

THE COST OF BRINGING A STATUTORY DERIVATIVE ACTION IN AUSTRALIA- IS IT TIME TO RECONSIDER THE TERMS OF SECTION 242 OF THE *CORPORATIONS ACT 2001*?

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I. INTRODUCTION

In Australia, the right to bring derivative actions at general law has been replaced by a statutory right to bring derivative actions. The procedure for bringing statutory derivative actions is set out in Part 2F.1A (sections 236 to 242) of the *Corporations Act 2001* (the Act).

Applicants as defined in s 236(1) (a) must first apply to the Court for leave ‘to bring or intervene in proceedings on behalf of a company’ (s 237(1)). The action is derivative because the applicant relies on a cause of action belonging to the company rather than a personal cause of action. The Court must grant the leave application if it is satisfied of the criteria set out in s 237(2) (a) to (e) (the leave criteria). The Court may make any order it considers appropriate regarding the costs of the application and the derivative action (s 242).

This paper considers the leave applications brought under Part 2F.1A from 2001 to 2006. Particular attention will be paid to the costs issues relating to statutory derivative actions. Given that statutory derivative actions must be brought in the company’s name and the company receives the benefit of a successful action, surprisingly few successful applications have included costs orders requiring the company to indemnify the applicant for all or part of the associated costs.¹

Also surprising is the fact that almost one third of leave applications have been made on behalf of companies in some form of administration.² The use of statutory derivative actions in this way was not originally contemplated but it now appears settled that statutory derivative actions are available in such circumstances.³

The Australian legislation has its roots in both the New Zealand and the Canadian legislation.⁴ The terms of Part 2F.1A are distinct however in some key areas - the priority of the company’s interests and the issue of costs. Where relevant this paper will make comparisons between the approaches of the courts in these countries.

¹ Ramsay, I and Saunders B, ‘Litigation by Shareholders and Directors: An Empirical Study of The Statutory Derivative Action’ Centre for Corporate Law and Securities Regulation, The University of Melbourne 2006 at 35

² Ramsay & Saunders, above n 1, table 6 at 27.

³ *Carpenter v Pioneer Park Pty Ltd (In Liq)* [2004] NSWSC 1007 at [8] “the question should now be regarded as settled”.

⁴ *Companies Act 1993*(NZ); *Canadian Business Corporation Act 1985*.

The paper concludes with the suggestion that there are strong arguments to support a redrafting of s 242 to reflect the differing costs considerations that arise in relation to statutory derivative actions on behalf of companies under administration, compared with companies that are going concerns.

II. THE BACKGROUND: DERIVATIVE ACTIONS UNDER GENERAL LAW

Section 236(3) of the Act abolishes the right to bring a derivative action under general law. There remain only very limited circumstances where the rule in *Foss v Harbottle*⁵ continues to apply⁶. However, a brief consideration of the rule in *Foss v Harbottle* and the perceived deficiencies in derivative actions at general law provide useful background to understanding the terms of Part 2F.1A.

A. *The Rule in Foss v Harbottle and its Exceptions*

Derivative actions could only be brought at general law where an applicant could show that the particular circumstances fell within one of the exceptions to the rule in *Foss v Harbottle* (the rule). The rule had two aspects⁷ – ‘the proper plaintiff’ aspect and the ‘indoor management’ aspect. The proper plaintiff aspect formed the basis of the rule as it applied to derivative actions.

The rule applied where a cause of action belonged to a company. In such circumstances the rule held that the company was the proper plaintiff to bring an action. In *Foss v Harbottle*, Wigram V-C accepted that there could be exceptions to the rule and over time these exceptions were developed by the courts. English courts tended to recognise only four exceptions to the rule while a fifth exception was accepted in Australia.⁸

The significant exceptions of relevance were the fourth and fifth exceptions to the rule. The fourth exception allowed members to be co-joined with the company and bring derivative actions where fraud on the minority could be proved and the wrongdoers were in control of the company. The fifth exception allowed derivative actions where the interests of justice would be served.⁹

There was considerable uncertainty regarding the use of company funds to litigate derivative actions. In *Wallersteiner v Moir (No 2)*¹⁰ Lord Denning stated that applicants should be indemnified by the company for all costs incurred but should first satisfy the court by way of an ex parte application, that this was appropriate in the circumstances. English Courts tended to grant costs to applicants if they survived the

⁵ (1843) 67 ER 189; note however that the classic statement of the rule was not in the case itself but in *Edwards v Halliwell* [1950] 2 All ER 1064 at 1066; see Ramsay & Saunders, above n 1 at 10.

⁶ For example where a derivative action is to be brought on behalf of a corporation not meeting the definition of ‘company’ in s 9 of the Act - see *Carre v Owners Corporation* [2003] NSWSC 397.

⁷ See Austin, R and Ramsay, I ‘Ford’s Principles of Corporations Law’ 12th ed (2005) Reed International Books Australia Pty Ltd at [11.300].

⁸ See Ramsay & Saunders, above n 1 at 10.

⁹ The other so-called exceptions were actually circumstances where the rule did not operate.

¹⁰ [1975] QB 373.

sometimes lengthy process involved in determining the issue of standing.¹¹ Australian courts on the other hand were prepared to consider the substantive and standing issues together. While this had the effect of minimizing the impact of *Foss v Harbottle*, it also reduced the chances of the applicant having access to company funds to assist with the action.¹²

The rule and its exceptions were subjected to extensive criticism over many years yet the introduction of a statutory scheme for bringing derivative actions was not greeted with unanimous support.

