

# WHITHER THE STATUTORY DERIVATIVE ACTION?

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*A derivative action is brought by an individual shareholder or other person on behalf of a corporation. It serves a dual purpose. First, it ensures that a shareholder has a right to recover property or enforce rights for the corporation if the directors refuse to do so. Second, it helps to guarantee some degree of accountability and to ensure that control exists over the board of directors and senior officials either directly, by allowing shareholders the right to bring an action against directors or officers if they have breached their duty, or indirectly, by the threat of such an action if duties might be breached. This article examines the utility of the derivative action with particular reference to the second of these purposes. Recent case law is examined critically to determine how the courts are interpreting the statutory preconditions to bringing such an action. It is suggested that bad drafting and overly-cautious judges are placing an increasing and unnecessary burden on applicants. The main focus is on the judicial trend towards narrowing the scope and hence the effectiveness of the derivative action by limiting potential applicants and requiring more information to satisfy the demand requirement. Particular consideration is also given to the possibility of the acceptance of special litigation committees in Canada.*

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*L'action oblique est une action intentée par un actionnaire ou toute autre personne au nom d'une société. Son but est double. Elle donne d'abord à l'actionnaire, si les administrateurs refusent de le faire, le droit de faire rentrer la société en possession de biens qui lui appartient ou de faire respecter les droits de cette société. Elle permet aussi jusqu'à un certain point de garantir que le conseil d'administration et les cadres supérieurs s'acquittent de leurs obligations et sont soumis à un certain contrôle, soit directement, en donnant à l'actionnaire le droit d'intenter une action contre les administrateurs ou cadres qui n'accomplissent pas leur charge, soit indirectement, en menaçant d'intenter une action s'ils n'accomplissaient pas leur charge. Dans cet article, l'auteure, qui s'attache surtout au deuxième cas, examine dans quelle mesure cette action oblique est utile. Elle étudie la jurisprudence récente pour savoir comment les tribunaux interprètent les conditions que la loi impose à l'actionnaire qui veut intenter ce genre d'action. Elle avance que les difficultés imposées aux demandeurs par la mauvaise rédaction des lois et par les juges trop prudents sont de plus en plus nombreuses et inutiles. Elle s'intéresse surtout à la tendance que montrent les tribunaux à réduire la portée et donc l'efficacité de l'action oblique en limitant le nombre de ceux qui aimeraient en intenter une, et en exigeant plus de renseignements pour satisfaire les conditions de dépôt d'une demande. Elle considère en particulier l'acceptation possible de comités spéciaux sur les procès.*

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### *Introduction*

[I]deals of corporate law define, in connection with economic institutions, the image to which our society aspires.<sup>1</sup>

This article will examine the ideals of the statutory derivative action focussing on the aims, objectives and purposes sought to be achieved by its existence. The Federal provisions<sup>2</sup> will be used as a model although references will be made to other statutes where differences occur. In order to do this effectively, the common law position towards derivative actions will be canvassed briefly to illustrate the difficulties in the common law which gave rise to the need for a subsequent enactment of a statutory derivative action. There will also be a discussion of the validity and value of the derivative action in the modern corporation. The main focus will be on the current judicial trend towards, (1) narrowing the scope and hence the effectiveness of the derivative action by limiting potential applicants, and (2) requiring more information to satisfy the so-called demand requirement; and particular emphasis will also be given to the possibility of the acceptance of special litigation committees in Canada. It should be noted at the outset that the article concerns itself primarily with the functioning of the derivative action in widely-held corporations, although many of the comments made and concerns raised could, of course, apply equally to a small or closely-held corporation.

The modern corporation, and consequently modern corporation statutes, is premised on two complementary principles: the concepts of separate legal personality and internal autonomy. These principles are particularly important from the perspective of shareholder remedies. The separate legal entity of the corporation ensures that when a wrong is done to the company then it is a wrong for which only the corporation can sue and not individual shareholders. Accordingly, the corporation is the only proper plaintiff. Complementing this, the internal autonomy rule requires that the corporate decision to sue must be taken by the board of directors, or in certain circumstances by the majority of shareholders in general meeting.<sup>3</sup> A "catch-22" situation arises from the overlap of these two

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<sup>1</sup> Jan Deutsch, *Corporate Law as the Ideology of Capitalism* (1983), 93 *Yale L.J.* 395, at p. 397.

<sup>2</sup> Canada Business Corporations Act, S.C. 1974-75-76, c. 33 as am., ss. 231, 232, 233, 235 (hereafter the federal model, federal Act or, in footnotes, C.B.C.A.). Most provinces which have statutory derivative actions follow this model: see Alberta Business Corporations Act, S.A. 1981, c. B-15, s. 232; Manitoba Corporations Act, S.M. 1976, c. 40 (C.C.S.M., c. 225), s. 232; New Brunswick Corporations Act, S.N.B. 1981, c. B-9.1, s. 164; Ontario Business Corporations Act, S.O. 1982, c. 4, s. 245; Saskatchewan Business Corporations Act, R.S.S. 1978, c. B-10, s. 232. The British Columbia Company Act, R.S.B.C. 1979, c. 59, s. 225 (B.C.C.A.) has taken a slightly different approach. Accordingly it will be most commonly referred to for comparative purposes. The remaining provinces have not enacted provisions and continue to rely on the common law.

