does not:

- prevent a person applying for leave under s 237;
- prevent an applicant from bringing or intervening in proceedings if leave has been granted; nor
- have the effect that proceedings brought or intervened in with leave under section 237 must be determined in favour of the defendant, or that an application for leave under that section must be refused.

However, the court may take the ratification into account in deciding what order to make in the actual proceedings or in deciding whether to grant leave (s 239).

Section 240 provides that proceedings brought or intervened in with leave must not be discontinued, compromised or settled without the leave of the court.

Section 241 empowers the court to make any orders, and give any directions, that it considers appropriate in relation to proceedings brought or intervened in with leave, or an application for leave.

Section 242 provides that the court may at any time make any orders it considers appropriate about the costs of:

- the person who applied for or was granted leave;
- the company; or
- any other party to the proceedings or application,

in relation to proceedings brought or intervened in with leave under section 237 or an application for leave under that section. An order under s 242 may require indemnification for costs.

IV Empirical Study and Analysis of Data

Research Methodology

The objective of the research methodology was to locate and analyse every case decided under Part 2F.1A. Research was conducted using a number of electronic databases,[141] with search terms based on the relevant legislative provisions.[142] Only those cases which involved an application for leave under s 237 to either bring or intervene in proceedings, or an appeal from such an application, were reviewed for the study. Each case was read and, for each case, the following 14 questions were, to the extent possible, answered:

1. When was the case decided?
2. What court was the case decided in?
3. Was it at first instance or on appeal?
4. Who was the applicant?
5. What type of company was it?
6. What were the allegations pleaded?
7. Was the oppression remedy also relied on?
8. Who defended the application?
9. Was leave granted?
10. If the application was not successful, why not?
11. What were the sections of Part 2F.1A relied on?
12. Did the court refer to the substance of the case?
13. What was the length of the hearing?
14. Did the court award funding for the litigation by the company?

The research located 31 cases for the period from March 2000 (the introduction of Part 2F.1A) to 12 August 2005.[143]

[141] The LexisNexis AU, Austlii and Centre for Corporate Law and Securities Regulation databases were searched.

[142] The following search terms were used: "derivative action" for the period 13 March 2000 – 12 August 2005; "Corporations Act 2001 Part 2F.1A", ""Corporations Act 2001" Part 2F.1A", "Corporations Act 2001 Pt 2F.1A", ""Corporations Act 2001" Pt 2F.1A", "Corporations Act 2001 s 236", ""Corporations Act 2001" s 236", "Corporations Act 2001 s 237" and ""Corporations Act 2001" s 237".

[143] There have been subsequent cases up to the date of completion of this paper (February 2006). However, the authors do not believe these cases alter the conclusions reached in this study.

Background Information

Table 1 shows the distribution of cases according to the year in which the leave application was decided.

Table 1: When was the case decided?

Year of Application	Number of Cases	Percentage
2000 (from 12 March)	3	9.7%
2001	7	22.6%
2002	6	19.4%
2003	4	12.9%
2004	9	29%
2005 (to 12 August)	2	6.5%
Total	31	100%

For the time period of study, the research yielded only 31 cases. This is a modest number of cases. It is possible, as some have argued,[144] that the statutory derivative action has failed to make a significant impact. Yet the issue of impact cannot be determined solely on the basis of the data in Table 1.

In order to gain additional insight into the impact of the statutory derivative action, the following research was undertaken. A search of electronic databases of judgments of Australian courts was undertaken for judgments in which *Foss v Harbottle* was considered by courts for the 5 year period immediately preceding the introduction of the statutory derivative action (ie, 1995-1999). This research found 30 judgments. This indicates that when a similar period of years is examined (1995-1999 for *Foss v Harbottle* and 2000-2005 for Part 2F.1), the statutory derivative action is not resulting in a greater number of judgments than the common law derivative action which it replaced.

Table 1 indicates that the distribution of cases across the five years is fairly even, and does not seem to indicate either increasing or decreasing popularity.

Table 2 shows the distribution of cases according to the court in which the application was heard.

[144] See above notes 127-29 and accompanying text.

Table 2: What court heard the application for leave?

Court	Number of Cases	Percentage
Supreme Court of Victoria	2	6.5%
Supreme Court of New South Wales	18	58.1%
Supreme Court of South Australia	1	3.2%
Supreme Court/Court of Appeal of Western Australia	1	3.2%
Supreme Court/Court of Appeal of Queensland	7	22.6%
Federal Court of Australia	2	6.5%
Total	31	100%

The court in which the most cases have been heard is the New South Wales Supreme Court. Only two cases have been heard in the Federal Court.

Table 3 shows the distribution of cases according to whether the decision was a decision at first instance or on appeal.

Table 3: Was the case at first instance or on appeal?

Nature of case	Number of Cases	Percentage
First instance	27	87.1%
Appeal	4	12.9%
Total	31	100%

Few leave applications have been appealed. The majority of applications decided were decisions at first instance.

Who was the Applicant?

Table 4 details information about the applicant.

Table 4: Who was the applicant?

Applicant[145]	Number of Cases	Percentage
Former director with no shareholding	1	3.2%
Former director and current minority shareholder	2	6.5%
Former director and current 50% shareholder	1	3.2%
Total number of cases involving former directors	**4**	**12.9%**
Director and minority shareholder	4	12.9%
Director and 50% shareholder	5	16.1%
Director and shareholder, shareholding unknown	3	9.7%
Total number of cases involving current directors who are also shareholders	**12**	**38.7%**
Minority shareholder	6	19.4%
50% shareholder	1	3.2%
Majority shareholder	2	6.5%
Shareholder with unknown shareholding	3	9.7%
Total number of cases involving shareholders who are not also current or former directors	**12**	**38.7%**
Not specified	3	9.7%
Total	31	100%

[145] In Table 4 the singular is used for ease of presentation. It should be noted that some cases involved multiple applicants (ie, several minority shareholders were applicants in some cases).

Almost all applicants are shareholders as at the date of the application or were former shareholders. Excluding those applicants whose position is unknown, only one case involved an applicant who was not a current shareholder. Nineteen cases involved either minority or 50% shareholders, which is 86.3% of those applicants whose shareholding is known (22 in total).

In 16 of the 31 cases (51.6%) the applicant was a current or former director and in 15 of these 16 cases the director was also a shareholder.

What Type of Company is Involved?

Table 5 details whether the company concerned is a public or privately held company.

Table 5: Is the company public or privately held?

Type of company	Number of Cases	Percentage
Private	27	87.1%
Public	4	12.9%
Total	31	100%

The vast majority of cases involved privately held companies. The government reports saw the statutory derivative action as an important means of maintaining investor confidence,[146] which seems to indicate that the primary role of the statutory derivative action was intended to be in large public companies, where shareholders were to act as watchdogs, guarding their investments by monitoring the actions of management. Instead, the statutory derivative action has been much more widely used in small proprietary companies, to overcome internal disputes.

It is also significant that a large number of cases involved companies which were under some form of administration, for example liquidation, receivership or other external administration. Table 6 presents this information.

Table 6: Was the company solvent or under some form of administration?

State of company	Number of Cases	Percentage
Solvent	21	67.7%
Under some form of administration[147]	10	32.3%
Total	31	100%

[146] See CLERP Proposals for Reform, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors* (Paper No 3, 1997) at 8.

[147] This is broadly defined for ease of presentation, and includes liquidation, receivership or other external administration.

In nearly a third of the cases considered the company in question was subject to some form of administration and was thus in financial difficulty. This has presented difficult problems for courts with respect to the question of costs, which is discussed in more detail below.

Several cases have considered the applicability of Part 2F.1A to a company in liquidation. Although Einstein J of the NSW Supreme Court held in *BL & GY International* that Part 2F.1A does not apply to a company in liquidation,[148] and the Western Australian Supreme Court expressed doubt as to whether Part 2F.1A has any application to a company in liquidation,[149] the majority of cases have held that it does.[150] Einstein J, in light of these cases, has since reversed his opinion.[151] 'The question should now be regarded as settled' that Part 2F.1A applies to a company in liquidation.[152]

The inherent jurisdiction of a court to permit a proceeding to be taken in the name of a company in liquidation at the instigation of a creditor or contributory has survived.[153] Section 237(3), which creates a rebuttable presumption against commencing actions against third parties, will not operate to create a presumption that proposed proceedings are not in the best interests of the company if the company is in liquidation. Section 237(3):

> …cannot create any rebuttable presumption that the granting of the leave [the applicant] seeks is not in the best interests of the company. This is because s 237(3) is capable of operating to create such a presumption only if the relevant company's decision not to bring the proceedings itself was a decision of the company's directors: see s 237(3)(c). Here, corporate decision-making is no longer in the hands of the company's directors.[154]