B. *Main Criticisms of the Proposal to Introduce a Statutory Derivative Action*

Most of the opposition was based on the claim that a statutory scheme was unnecessary. The major arguments were that:

- 1 the rule in *Foss v Harbottle* could be and often was circumvented, particularly in Australia. Courts tended not to deal with standing as a preliminary issue or alternatively were prepared to use the fifth exception and allow derivative actions where to do so was in the interests of justice¹³; and
- 2 existing statutory remedies such as the oppression remedy in s 232 and the statutory injunction in s 1324 of the Act covered the inadequacies of derivative actions at general law.¹⁴

C. *Key Criticisms of the Derivative Action at General Law*

The statutory derivative action was introduced by the *Corporate Law Economic Reform Program Act 1999* (the CLERP Act) following a number of significant Reports¹⁵ where Australia 'placed the statutory derivative suit under the microscope'¹⁶.

¹¹ Based on establishing that the circumstances fell within one of the exceptions to the rule in *Foss v Harbottle*.

¹² See Sealy, L 'The Rule in *Foss v Harbottle*: the Australian Experience' (1989)10(3) *The Company Lawyer* 52 at 52.

¹³ Sealy, above n 8 at 52; Prince, P 'Australia's Statutory Derivative Action: Using the New Zealand Experience' 18 *C&SLJ* 493 at 497.

¹⁴ Baxt, R 'Do We Really Need a Statutory Exception to *Foss v Harbottle*?' (1994) 22 *ABLR* 298; see also Sealy above n 8 at 56; but others considered that it was the inadequacy of these remedies that lead to the introduction of statutory derivative actions- see Bottomley, S 'Shareholder Derivative Actions and Public Interest Suits: Two Versions of the Same Story' (1992) 15 *UNSWLJ* 127 at 144.

¹⁵ CLERP Proposals for Reform, Paper No 3 'Directors' Duties and Corporate Governance', 1997; Companies and Securities Advisory Committee 'Report on a Statutory Derivative Action', 1993; Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, 'Corporate Practices and the Rights of Shareholders', 1991; 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 1990.

¹⁶ De Vere Stevens, K 'Should We Toss *Foss*? Towards an Australian Statutory Derivative Action' (1997) 25 *ABLR* 127 at 127.

The Explanatory Memorandum identified three significant deficiencies in the derivative action¹⁷:

- 1 ratification or possible ratification by the general meeting caused significant barriers for applicants. A derivative action could only be brought if the impugned conduct was unable to be ratified by the company. Further complexity was caused by the uncertainty as to which acts and omissions were ratifiable;
- 2 the lack of access to company funds by shareholders to finance proceedings meant that the cost barriers could be prohibitive;
- 3 the requirement that the potential cause of action fell within the exceptions to the rule in *Foss v Harbottle* resulted in a 'profusion of muddle and ambiguity'¹⁸. To fall within the fraud on the minority exception for instance, an applicant had to prove both fraud and control of the company by the wrongdoers.¹⁹ The 'interests of justice' exception was uncertain as to its scope.

D. Has Part 2F.1A Addressed the Key Criticisms?

The problems associated with ratification or possible ratification have been overcome. While the Court may consider the issue of ratification, an applicant will not be prevented from bringing a statutory derivative action on this basis alone (s 239(1) and (2)).

The terms of Pt 2F.1A have also overcome the standing problems associated with the rule in *Foss v Harbottle*. Rather than having to contend with the difficulties and uncertainties surrounding the exceptions to the rule, an applicant must apply for leave to bring a statutory derivative action – the Court must grant leave if it is satisfied of the criteria set out in s 237(2).

Significant barriers still remain however where an applicant wishes to use company funds to meet the costs associated with statutory derivative actions. Ramsay pointed out almost fifteen years ago that the problems of costs needed to be addressed 'if shareholder litigation is to be meaningful'²⁰ and that the main impediment was not the deficiencies with the general law but rather 'a lack of incentives to commence litigation'²¹.

¹⁷ Explanatory Memorandum to the *Corporate Law Economic Reform Program Bill* at [6.15] accessed by <http://scaleplus.law.gov.au/html/ems/0/1998/0/0642378797.htm> last viewed 14/10/2006.

¹⁸ Sealy, above n 12 at 54.

¹⁹ Particularly as the English courts adopted a conservative approach to control requiring that the defendants control a majority of the voting shares- this point is made in Ramsay & Saunders, above n 1 at 10.

²⁰ Ramsay, I 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 UNSWLJ 149 at 150.

²¹ Ibid.

III. PT 2F.1A –WHAT IS THE PROCEDURE UNDER PART 2F.1A TO OBTAIN LEAVE TO BRING A STATUTORY DERIVATIVE ACTION?

A. *Who can make an application?*

S 236 (1)(a) sets out the categories of persons who may be permitted to bring proceedings on behalf of the company, or intervene in proceedings to which the company is a party. Such ‘persons’ must satisfy the court that they are either:

- (i) a member, former member, or person entitled to be registered as a member of the company or of a related body corporate; or
- (ii) An officer or former officer of the company²²

Predictably most applications for leave are brought by existing shareholders.²³ One commentator has stated ‘at heart, the derivative action is a remedy for shareholders who want to remain in the company and challenge the wrongdoing by directors’²⁴.

It is not necessary for the applicant to have been a shareholder or director at the time the alleged wrong against the company was committed. Interestingly and perhaps unfairly, where the applicant is a former officer of the company with nothing obvious to gain directly by the success of the derivative action, the onus on the applicant to satisfy the leave criteria appears higher. Particular attention will be paid, for instance to why the application is being made.²⁵

The personal qualities of the applicant are not relevant although the motives for bringing the application for leave are relevant. In *Maier v Honeysett Maier Electrical Contractors*²⁶ the suggestion was made by counsel that the wording in s 237 (2) (c):

it is in the best interests of the company that *the applicant* (emphasis added) be granted leave

requires a consideration of the personal qualities of the applicant. This suggestion was rejected by the Court.