<sup>3</sup> In the case of a company incorporated in a letters patent or New York style registration jurisdiction, e.g., a federal company, even this latter proposition is doubtful:

tenets when the wrongs that are done to the company are done by the very people who control the company, the board of directors or, as the case may be, the majority shareholders. It is highly unlikely that wrongdoers will propose bringing an action on behalf of the company against themselves. Consequently, from the minority shareholders' perspective, the combination of these factors has often been disastrous. It has been extremely difficult, if not impossible, to bring an action against a miscreant director if the wrong complained of can be classified as a wrong to the corporation instead of, or in addition to, a personal wrong to a shareholder.<sup>4</sup>

### I. *The Common Law Position*

The common law position was clearly pronounced in the seminal case of *Foss v. Harbottle*,<sup>5</sup> in which the Vice-Chancellor held that a shareholder had no *locus standi* to sue on the company's behalf where the breach complained of was a wrong done to the company by the directors. Any decision to sue must be taken by the board of director or the shareholders in general meeting, failing which no action could be brought. Four exceptions to the rule in *Foss v. Harbottle* were developed, enunciated by Jenkins L.J. in *Edwards v. Halliwell*.<sup>6</sup> These consisted of conduct which could be classified as: *ultra vires* acts; fraud on the minority; requiring special majorities which had not been obtained; or giving rise to a personal cause of action.

The first, third and fourth of the exclusions are self-evident, and strictly speaking, do not fall within the ambit of the *Foss v. Harbottle* rule. The former two merely allow a shareholder to bring an action where some illegality has taken place, and the latter is simply a reaffirmation that a shareholder has in some circumstances (for example, for voting rights) a personal right of action. All are independent actions regardless of the *Foss v. Harbottle* rule. The only true exception to the rule is the second category: that of fraud on the minority. Not surprisingly then, this is the category most invoked and the one that has raised the most problems.

Fraud on the minority, defined loosely, concerns an abuse of power, usually by the directors. The applicant must show evidence of abuse and

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see B. V. Slutsky, *The Division of Power Between the Board of Directors and the General Meeting*, in J.S. Ziegel (ed.), *Studies in Canadian Company Law* (1973), vol. 2, p. 170 *et seq.*; *Kelly v. Electrical Construction Co. Ltd.* (1907), 16 O.L.R. 232 (Ont. H.C.).

<sup>4</sup> The distinction between personal and derivative actions continues to plague the courts to this day. For an excellent description of the problems in this area, see S.M. Beck, *The Shareholders' Derivative Action* (1974), 52 Can. Bar Rev. 159. See also M.S.P. Baxter, *The Derivative Action Under the Ontario Business Corporations Act: A Review of Section 97* (1981), 27 McGill L.J. 453, at pp. 455-457; *Goldex Mines Ltd. v. Revill et al.* (1974), 54 D.L.R. (3d) 672, 7 O.R. (2d) 216 (Ont. C.A.); *Hoskin v. Price Waterhouse Ltd.* (1982), 136 D.L.R. (3d) 553, 37 O.R. (2d) 464 (Ont. Div. Ct.).

<sup>5</sup> (1843), 2 Hare 461, 67 E.R. 189 (V.C.).

<sup>6</sup> [1950] 2 All E.R. 1064 (C.A.).

furthermore that the conduct was not in the best interests of the company.<sup>7</sup> This is no easy task. Although the courts have proclaimed a willingness to intervene in any case where injustice is being worked, and to "prevent the management of companies being so conducted as to produce injustice or injury to any of the members",<sup>8</sup> the practical results have been slight. The courts' concept of injustice has a high threshold.

The inequities that may arise because of the courts' refusal to widen the concept of "fraud on the minority" is illustrated well by the case of *Pavlides v. Jenson*.<sup>9</sup> In this case the directors sold assets worth over a million pounds for only one hundred and eighty-two thousand pounds. Not surprisingly, the minority shareholders complained. There were allegations of fraud and gross mismanagement. The court held that the action was not maintainable, negligence only having been shown; no fraud on the minority could be proved. This meant that as the shareholders could ratify the negligent acts in general meeting the applicant shareholder had no right to bring the action. The effects of *Pavlides v. Jenson* have been ameliorated to some extent by the recent case of *Daniels v. Daniels*,<sup>10</sup> where in circumstances similar to *Pavlides v. Jenson*, a minority shareholder was given standing to bring an action. However, the court decided that in order to establish a fraud on the minority it had to be shown not only that a wrong was done to the corporation, but that the wrong also actually benefitted the wrong-doing directors.<sup>11</sup>

Despite this minor relaxation, however, the prohibitive general rule in *Foss v. Harbottle* has been extended to cover most cases where the wrongs complained of are in fact carried out by the directors. It is alive and well and still living in England<sup>12</sup> and in some provinces in Canada.<sup>13</sup> There are advantages to such a strict rule. Certainly when *Foss v. Harbottle* is placed in its historical context, in the midst of the industrial revolution and at the height of the railway boom, it is understandable. Freely available registration of companies was still unavailable<sup>14</sup> and automatic lim-

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<sup>7</sup> See L.C.B. Gower, *Principles of Modern Company Law* (4th ed., 1979), pp. 616-630.

<sup>8</sup> *Re Langham Skating Rink Co.* (1887), 5 Ch. D. 669, at p. 679 (C.A.).

<sup>9</sup> [1956] Ch. 565, [1956] 2 All E.R. 518 (Ch. D.).

<sup>10</sup> [1978] Ch. 406, [1978] 2 All E.R. 89 (Ch. D.).

<sup>11</sup> *Ibid.*, at pp. 413-414 (Ch.), 96 (All E.R.).

<sup>12</sup> For recent English cases see *Estmanco (Kilner House) Ltd. v. Greater London Council*, [1982] 1 W.L.R. 2, [1982] 1 All E.R. 437 (Ch. D.); *Prudential Assurance Co. Ltd. v. Newman Industries Ltd. (No. 2)*, [1982] Ch. 204, [1982] 1 All E.R. 354 (C.A.).

<sup>13</sup> See *supra*, footnote 2.

<sup>14</sup> Introduced one year later by the Joint Stock Companies Act, 7 & 8 Vict., c. 110, although its forerunner, the Trading Companies Act, 1 Vict., c. 73, had permitted registration by grant of letters patent which depended upon regal or delegated ministerial discretion.

ited liability another decade away.<sup>15</sup> The courts may have been insulating entrepreneurs from actions by individual shareholders to encourage risk-taking and bold management. Basing the decision on technical grounds, the courts were paving the way to Weber's formal rationality<sup>16</sup> and accordingly the enhancement of capitalism. Witness the Vice-Chancellor's remarks:<sup>17</sup>

But . . . it must not be without reasons of a very urgent character that established rules of law and practice are to be departed from . . .