[148] *BL & GY International Co Ltd v Hypec Electronics Pty Ltd* (2001) 164 FLR 268; (2001) 19 ACLC 1622; [2001] NSWSC 705 at [73].
[149] *HPM Pty Ltd v Fear* [2002] WASCA 249 at [18]-[19].
[150] *Brightwell v RFB Holdings Pty Ltd (in liq)* (2003) 171 FLR 464; (2003) 44 ACSR 186; (2003) 21 ACLC 355; [2003] NSWSC 7; *Roach v Winnote Pty Ltd (in Liq)* [2001] NSWSC 822; *Mhanna v Sovereign Capital Ltd* [2004] FCA 1040 at [9]; *Mhanna v Sovereign Capital Ltd* [2004] FCA 1252 at [17]; *Charlton v Baber* (2003) 47 ACSR 31; (2003) 21 ACLC 1671; [2003] NSWSC 745 at [25-27]. In *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457; (2004) 51 ACSR 299; (2004) 23 ACLC 93; [2004] NSWSC 1007 at [7]-[8].
[151] *Kamper v Applied Soil Technology Pty Ltd* (2004) 211 ALR 337; (2004) 50 ACSR 738; [2004] NSWSC 891 at [11].
[152] *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457; (2004) 51 ACSR 299; (2004) 23 ACLC 93; [2004] NSWSC 1007 at [8].
[153] *Brightwell v RFB Holdings Pty Ltd (in liq)* (2003) 171 FLR 464; (2003) 44 ACSR 186; (2003) 21 ACLC 355; [2003] NSWSC 7 at [43]-[45], approving *BL & GY International Co Ltd v Hypec Electronics Pty Ltd* (2001) 164 FLR 268; (2001) 19 ACLC 1622; [2001] NSWSC 705 and *Roach v Winnote Pty Ltd (in Liq)* [2001] NSWSC 822.
[154] Ibid at [18].

What Were the Allegations Pleaded?

Table 7 details the allegations pleaded in the various cases.

Table 7: What were the allegations pleaded?

Allegations pleaded	Number of Cases	Percentage
Breach of directors' duties	10	32.3%
Breach of directors' duties and contract	6	19.4%
Breach of contract	5	16.1%
Oppressive conduct	2	6.5%
Recovery of debt	1	3.2%
Set aside default judgment	2	6.5%
Not specified	5	16.1%
Total	31	100%

Breaches of directors' duties were pleaded in 51.7% of the cases. This confirms, as discussed above, that managerial accountability is a key focus of the statutory derivative action.

Comparison of the Oppression Remedy and Part 2F.1A

Table 8 shows those cases in which the judgment of the court indicates that an oppression application (under Part 2F.1) was also brought in addition to the application to bring a statutory derivative action under Part 2F.1A.

Table 8: Was an oppression application also brought?

Oppression application also brought?	Number of Cases	Percentage
Yes	9	29%
No	22	71%
Total	31	100%

The data in Table 8 indicates significant overlap between Part 2F.1A applications for leave and oppression applications under Part 2F.1. This appears to be at variance with the experience in Canada, where the statutory derivative action has been little used due to the availability of the oppression remedy.[155]

[155] B Cheffins and J Dine, 'Shareholder Remedies: Lessons from Canada' (1992) 13 *Company Lawyer* 89; see also Brian R Cheffins, 'The Oppression Remedy in Corporate Law: The Canadian Experience' (1988) 10 *University of Pennsylvania Journal of International Business Law* 305.

There is perhaps an uncertain relationship between the oppression remedy and the statutory derivative action.[156] In *Goozee v Graphic World Group Holdings Pty Ltd*, Barrett J held that 'the court may, under s 237, grant leave to the plaintiffs to initiate proceedings based on s 232' [the oppression remedy].[157] Part 2F.1A has sometimes been used as a vehicle to bring an oppression action.[158] In *Chapman v E-Sports Club Worldwide Ltd* the application was refused because oppression was a more suitable remedy.[159] In *Fiduciary Ltd v Morningstar Research Pty Ltd*, security for costs had been required for oppression proceedings to continue.[160] As a consequence, an action under Part 2F.1A was commenced. Leave was granted, but on the condition that security for costs also be paid.[161] Thus bringing a statutory derivative action as opposed to an oppression action made little difference to the applicant's position. In *Hassall v Speedy Gantry Hire Pty Ltd*, oppression proceedings were already on foot. Moynihan J, in dismissing the Part 2F.1A application, held that:

> …the proposed proceeding will largely duplicate and is founded essentially on the same complaints as those pursued in the oppression action, and it has not been satisfactorily demonstrated that the relief available in the oppression proceeding will not be adequate.[162]

[156] Kluver, above n 49 at 10.
[157] (2002) 170 FLR 451; (2002) 42 ACSR 534; (2002) 20 ACLC 1502; [2002] NSWSC 640 at [22].
[158] Cf *Reale v Duncan Reale Pty Ltd* [2005] NSWSC 174.
[159] (2000) 35 ACSR 462; [2000] VSC 403 at [15].
[160] *Fiduciary Ltd v Morningstar Research Pty Ltd* (2004) 208 ALR 564; [2004] NSWSC 664.
[161] *Fiduciary Ltd v Morningstar Research Pty Ltd* (2005) 53 ACSR 732; [2005] NSWSC 442.
[162] [2001] QSC 327 at [11].

Who Defended the Application?

Table 9 details who defended the application.

Table 9: Who defended the application?

Defender of application	Number of Cases	Percentage
Director and majority shareholder	3	9.7%
Director and 50% shareholder	2	6.5%
Director and shareholder, shareholding unknown	7	22.6%
Total number of cases involving directors or directors who are also shareholders	12	38.7%
Majority shareholder	5	16.1%
Minority shareholder	1	3.2%
Total number of cases involving shareholders who are not also current or former directors	6	19.4%
Former director	1	3.2%
Liquidator	1	3.2%
3rd party	6	19.4%
None	2	6.5%
Not specified	3	9.7%
Total	31	100%

The defender of the application is used in this context to mean the person who opposed the application, and is to be distinguished from a defendant. In a leave application there is no formal defendant, however if the leave sought is granted, there may be a defendant in the actual trial, depending upon the allegations pleaded. Obviously, in many cases they will coincide, particularly in cases where breach of directors' duties is alleged, for the directors will seek to prevent the case proceeding to trial and oppose the Part 2F.1A application.[163] But this is not so in all cases. In *Carpenter v Pioneer Park Pty Ltd*, [164] the applicant sought leave to bring an action on behalf of the company against ANZ Bank; however, it was the liquidator who opposed the application.

[163] For example *Advent Investors Pty Ltd v Goldhirsch* (2001) 37 ACSR 529.
[164] (2004) 211 ALR 457; (2004) 51 ACSR 299; (2004) 23 ACLC 93; [2004] NSWSC 1007.

Was Leave Granted?

Table 10 details the successful and unsuccessful cases.

Table 10: Was leave granted?

Holding of court	Number of Cases	Percentage
Leave granted	19	61.3%
Leave refused	12	38.7%
Total	31	100%

In a large proportion of the cases the applicant was able to satisfy the court of the leave criteria and leave was granted. This suggests that the leave criteria and their application by the courts do not present 'insurmountable hurdles' for applicants, and the leave criteria do not make it overly difficult to bring a statutory derivative action.[165]

If the Application was not Successful, why not?

Table 11 details the reasons why the unsuccessful cases were unsuccessful.

Table 11: Why the application was not successful

Reason unsuccessful	Number of Cases	Percentage
(a) Not proven that company will not bring proceedings	1	8.3%
(b) Not in good faith	1	8.3%
(b),(c) Not in good faith and not in company's best interests	3	25%
(b),(c),(d) Not in good faith, not in company's best interests and no serious question to be tried	2	16.7%
(c),(d) Not in company's best interests, no serious question to be tried	1	8.3%
(d) No serious question to be tried	1	8.3%
Total number of cases in which criteria were not met	**9**	**75%**
Barred by s 236(3)	1	8.3%

[165] As Clyne argued, see above n 133.

Application premature	1	8.3%
Claim not in company's name	1	8.3%
Total	12	100%

The total percentage of the unsuccessful cases in which the criteria were not met is 75%. The main reason why applications are unsuccessful is a failure to satisfy the court of the leave criteria. This confirms that the role of the leave criteria, which is discussed in more detail below, is to screen proposed actions and prevent unmeritorious or vexatious claims from being litigated. This data also indicates that in unsuccessful cases, it will often be the case that more than one criterion will not have been satisfied.

What Sections were Considered?

Table 12 provides information on which sections of Part 2F.1A were discussed by the courts.

Table 12: What sections were considered?

Sections	Number of Cases	Percentage
236	1	3.2%
236, 237	23	74.2%
237	1	3.2%
237, 242	1	3.2%
237, 239	1	3.2%
236, 237, 240	1	3.2%
236, 237, 241, 242	1	3.2%
236, 237, 242	2	6.5%
Total	31	100%

The vast majority of cases consider only the leave criteria in s 237 and pay little attention to the other provisions of Part 2F.1A. In particular, s 242, which deals with the costs of the application, has received scant consideration, being discussed in only three cases.