There is a requirement to consider the suitability of the applicant to bring the action but this only extends as far as ensuring that the applicant is not pursuing a personal agenda at the expense of the best interests of the company as a whole.

²² Standing under general law derivative actions was limited to members. The draft legislation allowed a broader group including creditors to bring such actions but the final legislation restricted the categories to those listed in s.236 (1) (a).

²³ See Ramsay & Saunders, above n 1, table 4 at 26.

²⁴ Reisberg, A ‘Shareholders’ Remedies: In Search of Consistency of Principle in English Law’ (2005) EBLR 1065 at 1081.

²⁵ See for example *Fiduciary v Morningstar Research* [2004] NSWSC 664 at [34].

²⁶ [2005] NSWSC859 at [47].

While there must be a causative link between the wrongful actions and the company's harm, it is questionable whether the injury to the company has to have a connection with the status of the applicant. The decision in *Swansson v Pratt*²⁷ suggest so, however it is difficult to agree that such a restriction is necessary, given that the action is for the benefit of the company rather than the applicant.

B. *The Leave Criteria*

A person who has standing under s 236 (1) may apply to the court under s 237 for leave to bring or intervene in proceedings. Section 237 (2) states that:

the Court must grant the application for leave 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.

While the terms of s 237 do not make it clear whether the Court retains a residual discretion to grant leave in other circumstances, recent judicial interpretation of the section has consistently concluded that no such discretion exists.²⁸

Although leave applications can be determined ex parte, the company may be present asserting that the criteria have not been met. Where the company is in liquidation, the liquidator may oppose the application.²⁹ The courts have been reluctant however to include interested parties in the process where those parties are outside the company.³⁰

C. *How Have the Courts Interpreted and Applied the Leave Criteria to Date?*

The applicant must satisfy the Court, on the balance of probabilities, of all the requirements set out in the leave criteria of s 237(2).

1. *s 237(2) (a) - the Company Itself will not Bring the Proceedings*

This criterion has been described as 'the critical hurdle'³¹ because derivative actions can only be justified where the proper plaintiff (being the company) will not take the appropriate action. In practice only a small number of leave applications have been unsuccessful on this basis.³²

²⁷ [2002] NSWSC 583 at [42].

²⁸ See *Charlton v Baber* [2003] NSWSC 745 at [31].

²⁹ In *Carpenter v Pioneer Park Pty Ltd (In Liq)* [2004] NSWSC 1007 - in this case the liquidator opposed the leave application.

³⁰ See *Carpenter v Pioneer Park Pty Ltd (In Liq)* [2004] NSWSC 1007 at [16]. The provisions do not have in view the welfare or interests of persons who are 'outsiders'.

³¹ See *Karam v ANZ Banking Group Ltd* [2000] NSWSC 596.

³² See for example *Deangrove Pty Ltd (Rec and Mgrs Apted) v CBA* [2001] FCA 173.

Timing can be important to this determination. For instance if there is a dispute between directors or between shareholders that, if resolved would mean the company may bring the action itself, the relevant consideration in the leave application is not whether such possibility will transpire but rather ‘whether it is probable (now) that the company will not itself bring (or take responsibility for) proceedings.’³³ ‘Possible future eventualities’ only form one part of ‘the factual matrix upon which a judgment of the present possibilities is made.’³⁴ If the present situation is such that that the company is unlikely to bring the action, even if there is a chance that this may change in the future the criteria in s 237(2)(a) will be met.

Courts have been satisfied that the company will not bring the action where the defendant director is denying the allegations³⁵ or where the company is a closely held family company and the majority of the shareholders (being family members) do not wish the action to be taken³⁶ or where the company does not have sufficient funds to bring the action³⁷ or where the company is beset with internal divisions and unable to bring the action.³⁸

Since it is now clear that derivative actions can be brought when a company is in liquidation, it will be necessary to consider the views of the liquidator to determine whether the company in liquidation will bring the action. Where a company is in receivership this decision can still be made by the directors³⁹ but may also be made by the receiver. Therefore possible action by either party must be contemplated.

2. s.237 (2) (b) – the Applicant Must be Acting in Good Faith

The concept of ‘good faith’ does not require goodwill – ‘it is not the law that only a plaintiff who feels goodwill towards a defendant is entitled to sue’⁴⁰ - but it does stop at allowing applicants to act on a personal vendetta or use derivative actions to benefit from their own wrong doing.⁴¹ The judgments recognise that there is likely to be some element of personal motivation in bringing the action.

Good faith is ‘a question of fact as to the applicant’s motives in bringing the action’.⁴² Palmer J in *Swansson v Pratt*⁴³ provides some useful guidelines as to how to assess whether an applicant is acting in good faith for the purposes of a s 237 leave application. There are two interrelated factors that the court will consider:

- 1 Whether the applicant ‘honestly believes that a good cause of action exists and has a reasonable prospect of success.’ This is largely a subjective test to be determined by looking at the facts but has an objective element. It is necessary to

³³ *Maher v Honeysett Maher Electrical Contractors* [2005] NSWSC 859 at [26].

³⁴ *Carpenter v Pioneer Park Pty Ltd (In Liq)* [2004] NSWSC 1007 at [29].

³⁵ *Braga v Braga Consolidated Pty Ltd* [2002] NSWSC 603.