The private Act under which the company had been incorporated clearly placed management in the hands of three named directors and this was highly influential.<sup>18</sup> Strict statutory interpretation required that they could not be challenged except by the "proprietors" of the company, that is, all the shareholders in general meeting.<sup>19</sup> To allow an individual shareholder to bring such an action would violate the norms of management and ownership. It would be the very antithesis of the statutory control structure to allow a shareholder to make in essence a managerial decision. Injustice, we are to assume, is not a problem because individual shareholders contract into this arrangement upon entering the corporation and therefore should be aware of the consequences.

There are other reasons still applicable today for the courts' refusal to enter the corporate fray in this area. The courts are reluctant to intervene in the business affairs of corporations which are private entities. All internal disputes should be resolved by members themselves. This ensures that the shareholders in general meeting do have the last say in the company's affairs. If the irregularity is one which can be ratified, *Foss v. Harbottle* prevents an action being brought until a general meeting has been held to decide the issue. Furthermore, as one commentator has pointed out, the decision in *Foss v. Harbottle* may not have been merely a "subservience to form but a judgement [on the part of the courts] on the wisdom and feasibility of attempting unlimited supervision of organizations designed to maintain a large measurement of self-governance".<sup>20</sup> One danger of allowing such an action would be the prospect of unlimited litigation, with disgruntled shareholders running to the courts every time

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<sup>15</sup> Introduced by the Limited Liability Act, 18 & 19 Vict., c. 133.

<sup>16</sup> See Max Weber, *Economy and Society* (eds. G. Roth and C. Wittich, 2nd ed., 1978), vol. 2, p. 809 *et seq.*

<sup>17</sup> *Foss v. Harbottle*, *supra*, footnote 5, at pp. 492 (Hare), 203 (E.R.). A curious statement given that previous cases had allowed standing: see B.S. Prunty, *The Shareholders' Derivative Suit: Notes on its Derivation* (1957), 32 N.Y.U.L.R. 980, at p. 983.

<sup>18</sup> *Ibid.*, at pp. 492-493 (Hare), 203 (E.R.) the Vice-Chancellor comments: "The result of these clauses [of the Private Act] is that the directors are made the governing body . . . such is the general effect of the provisions of the statute".

<sup>19</sup> *Ibid.*, at pp. 491 (Hare), 202 (E.R.).

<sup>20</sup> Prunty, *loc. cit.*, footnote 17.

a corporate resolution is passed or action taken which is not entirely to their liking or in their interests.

## II. *The Statutory Derivative Action*

While there may have been good reason for insulating directors and managers in the past, there does not seem to be the same urgency or necessity today. Indeed the concept of the corporation (and accordingly the role it plays in society) has changed quite drastically over the years and with it the need for new and different statutory controls has arisen. The view of the corporation as an organization with an owner/manager control structure was successfully challenged by Berle and Means<sup>21</sup> in 1932. They illustrated that there had been an effective split in ownership and control, a movement towards managerial capitalism.<sup>22</sup> Even so, this concept of the corporation is still premised on the notion that the shareholders are still "owners" of the corporation and can accordingly internally regulate corporate affairs. Today even this is challenged. Indeed, unless a flexible definition of "ownership" and "property rights" is taken, it is difficult to conceive how the shareholders of, for example, General Motors, *own* this vast corporation. They are merely passive investors who in return for an injection of capital into the corporation receive a conditional right to future income flows in the form of dividends. Some commentators have expressed the view that we have moved towards tertiary capitalism, where institutional investors who have no personal stake in the corporation exercise effective control over it.<sup>23</sup> Others reject this, considering instead that corporations should be conceived as nothing more than a series of complex contractual relationships,<sup>24</sup> with the directors cast in the role of agents without principals.<sup>25</sup>

As the concept of the corporation changes, and particularly as control structures change and evolve, so must corporate law. New mechanisms must replace outdated and anachronistic controls. The awareness that the general meeting no longer practically or effectively controls the board of directors by means of its statutory and residual powers, particularly the

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<sup>21</sup> A.A. Berle and G.C. Means, *The Modern Corporation and Private Property* (1932).

<sup>22</sup> Ralph Miliband, *The State in Capitalist Society, The Analysis of the Western System of Power* (1973), ch. 2.

<sup>23</sup> See A.A. Berle, *Modern Functions of the Corporate System* (1962), 62 *Colum. L. Rev.* 433.

<sup>24</sup> Richard Smith, *Shareholders' Derivative Suits and Shareholders' Welfare: An Evaluation and a Proposal* (1983), 77 *N.W.U.L.R.* 856, at p. 863; A.A. Alchain and H. Demsetz, *Production, Information Costs, and Economic Organisation* (1972), 62 *Am. Econ. Rev.* 777, at pp. 781-783.

<sup>25</sup> See Ian McNeil, *The New Social Contract, An Inquiry into Modern Contractual Relations* (1980), p. 78.

right to appoint or remove directors, must generate new statutory control mechanisms.

There is general agreement on the power of large corporations. Placed in this wider context, the corporation is viewed as a major economic force in society over which self-elected and self-perpetuating individuals have complete autonomy and who are ultimately, practically speaking, responsible to no one. Accordingly, in the last few decades there has been increasing conflict between a desire to facilitate business and entrepreneurial activities while attempting to ensure some public or private control is kept over this major economic force in our society and those who govern it. Emphasis has been placed on a return to corporate democracy and some accountability of directors.

Giving a statutory right to bring a derivative action, that is an action brought by an individual shareholder on behalf of the company, may be a small step towards ensuring some degree of accountability.