Did the Court Consider the Substance of the Case?

Table 13 provides information on whether the court considered the substance of the case. Five categories of analysis have been used:

- Not referred to: the allegations were not mentioned.
- Briefly referred to: the allegations were mentioned with no particulars.
- Referred to: the allegations were mentioned with some particulars.

- Referred to in detail: the allegations were considered in detail with detailed discussion of the facts and particulars.
- Determined: the substantive case was finally decided.

Table 13: Did the court consider the substance of the case?

Substance of case	Number of Cases	Percentage
Not referred to	6	19.4%
Briefly referred to	7	22.6%
Referred to	10	32.3%
Referred to in detail	7	22.6%
Determined	1	3.2%
Total	31	100%

It cannot be said that courts are inclining towards over-extensive discussion, nor can it be said that courts are not considering the issues in sufficient detail. It seems that judicial scrutiny of the proposed action appropriately reflects the complexity of the case at hand.

What was the Length of the Hearing?

Table 14 indicates the length of the leave hearing.

Table 14: What was the length of the hearing?

Length of hearing	Number of Cases	Percentage
1 day	4	12.9%
2 days	20	64.5%
3 days	2	6.5%
4 days	2	6.5%
5 days	2	6.5%
7 days	1	3.2%
Total	31	100%

Over 75% of leave applications involved hearings of two days or less. The longest hearing was 7 days, but this case involved a particularly complex fact situation.[166] The mean hearing length was 2.4 days, the median length was 2 days. When this information is considered in light of the information presented in Table 13, it can be seen that the fears of some, as noted

[166] *Cannon Street Pty Ltd v Karedis* [2004] QSC 104.

in the discussion above, that the need for applicants to satisfy the court of the leave criteria would turn leave applications into mini-trials, have not been borne out.

Data on Costs

The following two tables set out evidence on the approach of the courts to the question of costs. The tables consider only successful applications, that is, those cases in which leave to bring a derivative action or intervene in proceedings was granted.

Did the court award the applicant costs for the application?

Table 15 indicates, in cases where the applicant was successful, whether the court granted the applicant costs for the leave application itself.

Table 15: Was the successful applicant granted costs for the leave application?

Were costs granted?	Number of Cases	Percentage
Yes	3	15.8%
Yes in part	1	5.3%
No	4	21%
Costs not discussed	5	26.3%
Costs reserved	6	31.6%
Total	19	100%

Did the court award funding for the litigation from the company's resources?

Table 16 indicates, in cases where the applicant was successful in having leave granted, whether the court required the company to fund the applicant in relation to the substantive litigation (ie, to fund the subsequent trial as opposed to funding the leave application).

Table 16: Was the company required to fund the applicant in relation to the substantive litigation?

Was funding granted?	Number of Cases	Percentage
No	5	26.3%
Not discussed	14	73.7%
Total	19	100%

Table 16 indicates that of the 19 cases in which the leave application was successful, in none of these cases did the court, as part of granting the leave application, require the company to fund the applicant in relation to the substantive litigation to follow the leave application.

Analysis of Key Issues

The Cost of Litigation

Section 242 deals with costs in relation to derivative proceedings. The section 'gives the court a broad discretion to make any orders it considers appropriate about the costs of the applicant, the company, or any other party to the proceedings or the application'.[167] The section confers broad powers on the courts. Section 242:

> …empowers the court to make "any orders it considers appropriate about the costs" of the persons to whom it refers. The court is thus free to approach matters with which the section deals unconfined by statutory prescriptions and by reference to the discretions that apply in the ordinary course in deciding applications for costs.[168]

The purpose of this broad discretion is stated in the Explanatory Memorandum:

> The Court's discretion regarding the allocation of costs is aimed at providing an additional safeguard in respect of use of company funds. In particular, the Court would be able to protect a bona fide shareholder against liability for costs indemnifying them out of company funds while at the same time allowing the Court a further means of discouraging unmeritorious action.[169]

Because the cost of litigation was the major disincentive attaching to common law actions,[170] the operation of s 242 must be considered carefully. The Australian provision can be contrasted with the equivalent New Zealand provision. Section 166 of the *Companies Act 1993 (NZ)* provides that, when an application for leave is made, the court must order that the cost of the proceedings will be paid by the company. In contrast, under Part 2F.1A of the *Corporations Act*:

> …the provisions are deliberately drafted in a manner that denies the successful applicant the assurance that court recognition will result in the company becoming liable for the reasonable costs of litigating on its behalf.[171]

It has been argued has stated that the Australian provisions with respect to costs are 'deficient and disappointing':

> …the problem for the minority shareholder is that these monetary incentives remain a mere prospect and might be affected by the uncertainty inherent in the exercise of judicial discretion.[172]

There are some judicial statements that successful applicants should not be expected to bear the costs of a statutory derivative action. For example, in *Foyster*, Barrett J stated:

> In the ordinary course, one would expect that a member or officer compelled to resort to s 237 to ensure that a defendant company was represented in proceedings should be protected, as to costs, by the company itself or by parties privy to the circumstances giving rise to the

[167] Explanatory Memorandum to the *Corporate Law Economic Reform Program Bill 1999 (Cth)* at [6.66].
[168] *Foyster v Foyster Holdings Pty Ltd* (2003) 44 ACSR 705; [2003] NSWSC 135 at [12].
[169] Explanatory Memorandum at [6.69]; CLERP Proposals for Reform, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors* (Paper No 3, 1997) at 39.
[170] Ramsay, above n 10 at 162; Prince above n 134 at 494.
[171] Fletcher, above n 135 at 299.
[172] Hargovan, above n 72 at 648.

> need for the s 237 application. Such a member or officer becomes, after all, the surrogate of the normal corporate decision makers whose decision has not been forthcoming.[173]

However, courts may require applicants to bear the costs of the litigation for several reasons. First, courts are understandably reluctant to prevent the situation described in *Swansson*:

> An order under s 242 that [the company] bear the costs of the litigation would have required the company to sell a substantial part of its assets in order to fund what can only be described as a litigation with questionable prospects of success.[174]

Second, there is the "best interests of the company problem". In several cases courts have only considered an action to be in the best interests of the company if the company stands to lose nothing if the action is ultimately unsuccessful. Therefore, the applicant must fund the litigation. This can be seen, for example, in *Metyor*. If the action was ultimately successful, the company would benefit without cost to itself. If unsuccessful, the company would not be disadvantaged, for '[i]t will be the plaintiffs, and not [the company], that will bear the stigma, if any, of defeat as well as the not inconsiderable costs of the proceedings'.[175] Only under these circumstances was the court prepared to hold that the action was in the best interests of the company.

This approach is also evidenced in *Fiduciary*. The court was only prepared to find that the action was in the best interests of the company and grant leave on the condition that the applicant provide security for costs and indemnify the company for any costs incurred.[176] In *McLean*, leave was granted, but such leave was:

> conditioned on an undertaking that in the absence of consent by all directors to payment, the funds of the company would not be utilised to pay solicitors' fees and outlays without leave of the court.[177]

Third, there is what might be termed the "additional safeguard" problem. As discussed, s 242 is designed to provide 'an additional safeguard in respect of use of company funds'. While courts have the power to grant funding to the applicant from the company's resources, this section is also 'a further means of discouraging unmeritorious action'. The effect of this approach to the question of costs can be seen in *Charlton v Baber*. The court found that the leave criteria had been met, and had granted leave to bring the action. The court then held that any costs order should be:

> designed to cater for the possibility that those proceedings will achieve no more than a pointless recycling of funds. It would, of course, be an entirely different matter if the derivative claims produced enough to see some return generated for unsecured creditors.[178]

That is, in this case company funds should not be provided to fund the litigation unless some distinct benefit accrues to the general body of creditors.[179] Section 237(2)(c) had previously required the court in *Charlton* to find that the action was in the best interests of the company,

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[173] *Foyster v Foyster Holdings Pty Ltd* (2003) 44 ACSR 705; [2003] NSWSC 135 at [13].
[174] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [77].
[175] *Metyor Inc (formerly Talisman Technologies Inc) v Queensland Electronic Switching Pty Ltd* [2002] QCA 269; [2003] 1 Qd R 186; (2002) 42 ACSR 398; (2002) 20 ACLC 1517 at [19].
[176] *Fiduciary Ltd v Morningstar Research Pty Ltd* (2005) 53 ACSR 732; [2005] NSWSC 442.
[177] *McLean v Lake Como Venture Pty Ltd* [2003] QCA 562; [2004] 2 Qd R 280 at 297.
[178] *Charlton v Baber* (2003) 47 ACSR 31; (2003) 21 ACLC 1671; [2003] NSWSC 745 at [72].
[179] Ibid at [74].

that is, that the action clearly presented genuine prospects of enhancing returns to creditors. This the court had found.[180] Yet this was not considered sufficient for the court to grant funding – some further 'distinct benefit' must accrue to the company for funding to be granted from the company's resources. This approach to s 242 places a higher threshold on the granting of costs than the high threshold of "the best interests of a company" which is used to determine if the application for leave should be granted.

