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THE SHAREHOLDERS' DERIVATIVE ACTION

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Introduction

One of the major socio-legal problems of the twentieth century has been how to call to account representative power. Traditional political theory has relied on the ballot box. Holders of public office, labour union leaders and corporate directors are all voted into office and at regular intervals must submit themselves and their records to an appropriate constituency for a further span of official life. Through this periodic, democratic ritual our representatives are held accountable and their power is said to be legitimized. This theory of the ballot box may have worked well enough in ruder times of smaller and simpler economic and social units. But in a time when enormous size, baffling complexity and byzantine sophistication characterize our political and economic institutions, and the appropriate constituencies are themselves uncertain, shifting and heterogeneous, the ballot box is no longer seen as a sufficient guarantor of democratic control. New modalities of accountability are being sought, new constituencies are being identified, and power and the bureaucracies, both public and private, through which it is exercised are being analyzed afresh and redefined.

The large corporation, as the dominant economic institution of our time, is particularly being redefined. No longer is it seen as a private institution operating solely for profit on behalf of and answerable only to its one true constituency, its shareholders.

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It is realized that it is a public institution in the sense that its major decisions have as significant an impact on the economy as do those of government and that its constituency, like government's, is the entire citizenry whether in the guise of shareholder, worker, consumer, supplier, or simply user and enjoyer of clean air and water. And so a debate has ensued, mainly since the publication of Berle and Means' seminal study in 1932,¹ as to how the large corporation should be governed and by whom, how it is to be made answerable to broader public concerns while ensuring a reasonable return to investors, and whether its shareholders should be treated as owners or merely *rentiers* of capital.

While the debate over the public governance of the corporation has occupied the headlines it has not, until very recently, occupied the law journals. Legal scholarship has been, and still primarily is, concerned with the private governance of the corporation and with the relationship between the shareholders and the legal managers—the directors, and between majority and minority shareholders. That this is so is probably attributable to the fact that lawyers, both practicing and academic, are more proficient at and more comfortable with private ordering—with the narrow and intricate planning and shaping of the internal corporate structure than with the socio-economic problem of the large corporation as a governmental institution. And it is also attributable to the fact that the rights of the minority shareholder are still far from adequate. It is a tribute to the adroitness, imagination and singlemindedness of the corporate managers and their professional advisers, and to the overwhelming effect of economic power on the legislative process, that the nominal owners, the shareholders, are still, at this late date, engaged in an uphill legislative and judicial battle to obtain full and truly informative disclosure of corporate activities and their effects, and to protect their investment from fraud, over-reaching and self-dealing by their elected representatives and, on occasion, by their fellow shareholders.

At the level of private governance of the corporation the interests of the shareholder in the large, publicly-held corporation and in the small, private corporation come closer together than is often considered to be the case. The public shareholder is considered to be less the true capitalist-owner and more an investor with little, if any, understanding of the workings of the particular company. His vote is uninformed except as he is able to appreciate complex proxy material, and is but one of many thousands. The securities market provides him with a ready escape hatch should

¹ A. A. Berle, Jr., and Gardner C. Means, *The Modern Corporation and Private Property* (1932).

he become disenchanted with his investment and that market may well, for a time, protect him from the worst effects of fraud, unfair dealing or mismanagement.

The shareholder in the private company is still likened to the capitalist of old—a man who invests all, or a large portion of his capital in the enterprise, is himself one of the managers and has a day-to-day knowledge of the workings of the company and the activities of management. In so far as there is fraud or over-reaching by fellow directors or shareholders he is in a position to personally blow the whistle and to seek a remedy. He does not, however, have the securities market exit and if he cannot find redress in the narrow and tortuous legal avenues open to him he may well fit unhappily into the corporate jargon of being “locked in”, “frozen out”, “squeezed” or simply oppressed.²

Clearly, the shareholder in the private company needs adequate remedies written into the companies Acts to protect him from unfair dealing. But curiously enough it is the shareholder in the large, publicly-held company who has been the recipient of most legislative and judicial concern. This concern is most clearly manifested in legislation regulating the securities markets which, among other things, has greatly increased the personal rights of the individual shareholder. This has been particularly true in the United States where the judiciary has been quick to grant a civil right of action for breaches of the securities Acts,³ and is well on the road to reading a very general standard of fair dealing into the fraud provisions of rule 10b-5 of the Securities Exchange Act of 1934.⁴ Apart from civil remedies, the securities Acts themselves do much to protect the individual shareholder by regulating insider-trading, proxy solicitation, takeover bids, accounting practices, and requiring a much higher standard of general corporate and financial disclosure.

That these improvements have been made in the position of the public stockholder is all to the good. The stock market can be a very narrow and unsatisfactory outlet in many cases and, in any event, a shareholder should not have to pay for unremedied wrongdoing in a lower price for his shares. In short, the public shareholder needs a particular kind of protection against fraud and unfair dealing because he is not usually in a position to protect himself. It is unlikely that the average shareholder would ever become aware of corporate wrongdoing or be strong enough or have the resources to take remedial action even if he did. Those

² For a classic example of an oppressed shareholder who sought but did not receive aid from the courts see *Greenhalgh v. Arderne Cinemas*, [1950] 2 All E.R. 1120 (C.A.).

³ *J. I. Case Co. v. Borak* (1964), 377 U.S. 426.

⁴ See generally, Bromberg, *Securities Fraud—Rule 10b-5* (1968).

who call the directors of public corporations to account are increasingly other large financial aggregates who either have significant holdings in the corporation or are contending with it in one form or another, very large individual shareholders, or administrative agencies. The individual public shareholder can be increasingly confident that other, more expert investors are listening, watching and thinking about his investment.

The private minority shareholder is not in so secure a position. In law and in practice he is treated as a rugged individualist. There is no securities legislation with a host of proscriptions, commands and remedies upon which he can rely and neither do securities commissions, financial institutions, independent financial analysts, and large, sophisticated investors maintain watch for him and stand ready to help him. He must be his own watchdog and seek his own remedies. And if a remedy is not available then he should realize that "he is a minority shareholder and must endure the unpleasantness incident to that situation".⁵ For this reason much of the reform of the corporation Acts should be directed toward giving adequate protection to the private shareholder. It is not necessarily so directed, but that is often one of its primary effects. That is, from a purely company law aspect the rights and remedies that are written into the statutes are as equally available to the public as to the private shareholder—the public shareholder is as limited in the company law remedies he can pursue as is the private shareholder. But for the reasons adverted to above, it is to the private shareholder that adequate avenues of redress are most crucial.

One obvious avenue of redress for all shareholders is suit to compel the directors to live up to their fiduciary duties in conducting the company's business. But shareholder litigation has, through variations on the theme of the rule in *Foss v. Harbottle*,⁶ proved to be a narrow, hazardous and generally unsatisfactory remedy. Moreover, attempts to encourage shareholder litigation and clear the procedural thicket that all but blocks entrance to the courts have not, until recently, received much support. Indeed, shareholder litigation has drawn a curiously hostile reaction which has been aptly noted by Eugene Rostow:⁷

⁵ *Re Jury Gold Mine Development Co.*, [1928] 4 D.L.R. 735, at p. 736, per Middleton J.A. (Ont. C.A.).

⁶ (1843), 2 Hare, 67 E.R. 189 (hereinafter referred to as "the rule"). See generally Beck, *An Analysis of Foss v. Harbottle*, in Ziegel, ed., *Studies in Canadian Company Law*, Vol. 1 (1967), p. 545; Wedderburn, *Shareholders' Rights and the Rule in Foss v. Harbottle*, [1957] *Cambr. L.J.* 194, [1958] *Cambr. L.J.* 93.

⁷ Rostow, *To Whom and for What Ends Is Corporate Management Responsible?*, in Mason, ed., *The Corporation in Modern Society* (1959), p. 49.

[O]ne would expect those concerned for the integrity and future of private business institutions to applaud the intrepid souls who ferret out corporate wrongdoing, and risk their own time and money against a contingency of being rewarded if in the end sin is found to have flourished. Not at all. Such men are not treated as honored members of the system of private enterprise, but as its scavengers and pariahs At least they are viewed as necessary evils, the Robin Hoods of the business world, for whom a patronizing word may sometimes be said, when they succeed in revealing some particularly horrendous act.

Part of the feeling against shareholder litigation, particularly in the United States where Professor Rostow was writing, stems from the notion of "strikes suits" supported by an avaricious segment of the Bar. That there has been some abuse in the United States by shareholders who launched or threatened suits primarily to gain a quick settlement, aided by lawyers who gambled for large pay days through the workings of the contingent fee system, there is no doubt. But there is equally no doubt that the shareholders' derivative suit can be an important and effective agent in controlling directorial conduct. Indeed, Professor Rostow has characterized such shareholder actions as "the most important procedure the law has yet developed to police the internal affairs of corporations".⁸ And such abuse as the derivative suit does allow, can and has been effectively cured by appropriate rules of procedure.

Although the contingent fee and the "strike suit" are virtually unknown in Anglo-Canadian practice, there has been a similar hostility to shareholder inspired litigation. Some of it stems from an uninformed and exaggerated view of the American experience and some from a muffled notion that those who commence such suits are malcontents and troublemakers. But more importantly, the judiciary itself has not been receptive to such actions and has continued to apply the intricacies of the *rule*, derived as it is from nineteenth century partnership principles and unrealistic notions of an informed, independent body of shareholders, to effectively sidetrack the derivative suit. And the underlying judicial philosophy has continued to be that hardy perennial: "It is not the business of the court to manage the affairs of the company. That is for the shareholders and the directors."⁹

For these reasons an important part of the company law reform that has been under way in Canada since the new Business Corporations Act¹⁰ was introduced in Ontario in 1970 has been to provide a procedure whereby the road to the courts would be relatively smooth and straight for genuinely aggrieved minor-

⁸ *Op. cit.*, *ibid.*, at p. 48.

⁹ *Shuttleworth v. Cox Bros. & Co.*, [1927] 2 K.B. 9, per Scrutton L.J., at p. 23.

¹⁰ R.S.O., 1970, c. 53 (hereinafter referred to as "The Ontario Act").

ity shareholders. It is the purpose of this article to examine and compare the shareholders' derivative suit as provided by section 99 of the Ontario Act and section 229 of the draft federal Act¹¹ and to ask whether they provide an adequate procedure through which minority shareholders can seek a remedy for wrongs done to the corporation. As sections 99 and 229 are both modeled on rule 23.1 of the United States Federal Rules of Civil Procedure,¹² and as there has been over thirty years experience with it and its predecessor, rule 23(b), extensive reference will be made to the shareholders' derivative suit in the United States.

I. *A Recapitulation of Foss v. Harbottle.*

In order to understand and evaluate the reform of the derivative suit it is necessary to set out briefly the substantive and procedural problems spawned by the *rule*. The decision in *Foss v. Harbottle* was premised on the separate legal personality of the corporation and on majority rule in internal corporate affairs. If the corporation is a legal person separate from its members, it follows that for a wrong done to it the corporation itself is the only proper plaintiff. The two shareholders who appeared as plaintiffs in *Foss v. Harbottle* alleged, *inter alia*, a sale by the directors of their own property at inflated values to the company. The wrong alleged was thus a wrong to the company and the Vice-Chancellor ruled that the plaintiffs had no standing to sue on behalf of the corporation.

As to the transaction itself and bringing suit for damages for the injury caused by it, those were both matters to be decided upon by the company in general meeting. The purchase of their own lands for the corporation by the directors was a transaction that was voidable at the option of the corporation. The corporate pleasure was to be determined by the shareholders in general meeting and as the plaintiffs did not represent a majority, or allege that the will of the majority had been determined, they had no standing to sue in the name of the company. The court was not going to be put in the position of ruling on a breach of trust that the principal might elect to confirm. Moreover, the decision whether or not to bring suit in the company name belongs at

¹¹ Bill C-213, Canada Business Corporations Act, 1st Session, 29th Parliament, 21-22 Eliz. II, 1973 (hereinafter referred to as "the federal Act"). The federal Act was given first reading on July 18th, 1973 but did not proceed any further before the session ended. It is expected that the government will re-introduce it in the session which commenced on February 24th, 1974. Section 222 of the British Columbia Companies Act, S.B.C., 1973, c. 18 is virtually identical to s. 229 of the federal Act and is now in force in that province.

¹² 28 U.S.C.A., rule 23.1.

common law to the general meeting where, once again, the majority rules.¹³ In short, the will of the majority had not been ascertained and the plaintiffs were non-suited. Thus in 1843, one year before the first modern companies Act, the Court of Chancery applied its rule of non-interference in the internal affairs of a partnership to the incorporated company.¹⁴ Internal affairs were a matter for the majority and the majority was thus firmly established in a pivotal position and has remained there ever since. Two other judicial extensions to the rule in *Foss v. Harbottle* soon increased the power of the majority even more.

In *Mozley v. Alston*¹⁵ two shareholders brought a personal action for a declaration that the board of directors was holding office illegally and in contravention of the terms of the company's Act of incorporation. James L.J. was of the opinion that the rule applied. An usurpation of the office of director was a wrong done to the company and the company was the only proper complainant. His Lordship did not consider the argument that the plaintiffs were asserting a personal right to have the internal governmental affairs of the company conducted in accordance with its terms of incorporation and according to which terms they had subscribed their capital.

This "irregularity" branch of the rule was further settled in 1875 in *MacDonald v. Gardiner*.¹⁶ The articles provided for the taking of a poll upon the demand of five members. When a poll was demanded on a motion to adjourn, the chairman ruled there could be no poll on that question. The Court of Appeal said that the matter was an internal dispute and for the majority to decide—the rule applied. The court did not advert to the section that has been in the English Companies Act since 1856¹⁷ which constitutes the memorandum and articles a contract between the members and the company and thus to the fact that the plaintiff could be considered as suing to enforce his personal right to have his contract enforced according to its terms. This irregularity branch of the rule has been approved by the Privy Council and applied in many cases:¹⁸

¹³ *Isle of Wight Ry. Co. v. Tahourdin* (1883), 25 Ch. D. 320.

¹⁴ It has been noted that just at the time *Foss v. Harbottle* applied the old partnership rule to the incorporated company, the Court of Chancery was itself relaxing this rule to meet the problems raised by the unincorporated joint stock company which might have as many as 3,000 members who at law were still treated as partners, e.g. *Carlen v. Drury* (1812), 1 V. & B. 154, 35 E.R. 61. See generally, Wedderburn, *op. cit.*, footnote 6, pp. 196-197 and references noted there.

¹⁵ (1847), 1 Ph. 790; 41 E.R. 833.

¹⁶ (1875), 1 Ch. D. 13.

¹⁷ Now s. 20(1) of the Companies Act, 1948.

¹⁸ *Burland v. Earle*, [1902] A.C. 83 (P.C.).

. . . no mere informality or irregularity which can be remedied by the majority will entitle the minority to sue, if the act when done regularly would be within the powers of the company and the intention of the majority of shareholders is clear.