Shareholders derivative suits [are] a vital support to . . . free enterprise economy, . . . derivative suits are the major policemen of managerial integrity, and . . . without derivative suits, passive equity investment integrity could not flourish.<sup>26</sup>

This will be the major premise upon which analysis of the statutory derivative action will proceed: that the main intent and purpose of the statutory derivative action is, and ought to be, to aid managerial accountability. On a traditional level this will help restore or enhance investor confidence.<sup>27</sup> Shareholders should have a right to get wrongs righted in a corporation in which they have only a minority shareholding; wrongdoers should not be allowed to escape scot-free because they control the proxy machinery or have a majority shareholding. In addition, and less traditionally, the public has an interest in corporations being well and honestly managed. Allowing shareholders and perhaps others to bring derivative actions is a cheap and efficient way of uncovering any dishonesty that may be taking place. As the American Law Institute Report correctly notes, "the substitution of public enforcement through state-initiated actions for a private action would both be very costly and probably logistically infeasible".<sup>28</sup>

Derivative actions are in effect liability rules designed to act as a deterrent and, as a necessary corollary, create incentives to engage in socially desirable conduct, in this case honest and skilful management.

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<sup>26</sup> A.F. Conard, *Winnowing Derivative Suits Through Attorneys Fees* (1984), 47: 1 *Law and Contemp. Prob.* 269, at p. 269.

<sup>27</sup> Although this may be more imagined than real. According to D.R. Fischell and M.J. Bradley, *The Role of Liability Rules and The Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, Law and Economics Workshop Series, Number WS11-11, University of Toronto, 1985, p. 4, shareholders do not value derivative actions as a method of corporate governance. The empirical evidence on which this is based is very limited however; see *ibid.*, pp. 26-37.

Facilitating such conduct must of course be done in such a manner as to avoid undue interference with managerial decision-making and risk-taking. The desire to maintain an appropriate balance between corporate self-determination and the desire to ensure, from a shareholder's (and the public's) perspective, that the directors or majority shareholders do not run roughshod over minority shareholders' rights or abuse the corporate form has produced much of the tension that exists in present day statutory shareholder remedies and in the judicial decisions in this area.

In Canada, mindful of the problems of minority shareholders in attempting to bring directors or senior management to task for misdeeds or negligence, most legislatures decided that the shareholders should be given a statutory derivative action.<sup>29</sup> The Canada Business Corporation Act introduced this provision in 1974.<sup>30</sup> The provision reads:

232. (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.

(2) No action may be brought and no intervention in an action may be made under subsection (1) unless the court is satisfied that

- (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;
- (b) the complainant is acting in good faith; and
- (c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.

The justification for making a complainant apply for leave to commence an action (and show that the prerequisites have been fulfilled) is to prevent strike suites and unnecessary harassment of corporations.<sup>31</sup> Perhaps it is also a recognition that the costs of a derivative action "enforced by those with a small economic stake in the venture outweigh the benefits unless limitations are imposed to reduce these costs".<sup>32</sup> It is the process of balancing conflicting interests.

<sup>28</sup> American Law Institute's (A.L.I.), Principles of Corporate Governance: Analysis and Recommendations, Council Draft No. 1 (T.D. no. 1), at p. 232. The American Law Institute has not yet approved any of the drafts (there are five) or any specific proposals.

<sup>29</sup> See *supra*, footnote 2.

<sup>30</sup> S.C. 1974-75-76, c. 33. Ontario was the first to introduce the statutory derivative action, R.S.O. 1970, c. 53, s. 99, followed by British Columbia, Companies Act, S.B.C. 1973, c. 18, s. 222.

<sup>31</sup> Cf. Interim Report of the Select Committee on Company Law, Ontario, 27th Legis., 4th Sess. (1967) (the Lawrence Report), p. 63, para. 7.4.2.

<sup>32</sup> Fischel and Bradley, *op. cit.*, footnote 27, pp. 43-44.

Indeed, these procedural safeguards have been considered so essential that the courts have insisted that *anyone* who wishes to bring a derivative action must apply under the statutory provisions. Even those who would previously have fallen within one of the exceptions to *Foss v. Harbottle* (and accordingly have had an automatic right to commence an action) must now apply for leave.<sup>33</sup>

The mainstay of the provision is the paramount role given to the courts in determining who shall be allowed to bring an action on behalf of the corporation. The actual circumstances in which somebody may be granted leave to bring a derivative action on behalf of the corporation is missing from the statute. Compliance with the prerequisites is mandatory, but once complied with, the court's option to grant leave is discretionary. Nevertheless it is difficult to envisage a situation where the court would not grant leave if the requirements have been met and certainly there has not been such a case to my knowledge. However, the courts still have to resolve the balancing of the delicate issues involved in deciding whether or not to allow a shareholder or other applicant to bring a derivative action. This is being achieved by turning what are, in effect, procedural prerequisites into substantive tests.

The extent to which the courts have been successful in maintaining or creating a delicate balance between the needs of the minority shareholders and the public on the one hand, and the corporation and directors on the other hand, will be reviewed in the next section of this article. Recent cases suggest that the courts are beginning to take a more restrictive approach to the shareholder's right to bring an action, and this development should be watched with considerable care by those interested in ensuring free, open and honest management of corporations.

### III. *Judicial Attitudes to Statutory Derivative Actions*

#### A. *Status Requirements: The Acceptable Applicant, Good Faith and Present Membership.*

The rationales for limiting the potential applicants, for requiring that the action should be in good faith and, in the case of British Columbia for requiring contemporaneous shareholding, are apparent but not uncontroversial. This is particularly so if the view is taken, as here, that the main *raison d'être* of the derivative action is to enhance managerial accountability.