Kaplan and Elwood have criticised this approach in the Canadian context:

> It is curious that a test for interim funding would revisit the merits of the action, when the court will have already found that the action has sufficient merit to satisfy the "interests of the company" requirement for leave.[181]

Another issue arises from the fact that in 32% of the cases considered, the relevant company was under some form of external administration. This presents a significant problem for the courts. If there are no funds available for the company to finance such litigation, it is impossible that it should do so, for before a court can make an order for costs under s 242, there must be evidence of the company's ability to pay such costs.[182]

In *Carpenter v Pioneer Park Pty Ltd*, Barrett J stated:

> In the present circumstances of the company, unsecured creditors will receive nothing as all funds in the liquidator's hands have been exhausted. The absence of funds also means that if the company … sues and is unsuccessful, any costs order that may be made against the company itself will not be able to be satisfied. And of necessity, pursuit of the proceedings on the company's behalf will have to be financed by [the applicant]. [183]

In these proceedings, security for costs was required to be provided by the applicant in the sum of $600,000.[184]

Neither the statutory provisions, nor the approach of the courts, provide any certainty of litigation funding.[185] The analysis of the cases indicates that courts have been cautious in relation to the issue of costs.

Examination of the application of the leave criteria

Section 236(1)(b) provides that in order to bring a derivative action, the applicant must obtain the leave of the court. Section 237(2) sets out five criteria which must be satisfied for a court to grant leave. The Explanatory Memorandum highlights the crucial importance of the proper application of the leave criteria in the scheme of Part 2F.1A:

> The criteria seek to strike a balance between the need to provide a real avenue for applicants to seek redress on behalf of a company where it fails to do so and the need to prevent actions proceeding which have little likelihood of success.[186]

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[180] Ibid at [53].
[181] Kaplan and Elwood, above n 5 at 465.
[182] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [75].
[183] (2004) 51 ACSR 299 at [20].
[184] *Pioneer Park Pty Ltd (in liq) v ANZ Banking Group Ltd* [2005] NSWSC 498.
[185] Thai, above n 127 at 136.
[186] Explanatory Memorandum to the *Corporate Law Economic Reform Program Bill 1999 (Cth)* at [6.33].

The statutory derivative action has replaced the exceptions to *Foss v Harbottle*, so that no derivative action can now be commenced except under Part 2F.1A and with leave of the court.[187] The court plays a key role in the operation of the statutory derivative action.[188] The court's role was stated by Barrett J in *Carpenter v Pioneer Park*:

> The court's function is essentially a screening function. It must assess against specified criteria the litigation proposal the applicant has in mind for the company. If that proposal is found by the court to meet the criteria, it must grant leave enabling the applicant to pursue it for the company.[189]

There are good reasons for requiring leave to be obtained:

> If any member or officer or former member or office was able to cause the company to commence proceedings before leave was granted, a multiplicity of suits might arise. Moreover a member or officer could usurp the proper functions of the company. A company is entitled to decide for itself whether it wishes to bring, defend or intervene in legal proceedings. Where a company will not itself bring, defend or intervene in proceedings it is necessary that there be some filtering system such as the requirement for leave before proceedings are commenced in the name of the company.[190]

The leave criteria seek to balance these aims:

> Part 2F.1A is, by its terms, intended to keep a careful balance between facilitating the bringing of derivative actions, where the earlier rule in *Foss v Harbottle* and its exceptions were seen to create undue difficulty, and protecting a company from too ready and unwarranted interference in its internal management.[191]

There are indications in the Explanatory Memorandum that a pragmatic and practical approach ought to be taken in deciding whether leave should be granted.[192]

Under s 237(2), the court is required to grant leave if it is satisfied that all of the criteria in paras (a)–(e) have been met. If the court is not satisfied that all the criteria have been met, it must refuse leave.[193] The court does not retain a residual discretion to grant leave if the

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[187] *Chapman v E-Sports Club Worldwide Ltd* (2000) 35 ACSR 462; [2000] VSC 403 at [2].

[188] Michael St Patrick Baxter, 'The Derivative Action under the *Ontario Business Corporations Act*: A Review of Section 97' (1982) 27 *McGill Law Journal* 453 at 475.

[189] *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457; (2004) 51 ACSR 299; (2004) 23 ACLC 93; [2004] NSWSC 1007 at [16].

[190] *RTP Holdings Pty Ltd v Roberts* (2000) 36 ACSR 170; [2000] SASC 386 at [14].

[191] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [22].

[192] *Herbert v Redemption Investments Ltd* [2002] QSC 340 at [32].

[193] *Charlton v Baber* (2003) 47 ACSR 31; (2003) 21 ACLC 1671; [2003] NSWSC 745 at [31], *Goozee v Graphic World Group Holdings Pty Ltd* (2002) 170 FLR 451; (2002) 42 ACSR 534; (2002) 20 ACLC 1502; [2002] NSWSC 640 at [27]; *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457; (2004) 51 ACSR 299; (2004) 23 ACLC 93; [2004] NSWSC 1007 at [31]; *Herbert v Redemption Investments Ltd* [2002] QSC 340 at [25]; *RTP Holdings Pty Ltd v Roberts* (2000) 36 ACSR 170; *Jeans v Deangrove Pty Ltd* (2001) NSW SC 84 at [13]; *Isak Constructions (Aust) Pty Ltd v Faress* (2003) 47 ACSR 224; [2003] NSWSC 784 at [10]; *Mhanna v Sovereign Capital Ltd* [2004] FCA 1040 at [9]. *RTP Holdings Pty Ltd v Roberts* (2000) 36 ACSR 170; [2000] SASC 386 at [19]; *Fiduciary Ltd v Morningstar Research Pty Ltd* (2005) 53 ACSR 732; [2005] NSWSC 442 at [16]; *McLean v Lake Como Venture Pty Ltd* [2003] QCA 562; [2004] 2 Qd R 280 at [2]; *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* [2001] QSC 324 at [37]; *Saltwater Studios Pty Ltd v Hathaway* [2004] QSC 435 at [5].

criteria are not fulfilled.[194] The applicant bears the onus of satisfying the court that, on the balance of probabilities, all the requirements of s 237(2) have been fulfilled.[195]

In this section, the leave criteria are examined separately and assessed against the objective identified in the Explanatory Memorandum.

(a) Inaction by the company

The court must be satisfied that 'it is probable that the company will not itself bring the proceedings, or properly take responsibility for them, or for the steps in them'.[196] Without this provision, 'the ability of the board to manage a company would be undermined'.[197]

Although described as the 'critical hurdle',[198] this criterion seems to have a low threshold. In *Charlton v Baber*, Barrett J only required grounds for finding that it was probable that the company would not bring proceedings.[199] 'In most cases, it will be readily apparent whether this requirement is satisfied',[200] all that is required is some evidence establishing the unlikelihood of action.[201] Where the board is deadlocked, or the alleged wrongdoer controls the board, this is a clear inference that proceedings will not be brought,[202] and is, of course, all the more easily satisfied when the allegations are that the directors have breached their duties.[203] If there is not a clear-cut refusal, the applicant bears the onus of establishing that refusal is to be inferred.[204] Lack of funding on the part of the company to commence litigation will also satisfy this criterion.[205]

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[194] *Charlton v Baber* (2003) 47 ACSR 31; (2003) 21 ACLC 1671; [2003] NSWSC 745 at [31]; *Chapman v E-Sports Club Worldwide Ltd* (2000) 35 ACSR 462; [2000] VSC 403 at [5].
[195] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [26]; *Cannon Street Pty Ltd v Karedis* [2004] QSC 104 at [178].
[196] Section 237(2)(a).
[197] Hargovan, above n 72 at 643.
[198] *Karam v Australia & New Zealand Banking Group Ltd* (2000) 34 ACSR 545; [2000] NSWSC 596 at [34].
[199] (2003) 47 ACSR 31; (2003) 21 ACLC 1671; [2003] NSWSC 745 at [39].
[200] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [28].
[201] Cf *Braga v Braga Consolidated Pty Ltd* [2002] NSWSC 603 at [5], *Brightwell v RFB Holdings Pty Ltd (in liq)* (2003) 171 FLR 464; (2003) 44 ACSR 186; (2003) 21 ACLC 355; [2003] NSWSC 7 at [27], *Charlton v Baber* (2003) 47 ACSR 31; (2003) 21 ACLC 1671; [2003] NSWSC 745 at [35]; *Isak Constructions (Aust) Pty Ltd v Faress* (2003) 47 ACSR 224; [2003] NSWSC 784 at [11]-[12], *Mhanna v Sovereign Capital Ltd* [2004] FCA 1040 at [10].
[202] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [31]; *Cannon Street Pty Ltd v Karedis* [2004] QSC 104 at [145]; *Braga v Braga Consolidated Pty Ltd* [2002] NSWSC 603 at [5]; *Lakshman v Law Image Pty Ltd* [2002] NSWSC 888 at [22]; *Reale v Duncan Reale Pty Ltd* [2005] NSWSC 174 at [10], *Saltwater Studios Pty Ltd v Hathaway* [2004] QSC 435 at [6]; *Metyor Inc (formerly Talisman Technologies Inc) v Queensland Electronic Switching Pty Ltd* [2002] QCA 269; [2003] 1 Qd R 186; (2002) 42 ACSR 398; (2002) 20 ACLC 1517 at [9]; *RTP Holdings Pty Ltd v Roberts* (2000) 36 ACSR 170; [2000] SASC 386 at [19].
[203] *Herbert v Redemption Investments Ltd* [2002] QSC 340 at [26]; Shelley Bielefeld, Sue Higginson, Jim Jackson and Aidan Ricketts, 'Directors' Duties to the Company and Minority Shareholder Environmental Activism' (2005) 23 *Company and Securities Law Journal* 28 at 41.
[204] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [29].
[205] *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 51 ACSR 299 at [9].