³⁶ *Swansson v Pratt* [2002] NSWSC 583.

³⁷ *Carpenter v Pioneer Park Pty Ltd (In Liq)* [2004] NSWSC 1007.

³⁸ *Foyster v Foyster Holdings* [2003] NSWSC 135.

³⁹ *Jeans v Deangrove P/L* [2001] NSWSC 84.

⁴⁰ *Swansson v Pratt* [2002] NSWSC 583 at [41].

⁴¹ See *Fiduciary v Morningstar Research* [2004] NSWSC 664 at [31].

⁴² *Fiduciary v Morningstar Research* [2004] NSWSC 664 at [29].

⁴³ [2002] NSWSC 583 at [36].

consider whether the applicant's belief is one that 'no reasonable person in the circumstances could hold'⁴⁴; and

2 Whether the applicant has a collateral purpose that would amount to an abuse of process.⁴⁵ Even if the applicant believes a good cause of action exists, the applicant will not be acting in good faith if the intention is to use the action for some type of personal advantage. The proceedings should be brought for the benefit of the company as a whole, not for the advantage of the applicant.

3. *s 237(2) (c) - It Must be in the Company's Best Interests that the Applicant be Granted Leave*

The language 'best interests' does not require evidence of 'some absolute or superlative' interest for the company although it is not sufficient to show that the application '*appears to be*' (emphasis in original) or '*is likely to be*' (emphasis in original) in the company's best interests.⁴⁶

Interestingly the Australian legislation differs from that of both Canada and New Zealand. In Canada the courts have to be satisfied that granting leave '*appears to be*' (emphasis added) in the company's best interests. In New Zealand the courts must have '*regard*' (emphasis added) to the company's interests.

Australia's draft legislation used the term '*appears*' (emphasis added) in the context of the company's best interests. The enquiry must not be into the potential of the action but instead 'it must be found that pursuit of the particular action will positively serve the '*best interests of the company* (emphasis added).' This is consistent with the approach taken to the applicant's good faith. It is not sufficient for instance to show a real chance that the company will gain from the proceedings if in fact the real gain is to *the applicant*.⁴⁷

The key issue is the context in which the leave is being sought⁴⁸ and a paramount concern for the company's 'separate and independent welfare'⁴⁹ rather than that of the applicant.⁵⁰

⁴⁴ *Maher v Honeysett Maher Electrical Contractors* [2005] NSWSC 859 at [31].

⁴⁵ The issue of collateral purpose was significant in *Carpenter v Pioneer Park Pty Ltd* [2004] NSWSC 1007 because the applicant was involved in a number of litigious contests with the potential defendant and stood to benefit personally if the derivative action proceeded. However the court was satisfied that the benefits of the derivative action were over and above the personal benefits to the applicant as the damages in this case could be very substantial.

⁴⁶ This point was made by Palmer J in *Swansson v Pratt* [2002] NSWSC 583 at [55]. This interpretation has subsequently received strong judicial support- see *Carpenter v Pioneer Park Pty Ltd* [2004] NSWSC 1007 at [18]. This interpretation of 'best interests' is also consistent with the approach taken by the courts in interpreting the concept for the purposes of assessing possible breaches of directors duties under s 181.

⁴⁷ See *Maher v Honeysett Maher Electrical Contractors* [2005] NSWSC 859 at [52].

⁴⁸ *Charlton v Baber* [2003] NSWSC 745 at [46].

⁴⁹ *Jeans v Deangrove P/L* [2001] NSWSC 84 at [52].

⁵⁰ The consideration must be the best interests of the company from the perspective of the company and not from that of the applicant - *Talisman Technologies Inc v Old Electronic Switching P/L* [2001] QSC 324 at [40].

Where the company is a going concern, the best interests of the company can be equated with the best interests of the shareholders as a group.⁵¹ Where the company is in liquidation, the consideration moves from the interests of the shareholders to the interests of the creditors.⁵²

Courts have considered the following enquiries to be of relevance to determine whether an application is in the best interests of the company:

- 1 Is the applicant's claim highly speculative?⁵³
- 2 What effect will litigation have on the company's business?⁵⁴
- 3 Is the company small or large and what is the relationship between the applicant and other members and officers in the company?⁵⁵ If the company is a small family company, do the other family members support the application?
- 4 Are there other means available to give redress? For example can the applicant seek a personal remedy?
- 5 Will the action be of any practical benefit to the company - in other words is the defendant able to meet the judgment if successful?

The Explanatory Memorandum adds a further suggestion. In determining whether an application is in the company's best interests, the Court should consider whether the company has made a business decision not to bring the action. If so the courts should refuse leave.⁵⁶

4. *s 237(2) (d) - Is There a Serious Question to be Tried?*

An applicant must show 'a solid foundation...giving rise to a serious dispute'⁵⁷ or an 'arguable case'⁵⁸. The evidence must reach the same standard as applies for an interlocutory injunction.

In reality this criterion has a 'relatively low threshold to surmount'⁵⁹ because the courts are not required to consider the merits of the application in any depth. When deciding

⁵¹ *Ngurli Ltd v McCann (1953) 90 CLR 425; Greenhalgh v Ardenne Cinemas Ltd [1946] 1 All ER 512.*

⁵² *Kinsela v Russell Kinsela Pty Ltd (In Liq) (1986) 4 NSWLR 722.*

⁵³ *Herbert & Ors v Redemption Investments Ltd [2002] QSC 340 at [38].*

⁵⁴ *McLean Anor v Lake Como Venture P/L Anor; Lake Como Venture P/L & Ors v Progressive Projects P/L & Ors [2003] QCA 562 at [8].*

⁵⁵ *Swansson v Pratt [2002] NSWSC 583 at [57].*

⁵⁶ Explanatory Memorandum, above n 17, at [6.38]. This requirement is expressly stated in s 237(3)(c) which applies where the company has made decisions regarding proceedings against third parties. It seems also to be expected where directors have made decisions regarding internal issues. Such an approach reflects the general reluctance to 'second guess' business decisions made by directors.