The Federal Act<sup>34</sup> provides a wide-ranging potential pool of applicants by conferring a right of application upon "complainants". This category includes, *inter alia*, shareholders and creditors (past and present),

<sup>33</sup> *Farnham v. Fingold* (1973), 33 D.L.R. (3d) 156, 2 O.R. 132 (Ont. C.A.); *Shield Development Company Limited v. Snyder*, [1976] 3 W.W.R. 44 (B.C.S.C.).

<sup>34</sup> *Supra*, footnote 2, s. 231.

the Director, and finally anyone considered a “proper person” at the court’s discretion. The British Columbia Act<sup>35</sup> provides a more limited applicant pool, referring only to members and directors. Although the meaning of member is given an extended definition to include anyone considered a “proper person” by the court, either legislative design or more likely bad drafting has curtailed its possible ambit. A “member”, narrowly or widely defined, is required, unlike a director, to have been a member at the time of the transaction giving rise to the action. Hence it cannot be extended to include present creditors who were not also past creditors or other “proper persons” who did not have some relationship to the company at the dates of the events out of which the claim arises. This should obviously be changed.

Whether the courts will use their discretion to widen the pool of applicants is questionable in any event. Certainly the decision in *Re Daon Development Corporation*<sup>36</sup> represents an unfortunate judicial reluctance to use the statutory discretion and indeed a willingness to restrict its ambit. In *Daon* a debenture holder was refused standing on the grounds that his remedies, if any, should arise from and accordingly be detailed in his debenture trust documents. Only if the debt was in default or the company insolvent would the court look favourably upon a creditor applicant. Wallace J. thought that to be a “proper person” an applicant must have “some particular legitimate interest in the manner in which the affairs of the company are managed”.<sup>37</sup> That led him to the following conclusion:<sup>38</sup>

. . . The section requires that the category [“proper person”] be composed of those persons who have a direct financial interest in how the company is being managed and are in a position—somewhat analogous to minority shareholders—where they have no legal right to influence or change what they see to be abuses of management or conduct contrary to the company’s interest.

This is an unnecessarily restrictive interpretation and one which it is hoped will not be followed by future courts.

There are many good reasons for taking an ever-expanding view of possible applicants. Certainly one would hope that employees will be deemed to have a sufficient interest to be considered applicants. Although strictly speaking they would probably not fall within Wallace J.’s requirement of “direct financial interests”, they should be allowed standing. Employees stand to lose their livelihood through negligent or fraudulent management—a consequence more disastrous than the direct economic loss which might be suffered by shareholders (particularly those with

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<sup>35</sup> *Supra*, footnote 2, s. 225.

<sup>36</sup> (1984), 54 B.C.L.R. 235 (B.C.S.C.).

<sup>37</sup> *Ibid.*, at p. 243.

<sup>38</sup> *Ibid.*

diversified portfolios which lessens the effect of such a happening). *Teck Corporation Limited v. Millar*<sup>39</sup> lends support to this view. If directors may (and indeed should) take the interests of employees into account in their decision-making, it would seem to be a logical step to allow employees some means of enforcing adherence to and protection of their interests.

From a market (and accordingly) public perspective it would also be advantageous to ensure that an action can be brought by the Registrar of Companies. The Federal Act has done this by explicitly granting a right of application to the Director. Other provinces should follow suit. This recommendation could be attacked on the grounds that it forces upon shareholders the costs of enforcing socially desirable conduct, in effect forcing subsidization of the public good.<sup>40</sup> But the proposal can be defended on two grounds. Firstly, many shareholders hold diversified portfolios and have therefore a tangible economic interest in ensuring honest and open corporate governance, both firm-specific and generally. Secondly and more specifically, they have a direct economic interest in the action. All gains, compensation or damages awarded as a result of the action will be the company's and thus enhance the value of their shareholdings. Even in cases where the direct economic benefits are not large, or perhaps non-existent, there are still gains. Shareholders have a direct interest in deterring misfeasance and in increasing managerial integrity. They benefit directly through firm-specific enhanced managerial efficiency, and indirectly, as holders of diversified portfolios or merely as future vendors in a buoyant market, because of increased market confidence.

Finally and importantly, the category of applicants should not remain or become static. The changing face of capitalism and the role which corporations play in furthering its aims dictate the necessity of flexibility. As the notion of which interests the corporation is working towards changes, and becomes increasingly sophisticated, so must the pool of applicants change. Any fears regarding floodgate possibilities or limitless applications can be dealt with by the other procedural or substantive requirements.

The second standing requirement, that of *bona fides*, is also open to criticism. *Bona fides* of an applicant is argued to be necessary to prevent vexatious or malicious actions and this has been the interpretation taken by the courts so far. Interestingly, *bona fides* has not been defined in a positive sense, that is by a general statement of the type of conduct which will fulfill the requirement. It has only been defined negatively by the courts, telling applicants which conduct does not fulfill the requirement. For example, a court dismissed an application on the grounds that the applicant shareholders, children of the alleged wrongdoing director, were

<sup>39</sup> (1972), 33 D.L.R. (3d) 288, [1973] 2 W.W.R. 385 (B.C.S.C.).

<sup>40</sup> See, e.g., Fischel and Bradley, *op. cit.*, footnote 27, p. 49.

not acting in good faith.<sup>41</sup> Surprisingly this opinion appears to have been primarily based on the fact that two large banks had faith in the defendant, and that the children had done little if anything to support the company. One can only hope that this decision has more to do with preventing this statutory action being used to solve family squabbles than the fact that bankers are the best plumbines of good faith!

In *Abraham v. Prosoccer Ltd.*<sup>42</sup> a finding of a lack of *bona fides* also led to the dismissal of a request by one shareholder to continue an action which was being settled by the present plaintiff shareholder. The court held that the applicant merely wanted to get a better settlement for himself and take the benefit of thousands of dollars contributed by the other shareholders to bring the action so far, and thus could not be said to be acting in good faith. Given the existing controls over self-interested applicants by the requirement of court approval of settlements,<sup>43</sup> this decision seems somewhat over zealous and unnecessary. If the action is meritorious, why should an applicant be compelled to respend thousands of dollars to obtain the same information as the other shareholders?