(b) Applicant's good faith

The court must be satisfied that 'the applicant is acting in good faith'.[206] Good faith concerns the subjective motivation of the applicant for leave.[207] Generally speaking, the courts have held that an applicant is acting in good faith unless some factor or inference establishes lack of good faith.[208] For example, in *BL & GY International Co Ltd v Hypec Electronics Pty Ltd*, Einstein J held that there were 'no indications that Mr Mead is acting otherwise than in good faith'.[209]

The leading discussion of good faith is Palmer J's widely followed approach in *Swansson v Pratt*.[210] There are two factors to which the courts will have regard in considering good faith:

> The first is whether the applicant honestly believes that a good cause of action exists and has a reasonable prospect of success. Clearly, whether the applicant honestly holds such a belief would not simply be a matter of bald assertion: the applicant may be disbelieved if no reasonable person in the circumstances could hold that belief. The second factor is whether the applicant is seeking to bring the derivative suit for such a collateral purpose as would amount to an abuse of process.[211]

(1) The honest belief of the applicant

Although mere bald assertion is not sufficient to establish honest belief,[212] an honest belief can be satisfied on very low evidence. In *Lakshman v Law Image Pty Ltd*, even though the plaintiff admitted that he had no evidence on which to ground his allegations,[213] the judge stated:

> I am satisfied that the plaintiff has an honest belief that Raj has not acted in the best interests of the company and has in fact acted contrary to its interests and that there is some basis for that belief.[214]

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[206] Section 237(2)(b).

[207] *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* [2001] QSC 324 at [31], see also *Saltwater Studios Pty Ltd v Hathaway* [2004] QSC 435 at [9].

[208] Cf *Reale v Duncan Reale Pty Ltd* [2005] NSWSC 174 at [10]; *Braga v Braga Consolidated Pty Ltd* [2002] NSWSC 603 at [6]; *Brightwell v RFB Holdings Pty Ltd (in liq)* (2003) 171 FLR 464; (2003) 44 ACSR 186; (2003) 21 ACLC 355; [2003] NSWSC 7 at [28]; *Charlton v Baber* (2003) 47 ACSR 31; (2003) 21 ACLC 1671; [2003] NSWSC 745 at [44]; *Herbert v Redemption Investments Ltd* [2002] QSC 340 at [30]; *Isak Constructions (Aust) Pty Ltd v Faress* (2003) 47 ACSR 224; [2003] NSWSC 784 at [13]; *Prendergast v DaimlerChrysler Australia Pacific Pty Ltd* [2004] NSWSC 131 at [97].

[209] (2001) 164 FLR 268; (2001) 19 ACLC 1622; [2001] NSWSC 705 at [89]. See similar statements in *Braga v Braga Consolidated Pty Ltd* [2002] NSWSC 603 at [6].

[210] Followed in *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457; (2004) 51 ACSR 299; (2004) 23 ACLC 93; [2004] NSWSC 1007 at [22]; *Charlton v Baber* (2003) 47 ACSR 31; (2003) 21 ACLC 1671; [2003] NSWSC 745 at [40]; *Goozee v Graphic World Group Holdings Pty Ltd* (2002) 170 FLR 451; (2002) 42 ACSR 534; (2002) 20 ACLC 1502; [2002] NSWSC 640 at [56]; *Fiduciary Ltd v Morningstar Research Pty Ltd* (2005) 53 ACSR 732; [2005] NSWSC 442 at [21]; *Herbert v Redemption Investments Ltd* [2002] QSC 340 at [27]; *Isak Constructions (Aust) Pty Ltd v Faress* (2003) 47 ACSR 224; [2003] NSWSC 784 at [13]; *Lakshman v Law Image Pty Ltd* [2002] NSWSC 888 at [23].

[211] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [36].

[212] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [36]; *Fiduciary Ltd v Morningstar Research Pty Ltd* (2005) 53 ACSR 732; [2005] NSWSC 442 at [22].

[213] *Lakshman v Law Image Pty Ltd* [2002] NSWSC 888 at [23].

[214] Ibid at [26].

However, other cases have held that if there is no evidence to support the applicant's claims, the court will infer that there was no honest belief.[215] Reliance on advice from counsel which is reasonably based on factual evidence can indicate honest belief.[216]

(2) Collateral purpose

Seeking to bring an action for an ulterior purpose will establish lack of good faith.[217] In considering ulterior purposes the courts apply the principles of abuse of process set out in *Williams v Spautz*.[218] In that case Mason CJ, Dawson, Toohey and McHugh JJ said that an abuse of process is:

> when the purpose of bringing the proceedings is not to prosecute them to a conclusion but to use them as a means of obtaining some advantage for which they are not designed or some collateral advantage beyond what the law offers.[219]

Judicial examination shows that acting for a collateral purpose means pursuing interests other than those of the company.[220] Good faith means that the application is being made in good faith having regard to the interests of the company.[221] The concept of good faith is inextricably linked with the obligations to act honestly and for no ulterior purpose.[222]

In seeking to determine whether the applicant is bringing an action for an ulterior purpose, courts may use evidence to draw inferences about the motives of the applicant.[223] Not filing an affidavit or appearing can be evidence of lack of good faith.[224] In *Swansson*, it was said that it will be relatively easy for the applicant to demonstrate good faith where:

(1) the applicant is a current shareholder of the company who has more than a token shareholding and the derivative action seeks recovery of property so that the value of the applicant's share would be increased; or

(2) the applicant is a current director or officer of the company and the applicant has a legitimate interest in the welfare and good management of the company, which warrants litigation to recover property or ensure that the majority of the shareholders or of the board of directors do not act unlawfully to the detriment of the company as a whole.[225]

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[215] *Goozee v Graphic World Group Holdings Pty Ltd* (2002) 170 FLR 451; (2002) 42 ACSR 534; (2002) 20 ACLC 1502; [2002] NSWSC 640 at [57].
[216] *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457; (2004) 51 ACSR 299; (2004) 23 ACLC 93; [2004] NSWSC 1007 at [23].
[217] *Cannon Street Pty Ltd v Karedis* [2004] QSC 104 at [172]-[175].
[218] (1992) 174 CLR 509.
[219] Ibid at 526-7.
[220] *Fiduciary Ltd v Morningstar Research Pty Ltd* (2005) 53 ACSR 732; [2005] NSWSC 442 at [21].
[221] *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* [2001] QSC 324 at [27]; *Cannon Street Pty Ltd v Karedis* [2004] QSC 104 at [169]-[175].
[222] *Cannon Street Pty Ltd v Karedis* [2004] QSC 104 at [175].
[223] Cf *Chapman v E-Sports Club Worldwide Ltd* (2000) 35 ACSR 462; [2000] VSC 403 at [10]-[11]; *Cannon Street Pty Ltd v Karedis* [2004] QSC 104 at [180]; *Hassall v Speedy Gantry Hire Pty Ltd* [2001] QSC 327 at [14]; *Goozee v Graphic World Group Holdings Pty Ltd* (2002) 170 FLR 451; (2002) 42 ACSR 534; (2002) 20 ACLC 1502; [2002] NSWSC 640 at [68].
[224] *Chapman v E-Sports Club Worldwide Ltd* (2000) 35 ACSR 462; [2000] VSC 403.
[225] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [38].