⁵⁷ *BL & GL International Co. Ltd v Hypec Electronics Pty Ltd; Colin Anthony Mead v David Patrick Watson & Ors [2002] NSWSC 38 at [75].*

⁵⁸ *Mhanna v Sovereign Capital Ltd [2004] FCA 1300 at [31].*

⁵⁹ *Swansson v Pratt [2002] NSWSC 583 at [25].*

whether or not to grant leave the courts tend to focus on the allegations rather than attempt to determine contested facts.⁶⁰

One commentator has pointed out that there is scope for the Court to appoint an independent person to investigate and report to the Court on the circumstances giving rise to the cause of action and assist with determining whether there is a serious question to be tried⁶¹. The courts are yet to do this.

5. s 237(2) (e) - Has the Company Been Given the Appropriate Notice?

In order to satisfy s 237(2) (e) (i) an applicant must serve a written notice on the company fourteen days before making the application for leave.⁶² These requirements can be dispensed with by virtue of s 237(2) (e) (ii) if the Court is of the view that it is appropriate in the circumstances. It is clear that courts are only prepared to do so where the company is already well aware of the applicant's intention to seek leave.

The courts have regard to the purpose of the notice requirements within the context of derivative actions. The response of the company to the notice may serve to assist in determining whether the company will itself bring the action (relevant to s 237(2) (a)) and will also enable the company to prepare for any subsequent court action.

IV. LEAVE APPLICATIONS BROUGHT ON BEHALF OF COMPANIES IN LIQUIDATION

Although early applications made under s 237 suggested otherwise, it is now apparent that leave may be granted where the company is in receivership or liquidation. This was not contemplated by the legislators as no reference is made to such companies in the draft legislation, the final legislation (Part 2F.1A) or the extensive Reports leading up to the introduction of the statutory derivative action⁶³.

A. How Do the Terms of Part 2F.1A Apply to Companies in Liquidation?

Part 2F.1A applies to proceedings brought or intervened in on behalf of 'a company' (emphasis added). Companies in liquidation satisfy the definition of 'company' in s 9⁶⁴ so prima facie such an interpretation is appropriate.

Under s 237(2) (a) the Court must be satisfied that the company will not bring proceedings. Where the company is in liquidation, the Court must be satisfied that the liquidator will not bring the proceedings.

Under s 237(2) (c) the Court must be satisfied that it is in the best interests of the company that the applicant be granted leave. Where the company is in liquidation the

⁶⁰ *Ehsmann v Nutectime International* [2006] NSWSC 887 at [6] and [60].

⁶¹ Duffy, M. 'Procedural Dilemmas for Contemporary Shareholder Remedies- Derivative Action or Class Action?' (2004) 22 C&SLJ 46 at 65.

⁶² The requirements of s 109X must be met to validly serve the notice on the company.

⁶³ See n 13.

⁶⁴ See *Brightwell v RFB Holdings* [2003] NSWSC 7 at [48].

applicant must satisfy the Court that the derivative action has a real chance of improving the return to the company's creditors.

Under s 237(3) there is a rebuttable presumption that granting leave is not in the best interests of the company where the proceedings involve a third party.⁶⁵ The company must have made a decision not to bring, defend, discontinue, settle or compromise the proceedings. In making that decision s 237(3) (c) states that:

- (c) all of the directors who participated in that decision:
 - (i) acted in good faith for a proper purpose; or
 - (ii) did not have a material personal interest in the decision; and
 - (iii) informed themselves about the subject matter of the decision to the extent they reasonably believed to be appropriate; and
 - (iv) rationally believed that 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 presumption will not apply where the directors have not made a decision. Where a company is in liquidation, the directors lose their power to make such decisions and instead such power resides in the liquidator.⁶⁶ The consequence is that the presumption can not apply where a company is in liquidation.

A significant issue exists in relation to the question of who bears the costs associated with derivative actions. A company in liquidation has limited, if any funds, available to meet such costs. In addition, it can be argued that a more conservative approach needs to be taken in order to protect the assets of the company in liquidation. Part 2F.1A does not at present provide the court with any guidance regarding these considerations.

V. THE ISSUE OF COSTS

The power of the Court to make costs orders is addressed in s 242 of the Act. General principles relating to costs may also be relevant.⁶⁷

Fletcher points out that the costs 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'⁶⁸.

A. *How Does Part 2F.1A Address the Issue of Who Pays for Derivative Actions?*

S 242 states:

the Court may at any time make any orders it considers appropriate about the costs of the following persons in relation to proceedings brought or intervened in with leave under section 237 or an application for leave under that section:

- (a) the person who applied for or was granted leave;
- (b) the company;

⁶⁵ S.237(4) defines third parties for the purposes of Pt 2F.1A.

⁶⁶ See *Brightwell v RFB Holdings* [2003] NSWSC 7 at [48].

⁶⁷ See *Foyster v Foyster Holdings* [2003] NSWSC 135.

⁶⁸ Fletcher, K, 'Clerk and Minority Shareholder Rights' (2001) 13 AJCL 290 at 300.

(c) any other party to the proceedings or application.

An order under this section may require indemnification for costs.

It has been suggested by the Supreme Court of New South Wales⁶⁹ that the word ‘brought’ in s 242 prohibits an applicant from seeking funding by the company until the leave application has been successful and the substantive action commenced.