The second extension of the *rule* came with the decision of the Privy Council in *North-West Transportation Co. v. Beatty*¹⁹ in 1887. What the Vice-Chancellor had said in *Foss v. Harbottle* must be done, was done in the *North-West* case. The controlling director who had purchased his own property for the company submitted the contract to the general meeting for its approval. Approval was given but only by reason of Mr. Beatty's votes *qua* shareholder. The Supreme Court of Canada held that an interested director could not use his shareholder's votes to confirm his own contract.²⁰ The Privy Council disagreed and ruled that Mr. Beatty was entitled to vote to approve the transaction.²¹ Moreover, as a general proposition, a shareholder was said to be entitled to exercise his vote "from motives or promptings of what he considers his own individual interest".²²

Subsequent companies Acts amendments and corporate draughtsmanship have added further complexity to the *rule* and have changed majority control from what it was in 1843. At common law a director could not submit a contract in which he was interested to the board for approval as he himself was disqualified from voting and the company was entitled to have the disinterested opinion of every director. Thus all such contracts had to go to the general meeting. This inconvenience was soon remedied by statutory amendment, now common to nearly all companies Acts, whereby the board could approve such transactions if the interested director declared his interest and refrained from voting. There was no longer any need to inform the shareholders of such transactions, much less seek their approval.

The power of the directors (and thus of the majority shareholders) was further increased by corporate draughtsmanship which, through the articles of association, vested management in the board of directors.²³ In the five Canadian letters patent jurisdictions and in Ontario, where incorporation is now by articles of

¹⁹ (1887), 12 App. Cas. 589 (P.C.).

²⁰ (1887), 12 S.C.R. 598.

²¹ *Supra*, footnote 19, at p. 594.

²² *Pender v. Lushington* (1877), 6 Ch. D. 70, at p. 76 (C.A.). A shareholder may not, however, exercise his votes to expropriate corporate property to his own advantage (*Cook v. Deeks*, [1916] 1 A.C. 554), or to oppress minority shareholders (*Brown v. British Abrasive Wheel Co.*, [1919] 1 Ch. 290). But see, *Greenhalgh v. Arderne Cinemas*, *supra*, footnote 2.

²³ Article 80 of Table A of the English Companies Act, 1948 is typical. Table A of each of the five Canadian memorandum jurisdictions, (B.C., Alberta, Saskatchewan, Nova Scotia, Newfoundland) contains a similar article.

incorporation, management power is vested in the board by statute. The power to manage includes the power, probably the exclusive power,²⁴ to use the corporate name in litigation. Thus the two matters of majority control that were at the heart of the judgment in *Foss v. Harbottle*, the possibility of shareholder approval of the contract in which the directors were interested, and the decision to sue in the corporate name, no longer belong to the majority and reside, almost exclusively, in the board of directors. This has not, however, prevented the directors themselves from resorting to the shareholders for ratification of their actions as a sort of safety-value protection, a manoeuvre which, as we shall see, has introduced a new complication into an already complex area of the law.

Taken in its purest form the *rule*, along with the additional corporate facts noted above, would allow the directors—majority shareholders to ride roughshod over the minority. Thus a number of exceptions have been worked out in an attempt to give shareholders who are aggrieved by an unremedied wrong to the company access to the courts to sue on behalf of the company. The exceptions to the *rule* are those listed by Jenkins L.J. in *Edwards v. Halliwell*.²⁵

1. *Ultra Vires Acts*: “. . . in cases where the act complained of is wholly ultra vires the company or association the rule has no application because there is no question of the transaction being confirmed by any majority.”
2. *Fraud on the Minority*: “. . . where what has been done amounts to what is generally called in these cases a fraud on the minority and the wrongdoers are themselves in control of the company, the rule is relaxed in favour of the aggrieved minority who are allowed to bring what is known as a minority shareholders action on behalf of themselves and all others.”
3. *Special Majorities*: “An individual member is not prevented from suing if the matter is one which could be validly done or sanctioned not by a simple majority of the members . . . but only by some special majority.”
4. *Personal Rights*: Where “the personal and individual rights of membership of [the plaintiff] have been invaded”, the rule “has no application at all”.

The *ultra vires* and special majorities exceptions are straightforward and pose few problems. But in the areas of fraud on the minority and personal rights the shareholder is up against the procedural maze of the *rule*. The line between personal and derivative actions is neither clear nor settled and the shareholder who begins his suit believing he has a personal right of action

²⁴ This point will be discussed more extensively, *infra*.

²⁵ [1950] 2 All E.R. 1064 (C.A.).

may be met by a ruling that the wrong of which he complains is not to him but to the company and he must comply with the *rule*—which may well mean that his grievance will go unremedied.

The fraud on the minority exception is the one most often invoked by the aggrieved minority shareholder. But although the courts have used such broad language as “the court will prevent the management of companies being so conducted as to produce injustice or injury to any of the members”,²⁶ and the court will interfere if the conduct of the majority is “oppressive” or “harsh” or, even more generally, if no adequate remedy remained except that of a suit by individual corporators “the claims of justice would be found superior to any difficulties arising out of technical rules respecting the mode in which corporations are required to sue”,²⁷ the path to an actual remedy has proved extremely narrow and hazardous. Indeed it is difficult, if not impossible, despite the generous sentiments of the judicial language, to find judicial interference to halt conduct that falls short of an expropriation of corporate assets.²⁸ The narrowness of the fraud exception is shown by *Pavlidis v. Jensen*,²⁹ a case in which the directors were accused of negligence for selling an asset for £182,000 which it was alleged was worth £1,000,000. A personal action was not maintainable as no shareholders’ individual right *qua* shareholder had been interfered with. Fraud was not pleaded as the sale of assets at an alleged £800,000 under-value was not a fraudulent expropriation of corporate assets, but was mere negligence. The *rule* was therefore applied as the general meeting had power to ratify the directors’ acts, or to decide not to take action for negligence. Even if fraud is involved the shareholder is always faced with the uncertain procedural hurdles of determining who has control, who are the wrongdoers, which corporate organ may take action in the company name, upon whom the demand to sue must be made, and whether or not the transaction is ratifiable.

It was to remedy these problems and to open the door to a wider range of shareholders’ derivative actions that section 99 was included in the Ontario Act and section 229 in the federal Act. What follows will be an analysis of the shareholders’ derivative suit in light of those sections. Some of the matters that have been adverted to above will be analyzed in more detail as the sections, particularly section 99, are procedural only and many of the problems of *Foss v. Harbottle* still lurk in the background.

²⁶ *Re Langham Skating Rink Co.* (1877), 5 Ch. D. 669, at p. 679 (C.A.); *Heyting v. Dupont*, [1964] 1 W.L.R. 843 (C.A.), at pp. 851, 854.

²⁷ *Foss v. Harbottle*, *supra*, footnote 6.

²⁸ See generally Beck, *op. cit.*, footnote 6, pp. 556-560.

²⁹ *Pavlidis v. Jensen*, [1956] Ch. 565.

II. *The Personal Action and the Derivative Suit Distinguished.*

Remedial legislation often has a perverse way of making the cure, or at least part of it, seem rather worse than the original problem. And this, to some shareholders, may well be the case with parts of sections 99 and 229. Certainly the requirement that leave of the court be obtained to commence the action³⁰ and approval be obtained to settle or discontinue it³¹ may be felt to have their drawbacks. And this feature of judicial supervision may now be mandatory if the statutory provisions are considered to be exhaustive of the shareholders' right to bring a derivative action.³² This, coupled with the fact that recovery in a derivative suit belongs, by definition, exclusively, to the corporation³³ may cause an aggrieved shareholder to search for an alternative remedy. The obvious alternative is a personal action. Moreover, the vital question of whether some directors' breaches of duty are ratifiable or not, and thus of whether a cause of action remains, may well depend on whether the aggrieved party is seen to be an individual shareholder or the corporation. The critical threshold question in shareholder litigation, therefore, is whether the action is personal or derivative. It was the answer to this question that tripped the plaintiffs in *Farnham v. Fingold*,³⁴ which was potentially the most significant corporate action ever launched in Canada, and which has bedevilled the course of action in *Goldex Mines Ltd. v. Revill et al.*³⁵ An analysis of the shareholders' derivative suit must therefore begin by attempting to clarify the distinction between it and the personal action.

A. *The Personal Action.*

The ownership of stock in a corporation carries with it a number of personal rights. A partial list of the most common are the right to receive timely³⁶ and informative³⁷ notice of company

³⁰ S. 99(2) Ontario Act; s. 229(1) federal Act.

³¹ S. 99(6) Ontario Act; s. 232(2) federal Act.

³² S. 230(c) of the federal Act empowers the court to direct that any amount payable by the defendant be paid directly to present or former shareholders. This important provision was judicially created in *Pearlman v. Feldman* (1955), 219 F. (2d) 173, and its significance will be discussed in greater detail *infra*.

³³ This was the holding of the Ontario Court of Appeal in *Farnham v. Fingold*, [1973] 2 O.R. 132 (C.A.).

³⁴ [1972] 3 O.R. 688; rev'd. [1973] 2 O.R. 132 (C.A.).

³⁵ [1973] 1 O.R. 659; leave to appeal granted, [1973] 2 O.R. 389; rev'd. [1973] 3 O.R. 869.

³⁶ *Ashton v. Powers*, [1921] 51 O.L.R. 309 (Ont. H.C.); *Charter Oil Co. Ltd. v. Beaumont* (1967), 65 D.L.R. (2d) 112 (B.C.C.A.).

³⁷ *Kaye v. Croyden Tramways Co.*, [1898] 1 Ch. 358 (C.A.); *Garvie v. Axmith*, [1962] O.R. 65 (Ont. H.C.).

meetings, the right to vote³⁸ at such meetings, the right to have a properly executed proxy accepted³⁹ and the right to inspect certain of the corporation's records.⁴⁰ Some of these rights arise out of the companies Acts (the right to inspect books), some out of the articles or by-laws (number of days before meeting by which notice must be given) and some out of judicial legislation to make the requirements of the statute or corporate contract meaningful (truly informative notice). As to a right that can be truly classified as personal, the individual shareholder has standing to bring a personal action to secure it. Other shareholders may have had similar rights infringed and may join in the action for redress in which case the action will be representative in form, but the substance remains the assertion of a personal right by each shareholder. The *locus classicus* is the judgment of Jessel M.R., in *Pender v. Lushington*:⁴¹

This is an action by Mr. Pender for himself. He is a member of the company, and whether he votes with the majority or the minority he is entitled to have his vote recorded—an individual right in respect of which he has a right to sue. That has nothing to do with the question like that raised in *Foss v. Harbottle* and that line of cases.

It might be thought that the line between personal rights and corporate rights would be well and clearly drawn. There is after all not much confusion between being denied the right to vote and a taking of property which depletes the corporate treasury. Between those two poles, however, there is uncertain ground and it is suggested that the personal rights category is in fact much broader than has been thought to be the case.

The reason for the confusion and for limiting personal actions stems from the idea that all wrongs committed by corporate directors and officers, and all duties owed by them, run exclusively to the corporation. The fictional legal entity is viewed by the courts as an unbreachable barrier behind which the directors are safe from personal shareholder attack. Moreover, acts by the directors which could readily be construed as their own personal acts are invariably seen as corporate acts. All of which is a natural result of the fact that a company acts only through its board of directors and, occasionally, its shareholders. But a director acts in a variety of capacities—as an agent of the company, as the company itself, and as an appointed officer to carry out such formal functions as running the proxy machinery and calling and conducting meetings. If a functional analysis were given to the directors' actions in each case it is suggested that it would lead

³⁸ *Pender v. Lushington* (1877), 6 Ch. D. 70 (C.A.).

³⁹ *Johnson v. Hall* (1957), 10 D.L.R. (2d) 243 (B.C.S.C.).

⁴⁰ *Cooper v. The Premier Trust*, [1945] O.R. 35 (Ont. C.A.).

⁴¹ *Supra*, footnote 38, at pp. 80-81.

to a result that would accord more with reality while widening the ambit of the shareholders' personal action. The matter was well stated by Judge Fuld in *Gordon v. Elliman*.⁴² At issue in the *Gordon* case was the alleged failure of the corporation to pay dividends in fraud of the minority shareholders in order to squeeze them out.⁴³ It was argued, successfully, that the action was derivative and that New York's security for expenses provision applied. Fuld J. dissented:⁴⁴

The action, is, in short, brought against the corporation as a legal entity and, if successful, will require the corporation to part with some of its assets in favour of its stockholders. I am, therefore, unable to follow the legal alchemy by which a breach of duty by the corporation—a corporate wrong is transmuted into a corporate right.

The vice of the test [is the action one to compel the performance of corporate acts which good faith requires the directors to take in order to perform a duty which they owe to the corporation?] is that it presupposes that every duty owed by corporate directors runs exclusively to the corporation as such and never directly to the stockholders in their personal and individual right. The law is otherwise.

. . . In a very real sense all suits against corporations—which must of necessity act through directors and officers—involve the action of the directors or of officers responsible to the directors. . . . In short, it simply is not the law that an attack on directors' conduct is, *ipso facto*, the assertion of a corporate right of action. The mere fact that the power to declare dividends resides in the directors and that a suit to compel a dividend payment challenges directors' action has no bearing on the question of whose right is involved in such a suit. We must seek elsewhere to ascertain the manner of the "right" that a court enforces when it overrules the decision of corporate directors

The confusion in Anglo-Canadian company law over whether a personal action is possible when the directors act for an improper purpose, other than taking corporate property, would be cleared up by the type of functional analysis that Judge Fuld advocated. Directors' fiduciary duties are said to be "owed to the company and to the company alone",⁴⁵ and "to redress a wrong done to the company, . . . the action should *prima facie* be brought by the company itself".⁴⁶ In issuing shares, for example, the di-

⁴² (1954), 119 N.E. 2d 331, (2d Cir.).

⁴³ Such an action would probably not be entertained by the Anglo-Canadian courts—the matter would be treated as being exclusively within the jurisdiction of the directors (if the shareholders, through the articles or by-laws, are given a dividend declaring power—it is invariably limited to an amount not exceeding that recommended by the directors). This is but one of many examples of the greater readiness of the American courts to protect minority shareholders. Once a dividend has been lawfully declared the amount due becomes a debt for which a shareholder may personally sue the company, *Re Severn and Wye Ry.*, [1896] 1 Ch. 559; *Re Sawtell, Ex. p. Bank of Montreal*, [1933] O.R. 295.

⁴⁴ *Supra*, footnote 42, at pp. 340-341.

⁴⁵ Gower, *The Principles of Modern Company Law* (3rd ed., 1969), p. 517.

⁴⁶ *Burland v. Earle*, *supra*, footnote 18, at p. 93.

rectors are exercising a fiduciary power which must be performed *bona fide* for the general advantage of the company. If they use the power to keep themselves in control, or to turn a minority into a majority, or to defeat the wishes of the majority, or to discriminate between groups of shareholders, they will have breached their fiduciary duty and an action will lie.⁴⁷ But an action by whom? The answer to that question is best approached by asking who, in reality, is the aggrieved party and not by the mechanistic application of the formula that the director is an agent, the company is the principal and therefore action for fraud, negligence or irregularity lies only at the suit of the company. Most cases of fraud will clearly involve a taking by the director to the detriment of the company and the company is the only proper complainant. But a variety of other cases in which the directors act improperly involve not a breach of duty by the agent but a causing of the company to perform a corporate act in an improper or irregular manner to the direct detriment of the shareholders and for which they ought personally to be able to sue.