Although it can be possible for an applicant to satisfy the requirement of good faith even when they have no financial interest in the company and no present involvement in its management:[226]

> where the applicant is a former shareholder or officer with nothing obvious to gain directly by the success of the derivative action, the court will scrutinise with particular care the purpose for which the derivative action is said to be brought.[227]

There is a degree of overlap between the requirement of good faith, the requirement that the action be in the best interests of the company, and also the requirement that there be a serious question to be tried. This is because:

> …the strength of the case, at a prima facie level, will have a bearing on the question whether it is in the best interests of the company that the case be run and this, in turn, will reflect on matters of motive and purpose that are relevant to the good faith question.[228]

Our research indicates that where the applicant failed to satisfy the court of one leave criterion, often other leave criteria were not satisfied also, which reveals the close relationship of the leave criteria.

(c) Best interests of the company

The court must be satisfied that 'it is in the best interests of the company that the applicant be granted leave'.[229] This has proven to be the criterion which has occasioned the most difficulty for the courts. This criterion:

> …allow[s] the Court to focus on the true nature and purpose of the proceedings. It would recognise that a company might have sound business reasons for not pursuing a cause of action open to it and that its management might legitimately have decided that the best interests of the company would be served by not taking action.[230]

Presumably this criterion has the financial state of the company in mind, but the closest the courts have come to defining the best interests of the company is to state that the best interests of the company is concerned with the welfare of the company.[231] Continuing to trade profitably is obviously in the best interests of the company.[232] Where a company is being wound up or is insolvent, its best interests are regarded as reflecting predominantly the interests of its creditors.[233]

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[226] Ibid at [34].
[227] Ibid at [39].
[228] *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457; (2004) 51 ACSR 299; (2004) 23 ACLC 93; [2004] NSWSC 1007 at [10]; *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* [2001] QSC 324 at [31]; *Saltwater Studios Pty Ltd v Hathaway* [2004] QSC 435 at [7].
[229] Section 237(2)(c).
[230] Explanatory Memorandum to the *Corporate Law Economic Reform Program Bill 1999 (Cth)* at [6.38].
[231] *Charlton v Baber* (2003) 47 ACSR 31; (2003) 21 ACLC 1671; [2003] NSWSC 745 at [52].
[232] *Goozee v Graphic World Group Holdings Pty Ltd* (2002) 170 FLR 451; (2002) 42 ACSR 534; (2002) 20 ACLC 1502; [2002] NSWSC 640 at [73].
[233] *Charlton v Baber* (2003) 47 ACSR 31; (2003) 21 ACLC 1671; [2003] NSWSC 745 at [53]; *Mhanna v Sovereign Capital Ltd* [2004] FCA 1040 at [11]; *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457; (2004) 51 ACSR 299; (2004) 23 ACLC 93; [2004] NSWSC 1007 at [19].

Whereas good faith under s 237(2)(b) concerns the subjective motivation of the applicant, s 237(2)(c) is an objective test.[234] Section 237(2)(c):

> …requires the court to be satisfied, not that the proposed derivative action *may be, appears to be*, or *is likely to be*, in the best interests of the company but, rather, that it is in its best interests.[235]

The inquiry 'is not an inquiry into possibility or potential'.[236] It must be found, on the balance of probabilities,[237] that 'pursuit of the particular legal action will positively serve the "best interests" of the company'.[238] This is a higher threshold than that of Canadian, New Zealand and Singapore legislation, which require that the action be in the *interests* of the company.[239] It was held in *Swansson* that in considering the best interests of the company, evidence will be required as to the following matters:[240]

- the character of the company;
- evidence of the business of the company;
- whether redress is available through other means; and
- the ability of the defendant to meet the judgment – ie the practical benefit of bringing the action.

These matters have not received systematic treatment in the cases, although some of the matters have been significant in certain cases. For example, where alternative proceedings are available or on foot, and these present a genuine prospect of recovery and are capable of granting a suitable remedy, an action under Part 2F.1A will not be in the best interests of the company.[241] In *Goozee*, the relief sought would have meant the winding up of a group of companies that were trading profitably. There was no basis for considering that to be in the best interests of those companies.[242]

The fact that the applicant has a personal claim against the company does not automatically disqualify the applicant:

> It cannot be said that merely because the applicant may also have a personal claim against the companies that it is not in the best interests of the companies to grant the application.[243]

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[234] *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* [2001] QSC 324 at [31].
[235] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [55].
[236] *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457; (2004) 51 ACSR 299; (2004) 23 ACLC 93; [2004] NSWSC 1007 at [19].
[237] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [56].
[238] *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457; (2004) 51 ACSR 299; (2004) 23 ACLC 93; [2004] NSWSC 1007 at [19].
[239] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [56]; Choo, above n 61 at 76.
[240] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [56]-[60].
[241] *Hassall v Speedy Gantry Hire Pty Ltd* [2001] QSC 327 at [11]; *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313 at [66]; (2002) 20 ACLC 1594; [2002] NSWSC 583; *Chapman v E-Sports Club Worldwide Ltd* (2000) 35 ACSR 462; [2000] VSC 403 at [15].
[242] *Goozee v Graphic World Group Holdings Pty Ltd* (2002) 170 FLR 451; (2002) 42 ACSR 534; (2002) 20 ACLC 1502; [2002] NSWSC 640 at [73].
[243] *Saltwater Studios Pty Ltd v Hathaway* [2004] QSC 435 at [10].

One judge held that internal disputes should be resolved before it can be determined what the best interests of the company are. On appeal, McPherson JA stated:

> To require that disputes between members be resolved before leave is granted to bring proceedings on behalf of the company would defeat the very purpose which those statutory provisions are designed to serve.[244]

He went on to say:

> …it appears to me it is just such a case as this that is contemplated by ss 236 and 237 as one in which it is in the best interests of the company that the plaintiffs should be granted leave to proceed on behalf of the company. There are two conflicting groups of shareholders, of whom one is, as the minority, unable to set the company in motion to vindicate its rights because the majority, who are alleged to be the wrongdoers, oppose the company's doing so.[245]

This can require a court to make a judgment as to the best interests of the company in circumstances in which the directors have been unable to do so.[246]

The question of the best interests of the company does not involve a cost-benefit analysis:

> I cannot accept that … what s 237(2)(c) has in mind is some kind of cost-benefit analysis of possible outcomes of the prospective litigation, which is an assessment that it would be almost impossible to make with any degree of confidence or accuracy.[247]

The strength of the case is directly relevant to the question of the best interests of the company: 'the strength of the case, at a prima facie level, will have a bearing on the question whether it is in the best interests of the company that the case be run'.[248] A consideration of whether an action is in the best interests of the company, then, must require the court to consider the strength of the case. If there is little probability of the action succeeding, it will obviously not be in the best interests of the company to bring it.[249]

Moreover, the Explanatory Memorandum contemplates a court weighing up the benefit of an action versus any potential detriment:

> This criterion … would recognise that a company might have sound business reasons for not pursuing a cause of action open to it … For example, a decision may be taken in a case where, although it may be clear that there has been a breach of duty by a director, the loss to the company may only be nominal. In this case, the costs of taking proceedings may outweigh any benefit to the company.[250]

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[244] *Metyor Inc (formerly Talisman Technologies Inc) v Queensland Electronic Switching Pty Ltd* [2002] QCA 269; [2003] 1 Qd R 186; (2002) 42 ACSR 398; (2002) 20 ACLC 1517 at [10].
[245] Ibid at [19].
[246] Cf *Prendergast v DaimlerChrysler Australia Pacific Pty Ltd* [2004] NSWSC 131 at [96], [98]-[99].
[247] *Metyor Inc (formerly Talisman Technologies Inc) v Queensland Electronic Switching Pty Ltd* [2002] QCA 269; [2003] 1 Qd R 186; (2002) 42 ACSR 398; (2002) 20 ACLC 1517 at [19].
[248] *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457; (2004) 51 ACSR 299; (2004) 23 ACLC 93; [2004] NSWSC 1007 at [10].
[249] *Herbert v Redemption Investments Ltd* [2002] QSC 340 at [37]-[38].
[250] Explanatory Memorandum to the *Corporate Law Economic Reform Program Bill 1999 (Cth)* at [6.38].

(d) A serious question to be tried

The court must be satisfied that 'if the applicant is applying for leave to bring proceedings – there is a serious question to be tried'.[251] The Explanatory Memorandum states:

> It is important in this regard that the application for leave to take proceedings is not turned into a trial of the substantive issues, without the applicant having the usual plaintiff's right to pre trial discovery and interrogatories. The applicant is simply required to show that proceedings should be commenced. On the other hand, this criterion would prevent the proceedings being abused by further frivolous or vexatious claims.[252]

The serious question to be tried criterion was adopted by the legislature because of its existing place in civil procedure.[253] Applying these established principles, the applicant must show 'sufficient colour of right to the final relief, in aid of which interlocutory relief is sought'.[254] Section 237(2)(d) requires some consideration of the merits of the case, but the courts are keen to avoid turning this into a mini-trial of the issues:[255]

> In order to ascertain whether there is a serious question to be tried for the purposes of s 237(2)(d), the court will not normally enter into the merits of the proposed derivative action to any great degree. The applicant has the same relatively low threshold to surmount as in the case of an application for an interlocutory injunction … cross-examination on the merits of the proposed derivative action will usually be permitted only with leave of the court and to a limited extent. [256]

Some degree of assurance, based on reliable evidence, is necessary to demonstrate that the proposed action is viable.[257] Although it has been described as a low threshold,[258] the discussion in *Charlton*, and the approach in other cases, would seem to suggest that a reasonable body of evidence is required to satisfy the court there is a serious question to be tried, although the merits of the claim will not be discussed in great detail.[259] Other cases have considered in some detail the merits of the proposed claim.[260] The approach of the

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[251] Section 237(2)(d).