Finally and just as illogically, it has been argued that lack of *bona fides* may be evidenced by the fact that an applicant has available other actions with substantially the same remedies.<sup>44</sup> It is difficult to appreciate why a decision not to pursue possible alternative actions should illustrate a lack of good faith. If the alleged misconduct gives rise to more than one cause of action, the applicant should be allowed the choice of action or, more usually, the right to plead in the alternative. Wishing to use the more appropriate cause of action seems to reflect rationality rather than evidence of lack of *bona fides*.

Indeed it is difficult to justify the need for the good faith requirement in any case. If a wrong has been committed and the other prerequisites fulfilled, it should make little, if any difference whether a plaintiff's motives are pure or not. This is all the more the case if the main reason for allowing statutory derivative actions is to ensure some watchdog role over corporate management which society cannot do or does not wish to undertake for administrative and expense reasons. The other procedural devices already deal adequately with malicious or unmeritorious actions.

Similar arguments can be made against a contemporaneous membership requirement.<sup>45</sup> If shareholders discover wrongdoing or gross mis-

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<sup>41</sup> See *Anderson v. Anderson* (1979), 105 D.L.R. (3d) 341, at pp. 343-344, 26 O.R. (2d) 769, at pp. 771-772 (Ont. H.C.), where the court refers to earlier proceedings involving a derivative action.

<sup>42</sup> (1981), 119 D.L.R. (3d) 167, 31 O.R. (2d) 475 (Ont. H.C.).

<sup>43</sup> C.B.C.A., *supra*, footnote 2, s. 235(2).

<sup>44</sup> See *Re Bellman and Western Approaches Ltd.* (1981), 130 D.L.R. (3d) 193, at p. 201, 33 B.C.L.R. 45, at p. 53 (B.C.C.A.).

<sup>45</sup> As exists in the B.C.C.A., *supra*, footnote 2, s. 225(2).

management has taken place prior to their purchase of shares, why should they be prohibited from maintaining an action? Presumably the response is that it is an essential precaution to stop strike suits or bounty hunters.<sup>46</sup> But again these considerations can be adequately and more appropriately dealt with by the court's supervision of settlements.<sup>47</sup> To require contemporaneous membership will cause inequity as between past and present shareholders, often discriminating against those who actually suffer the loss. If the acts have only recently come to light this will affect the value of all the shares held at the time the information reaches the market, regardless of whether the shareholders held them at the time of the breach of duty. It is hard to appreciate why the law should choose to protect only those shareholders who hold shares at the time of the breach and not all those who will be affected by it. It should be noted that the present shareholders who lack standing may nevertheless still benefit from a successful action brought by a shareholder with standing through enhanced share values if money is returned to the corporate coffer.

These three prerequisites should be reconsidered. They serve no sufficient purpose which outweighs the obvious benefits of allowing legitimate actions to be commenced. In the end they may protect wrongdoers from legal sanctions merely because the "wrong" person discovers or chooses to pursue the action. The only requirement which should remain should be a flexible definition of applicant to allow the courts to monitor who brings applications to stop possible corporate harassment. However, if the action furthers the goal of managerial accountability, status or motive should be irrelevant.

Moreover, the concerns which are raised by these restrictions can be more suitably and appropriately taken into account in assessing the remaining allied requirements, the demand requirement and the need for evidence that it is in the interests of the company that the action be brought. If these prerequisites are clearly not fulfilled the courts may not only dismiss the application but, in the case of a frivolous or malicious application, award costs against the applicant. This would appear to be the better way of dissuading *mala fides* applicants who do not have a valid cause of action rather than setting up a prohibition against all *mala fide* applicants regardless of the substantive validity of their cause of action.

#### B. *The Demand Requirement: Reasonable Notice or Reasonable Efforts*

The rationale behind this requirement is obvious. Individual shareholders should not be allowed to pursue actions on behalf of the company which, if the company had notice of them, it would decide to pursue

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<sup>46</sup> See M.P. Kryszynski, *Derivative Suits and the Special Litigation Committee—A Question of Balance in Michigan Law* (1982), 29 Wayne L. Rev. 149, at p. 153; Lawrence Committee, *op. cit.*, footnote 32, p. 62, para. 7.4.2.

<sup>47</sup> C.B.C.A., *supra*, footnote 2, s. 235(2).

itself. The right to maintain the action is, of course, the company's and it should certainly be allowed the first opportunity to pursue its rights if it so wishes. Accordingly both Acts provide that the applicants inform the company of alleged wrongdoing and of their intention to pursue an action. The specific provisions of the two Acts are quite different, but in practice the courts do not appear to have differentiated between the two. The Federal Act requires only that "reasonable notice" be given to the directors of the intention to apply to the court if the action is not prosecuted, defended or discontinued, as the case may be; whereas the counterpart section in British Columbia requires that "reasonable efforts" be made to cause the directors to commence or defend the action.<sup>48</sup> The courts do not appear to have placed a greater onus on applicants applying under the British Columbia legislation, although this will obviously remain a possibility. The more appropriate position seems to be the requirement of "notice" only, and the discussion will concentrate primarily on the federal legislation, although the analysis and criticism is equally valid, perhaps more so, for the potentially more onerous requirements in British Columbia.

What type of action will constitute reasonable notice or effort is not delineated in either act. In either case, determination of the amount of information which must be given to the directors to fulfill this requirement is crucial. Often shareholders have little hard evidence to support their claims because their access to corporate information is limited. Only upon discovery do they have full access to the information they will require. It would impose severe restraints on applicants if there was a court-imposed requirement that they verify and determine with any specificity the action to be pursued. Conversely, the board of directors must be given sufficient information regarding the alleged wrongs to reach a reasoned and informed decision as to whether the corporation should take action. Nevertheless, they are far better placed to seek out information if given an intimation of the area of wrongdoing. Accordingly, the burden on the applicant should remain relatively light.