No doubt a company may be said to have a vital interest in having its affairs conducted in a proper manner and in accordance with the law and its internal regulations. But how, to ask Judge Fuld's question, is a wrongful issuance of shares by the company *truly* turned into a wrong to the company for which only the company may seek redress? Only in the most theoretical sense may the company be said to have been injured by its directors' misuse of the power granted to them. A more realistic analysis is that by the misuse of their powers the directors have caused the company to issue shares to the detriment of one group of shareholders and to the advantage of another—including, most likely, themselves. It should follow, therefore, that the shareholders that have been injured have a personal right of action against the company and the directors for a declaration that the issue and allotment is void and for an injunction to restrain the voting of such shares if they are about to be used at a general meeting. This is the American position and it is suggested that it is in fact what has occurred in similar cases in England and in Canada.

In *Condec Corporation v. Lunkenheimer*⁴⁸ the directors of the defendant company caused it to enter into a merger agreement with a third company that involved the issuance of a large block of defendant's shares to the third company. The issue was large enough to prevent the plaintiff from exerting the voting control which it had just acquired through a cash tender offer. In declaring the issue void, the Delaware court observed:⁴⁹

⁴⁷ *Punt v. Symons*, [1903] 2 Ch. 506. See generally, Gower, *op. cit.*, footnote 45, p. 524 *et seq.*

⁴⁸ (1967), 230 A. 2d 769 (C. Ch. Del.).

⁴⁹ *Ibid.*, at p. 777.

Finally, we are not here concerned with the need of proving corporate injury as has been held to be the case when a stockholder attacks derivatively the spending of corporate funds for the purchase of his corporation's own stock. This rather is a case of a stockholder with a contractual right being deprived of such control by what is virtually a corporate legerdemain.

There was no doubt in the Vice-Chancellor's mind that the directors had breached their fiduciary duty which they owed "to the company and to the shareholders". But breach of fiduciary duty did not necessarily mean that a corporate right was being asserted. There is no need for the Anglo-Canadian courts to take the step that the American courts have long since taken and hold that the directors owe a fiduciary duty to the shareholders (and the majority shareholders, on occasion, to the minority) to allow a personal right of action in such cases. The reference above by the Vice-Chancellor to the shareholder's "contractual right" is presumably a reference to the right to vote that goes with each share. A tainted allotment to shift control deprives the shareholder of his votes which, in the aggregate, give him control. Seen in this light, the reasoning is the same as in *Pender v. Lushington*—the shareholder's personal rights have been interfered with.

The line of cases from *Piercy v. Mills*⁵⁰ and *Punt v. Symons*⁵¹ that deal with an invalid issuance of shares do not give any clear guide as to whether they were considered to be personal or derivative actions. The *form* of the action was usually representative (as it may be when personal rights are being asserted, and as it must be in a derivative suit) and the company and the wrongdoing directors were joined as defendants, so an argument for either cause of action is plausible. With one exception, however, there is no discussion in all these cases of the procedural necessities of the derivative action, or indeed any mention of the derivative action as there invariably is in the true derivative suit. In fact, *Piercy v. Mills* was an individual shareholder's action and it is submitted that each of the other cases were also personal actions brought in representative form. Moreover, analogous leading cases in which the directors were alleged to have breached their fiduciary duty by exercising their powers for an improper purpose have also been personal actions. *Smith v. Fawcett*⁵² was a personal action by the executor of a deceased shareholder alleging that the directors were exercising their unrestricted power to refuse transfers in bad faith. As there was no showing of bad faith the action failed, but there was no question of the standing of the individual plaintiff to challenge the directors' action. Similarly in *Galloway*

⁵⁰ [1920] 1 Ch. 77.

⁵¹ *Supra*, footnote 47.

⁵² [1942] Ch. 304 (C.A.).

v. *Halle Concerts Society*,⁵³ two individual shareholders successfully alleged that the directors had breached their fiduciary duty in causing the company to levy calls on their shares to the exclusion of the other shareholders.

What is occurring in these cases is an interference by the company with the rights of certain of the shareholders and is the same type of conduct that occurs in similar cases where the right of a shareholder to take personal action is firmly established. These cases⁵⁴ involve such matters as varying or abrogating class rights,⁵⁵ depriving a member of some right conferred upon him by the articles or by-laws,⁵⁶ altering the internal corporate structure in a manner that amounts to a fraud on the minority,⁵⁷ and depriving a member of his right to vote.⁵⁸ A personal action may be more readily granted in such cases because one group of shareholders is more clearly seen to be taking action that deprives another of their rights. But this is also the case where the directors, while acting for a collateral purpose, cause the corporation to act in a manner that deprives a group of shareholders of their rights. In such cases as *Piercy, Smith and Galloway*, the judicial reasoning, although it is not clearly expressed as such, is that in causing the company to do certain acts which are primarily of an internal nature and which primarily affect the shareholders (issue shares, make calls, refuse transfers, solicit proxies) the directors assume a fiduciary obligation toward the company as a whole, that is to the shareholders as a general body,⁵⁹ to act with an even hand and in good faith. If they breach that duty the shareholders may sue in their individual capacities for a declaration of their rights or to restrain the company from acting. Some observations of Russell L.J., in *Bamford v. Bamford*⁶⁰ may seem to clash with this argument. *Bamford* was, once again, an allotment of shares to fend off a takeover bid. The articles of association of the Bam-

⁵³ [1915] 2 Ch. 233.

⁵⁴ The following list of examples is taken from Gower, *op. cit.*, footnote 45, p. 593.

⁵⁵ *White v. Bristol Aeroplane Co.*, [1953] Ch. 65 (C.A.); *Greenhalgh v. Arderne Cinemas*, *supra*, footnote 2; *Re John Smith's Todcaster Brewery*, [1953] Ch. 308 (C.A.).

⁵⁶ *Edwards v. Halliwell*, *supra*, footnote 25; *Wood v. Odessa Waterworks Co.* (1889), 42 Ch. D. 636.

⁵⁷ *Brown v. British Abrasive Wheel Co.*, [1919] 1 Ch. 290. See other cases listed in Gower, *op. cit.*, footnote 45, p. 593, footnote 83.

⁵⁸ *Pender v. Lushington*, *supra*, footnote 38.

⁵⁹ I am here giving "the company as a whole" the meaning which Evershed M.R. gave it in *Greenhalgh v. Arderne Cinemas*, *supra*, footnote 2, to mean "the incorporators as a general body". That case concerned discrimination between majority and minority shareholders, but the principle is the same where the directors exercise their powers to cause the corporation to discriminate between shareholders.

⁶⁰ *Bamford v. Bamford*, [1969] 1 All E.R. 969 (C.A.).

ford Company vested the power to issue shares in the directors. The question in the case was not whether the directors had exceeded their powers, (it was assumed by Plowman J. that they had), but whether the shareholders might ratify such directorial excess and thus validate the issue.⁶¹ That was the point of law set down for argument, and on that basis Plowman J. treated the action as a personal one by the two individual plaintiffs to enforce the contract in the articles between the members and the company created by section 20(1) of the English Companies Act 1948.⁶² In short, the plaintiffs argued that the terms of their contract required that only the directors could issue shares and to allow the shareholders to ratify an unlawful issue would be, in effect, to allow them a power of issuance.

In the Court of Appeal, in the course of discussing the ratification point, Russell J.A. said:⁶³

The point before us is not an objection to the proceedings on *Foss v. Harbottle* grounds. But it seems to me to march in step with the principles that underlie the rule in that case.

After thus implicitly recognizing that the action was personal and not derivative, but expressing the opinion that some of the same principles applied, His Lordship then observed:⁶⁴

None of the factors that admit exceptions to that rule appear to exist here. The harm done by the assumed improperly motivated allotment is a harm done to the company, of which only the company can complain. It would be for the company by ordinary resolution to decide whether or not to proceed against the directors.

Russell L.J. then expressed the opinion that the decision whether or not to litigate was the equivalent of a decision on ratification. It is suggested that the analogy, and that was clearly all that it was, to *Foss v. Harbottle* for the purpose of deciding the ratification point was unfortunate. There is little, if any precedent for his Lordship's dictum that *only* the company can complain of an improper allotment. For the reasons advanced above it is suggested that an individual shareholder has standing to complain of such an allotment, or of any other corporate act which the directors cause the company to take for a collateral purpose.

The Australian courts have clearly treated an improper allotment of shares as giving rise to a personal action, although the reasoning in the leading cases is rather confused. In *Ngurli v. McCann*⁶⁵ the High Court held that in failing to consider the

⁶¹ The ratification point will be considered *infra*.

⁶² *Bamford v. Bamford*, [1968] 2 All E.R. 655.

⁶³ *Supra*, footnote 60, at p. 976.

⁶⁴ *Ibid.*

⁶⁵ (1954), 90 C.L.R. 425.

interests of the company as a whole in issuing new shares the directors had breached their fiduciary duty and “. . . the plaintiffs have a clear right to sue in their own names to remedy the breach of trust”.⁶⁶ In so holding, the High Court relied on the decisions of the Privy Council in *Burland v. Earle*⁶⁷ and *Cook v. Deeks*⁶⁸ to the effect that where the acts complained of are of a fraudulent character the minority can sue when the wrongdoers are in control. The High Court then reasoned that the right to issue new capital is an advantage which belongs to the company and the appropriation of a corporate advantage for the benefit of the majority to the exclusion of the minority is a fraudulent act. The difficulty with applying this reasoning to *Ngurli* (apart from the novel idea that the right to issue new shares is a corporate asset) is that both *Burland* and *Cook* were shareholders' derivative actions and what was clearly being referred to was the right of the minority to personally bring suit on behalf of the company when the wrongdoers are in control—the fraud exception to *Foss v. Harbottle*.

In *Provident International Corporation v. International Leasing Corporation*,⁶⁹ Helsham J. relied on *Ngurli* and held that the rule “. . . does not apply in the case of a fraud on the powers of directors, at any rate where the abuse of power concerns a purported issue of shares, and I am of the opinion that this is so where the fraud consists of no dishonesty but a mere attempt to use the power for purposes other than that for which it is given”.⁷⁰ But here again the non-applicability of the rule has reference to the ability of the minority to sue in a derivative and not a personal capacity. However, Helsham J. went on to use language that could be taken to be a holding that the directors owe fiduciary duties directly to the shareholders:⁷¹

The reason why the rule in *Foss v. Harbottle* does not apply in a case of fraud on a power such as the present no doubt resides in the fiduciary nature of the duty owed and the fact that it is owed to all the corporators of the company. A breach of duty owed to an individual shareholder as one of the corporators could not be ratified by a majority of shareholders; any attempt by a majority to ratify a breach of fiduciary duty by directors would be no less a fraud *qua* that shareholder than was the case in the acts of the directors.

⁶⁶ *Ibid.*, at p. 447. The trial judge would have granted the plaintiffs relief except that he considered the improper allotment a wrong done to the company for which only it could complain. The Full Court of the Supreme Court of South Australia reversed and set aside the allotment and the High Court affirmed.

⁶⁷ *Supra*, footnote 18.

⁶⁸ [1916] 1 A.C. 554.

⁶⁹ (1969), 89 W.N. (Pt 1) (N.S.W.) 370.

⁷⁰ *Ibid.*, at p. 375.

⁷¹ *Ibid.*, at p. 375.

It is certainly the accepted position in the United States that directors, and majority shareholders in certain cases, stand in a direct fiduciary relationship to the shareholders.⁷² But there is no case in the Commonwealth that so holds and as much as such a development is desirable and inevitable, it is not clear that that is what Helsham J. meant. *Provident International Corp.* is simply based on the proposition, elaborated above, that it is the shareholders who are directly affected when an improper allotment of shares is made and they therefore have a personal right to sue, have the *corporate* act declared void and to have the share register rectified. The directors who authorized the allotment may, but need not be, joined as co-defendants with the company. Helsham J. also relied on the more recent High Court judgment in *Harlowe's Nominees Pty. Ltd. v. Woodside Oil Co.*⁷³ which was a personal action to set aside an improper allotment and for rectification of the share register. There was no question either at trial or in the High Court of the plaintiff's right to maintain a personal action.

It may be, as in threatened *ultra vires* or illegal acts, that there is both a personal and corporate right of action. The shareholder may properly sue to restrain the company, or the company may proceed against the directors to restrain them from taking the proposed action.⁷⁴ "But the fact that this second alternative is a possible one is no reason for refusing to allow a member to sue the company if he has an independent right to do so".⁷⁵ So too in collateral purpose cases; the shareholders are the ones most directly concerned, and injured, in such cases and the fact that the corporation, in an indirect way, may also be injured by the failure of the directors to stay within their powers should not prevent the shareholders from asserting their personal rights.

Securities legislation provides the clearest example of both personal and corporate rights of action arising from the same wrongful act. Both the Ontario Securities Act and the Ontario Business Corporations Act provide for individual and corporate recovery when an insider trades in a company's securities with knowledge of material, confidential information.⁷⁶ Such a statutory provision is necessary for a personal action because of the holding

⁷² *Pepper v. Litton* (1939), 308 U.S. 295; *Jones v. H. F. Ahmanson & Co.* (1969), 460 P. 2d 464.

⁷³ (1968), 42 A.L.J.R. 123; *Ampol Petroleum Ltd. v. R. W. Miller (Holdings) Ltd.*, [1972] 2 N.S.W.L.R. 850, was also a personal action by a majority shareholder to set aside an allotment that was designed to dilute the majority position and aid another party in a takeover battle.

⁷⁴ Gower, *op. cit.*, footnote 45, p. 592.

⁷⁵ *Ibid.*

⁷⁶ The Business Corporations Act, R.S.O., 1970, c. 53, s. 150; The Securities Act, R.S.O., 1970, c. 426, s. 113. The draft federal Act contains a similar provision in s. 122 (2).

in *Percival v. Wright*.⁷⁷ But even if the statute were silent as to a corporate right of action it is suggested that one would exist, in addition to the personal right, by extension of the principles in *Regal (Hastings) Ltd. v. Gulliver*,⁷⁸ particularly as recently elaborated by the Supreme Court of Canada in *Canadian Aero Services Ltd. v. Terra Surveys Ltd.*⁷⁹ This result was reached recently in the United States where a common law derivative action was allowed both in cases of insider trading by directors⁸⁰ and by directors and "tippees".⁸¹

The courts in the United States have recognized, particularly in the context of securities legislation, that the same allegations of fact can support both a derivative and personal action. The leading case is *J. I. Case Co. v. Borak*⁸² in which the Supreme Court indicated that violation of the proxy solicitation requirements of the Securities Exchange Act of 1934 gave rise to a private as well as a derivative action. In the Court of Appeals the plaintiff had, *inter alia*, appealed from a trial holding that the cause of action in the first count in the complaint, which related to a denial of pre-emptive rights, was derivative and that Wisconsin's security for expenses statute applied. In reversing, the court held that the security for expenses statute was not applicable, saying:⁸³

. . . we think the trial court failed to recognize the principle that the same allegations of fact might support either a derivative suit or an individual cause of action by shareholders.

It is fairly clear that breaches of the proxy solicitation legislation in Canada give rise to a personal action.⁸⁴ The analogy is to the notice cases in which it has consistently been held that every shareholder is entitled to truly informative notice of matters proposed for decision.⁸⁵ Mandatory proxy solicitation and the infor-

⁷⁷ [1902] 2 Ch. 421.

⁷⁸ [1942] 1 All E.R. 378. See also Gower, *op. cit.*, footnote 45, p. 545.