[252] Explanatory Memorandum to the *Corporate Law Economic Reform Program Bill 1999 (Cth)* at [6.46].

[253] Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action* (July 1993) at 16; Explanatory Memorandum to the *Corporate Law Economic Reform Program Bill 1999 (Cth)* at [6.46]; *Goozee v Graphic World Group Holdings Pty Ltd* (2002) 170 FLR 451; (2002) 42 ACSR 534; (2002) 20 ACLC 1502; [2002] NSWSC 640 at [32]-[34]; *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [24]-[25]; *Reale v Duncan Reale Pty Ltd* [2005] NSWSC 174 at [11].

[254] *ABC v Lenah Game Meats Pty Ltd* (2001) 208 CLR 199 at 217 (Gleeson CJ), quoted in *Charlton v Baber* (2003) 47 ACSR 31; (2003) 21 ACLC 1671; [2003] NSWSC 745 at [55].

[255] Cf *Hurley v BGH Nominees Pty Ltd* (1982) 1 ACLC 387 at 394: 'in many 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'.

[256] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [25].

[257] *Herbert v Redemption Investments Ltd* [2002] QSC 340 at [34], [38].

[258] *Resource Equities Ltd v Western Ventures Pty Ltd* (2004) 51 ACSR 436; [2004] WASCA 242 at [15]; *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457; (2004) 51 ACSR 299; (2004) 23 ACLC 93; [2004] NSWSC 1007 at [17].

[259] *Charlton v Baber* (2003) 47 ACSR 31; (2003) 21 ACLC 1671; [2003] NSWSC 745; *Chapman v E-Sports Club Worldwide Ltd* (2000) 35 ACSR 462; [2000] VSC 403 at [13]-[14]; *Lakshman v Law Image Pty Ltd* [2002] NSWSC 888 at [15], [29]; *Carpenter v Pioneer Park Pty Ltd (in liq)* (2004) 211 ALR 457; (2004) 51 ACSR 299; (2004) 23 ACLC 93; [2004] NSWSC 1007 at [16].

[260] *Mhanna v Sovereign Capital Ltd* [2004] FCA 1300 at [24], [31]; *Prendergast v DaimlerChrysler Australia Pacific Pty Ltd* [2004] NSWSC 131; *BL & GY International Co Ltd v Hypec Electronics Pty Ltd* (2001) 164 FLR 268; (2001) 19 ACLC 1622; [2001] NSWSC 705.

courts is expressed by Einstein J in *BL & GY International Co Ltd v Hypec Electronics Pty Ltd*:

> The claims sought to be litigated by Hypec Electronics appear at least on the materials and evidence adduced on the applications, to have a solid foundation in terms of giving rise to a serious dispute… Whether the material presently before the Court will ultimately withstand the heat of litigious contest is of course another matter.[261]

(e) Notice of proceedings to company

The court must be satisfied either that 'at least 14 days before making the application, the applicant gave written notice to the company of the intention to apply for leave and of the reasons for applying' or that 'it is appropriate to grant leave' even though notice was not given.[262] This requirement 'allows the company time to address the applicant's concerns prior to the hearing date'.[263] The courts have shown willingness to grant leave even if the notice requirement has not been satisfied.[264]

The fullest consideration of this provision was given by Barrett J in *Isak*:

> I agree that there is no point in insisting on form merely for form's sake. At the same time, however, the discretion conferred by s 237(2)(e)(ii) must be exercised with the objectives of s 237(2)(e)(i) in mind. Those objectives entail awareness by the company concerned not only of the applicant's intention to seek leave under the section but also of the reasons for the application. A decision under s 237(2)(e)(ii) effectively to dispense with those requirements would, it seems to me, be justified only where it was clear to the court that the company was already aware of the matters with which s 237(2)(e)(i) is concerned or that there was some good reason to allow the applicant to represent the company despite its not being so aware.[265]

Conclusions on Leave Criteria

Of derivative litigation in Canada, it has been said that:

> …the practical reality is that the merits of the lawsuit have become a significant, costly and time-consuming battleground in leave proceedings … enormous amounts of time and money [are expended] in pursuing the factual minutia.[266]

In Australia, it seems this has not occurred although a reasonable evidentiary burden lies on any applicant.[267] Failure to muster enough evidence will lead to the rejection of the

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[261] *BL & GY International Co Ltd v Hypec Electronics Pty Ltd* (2001) 164 FLR 268; (2001) 19 ACLC 1622; [2001] NSWSC 705 at [75].
[262] Section 237(2)(e).
[263] Explanatory Memorandum to the *Corporate Law Economic Reform Program Bill 1999 (Cth)* at [6.49].
[264] *Braga v Braga Consolidated Pty Ltd* [2002] NSWSC 603 at [8]; *Brightwell v RFB Holdings Pty Ltd (in liq)* (2003) 171 FLR 464; (2003) 44 ACSR 186; (2003) 21 ACLC 355; [2003] NSWSC 7 at [34]; *Prendergast v DaimlerChrysler Australia Pacific Pty Ltd* [2004] NSWSC 131 at [100]; *RTP Holdings Pty Ltd v Roberts* (2000) 36 ACSR 170; [2000] SASC 386 at [25]; *Karam v Australia & New Zealand Banking Group Ltd* (2000) 34 ACSR 545; [2000] NSWSC 596 at [35]; *Saltwater Studios Pty Ltd v Hathaway* [2004] QSC 435 at [5]; *Lakshman v Law Image Pty Ltd* [2002] NSWSC 888 at [20].
[265] *Isak Constructions (Aust) Pty Ltd v Faress* (2003) 47 ACSR 224; [2003] NSWSC 784 at [21].
[266] Kaplan and Elwood, above n 5 at 460.
[267] *Chapman v E-Sports Club Worldwide Ltd* (2000) 35 ACSR 462; [2000] VSC 403 at [13]-[14]; *Charlton v Baber* (2003) 47 ACSR 31; (2003) 21 ACLC 1671; [2003] NSWSC 745; *Unconventional Conventions Pty Ltd v Accent Oz Pty Ltd* (2004) 52 ACSR 95; [2004] NSWSC 1101 at [9].

application[268] or its adjournment.[269] Some cases have subjected the criteria to extensive scrutiny.[270] If the defendants accept that the criteria have been met, the court will be likely to accept that the criteria have been satisfied, however, some evidence may be necessary.[271] In *BL & GY International Co Ltd v Hypec Electronics Pty Ltd*, Einstein J stated that 'the Court ought … to closely consider the matters identified in subs 2(a) – subs 2(d)'.[272] In other cases the leave criteria received scant consideration. In *Keyrate*, the court said only: 'I am satisfied as to the matters pursuant to s 237(2)',[273] although it should be noted that the defendants had accepted that the other preconditions save s 237(2)(c) were met. In *Karam*, the court said: 'I am equally satisfied that paras (b), (c) and (d) would be satisfied'.[274]

Our research indicates that leave applications are not turning into expensive and lengthy "mini-trials". Rather, the length of the hearings and the judicial scrutiny of the proposed actions reflect the complexity of the cases. In general, we suggest the criteria are being applied appropriately to achieve the purposes which they are designed to achieve.