Fortunately, the courts approached the determination of the information required with some flexibility. Generally it has been sufficient to identify the impugned transaction. For example, it has been held that the shareholder need not specify the exact cause of action (nor each and every cause of action), but merely give the board of directors sufficient facts to found an endorsement on a generally endorsed writ of summons.<sup>49</sup>

The exact amount of information which must be given may, however, vary depending upon the expertise of the person who is to receive it.

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<sup>48</sup> C.B.C.A., *supra*, footnote 2, s. 232(2); B.C.C.A., *ibid.*, s. 225(3).

<sup>49</sup> See *Re Northwest Forest Products Ltd.*, [1975] 4 W.W.R. 724 (B.C.S.C.); *Re Bellman and Western Approaches Ltd.*, *supra*, footnote 44.

Indeed, in *Armstrong v. Gardiner*<sup>50</sup> Cory J. considered that two letters sent by the applicant's lawyer outlining grievances, without any particulars, were sufficient to fulfill the requirement. The extent of specificity seems to have depended in this case upon the expertise and qualifications of the director receiving the demand letter. The fact that the President of the company (to whom the letters were addressed) was a lawyer seemed to play an important factor in the court's conclusion that the letters were sufficient.<sup>51</sup> This type of subjective test could lead to grave uncertainty and inequities being created. It seems very arbitrary, as it is highly probable that most non-legal presidents or directors would, as a matter of course, consult a lawyer for legal advice on receipt of such a letter. It is hoped that this decision is not followed by future courts.

Most problems arise in the situation where the directors are themselves the wrongdoers. In these cases, the shareholder can often be assured that there is no possibility whatsoever that the directors will resolve to bring an action on behalf of the company against themselves. To inform them and indeed ask them to bring such an action can only lead to hostility and, more importantly, delay in what are already lengthy proceedings. Some commentators have suggested that in these circumstances the demand requirement can be and should be dispensed with in accordance with a futility test.<sup>52</sup> The extent to which one has to go through with the formalities in such a case was faced in *Re Daon Development Corporation*.<sup>53</sup> This case involved a bitter dispute between rival groups of shareholders with accusations of, *inter alia*, payment of dividends by the directors while the company was insolvent. Counsel for the applicant shareholders had written to Daon's board of directors ten full days after a notice of motion had been filed, forwarding an affidavit which revealed a cause of action. The letter contained the following statement:<sup>54</sup>

Unless the company is prepared to join in the writer's application in Supreme Court for leave to commence that action, or undertake before the Court to carry that action then such failure will be deemed to be a refusal to prosecute the action pursuant to the provisions of the Company Act.

Counsel for the applicant had argued that this request was sufficient. The law should not require him to carry out an obvious futile act of making a

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<sup>50</sup> (1970), 20 O.R. (2d) 648 (Ont. H.C.).

<sup>51</sup> *Ibid.*, at p. 652.

<sup>52</sup> See J.H. Schnell, A Procedural Treatment of Derivative Suit Dismissals by Minority Directors (1981), 69 Cal. L. Rev. 885, at p. 886. The Federal Court of the United States takes this position: *Galfand v. Chestnutt Corp.*, 402 F. Supp. 1318 (S.D.N.Y., 1975), modified, 545 F.2d 807 (2nd Cir., 1976), cert. denied, 435 U.S. 943 (1978); *Clark v. Lomas & Nettleton Financial Corporation*, 625 F.2d 49 (5th Cir., 1980).

<sup>53</sup> *Supra*, footnote 36.

<sup>54</sup> *Ibid.*, at p. 240.

reasonable effort to get the directors to commence an action; the directors would never have consented to bringing the action.

Wallace J. decided that the letter did not satisfy the "reasonable efforts" requirement of the British Columbia Act. It is doubtful whether it would have met the Federal notice test, given the reasons of Wallace J. A demand that the directors commence an action, without giving them time or notice in which to do so, could not constitute compliance with the requirements. Even if counsel and the applicant were convinced that the company would not join in their action they could not circumvent the requirement:<sup>55</sup>

Firstly, it is a statutory requirement . . . and that . . . at the very least involves giving reasonable notice to the directors of the request together with details of the nature of the claim . . . Secondly, the condition can be easily performed without undue expense or effort . . .

These words have probably added a more stringent test to the concept of reasonable efforts, or indeed reasonable notice, than existed previously. In particular, the lapse of time before one can be considered to have given reasonable notice is left uncertain, although clearly the applicant had not fulfilled the requirement in this case. Additionally, although this is not gone into in any depth, one is left wondering whether or not the details of the nature of the claim which Wallace J. insisted be given to the directors has added a stricter requirement for information than previous case law has suggested. It should be recalled there are grave difficulties in obtaining information prior to discovery in these types of actions. The courts should be wary of imposing greater informational requirements than is absolutely necessary to ensure that all considerations are weighed. However, it should be noticed that a similarly phrased demand in *Re Berenski*<sup>56</sup> was accepted by Batten J. as "reasonable notice". This could reflect a less stringent test for the requirement of "reasonable notice" than for that of "reasonable efforts". The point is not discussed in any detail, and the difference in result in the two cases is more likely a reflection of the earlier delivery date of the demand notice in *Berenski* than in the *Daon*.

Two interests are at stake here: the right of the board to have sufficient time to make an informed and reasoned decision on whether an action should be brought by the company, and the possible abuse by a hostile board of this provision to delay, hamper and cause further and unnecessary expense to an applicant, for whom timeliness may be extremely important and the delay and expense already nearly overwhelming. Perhaps a distinction may be drawn between cases where the board is apparently neutral and those where a board is comprised of those who are to be the defendants. In the latter case there may be little point in requiring the

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<sup>55</sup> *Ibid.*, at pp. 240-241.