⁷⁹ (1974), 40 D.L.R. (3d) 371 (S.C.C.).

⁸⁰ *Diamond v. Oreamuno* (1969), 248 N.E. 2d 910 (N.Y.C.A.).

⁸¹ *Schein v. Chasen* (1973), 478 F. 2d 817 (2nd Cir.).

⁸² (1964), 377 U.S. 426.

⁸³ *Borak v. J. I. Case Co.* (1963), 317 F. 2d 838 (7th Cir.), at p. 845. The most important aspect of the *Borak* decision was the holding that violation of s. 14(a) of the Securities Exchange Act of 1934 gave rise to a private right of action for damages notwithstanding that the Exchange Act did not explicitly so provide but rather provided other remedies for its breach.

⁸⁴ *Charlebois v. Bienvenu* (1967), 64 D.L.R. (2d) 683 (Ont. H.C.); *Babic v. Milinkovic* (1972), 22 D.L.R. (3d) 732 (B.C.S.C.); *Rudkin v. British Columbia Automobile Association* (1969), 70 W.W.R. 649 (B.C. S.C.). In *Charlebois*, Fraser J. was of the opinion that the case stated came within the fraud exception to *Foss v. Harbottle*. It is suggested that *Charlebois* was in fact a personal, class action. This point will be discussed, *infra*, footnote 129.

⁸⁵ *Garvie v. Axmith*, *supra*, footnote 37 and cases cited therein.

mation circular that must accompany it, is an attempt to provide fuller corporate disclosure on a continuing, consistent basis—it is simply notice in the modern form. If the statutory provisions have not been complied with, or if the material is inadequate or misleading, a shareholder has a personal right to sue for a declaration that the meeting and all acts done at it are void.⁸⁶ It may also be, as the United States Supreme Court thought in *Borak*,⁸⁷ that deceptive proxy solicitation also gives rise to a derivative action. It tells nothing against the right to bring a personal action for a declaration to agree with Justice Clark that:⁸⁸

The injury which a stockholder suffers from a corporate action pursuant to a deceptive proxy solicitation ordinarily flows from the damage done to the corporation, rather than from the damage inflicted directly upon the stockholder. The damage suffered results not from the deceit practiced on him alone but rather from the deceit practiced on the stockholders as a group.

In *Charlebois v. Bienvenu*,⁸⁹ Fraser J. also seemed to be of the opinion that the sending of a misleading proxy statement could support a derivative suit but on somewhat different grounds than those expressed in *Borak*:⁹⁰

The defendants were also in breach of duty owed to the company quite apart from the requirements of the *Corporations Act*. The relationship of directors to a company is fiduciary and to hold an annual meeting and election of directors after sending out a misleading information circular . . . would seem *prima facie* to be a breach of that duty.

B. *Farnham v. Fingold and Goldex Mines v. Revill*.

The distinction between a personal and a derivative action becomes more acute if leave of the court is required to commence a derivative action. A personal action brought in representative form cannot be turned into a derivative action merely by asking that it be so treated if the plaintiff is faced with a motion for dismissal on the basis that the cause of action belongs exclusively to the company. Nor will the court grant a request by the plaintiff on the hearing of such a motion that leave be granted *nunc pro tunc*. Such motions to strike out pleadings and for dismissal arose in the recent Ontario cases of *Farnham v. Fingold*⁹¹ and *Goldex Mines v. Revill*.⁹² As these cases are the first to discuss the distinction between the personal and derivative action in light of the requirements of section 99 of the Ontario Act, it is proposed to examine them in some detail.

⁸⁶ *Charlebois v. Bienvenu*, *supra*, footnote 84.

⁸⁷ *Supra*, footnote 82.

⁸⁸ *Ibid.*, at p. 432.

⁸⁹ *Supra*, footnote 84.

⁹⁰ *Ibid.*, at p. 694.

⁹¹ *Supra*, footnote 34.

⁹² *Supra*, footnote 35.

The essence of the claim in *Farnham* was that the premium over market value that the controlling shareholders of Slater Steel had received on the private sale of their shares should be shared *pro rata* with the minority. The action was brought as a personal, class action by the plaintiff suing on behalf of himself and all the other shareholders of Slater Steel except the defendant majority shareholders. As the action was personal the claim was necessarily based on a fiduciary duty owed directly by the majority controlling shareholders to the minority. The defendants moved for dismissal and alternatively to strike out most of the statement of claim on the grounds, *inter alia*, that the law does not recognize such a fiduciary duty and that leave to commence the action had not been obtained pursuant to the requirements of section 99 of the Ontario Act. In short, the defendants contended that if any duty was owed it was to the company and the action was therefore derivative and within the requirements of section 99.

Morand J. refused to decide the vital question of whether the fiduciary duty alleged existed. Rather, he looked at the developing law of fiduciary obligations both in the courts,⁹³ in corporate⁹⁴ and securities legislation⁹⁵ and through decisions of securities commissions⁹⁶ and held that the matter was at least arguable and therefore should be left to the trial judge. If such a duty did exist then the action was properly a personal one and was also proper as a class action. For these reasons, Morand J. dismissed the motion. The defendants then sought and obtained leave to appeal.

The Court of Appeal⁹⁷ recognized that the plaintiffs' claims were novel in Canadian law and depended upon applying or extending the principles of *Perlman v. Feldmann*⁹⁸ and noted, with approval, that the appellants were no longer contending that such a difficult question of law should be decided in interlocutory proceedings. However they were still claiming that certain paragraphs of the statement of claim dealt with duties owed to and damages suffered by Slater Steel. Such matters were properly the subject of a derivative action and the requirements of section 99 were invoked. Jessup J.A. agreed and dismissed the action in so far as it was derivative without prejudice to the plaintiffs' right to apply under section 99.⁹⁹

⁹³ Morand J., cited *Perlman v. Fieldmann* (1955), 219 F. 2d 173 (2nd Cir.) and *Brown v. Halbert* (1969), 76 Cal. Rptr 781.

⁹⁴ Ontario Business Corporations Act, *supra*, footnote 10, s. 150.

⁹⁵ The Securities Act, R.S.O., 1970, c. 426, s. 113.

⁹⁶ *In the Matter of Consolidated Manitoba Mines Limited and Great Basin Metal Mines Limited*, O.S.C. Bulletin, Dec. 1966, p. 8.

⁹⁷ *Supra*, footnote 34.

⁹⁸ *Supra*, footnote 93.

⁹⁹ In so doing, Jessup J.A. also held that section 99 was exhaustive of a shareholder's right to bring a derivative action. This important point will be discussed more fully *infra*.

The difficulty with the judgment is that the offending paragraphs in the statement of claim,¹⁰⁰ particularly paragraphs 29 and 32, went to the heart of the plaintiffs' claim to share in the control premium received by the majority shareholders. Paragraph 29 spoke of the defendants acting "in contravention of their fiduciary duty to Slater Steel . . . and the general shareholders thereof by entering into an agreement for the sale of shares of the controlling shareholders . . .". More particularly, sub-paragraph 29(F) spoke of "the sale of control . . . at a premium price without regard to the general welfare of the shareholders of Slater Steel . . .". Paragraph 36 then makes it crystal clear that the plaintiffs were suing derivatively¹⁰¹ and "in addition and/or in the alternative", were claiming personally by reason of the fiduciary duty owed directly to them.¹⁰² The decision, however, cannot be read as deciding either that a cause of action exists when the controlling shareholders sell their shares at a premium¹⁰³ or that if it does it is derivative rather than personal. The only substantive holding was that section 99 was exhaustive of the shareholders' right to bring a derivative action. As the action as pleaded primarily raised a derivative claim the motion to dismiss was granted.

It was clear in *Farnham* that the plaintiffs were not themselves sure as to whether their claim was personal or derivative and they tried to have it both ways.¹⁰⁴ *Prima facie*, there is nothing wrong

¹⁰⁰ Statement of Claim, 7454/71, Registry, Supreme Court of Ontario.

¹⁰¹ *Ibid.*, para. 36 "The plaintiff states that this action is brought on behalf of Slater Steel Industries Limited and all of its shareholders except such shareholders as are defendants . . .".

¹⁰² *Ibid.*, ". . . in addition and/or in the alternative the remedies sought by the plaintiff in this action are enforceable by him personally pursuant to . . . the fiduciary duties owed by the defendants to him personally".

¹⁰³ There is no case that clearly holds that the majority are under obligation to share a control premium *pro rata* with all the shareholders. Such a principle might, however, be taken out of the language and the holding in *Jones v. Ahmanson* (1969), 460 P. 2d 464. *Perlman, supra*, footnote 93, depended on the finding of an appropriation of a corporate advantage for the exclusive benefit of the majority. In Ontario, the Select Committee on Company Law of the Legislative Assembly has recently recommended, in a 6-5 split opinion, that the controllers not be statutorily required to share their premium; Report on Mergers, Amalgamations and Certain Related Matters (Ontario, 1973), pp. 28-33. For analyses of the problem see Jennings, Trading in Corporate Control (1956), 44 Cal. L. Rev. 1; Leech, Transactions in Corporate Control (1956), 104 U. Pa. L. Rev. 725; Hill, The Sale of Controlling Shares (1957), 70 Harv. L. Rev. 986; Andrews, Stockholders' Right to Equal Opportunity in the Sale of Shares (1965), 78 Harv. L. Rev. 505.

¹⁰⁴ What was clear is that once one is in the thralls of section 99 the approval of the court is necessary for settlement and if one can guess, that is what the plaintiffs wished to avoid. Whether an action based on the taking of a control premium should be brought as a personal or derivative action depends on the theory that one adopts as to the duty of the controllers to share. Jennings, *ibid.*, at p. 9, adopts Berle's asset theory which

with mixing a personal and a derivative claim in the same action. The statement in Professor Wedderburn's classic article¹⁰⁵ on *Foss v. Harbottle* to the effect that a shareholder cannot join a personal claim in a derivative action is too broad. The case relied on, *Stround v. Lawson*,¹⁰⁶ merely said that under the operative rule of practice the "plaintiff . . . cannot join the two causes of action which he is putting forward in different capacities, unless he can shew that they both arise out of the same transaction". The modern rules of practice with respect to joinder are to the same effect.¹⁰⁷ Parties may not join more than one cause of action unless they can show they arose out of the same transaction or series of transactions. This is simply a rule of practice to prevent disparate causes being mixed in one trial—it has nothing to do with substantive company law and a personal and a derivative action may well be joined, as in *Farnham*, if the claims arise out of the same series of events.¹⁰⁸

It may be asked why, and in what situations, one would want to join a personal and a derivative action? The personal action is almost invariably for a declaration or injunction or both, but

would require a derivative action. Berle claimed that a premium is paid for control because the purchaser is "buying power and not stock". Thus, "the power going with the 'control' is an asset which belongs only to the corporation, and . . . payment for that power, if it goes anywhere, must go into the corporate treasury". Berle & Means, *op. cit.*, footnote 1, p. 244. The other theory is that in certain circumstances the majority shareholders owe a fiduciary duty directly to the minority, *Jones v. Ahmanson, ibid.* The taking of a control premium would be such a circumstance. "Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority. Any use to which they put the corporation or their power to control the corporation must benefit all shareholders proportionately . . .", *Jones v. Ahmanson, ibid.*, at p. 470 and see particularly pp. 472-473. On this view a minority shareholder would have a personal action. It is submitted that this is the preferable position as, in reality, it is the minority shareholder who directly suffers loss or injury and it is to him that a *pro rata* share of the premium should go. *Perlman* tried to have it both ways—the suit was derivative but the court ordered the minority's share of the premium to be held on trust for them. Surely a direct, personal action is preferable and more realistic. In *Farnham, supra*, footnote 34, the Ontario Court of Appeal was of the opinion that a class action would be appropriate in such a case as the claim is not for individual damages but for a global sum—the premium—and each member of the class, once it has been properly defined, can simply claim his proportionate share of the fund.

¹⁰⁵ Wedderburn, *op. cit.*, footnote 6, at p. 206.

¹⁰⁶ [1898] 2 Q.B. 44 (C.A.).

¹⁰⁷ See *e.g.* rule 66, Ontario Rules of Practice.

¹⁰⁸ Both the English and Canadian courts have allowed personal and derivative claims to be joined and have dealt with the merits of each in the same action. See *e.g.* *Gray v. Yellowknife Gold Mines Ltd.* (No. 1), [1947] O.R. 928 (C.A.); *Stone & Holt v. Margolian Ltd.* (1957), 8 D.L.R. (2d) 115 (N.S.S.C.); *Foster v. Foster*, [1916] 1 Ch. 541. The two most important corporate jurisdictions in the United States, New York and Delaware, both allow such joinder. See *e.g.* *Benson v. Braun* (1955), 145 N.Y.S. 2d 711; *Bennett v. Brevil Petroleum Corp.* (1953), 99 A. 2d 236.

rarely for damages. The derivative action is most often for damages although a claim for a declaration or injunction is quite possible. Will not either the one or the other action give the plaintiff the remedy that he seeks? The answer, it is suggested, is that it will. But not in all cases. A breach of duty owed to the company might well involve, as part of a scheme, some variation of shareholders rights which could be challenged by a personal action.¹⁰⁹ Moreover, securities law, both through legislation and judicial creativity, is more often giving shareholders personal damage claims in situations where the corporation also has a cause of action. Insider trading legislation in Ontario has been referred to as an example of this.¹¹⁰ Another example is the American cases where shareholders have sold their shares (either in the same company or of another company through a take-over) for less than their true value or have purchased shares for more than they were worth because of misconduct by management and the company has also been injured by such misconduct.¹¹¹

The *Goldex*¹¹² case involved a fight for control of a mining company. The heart of the matter concerned the calling of the annual meeting by the company, Probe Mines Ltd., and the sending of allegedly misleading proxy solicitation material in connection therewith. Goldex issued a writ (action one) on behalf of itself and all other shareholders in Probe except the defendant directors and joined Probe as a defendant. Thus the action could have been either a personal, class action or a derivative action. Leave pursuant to section 99 of the Ontario Act was not obtained. The relief sought was an injunction against holding the meeting and a declaration that the proxies solicited were null and void. Probe was determined to proceed with an annual meeting and called a second one at a later date pursuant to a fresh set of directors' resolutions. Goldex again issued a writ (action two) framed in the same manner, again asking an injunction and declaration. In action two, however, Goldex included in its writ allegations of the purchase of properties for shares from parties friendly to the defendant members of the Probe board and a collateral agreement that placed the shares in escrow subject to Probe retaining the voting rights. There were also allegations of

¹⁰⁹ This was the case in *Hogg v. Cramphorn*, [1967] Ch. 254.

¹¹⁰ *Supra*, footnotes 94 and 95. The major example of this is the personal damages claims allowed in the United States through breaches of rule 10b-5 of the Securities Exchange Act of 1934 since the decision of the U.S. Supreme Court in *J. I. Case v. Borak*, *supra*, footnote 3.

¹¹¹ The more than twenty-five *Georgia Pacific* cases are the leading examples of this situation. See Clare, *The Derivative and Class Action—Another Point of View in The Law, Disclosure and the Securities Markets Materials* (1970), p. 93, at pp. 109-112.

¹¹² *Supra*, footnote 35.

secret agreements for some of the shares so issued to come back to certain members of the Probe board.