It is the author’s view that such a limited interpretation is inconsistent with the broad discretion given to the Court regarding costs. S 242 allows the Court *at any time* (emphasis added) to make *any orders* (emphasis added) it considers appropriate.

Several commentators have been critical of the broadness of the discretion, with one commenting that ‘shareholders are at the mercy of the court’s decision as to what is “appropriate” pursuant to ... s 242’⁷⁰. It is this author’s view that it is desirable to maintain the Court’s discretion where the company is in liquidation but less so where the company is a going concern.

B. *Reasons Why the Company Should Pay the Applicant’s Costs*

There are strong arguments to support the view that the company should bear the costs associated with statutory derivative actions.

1 Statutory derivative actions are brought in the name of the company⁷¹. Barrett J pointed out in *Foyster v Foyster Holdings Pty Ltd* that an applicant who has been forced to resort to s 237 to protect a company ‘becomes after all the surrogate of the normal corporate decision makers whose decision has not been forthcoming’⁷² and therefore should not have to fund the litigation.

2 The remedy of a successful derivative action will go to the company not the applicant. Unlike the Canadian legislation, Part 2F.1A makes no provision for a portion of the remedy to be distributed to the applicant.⁷³

3 Part 2F.1A provides adequate protection for the company against vexatious and unmeritorious litigation. Derivative actions are only permitted where leave has been granted by the Court.

4 Bona fide applicants with genuine grievances will be discouraged from initiating actions to protect the company’s best interests.

The applicant who has been given leave to bring the derivative action on behalf of a company that is a going concern should be reimbursed by the company for the costs

⁶⁹ *Charlton v Baber* [2003] NSWSC 745.

⁷⁰ Thai, L ‘How Popular are Statutory Derivative Actions in Australia? Comparisons with United States, Canada and New Zealand’ (2002) 30 ABLR 118 at 136.

⁷¹ S 236(3).

⁷² [2003] NSWSC 135 at [13].

⁷³ Cheffins, B and Dine, J ‘Shareholder Remedies: Lessons From Canada’ (1992)13(5) *The Company Lawyer* 89 at 93.

associated with the leave application and should also be indemnified on an ongoing basis to fund the substantive proceedings.⁷⁴

The Court has power to appoint an independent person to ensure that the costs are reasonable in the circumstances. S 241(1) (d) (iii) states:

The Court may 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, including:

-
(d) an order appointing an independent person to investigate, an report to the Court on:
 -
(iii) the costs incurred in the proceedings by the parties to the proceedings and the person granted leave.

The costs incurred in the proceedings by the parties and the person granted leave

B. Are there Circumstances where it is Appropriate for the Applicant to Bear the Costs of a Derivative Action?

An unsuccessful leave application

An applicant should be required to bear the costs associated with an unsuccessful leave application. The leave criteria play an essential function in protecting the company from vexatious and unmeritorious litigation.

Where the company is in liquidation

A company that is in liquidation does not have the funds available to bear the costs of the derivative action. It may be necessary for the applicant to indemnify the company and provide security for costs. If however the substantive proceedings are successful in improving the financial position of the company, there needs to be a mechanism to enable the applicant to recoup the costs of bringing the action. One way might be to allow the applicant to prove the debt to the liquidator under s 555 and s 556 of the Act and stand in line with other unsecured creditors.

Where the company is in receivership

Where the company is in receivership and there is disagreement between the directors and the receiver as to the bringing of the action, the action should only proceed where the company is indemnified for costs. If necessary the indemnity could be provided by someone other than the applicant. In *Deangrove Pty Ltd (Rec and Mger Aptd) v Commonwealth Bank of Australia*⁷⁵ the director brought the application for leave but a shareholder offered the indemnity.

Where the proceedings are discontinued

Where an applicant is successful in obtaining permission to settle or discontinue proceedings that have commenced, the applicant should also bear all associated costs.

⁷⁴ This is the suggestion in *Carpenter v Pioneer Park Pty Ltd (in Liq)* [2004] NSWSC1007.

⁷⁵ [2001] FCA 173.

s 240 requires:

Proceedings brought or intervened in with leave must not be discontinued, comprised or settled without the leave of the Court.

Where the applicant has been granted leave but later decides not to bring the substantive action, all costs incurred by both the company and the defendant should be paid by the applicant. This issue arose in *Isak Constructions v Faress*.⁷⁶ The applicant was successful in obtaining leave but decided not to pursue the derivative action and sought the Court's permission not to bring the substantive action.

The Court held that although the circumstances in *Isak Constructions v Faress* were not expressly addressed by s 240, the court had discretion to grant permission to the applicant not to commence the substantive proceedings. In such circumstances it is appropriate for the applicant to indemnify the company and the proposed defendant for all costs incurred.

If an application for leave is discontinued and this is the responsibility of the applicant then the applicant should pay costs. In *Foyster v Foyster*⁷⁷ two applicants - directors who were fiercely opposed to each other and causing the company into a deadlock - applied to the court to bring a derivative action on behalf of the same company. The resignation of one director meant that the company was no longer deadlocked and was therefore able to bring the proceedings itself. The Court ordered that the director who ultimately resigned pay the costs of the company.

Where it is appropriate to use a costs order as a penalty

In certain circumstances it is appropriate that the applicant be ordered to pay costs as a penalty. This occurred in *Jeans v Deangrove P/L*⁷⁸ where the Court held that "the present application which has occupied several days of court time, on an urgent basis, should never have been brought so belatedly". The applicant was required to pay not only the company's costs but also those of the Commonwealth Bank who was not a party to the proceedings but unusually, had been granted a right to be heard.