Transitional Issues

Part 2F.1A replaces the pre-existing law dealing with derivative actions.[275] In several cases difficulties have confronted the courts when the acts complained of were committed before Part 2F.1A came into operation, but the application for leave was brought after it came into operation. In *Advent Investors*, Warren J held that Part 2F.1A is a procedural provision and therefore applies retrospectively to causes of action arising prior to the commencement of Part 2F.1A:

> The essential point is that as stated by Mandie J [in *Chapman v E-Sports Club*], the statutory derivative action has displaced the common law derivative action. Part 2F.1A is clearly a procedural provision. It does not purport to alter the substantive rights and liabilities of a company that could previously have been enforced by a plaintiff, who was given standing to bring a derivative action on behalf of the company under an exception to the rule in *Foss v Harbottle*. In this context, Pt 2F.1A provides for a new procedure by which proceedings might be brought on behalf of the company.[276]

In *Swansson*, Palmer J held:

> The acts of which Ms Swansson complains occurred in 1994. Whatever entitlement she had from that time onwards to bring a derivative action in the name of [the company] against

[268] *Chapman v E-Sports Club Worldwide Ltd* (2000) 35 ACSR 462; [2000] VSC 403 at [13]; *Herbert v Redemption Investments Ltd* [2002] QSC 340 at [34]; *Unconventional Conventions Pty Ltd v Accent Oz Pty Ltd* (2004) 52 ACSR 95; [2004] NSWSC 1101 at [9].
[269] *Glodale Pty Ltd v McLellan* [2003] QSC 261.
[270] *Fiduciary Ltd v Morningstar Research Pty Ltd* (2005) 53 ACSR 732; [2005] NSWSC 442; *BL & GY International Co Ltd v Hypec Electronics Pty Ltd* (2001) 164 FLR 268; (2001) 19 ACLC 1622; [2001] NSWSC 705.
[271] *Fiduciary Ltd v Morningstar Research Pty Ltd* (2005) 53 ACSR 732; [2005] NSWSC 442 at [17]; *Karam v Australia & New Zealand Banking Group Ltd* (2000) 34 ACSR 545; [2000] NSWSC 596 at [35]; *Keyrate Pty Ltd v Hamarc Pty Ltd* (2001) 38 ACSR 396; [2001] NSWSC 491 at [23]; *Prendergast v DaimlerChrysler Australia Pacific Pty Ltd* [2004] NSWSC 131 at [97].
[272] *BL & GY International Co Ltd v Hypec Electronics Pty Ltd* (2001) 164 FLR 268; (2001) 19 ACLC 1622; [2001] NSWSC 705 at [71].
[273] *Keyrate Pty Ltd v Hamarc Pty Ltd* (2001) 38 ACSR 396; [2001] NSWSC 491 at [31].
[274] *Karam v Australia & New Zealand Banking Group Ltd* (2000) 34 ACSR 545; [2000] NSWSC 596 at [35].
[275] *Braga v Braga Consolidated Pty Ltd* [2002] NSWSC 603 at [2].
[276] *Advent Investors Pty Ltd v Goldhirsch* (2001) 37 ACSR 529 at [40].

> Mr Highland under any of the exceptions to the rule in *Foss v Harbottle* (1843) 2 Hare 461; 67 ER 189 has now been superseded by the provisions of CA Pt 2F.1A: s 236(3).[277]

In *Karam*, Santow J considered the history of Part 2F.1A and its remedial purpose, and concluded that the statutory derivative action had retrospective application and therefore displaced any potential recourse to the exceptions to the rule in *Foss v Harbottle* for the plaintiffs.[278] However, the fact that a common law derivative action has actually been commenced may lead to a different conclusion. In *Brightwell* Austin J held:

> [there] may be cases where the application of Pt 2F.1A to displace an existing derivative proceeding would deprive the plaintiffs of substantive rights, contrary to the remedial purpose of the new provisions… This suggests that Pt 2F.1A might be taken not to prevent a general law derivative action from going forward where the action is properly constituted under the general law principles and the subject-matter can be seen to confer rights on the plaintiffs as well as on the company which they seek to represent.[279]

In *Karam* and *Swansson* the court was being asked to constitute the proceeding as a derivative proceeding for the first time, so the court would not be taking away the plaintiffs' rights to continue with a properly constituted general law proceeding.[280] But in *Cadwallader*[281] and *Shum Yip*,[282] the proceedings had been properly constituted under the general law. Section 236(3) is not to be read to operate to discontinue proceedings which are already on foot, which would countermand the remedial legislative purpose.[283] The decisions in these cases seem to conflict with *Advent Investors*, where the court held that 's 236(3) … was intended to apply to events that existed prior to 13 March 2000, that is, to existing common law derivative proceedings' and stayed an existing common law derivative action.[284]

Can a Company be a Defendant in the Proceedings when Proceedings are Brought in its Name?

Section 236(2) provides that proceedings brought on behalf of a company must be brought in the company's name. Hamilton J has held that 'the proceedings for which leave was granted must always be proceedings brought in the name of the company'.[285] In *Metyor,* it was held that Part 2F.1A allows a company to be joined as co-defendant and is not confined to

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[277] *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313; (2002) 20 ACLC 1594; [2002] NSWSC 583 at [19].
[278] *Karam v Australia & New Zealand Banking Group Ltd* (2000) 34 ACSR 545; [2000] NSWSC 596 at [31].
[279] *Brightwell v RFB Holdings Pty Ltd (in liq)* (2003) 171 FLR 464; (2003) 44 ACSR 186; (2003) 21 ACLC 355; [2003] NSWSC 7 at [40], referring to *Cadwallader v Bajco* (2001) 189 ALR 370; [2001] NSWSC 1193; *Shum Yip Properties Development Ltd v Chatswood Investment & Development Co Pty Ltd* (2002) 40 ACSR 619; [2002] NSWSC 13 and *Karam v Australia & New Zealand Banking Group Ltd* (2000) 34 ACSR 545; [2000] NSWSC 596.
[280] *Brightwell v RFB Holdings Pty Ltd (in liq)* (2003) 171 FLR 464; (2003) 44 ACSR 186; (2003) 21 ACLC 355; [2003] NSWSC 7 at [40].
[281] *Cadwallader v Bajco* (2001) 189 ALR 370; [2001] NSWSC 1193.
[282] *Shum Yip Properties Development Ltd v Chatswood Investment & Development Co Pty Ltd* (2002) 40 ACSR 619; [2002] NSWSC 13.
[283] *Cadwallader v Bajco* (2001) 189 ALR 370; [2001] NSWSC 1193 at [240].
[284] *Advent Investors Pty Ltd v Goldhirsch* (2001) 37 ACSR 529 at [48].
[285] *Unconventional Conventions Pty Ltd v Accent Oz Pty Ltd* (2004) 52 ACSR 95; [2004] NSWSC 1101 at [6].

authorising proceedings to be brought on behalf of a company as plaintiff,[286] and Santow J in *Keyrate* held that s 236(2) does not require in every case 'that the company be actually made a plaintiff in a fresh summons or statement of claim, if it is already a defendant against whom relief is claimed'.[287] Barrett J stated in *Charlton v Baber*:

> The circumstance that [the company] is, at the same time, both a potential plaintiff and a potential defendant…, although perhaps at odds with a literal reading of s 236(2), … is a course sanctioned by Santow J in *Keyrate*…, a decision subsequently endorsed by the Queensland Court of Appeal in *Metyor*… which, in turn, was followed by Windeyer J in *Lakshman*… . *Keyrate* was followed by Austin J in *Brightwell*.[288]

V Conclusion

The key findings of the empirical study of the statutory derivative action judgments are the following:

- There have been only 31 judgments delivered during the period from 13 March 2000 (the introduction of Part 2F.1A) to August 2005. This is a modest number of judgments By way of comparison, for the period 1995 to 1999 (the 5 years immediately preceding the introduction of the statutory derivative action) there were 30 judgments in which *Foss v Harbottle* was considered. This indicates that when a similar period of years is examined, the statutory derivative action is not resulting in a greater number of judgments than the common law derivative action (represented by *Foss v Harbottle*) which it replaced.
- Most judgments (almost 60%) have been delivered by the Supreme Court of New South Wales.
- Part 2F.1A allows a member or officer (or former member or officer) to apply to bring a derivative action. Almost all applicants are shareholders. In 16 of the 31 cases the applicant was a current or former director and in 15 of these 16 cases the director was also a shareholder.
- Part 2F.1A mostly involves private companies (87% of the cases involve private companies).
- 32% of the cases involve a company which was under some form of external administration.
- In terms of allegations pleaded, the most common allegation was breach of directors' duties (52% of the cases).
- Leave was granted by the court in 61% of the cases.
- 77% of leave applications involved hearings of 2 days or less.
- Of the 19 cases in which the leave application was successful, in 4 of these cases (21%) the applicant was granted costs relating to the leave application with costs being reserved or not discussed in another 11 cases. In none of these 19 cases did the court, as part of granting the leave application, require the company to fund the applicant in relation to the substantive litigation to follow the leave application.

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[286] *Metyor Inc (formerly Talisman Technologies Inc) v Queensland Electronic Switching Pty Ltd* [2002] QCA 269; [2003] 1 Qd R 186; (2002) 42 ACSR 398; (2002) 20 ACLC 1517 at [14]-[15].
[287] *Keyrate Pty Ltd v Hamarc Pty Ltd* (2001) 38 ACSR 396; [2001] NSWSC 491 at 398-400.
[288] *Charlton v Baber* (2003) 47 ACSR 31; (2003) 21 ACLC 1671; [2003] NSWSC 745 at [5], case citations omitted.

The results of the empirical study indicate that the statutory derivative action has brought benefits to shareholders although it appears to have had only a modest impact upon shareholder litigation in Australia in terms of the number of judgments. In particular, the statutory derivative action has brought greater clarity and certainty to an area of law which previously was renown for its complexity.[289]

[289] Cf Colin Baxter, 'The True Spirit of Foss v. Harbottle' (1987) 38 *Northern Ireland Legal Quarterly* 6.