At the hearing of both actions, counsel for Probe argued that they were not properly before the court as Goldex had not obtained leave. Haines J., noted that the question of the exhaustiveness of section 99 was then before the Court of Appeal in *Farnham* and left the matter to be decided by the trial judge¹¹³ in the interests of uniformity. The question of whether or not either or both actions might have been personal was not considered. In any event, the injunctions asked in both actions were granted. Probe then sought leave to appeal.

On the application for leave to appeal,¹¹⁴ Galligan ruled that as the application before Haines J. was for interim injunctive relief it was incumbent upon the plaintiffs to establish a *prima facie* case to the relief sought. Further, it was an essential part of the proof of such case that the plaintiffs show they were entitled to bring the action. It was necessary, therefore, for the judge on the application to "determine *prima facie* whether or not the plaintiffs have status".¹¹⁵ Counsel for Goldex then submitted that both actions were personal and that leave was not therefore required. Galligan J. was thus faced with examining both actions to decide if they were personal or derivative. As to action one, he was of the opinion that it was solely an action for personal relief. However, it related to a meeting that never took place so there was no need to take any steps to enforce it. Action two caused more difficulty as the endorsement on the writ ran to five pages and mixed a number of different claims for relief. One part of the claim, that directed to the proxy material and the holding of the meeting was, as in action one, personal. But the part relating to an alleged improper agreement with respect to purchase of property and issuance of shares by the company in order that the incumbent directors might keep themselves in office could be construed as derivative and Galligan J. so held.¹¹⁶ That being the case, section 99 applied to that part of the claim and leave to appeal was granted.

On appeal, the Divisional Court held¹¹⁷ that the entire claim in action two was derivative and, following *Farnham*, held that leave had to be obtained.¹¹⁸ Before considering the merits of the

¹¹³ *Ibid.*, at p. 680. Haines J. did express the view that section 99 was not exhaustive. This point will be discussed *infra*.

¹¹⁴ *Goldex Mines Ltd. v. Revill et al.*, [1973] 2 O.R. 389 (Ont. H.C.).

¹¹⁵ *Ibid.*, at p. 394.

¹¹⁶ *Ibid.*, at p. 395.

¹¹⁷ [1973] 3 O.R. 869.

¹¹⁸ Goldex has appealed the ruling of the Divisional Court but the judgment of the Court of Appeal had not been handed down by the time this article was submitted for publication.

judgment of Hughes J., it is necessary to clear up a semantic difficulty that runs through all the judgments in *Farnham* and in *Goldex*. Hughes J. referred to counsel's contention that the actions "were class actions and not derivative actions . . .".¹¹⁹ It is clear from the context that Hughes J. appreciated that the class action he referred to was brought by the shareholders personally. But it leads to confusion to oppose the class action to the derivative action. A derivative action must, at common law and by the requirements of section 99 and section 229, be brought in representative form so that all the shareholders will be bound by the judgment and the company will not be harrassed by a multiplicity of actions. A personal action may (but need not) be brought in representative (class) form if it is proper to do so.¹²⁰ If it is not proper to do so, it proceeds as a personal, individual action rather than a personal, class action. And a shareholder may well have a personal claim against a company which would not be appropriately brought as a class action on behalf of his fellow shareholders. The substantive distinction for company law purposes is between the personal and the derivative action. It is respectfully suggested that it can only lead to confusion to refer to the class action in contrast to the derivative action which, while not in substance a class action, is brought in representative form.

Hughes J. agreed with Galligan J. that the paragraph in the endorsement on the writ in the second action which alleged a sale of property for shares contrary to the best interests of Probe stated a derivative cause of action. However, Hughes J. felt constrained to examine each of the fourteen paragraphs of the endorsement¹²¹ in light of the extensive relief granted by Haines J. He noted that the first five paragraphs all related to acts of the directors taken with respect to the calling of the annual meeting and the solicitation and voting of proxies. He then noted that each injunction asked for, including the injunction with respect to the matters referred to in the first five paragraphs, was sought on the grounds that "the Defendant Directors are in breach of their fiduciary duty to Probe".¹²² His Lordship then concluded that:¹²³

. . . all of the relief sought, and particularly that in respect of which relief was granted, is necessarily derived from rights, duties and obligations owed to Probe and enforceable by Probe.

It followed that the claim in action one, to dispose of the appeal

¹¹⁹ *Supra*, footnote 117, at p. 874.

¹²⁰ Rule 75, Ontario Rules of Practice.

¹²¹ *Supra*, footnote 117, at pp. 880-884.

¹²² *Ibid.*, at p. 885.

¹²³ *Ibid.*

although there was no *lis* subsisting, was also found to be derivative.¹²⁴

In coming to this conclusion, Hughes J. noted that it was not claimed that the resolutions or proxies were *ultra vires* of Probe, nor was breach of its by-laws claimed. The plaintiffs, therefore, were relying "presumably [on] breach of statute".¹²⁵ In concluding that all of the breaches alleged were based on duties owed to Probe and enforceable by Probe, his Lordship is saying, in effect, that all duties owed by the directors run exclusively to the company. What has been elaborated above with respect to the distinction between personal and derivative actions and the highly theoretical analysis required to reach such a conclusion applies to the judgment in *Goldex*. And, with respect, such a conclusion is wrong in law. The Ontario courts have consistently held that an individual shareholder has standing to seek a declaration or injunction or both for inadequate or insufficient notice of a meeting.¹²⁶ If the by-law with respect to the number of days notice for meeting is breached a shareholder has a personal right to have it enforced.¹²⁷ If the by-laws were silent as to the number of days notice and the directors gave more than fifty days notice contrary to section 106(2) of the Ontario Act can it be seriously contended that only a derivative action will lie? Moreover, the mandatory proxy solicitation and accompanying information circular now required by the Ontario Act is, as has been submitted, simply an extension and elaboration of the notice requirement. Indeed, the information that the courts mandated must accompany a notice of meeting is now required as part of the information circular: the information circular is simply the legislative response to the judicial requirement of fully informative notice.¹²⁸ Can it then be the case that non-compliance with the proxy requirements, or improper solicitation, or an inadequate or misleading information circular can only be remedied by a derivative action where before a personal action was possible? It is suggested that such a conclusion is wrong in law and that a shareholder has a personal right

¹²⁴ *Ibid.*, at p. 887.

¹²⁵ *Ibid.*, at p. 885.

¹²⁶ *Garvie v. Axmith*, *supra*, footnote 37 and cases cited therein.

¹²⁷ *Ashton v. Powers* (1921), 51 O.L.R. 309.

¹²⁸ Regulation 25(1) of the Ontario Act requires that the information circular "contain the information prescribed in Form 15". Item 10 of Form 15 (Ont. Reg. 492/70, Form 15) requires "If action is to be taken on any matter to be submitted to shareholders . . . such matter . . . should be described . . . in sufficient detail to permit shareholders to form a reasoned judgment concerning any such matter". This is simply a codification of the common law requirement with respect to informative notice which could be enforced by a personal action, see *e.g.* *Garvie v. Axmith*, *supra*, footnote 37.

of action to enforce the proxy requirements¹²⁹ and other similar requirements of the companies Acts that are directed at informing and protecting him.

C. "Irregularity" And Majority Rule.

The analytical and functional distinction between the personal and derivative suit that has been argued above applies equally to the "irregularity" branch of the *rule*. From a functional point of view what occurs in the irregularity cases is that the directors, often in their capacity of corporate officers, so use the corporate machinery in such matters as giving notice and calling and conducting meetings that they commit a breach of the internal regulations. Such a breach is in no sense an injury to the corporation and the major premise of the *rule* has no application. But the second premise of the *rule*, majority rule in the conduct of the company's affairs, is said to apply. Thus the matter is not one of the individual shareholder not having standing to sue because the wrong is not to him but to the corporation—it is to him and he does have standing—but is one of the possibility of majority approval of the breach. Through this side wind the shareholder is effectively nonsuited.

The difficulty with this analysis is that the articles and by-laws are in the nature of a contract between the members and the company. To allow a breach to be ratified is, in effect, to allow corporate business to be conducted as if the contract had been altered prior to the meeting when in fact it has not. Moreover, such a contractual alteration in the case of articles of association requires a special majority—a simple majority will not suffice. In the case of by-laws such an alteration must first be passed by the directors and then submitted to the shareholders for confirmation—the shareholders have no originating power, or power of amendment, apart from when a by-law is submitted to them for confirma-

¹²⁹ The judgment of Fraser J. in *Charlebois v. Bienvenu*, *supra*, footnote 84, may seem to contradict this statement. That case involved the sending of a deliberately misleading information circular. The defendants argued that the plaintiffs had no status to sue and invoked *Foss v. Harbottle*. There had been no allegation of fraud and the doctrine of majority rule was said to prevail. Fraser J. found that the facts alleged against the directors constituted constructive fraud and this was sufficient to give the plaintiffs standing. Fraser J. also relied strongly on the decision of the English Court of Appeal in *Baillie v. Oriental Telephone & Electric Co. Ltd.*, [1915] 1 Ch. 503 (C.A.) and said that it was similar to the instant case. It was indeed similar to *Charlebois* in that it involved inadequate and misleading notice, but most importantly it was a personal, class action and the Court of Appeal specifically held that *Foss v. Harbottle* did not apply. Fraser J. did not consider whether or not the action in *Charlebois* might be personal but it is respectfully suggested for the reasons advanced in the text above, and following *Baillie* and similar cases, that it was a personal, class action and that such an action is appropriate in similar proxy cases.

tion.¹³⁰ A further complicating matter is that the courts are uncertain as to which procedural matters are to be treated as irregularities capable of the confirmation and which are to be treated as matters of substance that must be adhered to.¹³¹ This unsatisfactory state of the law is pointed up by contrasting *Pender v. Lushington*¹³² with *MacDougall v. Gardiner*.¹³³

In *Pender*, Jessel M.R. ruled that a shareholder is entitled to have his vote recorded and may sue to enforce that right. In *MacDougall*, a poll was demanded on a motion to adjourn. The chairman ruled that there could be no poll on a question of adjournment. The Court of Appeal applied the second branch of the *rule* to dismiss a shareholders' action. But the effect of the adjournment was to postpone indefinitely a vote on important matters—a vote the directors wanted to avoid and a vote the plaintiffs, by their proxies, could control. Thus the procedural irregularity indirectly deprived the plaintiffs of their vote, a thing the court in *Pender* said could not be done. Other cases that might be contrasted with equally unsatisfactory results are *Cotter v. National Union of Seamen*¹³⁴ and *Pelech v. Ukrainian Mutual Benefit Assn.*¹³⁵ with *Garvie v. Axmith*¹³⁶ and *Re National Grocers Company*.¹³⁷

In *Cotter* the English Court of Appeal refused to intervene even though the irregularities were that improperly appointed delegates were allowed to vote and no notice was given of a proposal to lend the union's funds to a political movement. In *Pelech* the failure to give any notice of a proposed increase in dues because, as the court found as a matter of fact, the association's officers expected opposition to develop, did not give rise to a personal action.¹³⁸ In *Garvie* and in *Re National Grocers*,¹³⁹ the Ontario courts followed *Kaye v. Croydon Tramways Co.*¹⁴⁰ and held invalid resolutions passed by overwhelming majorities (nine-

¹³⁰ Business Corporations Act, 1970, S.O., 1970, c. 28, s. 21(3); *Kelly v. Electrical Construction Company* (1908), 16 O.L.R. 232.

¹³¹ The number of days notice that a shareholder must receive prior to a general meeting is usually treated as a matter of substance which the shareholder is entitled to insist upon. See *Ashton v. Powers* (1921), 51 O.L.R. 309.

¹³² *Supra*, footnote 38.

¹³³ [1875] 1 Ch. D. 13.

¹³⁴ [1929] 2 Ch. 58 (C.A.).

¹³⁵ [1940] 4 D.L.R. 342 (Man. K.B.).

¹³⁶ *Supra*, footnote 37.

¹³⁷ [1938] O.R. 142 (Ont. C.A.).

¹³⁸ Neither *Cotter* nor *Pelech* are company cases—*Cotter* involved a union and *Pelech* a society—but *Foss v. Harbotile* principles were specifically applied and the courts have extended the *rule*, through a majority ratification justification, to any organization which can sue or be sued in its own name. The leading modern analysis of the *rule* is contained in another union case, *Edwards v. Halliwell*, *supra*, footnote 56.

¹³⁹ [1938] 3 D.L.R. 106.

¹⁴⁰ *Supra*, footnote 37.

ty-five per cent in *Garvie*) because the notice was not informative enough to allow the shareholders to evaluate the proposed arrangements.

The highwater mark of applying the irregularity branch of the rule is the judgment of the Alberta Court of Appeal in *Watt v. Commonwealth Petroleum Ltd.*¹⁴¹ Proper notice was not given, votes were improperly accepted, and an interested person acted as a scrutineer. In dismissing a shareholder's personal action, McGillivray J.A. observed that:¹⁴²

The voting, the appointment of scrutineers and the recording of votes are all matters which if done regularly could not be questioned as being beyond the powers of the company. If done irregularly the wrong flowing from the irregularity is a wrong to the company and not to the plaintiff or other individual shareholders and so it is the company which has the cause of action.

As is often the case, bad judgments can be particularly illuminating and so it is with *Watt*. The first branch of the rule—action by the company alone for a wrong done to it, is tangled with the second branch, majority rule in the governance of the corporation's internal affairs. Only on the most theoretical analysis, as has been submitted above, can the wrongs in *Watt* be said to be wrongs to the corporation. The matter is one between shareholders with the directors acting as official functionaries. Surely it is the shareholders, and only the shareholders, who are wronged when there is improper notice, when votes are improperly accepted, or when scrutineers are not impartial. Whether the majority should be able to set right such wrongs is a wholly separate question. But the answer to that vital question might be very different depending upon whether one sees what is being approved as a wrong to the corporation, or as a wrong to one group of shareholders being approved by another, more numerous group.

Arrayed against the *Watt* decision, and those that agree with it, are numerous cases that give the shareholder personally enforceable rights with regard to the calling and conduct of meetings: the right to have properly executed proxies counted,¹⁴³ to have votes recorded,¹⁴⁴ to be heard,¹⁴⁵ to have improper votes excluded,¹⁴⁶ to move proper amendments,¹⁴⁷ to have disinterested scrutineers,¹⁴⁸ to have the chairman correctly determine the sense of

¹⁴¹ [1938] 4 D.L.R. 701. For an equally harsh application of the irregularity rule see *Watson v. Barrett* (1929), 41 B.C.R. 478.

¹⁴² *Ibid.*, at p. 707.

¹⁴³ *Johnson v. Hall* (1957), 10 D.L.R. (2d) 243 (B.C.S.C.).

¹⁴⁴ *Pender v. Lushington*, *supra*, footnote 38.

¹⁴⁵ *Wall v. London & Northern Assets Corp.*, [1898] 2 Ch. 469 (C.A.); *Armstrong v. McGibbon* (1906), 15 Que. K.B. 345.

¹⁴⁶ *Shaw v. Tatti Concessions Ltd.*, [1913] 1 Ch. 292.

¹⁴⁷ *Henderson v. Bank of Australasia* (1890), 45 Ch. D. 330 (C.A.).