C. What is the reality regarding costs issues?

In their recent empirical study on the statutory derivative action Ramsay and Saunders considered the data on costs⁷⁹. Where the applicant was successful in obtaining leave to bring the statutory derivative action, in only 21% of cases did that applicant also get costs granted in full or part.⁸⁰ Even more surprising is the fact that in no case was the company required to fund the applicant in relation to the substantive litigation.⁸¹

Ramsay and Saunders⁸² considered costs only in relation to successful leave applications. In such cases the Court had already been satisfied that the applicant was acting with bona

⁷⁶ [2005] NSWSC 679.

⁷⁷ [2003] NSWSC 135.

⁷⁸ [2001] NSWSC 84 at [13].

⁷⁹ Ramsay & Saunders, above n 1.

⁸⁰ Ramsay & Saunders, above n 1, table 15 at 35.

⁸¹ Ramsay & Saunders, above n 1, table 16 at 35.

⁸² Ibid.

fides and the action had a prospect of success and was in the best interests of the company. Yet, in such cases only 21% of applicants were granted costs in relation to the leave application and in no case was the applicant granted costs in relation to the substantive litigation!

The courts are reluctant to allow applicants access to company funds for derivative actions that are in the company's best interests even where the company is financially prosperous.⁸³

C. Possible Explanations for the Approach by the Courts

1. Limited Funds in the Company

Ramsay and Saunders cited this as a major reason for the courts reluctance and this author is in agreement.⁸⁴

Where the company has serious financial difficulties it is not possible for the company to fund the litigation up front. It is important however that when making costs orders, the courts clearly differentiate between such companies and those that are going concerns. This does not appear to be happening.

2. The 'Best Interests of the Company Problem'

Again this observation was made by Ramsay and Saunders.⁸⁵ They note the increasing instances where the Courts have linked costs issues to the 'best interest of the company' criteria in s 237(2) (c).

This author has observed the 'best interests of the company problem' occurring in two ways.

Firstly, the courts are requiring evidence of a likely tangible financial benefit to the company before being satisfied that the application for leave is in the best interests of the company. This may be appropriate if the purpose of derivative actions is compensatory. Kluver is of the view that 'compensation to the company is possibly the predominant but not the only rationale for derivative actions.'⁸⁶ Prince points out however that if derivative actions are also to perform a deterrence function and to improve issues of corporate governance, such a practice by the courts is not entirely appropriate.⁸⁷

Secondly, where a company is under receivership or in liquidation courts are only prepared to grant leave applications where the company is indemnified for costs. In such

⁸³ See *Ehsmann v Nutectime International*[2006] NSWSC 887.

⁸⁴ Ramsay & Saunders, above n 1, at 37.

⁸⁵ Ibid.

⁸⁶ Kluver, J "Derivative Actions and the Rule in *Foss v Harbottle*: Do We Need a Statutory Remedy?" (1993) 11 C &SLJ 7 at 16.

⁸⁷ Prince, P 'Corporate Law Economic Reform Program, Directors Duties and Corporate Governance: Proposals for Reform Paper (No 3)' (1997) 18 C&SLJ 493.

situations the courts consider the derivative action not to be in the best interests of the company if the company has to bear the risk of an unsuccessful action.⁸⁸

3. Most Applications under Part 2F.1A have been on Behalf of Small Proprietary Companies

Further explanations could be found in an analysis of the types of companies that have been the subject of leave applications. A significant number of applications have been made on behalf of small, quasi-partnership style companies. In circumstances where one party is seeking leave to bring a derivative action and the remaining parties involved are opposing the application the Courts are clearly reluctant to allow company funds to be used. In *Ehsmann v Nutectime International*⁸⁹ Austin J ordered the applicant to indemnify the company, and explained the reasons as follows:

In such a case as the present, where the company is essentially a vehicle to pursue the commercial interests of four parties, one of whom is at odds with the other three, who oppose the bringing of derivative claims... [i]f the indemnity were not given, the other three directors would as a practical matter be required to bear the burden of 65% of the company's costs of pursuing derivative claims which they do not want it to pursue.

It should be noted that there was no suggestion that the company was unable to meet the costs. It seems that even in circumstances where the company is financially secure the courts are reluctant to allow company funds to be used for derivative actions.

Similar issues arise where the company is a joint venture vehicle and one party alleges that the other has acted unlawfully causing the company loss. The courts tend to decide that it is appropriate to allow the complaining joint venturer to bring proceedings in the company's name against the other. However as the effect of the litigation will be indirectly to the benefit of the complaining joint venturer proportionately to its shareholding, that shareholder is required to fund the action.⁹⁰

The approach taken by the courts seems to ignore the principle that the company is a separate legal entity from its members, irrespective of its size.

One commentator has suggested that derivative actions are inappropriate in closely held companies because of the difficulty of clearly distinguishing between personal and derivative actions in such circumstances.⁹¹

4. The Uneasy Boundary between Derivative Actions and Personal Actions

Where the applicant is also bringing a personal action and the Court is prepared to hear the applications together, there appears to be a strong reluctance to order that the company pays *any* of the applicant's costs.⁹²

⁸⁸ For instance in *Fiduciary v Morningstar Research* [2004] NSWSC 664 at [49] the court was of the view that the risk of exposure to a substantial liability for costs in the event of the claim being unsuccessful works against the claim being in the company's best interests.

⁸⁹ [2006] NSWSC 887 at [62].

⁹⁰ See for instance *Fiduciary v Morningstar Research* [2004] NSWSC 664 at [47].

⁹¹ Thomas, C "Limited Liability Companies are off and Running" 57 SCL Rev 441 at 450.

⁹² see *Ehsmann v Nutectime International* [2006] NSWSC 887.

5. *Historical Reluctance*

Historically courts have been reluctant to involve themselves in a company's internal management issues, which are very often the source of statutory derivative actions⁹³. This could arguably result in a conservative approach to costs issues relating to statutory derivative actions. This has been noted by Beck who claims that in Canada there is 'hostility to shareholder inspired litigation.'⁹⁴ It could also be argued that Australasian courts have a general reluctance to granting indemnity costs.

VI. SUGGESTIONS FOR CHANGE

Ramsay has argued in favour of mandatory payment of costs by the company⁹⁵ or alternatively introducing contingency fees. Suggestions regarding the introduction of contingency fees can be dismissed on the basis that not only would this be inconsistent with Australia's fees structure, it is unlikely to encourage actions that are in the best interests of the corporation.⁹⁶

McConvill suggests that the Corporations Act should be amended to include a new subsection to s 242 to be referred to as s 242(2). He suggests that s 242(2) would entitle complainants to reasonable legal costs 'if the court is satisfied that the derivative action is not unmeritorious or doubtful'.⁹⁷

It is difficult to support a suggestion that effectively imports a new test into Part 2F.1A. The leave criteria are suitable to determine whether an action should proceed and are equally appropriate to assist with cost issues.

In Canada the court can order that the company pays the complainants legal fees on an interim basis. Kluver suggests that an interim fee structure arrangement in Australia enabling the court to rescind or vary a prior costs order 'would undoubtedly diminish the attraction of a derivative action.'⁹⁸ Some Canadian judges have expressed concern that the granting of interim costs provides too great an adversarial advantage at an early stage of litigation.⁹⁹

In Canada the Court also has power to require the corporation to pay reasonable fees to a plaintiff, whether or not the action is successful.

⁹³ Ramsay & Saunders, above n 1, table 7 at 29.

⁹⁴ Beck, S 'Shareholders' Derivative Action' (1974) 52 Canadian Bar Review 159 at 163.

⁹⁵ Ramsay, above n 20 at 164.

⁹⁶ De Vere Stevens, above n 16 at 134.

⁹⁷ McConvill, J, 'Part 2F.1A of the Corporations Act: Insert a new s.242 (2) or give it the Boot?' (2002)30 ABLR 309 at 309.

⁹⁸ Kluver, above n 86 at 23.

⁹⁹ Kaplan, W and Elwood, B, 'The Derivative Action: A Shareholder's "Bleak House"?' 36 UBCCL Rev 443 at 467.

Kaplan and Elwood discuss the changing attitude of the Canadian courts to costs issues.¹⁰⁰ Early decisions were very favourable to applicants. There was a prima facie right to indemnity were leave had been granted, although courts retained discretion to set the terms and conditions. Later cases have been less favourable to applicants. It has become necessary for applicants to establish financial need as a general requirement.¹⁰¹ It would not be desirable to see such a requirement in Australia. It is not recommended that the financial position of the applicant have any bearing on the decision as to who bears the costs.

In New Zealand there is a statutory presumption of company funding. The Court must order that the costs of proceedings be paid by the company when leave is successfully granted, unless it would be “unjust or inequitable for the company to bear those costs”.¹⁰² The practical effect has been that the courts will closely link the granting of leave to issues of costs. Leave tends only to be granted in circumstances where the Court is of the view that ‘a prudent business person in the conduct of his or her own business would commence proceedings’¹⁰³. An alternative test has also been used which requires the Court to determine ‘whether an applicant who had to use personal money would contemplate proceedings’¹⁰⁴.

CONCLUSIONS

The lack of access to company funds for applicants was noted as a key criticism of derivative actions at general law. The Explanatory Memorandum makes it clear that the purpose of the broad discretion under s 242 was not to deny bona fide applicants funding for statutory derivative actions:

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.¹⁰⁵

This paper has considered the terms of Part 2F.1A and examined the approach of the courts regarding access to company funds to bring derivative actions. Where the company is a going concern the company should be funding the action and bearing any burdens that may result where the action fails- in the words of Lord Denning ‘he who would take the benefit of a venture if it succeeds ought also to bear the burden if it fails.’¹⁰⁶ In many cases this is not happening.

Where the company is in liquidation, the company is not able to fund the derivative action unless the action results in a measurable financial improvement in the company’s financial position. The applicant will be required to fund the action and it may be appropriate to indemnify the company and provide security for costs.

¹⁰⁰ Ibid at 464.

¹⁰¹ Ibid.

¹⁰² s 166 *Companies Act 1993*(NZ).

¹⁰³ This is the *Vrij* test taken from *Vrij v Boyle* [1995] 3 NZLR 763.

¹⁰⁴ This is the *Frykberg* test from *Frykberg v Heaven* (2002) 9 NZLR 763; discussed in Watts, P ‘Company Law’ [2004] NZR 123

¹⁰⁵ Explanatory Memorandum, above n 17 at [6.69]

¹⁰⁶ *Wallersteiner v Moir (No 2)*[1975] QB 373.

Part 2F.1A does not at present reflect these differing costs considerations.

It is this author's suggestion that the court retains its broad discretion to make whatever orders it considers appropriate in relation to companies in liquidation. In relation to companies that are going concerns, there should be a statutory presumption in favour of company funding. A closer examination of the provisions in the New Zealand Act would be beneficial to assist with the framing of the new provision in this regard. The courts should use the already existing power in s 241 to appoint an independent advisor to assess the costs if necessary.

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