¹⁴⁸ *Dickson v. McMurray* (1881), 28 Gr. 533.

the meeting,¹⁴⁹ to have the directors meet and consider the necessity of a special general meeting before it is actually called,¹⁵⁰ to prevent the chairman from going behind the share register,¹⁵¹ and to challenge the status of a director to hold office.¹⁵²

Apart from the general nature of a shareholder's right to challenge matters that affect him in his capacity as shareholder,¹⁵³ there is the fact that the articles and by-laws are in the nature of a contract between the member and the company, and possibly between the members *inter se*, which each member should have standing to enforce. The provision that is now section 20(1) of the English Companies Act 1948, has been in that Act since 1856.¹⁵⁴ A similar provision appears in each of the memorandum jurisdictions in Canada. The Ontario Act does not constitute the by-laws as a contract but gives each shareholder the right to seek a compliance order where the corporation or any director or officer acts in breach of them.¹⁵⁵ The draft federal Act contains a similar provision.¹⁵⁶

The contractual nature of the articles was first given effect to in *Wood v. Odessa Waterworks Company*.¹⁵⁷ The articles empowered the directors, with the sanction of the company, to declare a dividend "to be paid" to the shareholders. Instead of paying a cash dividend, the shareholders resolved that interest-bearing bonds, redeemable at par by an annual drawing, should be paid out of the surplus account. The plaintiff brought a personal representative action on behalf of himself and all the other shareholders who had voted against the proposal to restrain the company from acting on the resolution. Mr. Justice Sterling ruled that

¹⁴⁹ *National Dwelling Society v. Sykes*, [1894] 3 Ch. 159; *Second Consolidated Trust Ltd. v. Ceylon Amalgamated Tea & Rubber Estates Ltd.*, [1943] 2 All E.R. 567 (C.A.). This list of examples is partially taken from Chumir, *Challenging Directors and the Rule in Foss v. Harbottle* (1965-66), 4 *Alta L. Rev.* 96, at p. 102.

¹⁵⁰ *Wood v. Pan-American Investment Ltd.* (1961), 28 D.L.R. (2d) 703 (B.C.S.S.).

¹⁵¹ *Tough Oakes Gold Mines Ltd. v. Foster* (1917), 39 O.L.R. 144, 34 D.L.R. 748 (Ont. H.C.).

¹⁵² *Theatre Amusements Co. v. Stone* (1915), 50 S.C.R. 32; *In re the Bodega Ltd.*, [1904] 1 Ch. 276; *Channel Collieries Trust Ltd. v. Dover*, [1914] 2 Ch. 506 (C.A.); *Holmes v. Keyes*, [1959] 1 Ch. 199 (C.A.).

¹⁵³ Such a right is clearly recognized in American company law unbelieved by questions of irregularity. See *e.g. Campbell v. Loew's Incorporated* (1957), 134 A. 2d 852 (C. Ch. Del.).

¹⁵⁴ 11 and 12 Geo. 6, c. 38, s. 20(1): "Subject to the provisions of this Act the memorandum and articles shall, when registered, bind the company and the members thereof to the same extent as if they respectively had been signed and sealed by each member, and contained covenants on the part of each member to observe all the provisions of the memorandum and the articles."

¹⁵⁵ The Ontario Act, s. 261.

¹⁵⁶ The federal Act, s. 237.

¹⁵⁷ (1889), 42 Ch. D. 636.

the article in question required a payment in cash or *in specie* that was immediately convertible to cash. The majority could not bind the minority to accept its plan as "the articles of association constitute a contract not merely between the shareholders and the company, but between each individual shareholder and every other".¹⁵⁸ If the majority wished to alter the articles, they had to comply with the article that required a special resolution for such alteration.

A more recent application of the same principle is the Australian case of *Krause v. J. G. Lloyd Pty. Ltd.*¹⁵⁹ The plaintiff, in a personal action, sought a declaration that one of the directors had not complied with the articles of association. There were further allegations of lack of quorums at directors' meetings and wrongful refusal to accept the nomination of the plaintiff as a director of the company. The defendants relied on the *rule* and *Mozley v. Alston*¹⁶⁰ to argue that all of the acts complained of were wrongs to the company of which only the company could complain.

Mr. Justice Hudson held that the rights of the plaintiff that were being infringed were "individual membership rights".¹⁶¹ To allow the majority to act as if the articles had been altered is to deprive the minority shareholders of their right to have the company run according to the rules by which the company and each of the members are contractually bound. Moreover, even if *Foss v. Harbottle* did apply, the special majority exception (alteration of the articles required a two-thirds majority) would apply to give the plaintiff standing. If it were otherwise:¹⁶²

. . . a company which, by its directors, had broken its own regulations by doing something without a special resolution which could only be done validly by a special resolution, could assert that it alone was the proper plaintiff in any consequent action, and the effect would be to allow a company acting in breach of its articles to do *de facto* by

¹⁵⁸ *Ibid.*, at p. 642. His Lordship relied on a similar ruling by the House of Lords in *Oakbank Oil Company v. Crum* (1882), 8 App. Cas. 65, at p. 71. Mr. Justice Sterling's further elaboration that the articles also constitute a contract between the members *inter se*, was not, strictly speaking, necessary for his decision. On this point see also *Rayfield v. Hands*, [1958] 2 W.L.R. 851. On the same basis as noted in the *Wood* case, the cases of *Grant v. U. K. Switchback R.Rys. Co.* (1888), 40 Ch. D. 135 and *Irvine v. The Union Bank of California* (1877), 2 App. Cas. 366 ought finally to be put to rest.

¹⁵⁹ [1965] V.R. 232 (S.C. Vict.).

¹⁶⁰ *Supra*, footnote 15.

¹⁶¹ *Kraus v. J. G. Lloyd Pty. Ltd.*, *supra*, footnote 159, at p. 235.

¹⁶² *Ibid.*, at p. 236 quoting from *Edwards v. Halliwell*, *supra*, footnote 25, at p. 1067. See also *Quin and Axtens, Ltd. v. Salmon*, [1909] 1 Ch. 311; *aff'd.*, [1909] A.C. 442. In the Court of Appeal, Farwell L.J. held that the plaintiff had the right to prevent an attempt to "alter the terms of the contract between the parties by a simple resolution instead of by a special resolution", at p. 319.

ordinary resolution that which according to its own regulations could only be done by special resolution.

It must be emphasized that *Krause* is not just an example of the special majority exception to the *rule*, but is, in the first instance a holding that a breach of the articles of association gives a shareholder a personal right to maintain an action for compliance.

It is instructive to compare *Krause* with *Mozley v. Alston*¹⁶³ which, along with *Foss v. Harbottle*, is taken to be the leading case that established the *rule*. A provision of the special Act which incorporated the company in *Mozley* required that one-third of the directors should retire each year. Two shareholders, in a personal action, alleged that this had not been done and that the entire board was therefore acting illegally. Lord Chancellor Cottenham ruled that an usurpation of the office of director was an injury to the corporation of which it alone could complain. There are two objections to this holding. The first is that it is carrying theory to an absurd point to hold that when directors unlawfully remain in office it is the corporation that is primarily injured. This point has been elaborated above and it is enough to point out that it is the shareholders who elect the directors—indeed it is probably their most important and meaningful act as shareholders, and if this right is interfered with it is they who are primarily injured and who should have standing to complain. Second, apart from any question of formal contract, a shareholder subscribes for shares on the basis that on matters relating to his rights as shareholder the terms of the company's governing documents will indeed govern unless and until they are properly changed. If they are improperly departed from, an individual shareholder should be able to sue to protect his rights. The decision in *Krause* is more in accord with the reality of the modern corporation and the relationship between the shareholders and the directors than that in *Mozley* which was decided some nine years before the first modern Companies Act of 1856 and which should no longer be followed.¹⁶⁴

In Canada there is a strong dictum by Duff J. in the Supreme

¹⁶³ *Supra*, footnote 15.

¹⁶⁴ See footnote 152, *supra*, and cases cited there for instances of a personal action by a shareholder to insist upon the disqualification of a director for breach of the articles. *Holmes v. Keyes*, *supra*, footnote 77, involved breach of a statutory provision, but it should make no difference in principle whether the breach is of the statute or of the articles, e.g. *Kaye v. Croydon Tramways Ltd.*, *supra*, footnote 37 (notice requirement in statute); *Baillie v. Oriental Telephones Co.*, [1915] 1 Ch. 503 (C.A.), (notice requirement in articles). An interesting expansion of a shareholder's personal rights was suggested by Street C.J. in *Ampol Petroleum*, *supra*, footnote 73, who said that "Persons buying shares in listed companies are entitled to expect directors faithfully to abide by Stock Exchange rules", at p. 882.

Court confirming the contractual effect of the articles and the personal right of a shareholder to insist upon their observance:¹⁶⁵

The articles of association are binding upon the company, the directors and the shareholders, until changed, in accordance with the law. So long as they remain in force, any shareholder is entitled, unless he is estopped from taking that position by some conduct of his own, to insist upon the articles being observed by the company, and the directors of that company. This right he cannot be deprived of by the action of any majority. In truth, the articles of association constitute a contract between the company and the shareholders which every shareholder is entitled to insist upon being carried out.

The position in the letters patent jurisdictions is less clear. There is no provision in these jurisdictions that constitute the letters patent and by-laws a contract between the members and the company. This flows from the fact that the foundation of a letters patent company is not a contract between the incorporators but the grant of a charter from the Crown in accordance with a statute. Both Wegenast¹⁶⁶ and Fraser and Stewart¹⁶⁷ state, however, that a shareholder has a right to insist that the company be governed according to the by-laws. The Ontario cases¹⁶⁸ have treated the by-laws as binding on the company and the members and have allowed personal actions to enforce them. The position in Ontario is changed by the new Act.

Incorporation in Ontario is no longer by a grant of letters patent from the Crown, but is by the signing and filing of articles of incorporation.¹⁶⁹ If the articles conform to law, a certificate of incorporation must issue.¹⁷⁰ Thus, in effect, incorporation is by registration as it is in the memorandum jurisdictions. To conform to those jurisdictions, and to secure the shareholders' rights, the Lawrence Report recommended that "the Ontario Act should specifically provide that individual shareholders may sue for the enforcement of individual rights including compliance with the provisions of the company's charter and by-laws".¹⁷¹ Section 261

¹⁶⁵ *The Theatre Amusement Co. v. Stone* (1915), 50 S.C.R. 32, at pp. 36-37.

¹⁶⁶ Wegenast, *Canadian Companies* (1931), p. 325, n. 22.

¹⁶⁷ Fraser and Stewart, *Company Law of Canada* (5th ed., 1962), p. 678. Both Wegenast and Fraser and Stewart cite, however, cases concerning the enforcement of the articles, restraining an *ultra vires* act, and a right derived from the statute, to support their propositions.

¹⁶⁸ *Rands v. Hiram Walker, Gooderham and Worts Ltd.*, [1936] O.R. 488; *Ashton v. Powers* (1921), 51 O.L.R. 309. There is a dictum to the contrary in *In re Good and Jacob Shantz & Co.* (1910), 21 O.L.R. 153, at p. 158. The dictum is *obiter* as the court found the by-law to be void.

¹⁶⁹ The Ontario Act, s. 4.

¹⁷⁰ *Ibid.*, s. 5. This same procedure for incorporation is contained in the draft federal Act.

¹⁷¹ Interim Report of The Select Committee on Company Law, 5th Session, 27th Legislature, Ontario, 1967, 15 & 16 Eliz. II, at p. 70.

of the Act does not constitute the articles of incorporation and by-laws a contract between the members and the company but provides that where a corporation or a director, officer or employee does not comply with any provision of the Act, the articles or the by-laws, a shareholder or creditor may apply to the court for an order directing compliance. This provision is fundamentally a sound one and provides broader rights than those that flow from the usual contractual provision. There are two points, however, that must be considered.

The first is that the shareholder himself should have been included in those who must comply with the corporation's governing documents so that one shareholder should be able to compel compliance by another.¹⁷² The second point is that it is still possible for a judge to destroy the intent of section 261 by continuing to apply the irregularity branch of the *rule*. That is, a judge may say that the by-laws are a matter for the majority and there is no point in making an order for compliance until the will of the majority is determined (or saying, in effect, that the will of the majority has been determined by the action they have taken). There are two reasons for hoping that section 261 will not be destroyed by this side wind. The first is the plain intent of the section itself. It was included as a result of the recommendation of the Lawrence *Report* to protect the shareholders' personal rights to have the corporation run according to its constating documents. The intent of section 261 is that any shareholder may seek the aid of the court in seeing that it is so run unless and until a lawful change has been made. This last point raises the second reason for objecting to the application of the irregularity branch of the *rule*. It is that changes in the by-laws, although they may be passed by a simple majority, are not in the control of the shareholders. That is the by-laws, or any change in them, can only be initiated by the directors who then must submit them to the shareholders for approval.¹⁷³ The only power of amendment the shareholders have is when a by-law is submitted to them for confirmation.¹⁷⁴ To allow the majority to regularize a departure from the by-laws would be to give the general meeting a power it does not possess. If the power to initiate by-laws is vested by statute in the directors, then that power resides exclusively in the

¹⁷² If the by-laws provided for pre-emptive rights, for instance, a shareholder should be able to enforce his rights against a shareholder who does not comply.

¹⁷³ The Ontario Act, s. 21. S. 101 does give the shareholders the right to initiate by-laws, but that section is not relevant in the context of the point being discussed.

¹⁷⁴ *Ibid.*, s. 21(3).

directors.¹⁷⁵ The argument made here is similar to the special majority point raised in *Edwards v. Halliwell*¹⁷⁶ and applied to a purported alteration of the articles in *Krause v. J. G. Lloyd Pty. Ltd.*,¹⁷⁷ and the result should be the same—the matter is beyond the competence of the majority.

Given the application of the contract and special majorities principles in memorandum jurisdictions, and of the exclusive power of the directors to initiate by-laws in letters patent jurisdictions, and of the application of section 261 in Ontario and of section 237 of the draft federal Act, is the irregularity branch of the *rule* completely ousted? As to any procedural requirement contained in the relevant companies Acts and in any of the governing corporate documents, it is suggested that it is. This branch of the *rule* ought now to be considered inconsistent with the modern legal position, insensitive to the realities of the governance of the corporation, and an unjustified interference with the rights of individual shareholders.

Apart from procedural requirements that arise out of the Act or the company's regulations, there are a number of requirements that are judge-made. Such requirements, which have already been noted,¹⁷⁸ include the right to be heard, the right to move amendments, the right to have the chairman take the correct sense of the meeting and the right to have impartial scrutineers. As a personal action has been allowed in each of these cases, it can be said that these judicial requirements are also beyond the power of the majority to interfere with. This may still leave some procedural trifles that ought not to form the basis of a shareholder's personal action. As Mellish L.J. observed in *MacDougall* "they are not all lawyers who attend these meetings and nothing can be more likely than that there should be something more or less irregular done at them".¹⁷⁹ But these "more or less" irregular matters ought truly to be trifles¹⁸⁰ that in no way intrude upon a shareholder's personal rights.

In summary it may be said that there is a wide category of shareholders' personal actions that are not affected by the *rule* and thus are not within the ambit of the legislative provisions that reform the *rule*. And for reasons of procedural simplicity and remedial advantage, a shareholder should always consider whether he might have a personal action before embarking on a derivative suit.

¹⁷⁵ *Kelly v. Electrical Construction Company* (1908), 16 O.L.R. 232, at p. 238-239.

¹⁷⁶ *Supra*, footnote 25.

¹⁷⁷ *Supra*, footnote 169.

¹⁷⁸ See footnotes 153 to 162, *supra*, for a list of the authorities.

¹⁷⁹ *MacDougall v. Gardiner, supra*, footnote 143, at p. 25.

¹⁸⁰ *Hayes v. Miron*, [1957] Que. Q.B. 538, at p. 554.

III. *Foss v. Harbottle Reformed.*

A. *The Scope of Majority Rule.*

There have as yet been no reported cases brought under section 99 of the Ontario Act and as the federal Act did not proceed past first reading in the last session of Parliament,¹⁸¹ it is not possible to discuss sections 99 and 229 in the context of specific facts. But as both sections purport to resolve many of the difficulties spawned by the *rule*, and as both are modeled to some extent on rule 23.1 of the American Federal Rules of Civil Procedure,¹⁸² it is possible to discuss them on the basis of the problems thought to be remedied and the issues likely to be raised.

On a plain reading, sections 99(1)¹⁸³ and 229(1)¹⁸⁴ appear to give a shareholder the right to bring an action, in representative form, on behalf of the company in *any* case in which the company could sue. And this seems to have been the intent, following rule 23.1, which speaks compendiously of “. . . an action . . . to enforce a right of a corporation”. Is it the case then that the four exceptions to the *rule*, *ultra vires*, special majority, personal rights and fraud on the minority¹⁸⁵ have been swept away in favour of a general right to sue on behalf of the corporation? To be specific, would the complaining minority in *Pavrides v. Jensen*¹⁸⁶ now be given their day in court? The answer to both questions is: not necessarily. For while both sections open the derivative suit to all corporate rights of action, nothing in either section gives guidance as to the *circumstances* under which such a suit may be maintained. Both sections require a demand upon the company to itself bring suit¹⁸⁷ but both are silent as to when the company,

¹⁸¹ *Supra*, footnote 11.

¹⁸² *Supra*, footnote 12 (hereinafter referred to as rule 23.1). Rule 23.1, which came into force in 1966, was formerly rule 23(b) which had been in the rules for some thirty years.

¹⁸³ S. 99(1): “Subject to subsection (2), a shareholder of a corporation may maintain an action in a representative capacity for himself and all other shareholders of the corporation suing for and on behalf of the corporation to enforce any right, duty or obligation owed to the corporation under this Act or under any other statute or rule of law or equity that could be enforced by the corporation itself, or to obtain damages for any breach of any such right, duty or obligation.”

¹⁸⁴ S. 229(1): “Subject to subsection (2), a complainant may apply to a court for leave to bring an action in the name and on behalf of a corporation or any of its subsidiaries, or intervene in an action to which any such body corporate is a party for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate.”

¹⁸⁵ *Edwards v. Halliwell*, *supra*, footnote 25, at p. 1067; Gower, *op. cit.*, footnote 45, pp. 584-585.

¹⁸⁶ *Supra*, footnote 29.

¹⁸⁷ S. 99(3)(b): “the shareholder has made reasonable efforts to cause the corporation to commence or prosecute diligently the action on its own behalf;”

s. 229(2)(a): “the complainant has given reasonable notice to the directors

through the directors, may justifiably respond that the matter is one that is capable of ratification by the shareholders and their opinion must be sought. Neither section, in terms, changes the case law on ratification, or on the ability of the directors to vote *qua* shareholders in their own best interests, and if the position still is that the minority may only bring a derivative suit when the majority may not ratify then the exceptions to *Foss v. Harbottle* continue to govern. For the line upon which minority shareholder action has always been said to run is the line between those acts which the majority may ratify and those which it may not.¹⁸⁸ Thus the substantive question in shareholders' derivative suits may be the same in the context of sections 99 and 229 as it was prior to the reform—what are the limits of the power of the majority?

Reliance is placed almost exclusively on the court in both sections to expand the scope of the minority shareholders' suit. Section 99 is silent as to the possibility of ratification by the majority. The drafters of the federal Act clearly considered the problem for section 232¹⁸⁹ directs that an application for leave is not to be dismissed *by reason only* that alleged breach may be or has been approved by the shareholders, but the court may take such facts into consideration in dealing with the case on its merits. Both sections thus leave the expansion of the minority's rights in the hands of the court. For both require that leave of the court is required to commence a derivative action and both require, *inter alia*, that the court be satisfied that the shareholder is acting in good faith and that it is in the interests of the corporation that the action be brought.¹⁹⁰ Thus under section 99 a court may well

of the corporation or its subsidiary of his intention to apply to the court under subsection (1) if the directors of the corporation or its subsidiary do not bring, diligently prosecute or defend or discontinue the action;" The requirement of demand is an important one and it will be discussed more extensively *infra*.

¹⁸⁸ See Gower, *op. cit.*, footnote 45, pp. 581-595. See generally Beck, *op. cit.*, footnote 6, and Wedderburn, *op. cit.*, footnote 6. *Hogg v. Cramphorn*, [1967] Ch. 254 has been said to be a rare exception to this—and the situation would be the same in any case in which ratification of directors' acts for a collateral purpose is allowed. See Wedderburn, Note (1967), 30 Mod. L. Rev. 77.

¹⁸⁹ S. 232(2): "An application made or an action brought or intervened in under this Part shall not be stayed, discontinued, settled or dismissed for want of prosecution without the approval of the court given upon such terms as the court thinks fit and, if the court determines that the interests of any complainant may be substantially affected by such stay, discontinuance, settlement or dismissal, the court may order any party to the application or action to give notice to the complainant."

¹⁹⁰ S. 99(3)(c): "the shareholder is acting in good faith and it is *prima facie* in the interests of the corporation or its shareholders that the action be commenced."

S. 229(2)(b): "the complainant is acting in good faith; and

use the accepted categories of ratification to deny leave on the basis that the matter is one that has traditionally been within the control of the majority and, absent unusual circumstances, it is not in the best interests of the company to bring suit when the majority have waived the alleged breach or may possibly do so. There is nothing in section 99, or anywhere else in the Ontario Act, that ousts the basic premise of majority rule. And notwithstanding the direction given in section 232, a court faced with an application under the federal Act could possibly take the same approach. It would not, it is suggested, necessarily be dismissing an application by reason only of ratification or its possibility to say that on the facts as pleaded, it is not in the best interests of the company to bring the action where there has been, or may be ratification.

It can only be hoped that the courts will use the statutory scheme in an enlightened manner to free the minority from the tangles of the *rule* and not consider themselves constrained by the traditional exceptions. This was clearly the intent of the company law reform committees that recommended statutory solution to the *Foss v. Harbottle* problem. In recommending a rule 23.1 solution the *Lawrence Report* said that:¹⁹¹

The remedy is one which can and should be adapted to Ontario law and practice to serve as an effective procedure whereby corporate wrongs can be put right.

In commenting on the proposed section 229, the federal reform group sounded a note of fervent optimism:¹⁹²

At one stroke this provision circumvents most of the procedural barriers that surround the present right to bring a derivative action . . . [w]e have relegated the rule to legal limbo without compunction, convinced that the alternative system recommended is preferable to the uncertainties—and obvious injustices—engendered by that infamous doctrine.

And most importantly, the federal Act clearly directs the court to look to the merits of each case regardless of the fact or possibility of ratification.¹⁹³ This is probably the only viable solution to the problem. It would be unwarranted to have a rule that, in effect, would prevent the majority from forgiving any breaches of duty. But it is equally unwarranted to have the minority cut off from court consideration of its grievance by such forgiveness, particularly when it may have been secured by the directors

(c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.”

¹⁹¹ Interim Report of The Select Committee on Company Law (Ont., 1967), p. 63.

¹⁹² 1 Proposals for a New Business Corporations Law for Canada (Canada, 1971), p. 161.

¹⁹³ S. 232, *supra*, footnote 189.

voting *qua* shareholders. Thus ratification should be treated as a cogent piece of evidence but as no more. This is the sense of section 232 of the federal Act and while the Ontario Act is silent on the point it is hoped that ratification will be treated in the same manner in order that section 99 may be made to play the role that was intended for it in corporate regulation.

The necessity of only treating ratification or its possibility as a piece of evidence is pointed up by the uncertain boundaries of majority rule. It is accepted doctrine that the majority may not "appropriate to themselves money, property or advantages which belong to the company or in which the other shareholders are entitled to participate".¹⁹⁴ This is the fraud on the minority exception to the *rule*¹⁹⁵ and appears to state a clear rule that would cover the ground from truly fraudulent takings to uncertain cases of corporate opportunity. But the rule is far from clear and dicta in such cases as *Regal (Hastings) Ltd. v. Gulliver*¹⁹⁶ and *Zwicker v. Stanbury*¹⁹⁷ suggest that the directors in those cases could have protected themselves from subsequent attack if they had secured prior approval from the shareholders for their actions. Yet both cases involved a taking of corporate property and they are difficult to reconcile with the general principle.¹⁹⁸ It has been suggested¹⁹⁹ that the dividing line between a *Regal* type situation and that in a case like *Cook v. Deeks*²⁰⁰ is the *bona fides* of the directors. The critical question under section 99 and 229 is: who is to be the judge of *bona fides*?

The courts have steadfastly refused to pass on the merits of a breach of fiduciary duty on the grounds that they cannot adequately investigate the matter and arrive at the truth.²⁰¹ But sections 99 and 229 now appear to force the courts into such a consideration. For in a *Regal* type situation there are three alternatives. The first is to say, consistent with the principle enunciated in *Burland v. Earle*,²⁰² that any taking of corporate property is

¹⁹⁴ *Burland v. Earle*, *supra*, footnote 18, per Lord Davey, at p. 93. See also *Menier v. Hooper's Telegraph Works* (1874), L.R. 9 Ch. App. 350; *Cook v. Deeks*, [1916] 1 A.C. 554 (P.C.); *Parke v. Daily News*, [1962] Ch. 927; *Zwicker v. Stanbury*, [1953] 2 S.C.R. 438, [1954] 1 D.L.R. 257.

¹⁹⁵ As to the uncertain scope of majority rule see the discussion in Gower, *op. cit.*, footnote 45, pp. 564-580.

¹⁹⁶ [1942] 1 All E.R. 378, per Lord Russell, at p. 389.

¹⁹⁷ *Supra*, footnote 195, per Kellock J., at p. 269 (D.L.R.).

¹⁹⁸ For a discussion of this difficult point see Beck, *The Saga of Peso Silver Mines: Corporate Opportunity Reconsidered* (1971), 49 Can. Bar Rev. 80, at pp. 114-119. Gower, *op. cit.*, footnote 45, pp. 564-566.

¹⁹⁹ Beck, *op. cit.*, *ibid.*, at p. 117.

²⁰⁰ *Supra*, footnote 195.

²⁰¹ *Regal (Hastings) Ltd. v. Gulliver*, *supra*, footnote 196, per Lord Wright, at p. 392.

²⁰² *Supra*, footnote 194.

not ratifiable and the court will require an accounting in all such cases.²⁰³ The second is to allow ratification in cases not involving *mala fides*. The third is for the courts to decide the matter on the basis of *bona fides* whether or not there has been ratification. Each alternative involves the court. In the first the court will simply set aside the particular transaction or require an accounting regardless of ratification and regardless of *bona fides* or do both. In the second, the court will have to make the determination of *bona fides*. Ratification, if it has been obtained, will simply be a piece of evidence. In the third, the court is in the same position of judging *bona fides* as in the second alternative, except that there has been no ratification. The one alternative that is not open, it is submitted, is for the court to treat ratification as being determinative of the matter, for that would be contrary to the spirit and intent of the new legislation. The only way the courts could avoid adjudication in such cases is for them to sweep aside the dicta in *Regal* and *Zwicker* and treat all breaches of fiduciary duty that involve the taking of corporate property, including the taking up of corporate opportunities, as non-ratifiable.

All breaches of fiduciary duty do not, of course, involve the taking of property that belongs, in law or equity, to the corporation. Nor, indeed, is the ambit of sections 99 and 229 defined by the scope of fiduciary duty. Both encompass the enforcement of any right belonging to the corporation. Thus the question of ratification is bound to arise in a number of different situations. The two most obvious are acts by the directors for a collateral purpose and breach of the directors' duty of care. It is submitted that in the collateral purpose cases the possible approaches are the same as those outlined above in the corporate property cases. That is the courts may decide that an issue of shares by the directors for an improper purpose is not ratifiable and will be automatically set aside. This was considered to be the position²⁰⁴ until the decision in *Hogg v. Cramphorn*²⁰⁵ which said that such a breach of duty could be waived by the shareholders. Thus a court considering the matter in the context of either section 99 or 229 could decide either to follow the old law and automatically

²⁰³ This is the position that has been argued for in the corporate opportunity cases. See Beck, *op. cit.*, footnote 208, at pp. 100-119. The contrary position has also been strongly argued; see Jones, *Unjust Enrichment and the Fiduciary's Duty of Loyalty* (1968), 84 L.Q. Rev. 472.

²⁰⁴ *Punt v. Symons & Co.*, [1903] 2 Ch. 506; *Piercy v. Mills*, [1920] 1 Ch. 77; *Bonisteel v. Collis Leather Co. Ltd.* (1919), 45 O.L.R. 195; *Legion Oils v. Barron* (1956), 2 D.L.R. (2d) 505; *Ngurli Ltd. v. McCann*, *supra*, footnote 65.

²⁰⁵ *Supra*, footnote 109. This decision was assumed to have been correct by the Court of Appeal in *Bamford v. Bamford*, *supra*, footnote 60, although the point was not directly in issue.

strike down such an issue²⁰⁶ or to allow ratification. But if ratification is allowed it should not be taken to be determinative of the matter. The court must consider the question of *bona fides* and decide the issue on its merits. Such improper issues as took place in *Punt v. Symons*,²⁰⁷ or *Piercy v. Mills*,²⁰⁸ or *Legion Oils v. Barron*²⁰⁹ should not be capable of shareholder approval. The facts of cases such as *Hogg v. Cramphorn* present a more difficult issue for decision but ratification, once again, should be treated only as a cogent piece of evidence. It is appreciated that Canadian courts may also follow the lead of the British Columbia Supreme Court in *Teck Corporation Limited v. Millar et al.*²¹⁰ and decide that an issue of shares that has, as one of its effects, the favouring of one party in a control fight is not *ipso facto* improper.²¹¹ Of course, such a decision also involves a judicial determination of the merits of the case and the directors' *bona fides*.

With respect to a breach of the directors' duty of care, it is surely clear that sections 99 and 229 were meant to give a complaining shareholder in a case like *Pavrides v. Jensen*²¹² his day in court. The possibility, or the fact, of ratification ought no longer to be a bar to such a hearing. Again, ratification should only be treated as evidence of the shareholders' views in the context of a judicial determination on the merits.

The weight to be given to ratification, and indeed the entire question of the rationale of judicial review of shareholders' decisions, raises the question of the principle of *North-West Transportation v. Beatty*.²¹³ It will be recalled that it was the decision of the Privy Council in that case that a director may use his votes *qua* shareholder, which he is entitled to cast in his own best interests, to waive his own breach of fiduciary duty. There is nothing in either the Ontario Act or the federal Act that changes that principle. Two points about the *North-West* case, however, should be recalled and emphasized. The first is that the Privy Council considered the *bona fides* of the transaction in sanctioning Mr. Beatty's conduct. Sir Richard Baggallay emphasized

²⁰⁶ It seems fairly clear that the Australian courts will continue to take this position unless the High Court reverses itself; see *Ngurli v. McCann*, *supra*, footnote 65.

²⁰⁷ *Supra*, footnote 204.

²⁰⁸ *Ibid.*

²⁰⁹ *Ibid.*

²¹⁰ (1973), 33 D.L.R. (3d) 288, [1973] 2 W.W.R. 385.

²¹¹ On the facts of *Teck* it was not necessary for Berger J. to decide not to follow *Hogg v. Cramphorn*, *supra*, footnote 109, and everything his Lordship said about the collateral purpose doctrine may be taken as dicta. For a discussion of *Teck* see Iacobucci, *The Exercise of Directors' Power: The Battle of Afton Mines* (1973), 11 Osgoode Hall L.J. 353.

²¹² *Supra*, footnote 29.

²¹³ *Supra*, footnote 19.

that the uncontradicted evidence²¹⁴ at trial was that the purchase of the boat was essential to the company's business; that the boat in question was suitable for the business; that no similar boat that was equally well suited was available; and that the price was neither excessive nor unreasonable. In short, the director may vote as shareholder but the court will give careful scrutiny to the merits of the transaction—and this is the same stance that it is submitted that courts should take in section 99 and 229 cases if the *North-West* principle is to remain intact.

The second point with respect to *North-West* is that the Privy Council overruled the Supreme Court of Canada. In the Supreme Court, Ritchie C.J. had held that:²¹⁵

. . . fair play and common sense alike dictate that if the transaction and act of the director are to be confirmed it should be by the impartial, independent, and intelligent judgment of the disinterested shareholders, and not by the interested director himself who should never have departed from his duty.

Thus it may well be that in the context of the realities of the governance of the modern corporation that the Canadian courts, and particularly the Supreme Court, should revert to the rule they first announced in 1887 and require a director to refrain from voting as shareholder in a matter in which he is interested. At the least, any matter which has been approved by the shareholders with the aid of the directors' votes should be subject to careful scrutiny by the court.

B. *Demand.*

Both sections 99²¹⁶ and 229²¹⁷ follow the common law²¹⁸ in requiring that a shareholder first attempt to have the company commence the action itself. This seems a reasonable requirement as the company should be given the opportunity of vindicating its own rights. And the directors, faced with an application to the court and possible trial, may well decide that corporate action is the responsible course. Moreover, such a request might result in

²¹⁴ *Ibid.*, at p. 594.

²¹⁵ (1887), 12 S.C.R. 598, at p. 604.

²¹⁶ S. 99(3)(b): "the shareholder has made reasonable efforts to cause the corporation to commence or prosecute diligently the action on its own behalf."

²¹⁷ S. 229(2)(a): "the complainant has given reasonable notice to the directors of the corporation or its subsidiary of his intention to apply to the court under subsection (1) if the directors of the corporation or its subsidiary do not bring, diligently prosecute or defend or discontinue the action."

²¹⁸ *Ferguson v. Wallbridge*, [1935] 3 D.L.R. 66 (P.C.), at p. 83. Demand was not required at common law on a showing that the alleged wrongdoers were in control. Sections 99 and 229 are silent on this point but it is submitted that the rule should be the same as at common law.

an amicable resolution of the dispute. Explanation may satisfy the shareholder that suit should not be brought or the directors may decide to revoke or restructure the matter that gave rise to the complaint. It must be emphasized that a refusal by the company to itself bring suit will not automatically allow the shareholder to proceed with a derivative action. He still must seek leave from the court and the directors may show that it is not in the company's best interests in the particular case to seek redress. The shareholder has the burden of establishing that it is, *prima facie*, in the best interests of the company that suit be brought and the court, once again, is made the arbiter.

There is, however, one aspect to the demand requirement, particularly in section 99, that may be troublesome. Section 99(3)(b) speaks of ". . . reasonable efforts to cause the corporation to commence . . . the action". Section 229(2)(a) refers to ". . . notice to the directors. . .". Does the "corporation" in section 99(3)(b) possibly mean that the decision of the shareholders must be sought? And might the directors be entitled to take such a position under section 229(2)(a)? There are two reasons, one legal and one practical, for suggesting that recourse to the shareholders is not required. Both the Ontario Act and the federal Act require that the company shall be managed by the directors.²¹⁹ The decision to sue or refrain from suing is clearly an essential management function. And it is equally clear that where the statute vests a particular power in one part of the corporation no residual power resides in the body at large.²²⁰ Thus the shareholders have no power to decide whether or not to sue and there should be no requirement that their opinion be sought either under the Ontario or the federal Act.

The practical objection to such a requirement, at least in the public company, is that to impose it would be to take away the remedy. The calling of a meeting of shareholders under either the federal Act or the Ontario Act involves the mandatory solicitation of proxies and the sending of an information circular.²²¹ If the complaining shareholder is opposed by management, which would probably be the case if it has demanded that a general meeting be called, he may feel that it is necessary to solicit proxies himself to put his case adequately before his fellow shareholders. But unlike management, the individual does not have access to the corporate treasury to pay the price of solicitation or, possibly, of a protracted proxy fight. And such cost could well act as an

²¹⁹ S. 132, Ontario Act; s. 96(1), federal Act.

²²⁰ *Kelly v. Electrical Construction Co.*, *supra*, footnote 130. The same rule holds where the articles vest management power in the directors in a memorandum company. See Gower, *op. cit.*, footnote 45, pp. 130-133.

²²¹ Ss 117, 118, Ontario Act; ss 140, 141, federal Act.

effective bar to the use of the statutory remedy. Moreover, whether or not the shareholder solicits proxies, it is notorious that it is extremely difficult to explain complex matters through an information circular and that there is an overwhelming tendency on the part of shareholders to support management. The case against requiring demand on the shareholders was cogently noted by the United States Court of Appeals in *Levitt v. Johnson*.²²² The company in *Levitt* had over 48,000 shareholders (not a large number in a public company) scattered over the United States. The trial court dismissed the claim because of the plaintiff's failure to allege a prior demand on the other shareholders. After noting that the purposes of such a demand are for the shareholders to decide either to take over the action themselves or to take no action, Judge Aldrich said:²²³

Neither of these purposes could be accomplished in any real sense unless the demand evoked a full and fair consideration of the issues, in depth, by the other stockholders. . . . here not only would the burden be enormous, but no disclosure that the plaintiff could be expected to make would be likely to persuade a majority to take over the action, or, conversely, permit an informed decision by the majority that the action be not instituted.

Judge Aldrich did not completely rule out the possibility of requiring a demand on shareholders (as he could not in the context of rule 23.1) but he said that it should be confined to those cases in which it "evoked a full and fair consideration of the issues, in depth, by the other stockholders". This might be possible in the small, private company but in such a case the majority, through the board, have already decided not to sue. If they vote as shareholders not to sue, the minority should have the right to have the court hear the *prima facie* case on the application for leave. If the majority refrain from voting, the minority will have its way. In either case, demand on the shareholders seems pointless. In summary, there are cogent legal and practical reasons why the courts should not read a requirement of prior demand on the shareholders into either section 99 or 229.

The practical objection to demand on shareholders applies also to a request by the directors that the shareholders' opinion on ratification be sought. If on the application for leave, management requests that the matter be adjourned to seek the opinion of the general meeting such a request should be denied. What has been said above with respect to the cost of a proxy battle, the difficulty of truly informing the shareholders, and the natural tendency to go along with management applies equally here.

²²² (1964), 334 F. 2d 815, cert. den. 379 U.S. 61.

²²³ *Ibid.*, at p. 818.

Moreover, if ratification, as has been submitted, is just a piece of cogent evidence to be taken into consideration in deciding the case on its merits, then the hearing on the merits should not be delayed while that piece of evidence is gathered. There may or may not have been ratification, but if there is a proper case for leave the action should proceed.

C. *Contemporaneous Ownership.*

Section 99(3)(a) of the Ontario Act requires that the applying shareholder have been a shareholder at the time the wrong complained of occurred.²²⁴ This is the American rule of contemporaneous ownership and illustrates the dangers of blindly following American legislative remedies without inquiring as to their rationale. The reason for the rule in the United States was to stop the collusive practice of the resident of one state transferring his shares to the resident of another to manufacture federal diversity jurisdiction in order that the matter be litigated in a federal court.²²⁵ Another reason is said to be to prevent "strike suits" and more particularly, purchased litigation.

The first reason clearly has no application to Canada. And the second reason has very little, if any, application given the absence of the contingent fee and the enormous potential cost liability that a litigant faces in Canada in contrast to his counterpart in the United States. Any small fear of "strike suits" is amply taken care of by the requirement of obtaining leave and the necessity of showing good faith and in the best interests of the corporation. The common law does not require contemporaneous ownership²²⁶ and there is simply no reason for it in the Canadian context. The inconsistencies created by the rule are pointed up by examining some contrasting situations. The fact that all or a majority of the shareholders of a company have changed does not deny the company the right to sue for a breach of duty that took place before such change. Indeed, that was exactly the situation in *Regal* and in *Peso Silver Mines v. Cropper*.²²⁷ The point simply is that a company is a continuing entity in which a changing group of shareholders hold various interests and its right to seek redress for an injury to it is in no way affected by the com-

²²⁴ S. 99(3)(a): "the shareholder was a shareholder of the corporation at the time of the transaction or other event giving rise to the cause of action."

²²⁵ Wright & Miller, *Federal Practice and Procedure* (1972), Vol. 7A, pp. 341-342.

²²⁶ *Seaton v. Grant*, [1867] 2 Ch. Ap. 459; *Bloxam v. Metro Ry.*, [1868] 3 Ch. App. 337.

²²⁷ (1966), 58 D.L.R. (2d) 1 (S.C.C.), aff'ing (1966), 56 D.L.R. (2d) 117 (B.C.C.A.).

position of that group. As the derivative action is for and on behalf of the corporation the same principle should apply.

The federal Act has no similar rule of contemporaneous ownership. Indeed, the federal Act goes quite far in the other direction and also gives standing to complain to former shareholders, to directors and officers, and to former directors and officers.²²⁸ The inclusion of directors and officers who may not be shareholders seems a sound expansion of the list of potential complainants for they may be in the best position to know of conduct that has injured the corporation. As the action is for the company's benefit there is every good reason why they should initiate it in appropriate circumstances. The same considerations apply to former shareholders and directors, although there is the additional consideration here that under the federal Act the court may order the award to be paid to present or former shareholders.²²⁹

D. *Shareholder Recovery.*

The federal Act, in section 230(c), gives the court the power to order that the award be paid to present or former shareholders. Such a distribution of a corporate recovery has been ordered in cases in the United States when the corporation was in liquidation or when the corporate assets had been sold.²³⁰ Providing that the rights of creditors are protected, such an order does no violence to corporate theory as it merely facilitates distribution. A more serious problem arises in the *Perlman v. Feldmann*²³¹ situation where such an order is made to prevent those who have participated or acquiesced in the wrong from sharing, indirectly as shareholders, in the recovery. "The courts . . . are forced to choose between competing equities: either certain shareholders will receive an unjustified benefit, or the defendants will be able to retain a portion of funds not rightfully theirs."²³² Of course, corporate recovery in *Perlman* would have meant that the purchasers would have indirectly recovered part of their purchase price. And in fact this is exactly what occurred in *Regal* when the action was brought by the corporation itself. On balance, such a power in the court seems justified but should be used sparingly keeping in mind that the funds are coming, in effect, out of the corporate treasury.

²²⁸ S. 228, federal Act.

²²⁹ S. 230(c), *ibid.*

²³⁰ *May v. Midwest Refining Co.* (1941), 121 F. 2d 431; *Sale v. Ambler* (1939), 6 A. 2d 519.

²³¹ *Supra*, footnote 93. See generally, *Multiparty Litigation in the Federal Courts* (1958), 71 Harv. L. Rev. 874, at pp. 946-950.

²³² *Ibid.*, at p. 946.

E. *Survival of Common Law Rights.*

In the Ontario Court of Appeal in *Farnham*,²³³ Jessup J.A. held that section 99 had abrogated the common law right to bring a derivative action and that leave of the court was therefore necessary in all such cases.²³⁴

. . . the very broad language of s. 99(1) embraces all causes of action under any statute or in law or in equity, that a shareholder may sue for on behalf of a corporation. All forms of derivative actions . . . come within it, and therefore s-s. (2) applies to all such actions.

In *Goldex*,²³⁵ Haines J., while the decision in *Farnham* was reserved in the Court of Appeal, expressed the opinion that section 99 ought not to be treated as exhaustive and that.²³⁶

. . . it would seem more appropriate to apply the rule of statutory construction that common law rights are not held to have been taken away or affected by a statute unless it is so expressed in clear language or must follow by necessary implication.

At first blush there is a good deal to be said for the position taken by Haines J. Section 99 was intended to widen the ambit of the shareholders' remedies and as there is nothing in express terms in section 99 that requires it, there is no reason why the common law remedy should be deemed to have been abrogated. Indeed, it may be argued that notwithstanding the wider ambit of section 99, the common law allowed a derivative action to be launched more quickly and less expensively.²³⁷

On balance, however, it is suggested that the opinion of Jessup J.A. as to the exhaustiveness of section 99 is preferable. It seems clear that the section was intended to be a code for the expansion and control of the derivative suit. Thus the judicial controls referred to above in the context of unfettered access to the courts. It would only lead to confusion to allow both common law and statutory actions. A more orderly development of the law would result from the one point of access to a derivative action and would allow for a body of experience and precedent to be built up to guide shareholders.

Conclusion

The one thing above all else that is clear about sections 99 and 229 is that they have moved the courts into the centre of the

²³³ *Supra*, footnote 34.

²³⁴ *Ibid.*, at p. 135.

²³⁵ *Supra*, footnote 35.

²³⁶ *Ibid.*, at p. 680.

²³⁷ See Zacks, Note, (1973), 8 U.B.C.L. Rev. 191.

corporate arena. Whether the courts can be expected to shift suddenly into an active role in corporate regulation after decades of standing passively behind the formula that: "It is not the business of the court to manage the affairs of the company. That is for the shareholders and the directors",²³⁸ is the vital question that only experience will answer. For if the courts are not willing to make the shift and play their essential role, statutory reform will turn out to be an illusory gain. The role that the judiciary must play was aptly put by Mr. Justice Black in the Supreme Court of United States in commenting on rule 23.1:²³⁹

The basic purpose of the Federal Rule is to administer justice through fair trials, not through summary dismissals as necessary as they may be on occasion. These rules were designed in large part to get away from some of the old procedural booby traps which common-law pleaders could set to prevent unsophisticated litigants from ever having their day in court. If the rules of procedure work as they should in an honest and fair judicial system, they not only permit, but should as nearly as possible guarantee that *bona fide* complaints be carried to an adjudication on the merits. Rule 23(b), like other civil rules, was written to further, not defeat the ends of justice.

²³⁸ *Shuttleworth v. Cox*, *supra*, footnote 9.

²³⁹ *Surowitz v. Hilton Hotels Corp.* (1966), 383 U.S. 363, at p. 373.