<sup>56</sup> (1981), 15 Sask. R. 182, at p. 184 (Sask. Q.B.).

formality of a demand (although from a point of due process it may still be desirable). In the former it is essential, although it might be worth stipulating a time frame in which the board must make a decision, as does the Ontario Act.<sup>57</sup> However, given the different type of complex actions or investigations it may be necessary for the board of directors to undertake before making a thorough and thoughtful decision, it may in the end be better to leave the matter to the court's discretion. Perhaps, interpreted correctly, the use of word "diligently" already encompasses an appropriately flexible time frame.

The greatest danger to the applicant from the demand requirement arises not, however, from the delay or further expense it may cause, but from its potential combination with the final prerequisite: that the action is in the interests of the company. In particular, it is unclear whether the demand requirement exists to allow the directors the right to reject an action simply because there is no valid action or whether their mandate goes further, allowing them to reject a valid cause of action because it is not in the best interests of the company to pursue it. If the latter view is correct, and there are good grounds for assuming it is,<sup>58</sup> will their determination or perhaps that of a special litigation committee be considered conclusive by the courts?

### C. *Substantive Requirement: The Interests of the Company*

"In the best interests of the company" is a phrase well known to corporate law, although there is still confusion as to its exact meaning. There is a voluminous amount of case law on the statutory requirement that the directors must act in the best interests of the corporation,<sup>59</sup> but the case law has not really furthered the discussion. Certainly there are few meaningful guidelines applicable to all cases. Indeed, it may well be that the meaning of the phrase should be kept fluid to deal with and adapt to changing circumstances and purposes.

The courts have given some indication as to what they consider will or will not be in the interests of the corporation with regard to whether it is permissible to allow a derivative action to be commenced. Looking at the court decisions in this area may give us some indication as how to determine the answers to four questions which are determinative in this area. The key questions are: who is the company; what criteria will be

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<sup>57</sup> Ontario Business Corporations Act, *supra*, footnote 2, s. 245(2), which provides for 14 days notice.

<sup>58</sup> All decisions by directors must, by statute, be made in the "best interests of the company": see C.B.C.A., *supra*, footnote 2, s. 117(1)(a); B.C.C.A., *ibid.*, s. 142(1)(a).

<sup>59</sup> See *e.g.*, *Hogg v. Cramphorn Ltd.*, [1967] Ch. 254, [1966] 3 All E.R. 420 (Ch. D.); *Teck Corp. Ltd. v. Millar*, *supra*, footnote 39; *Howard Smith Ltd. v. Ampol Petroleum Ltd.*, [1974] A.C. 821, [1974] 1 All E.R. 1126 (H.L.). See Gower, *op. cit.*, footnote 7, ch. 24.

used to determine the interests of this concept; how much evidence should be shown to meet the requirement; and finally and importantly, who should make the decision?

It is noteworthy that the derivative action sections of both the Federal and the British Columbia Acts use the phrase "interests of the corporation" as opposed to "best interests of the corporation". This raises the obvious question as to whether this is meant to be (as presumably it must be) a less stringent or perhaps a different test than *best* interest denotes. Certainly, looking at the earlier cases, this appears to be the way that it has been interpreted by the courts. For example, in *Re Northwest Forest Products Limited*<sup>60</sup> the court considered that the test was met if a *bona fide* claim against the corporation could be evidenced. It was not sufficient for the respondents to rebut the allegation by stating that the company would be prejudiced by pursuit of the claim; although the court did state that it had to consider the possible consequences of a final order on the corporation. Nevertheless, the burden was light. *Re Marc-Jay Investments Inc.*<sup>61</sup> followed this line of reasoning. One merely had to ask whether the action was frivolous, vexatious or bound to be unsuccessful. If the proposed action does not fall within one of these three highly suspect categories, then it should be allowed to proceed. The application must be based on more than "mere suspicion",<sup>62</sup> but the courts have allowed an action to proceed based upon the information and belief of others, recognizing that "[a]lmost invariably shareholders will be in such a disadvantageous position that they will not be able to obtain first-hand evidence and information upon which to found their motion".<sup>63</sup>

*Re Bellman Industries Limited and Western Approaches Ltd.*<sup>64</sup> similarly refused to place a heavy onus of proof upon the plaintiff in such an action, stating that a plaintiff need only show that an arguable case exists. If such a case *appears* to exist then the court should not interfere with the action being brought. An equally benign interpretation was taken by MacDonald J. in *W.E.H. Financial Corporation v. Powell River Town Centre Limited*.<sup>65</sup> The evidence concerning the alleged misconduct in this case was clearly conflicting, and the end result would depend on the credibility of two opposing witnesses. Although the judge leaned towards believing the defendant he decided, in my opinion quite rightly, that the

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<sup>60</sup> *Supra*, footnote 49.

<sup>61</sup> (1974), 50 D.L.R. (3d) 45, 5 O.R. (2d) 235 (Ont. H.C.).

<sup>62</sup> *Re Loeb and Provigo Inc.* (1978), 88 D.L.R. (3d) 139, at p. 142, 20 O.R. (2d) 497, at p. 500 (Ont. H.C.).

<sup>63</sup> Per Cory J. in *Armstrong v. Gardner*, *supra*, footnote 50, at p. 652. Similarly the court has allowed an application to proceed on someone else's affidavit: *Solmon v. Elkind* (1976), 3 C.P.C. 31 (Ont. H.C.).

<sup>64</sup> *Supra*, footnote 44, at pp. 201 (D.L.R.), 52-53 (B.C.L.R.).

<sup>65</sup> (1983), 49 B.C.L.R. 145 (B.C.S.C.).

preliminary application should not try to determine issues of credibility. The applicant had only to show "sufficient evidence which on its face discloses the possibility that [there was an action]".<sup>66</sup> Accordingly the court's role in these circumstances was only "to test the reasonableness on its face of the petitioners' version".<sup>67</sup> *Appotive v. Computrex Centres Ltd.*<sup>68</sup> also adopted this approach, refusing to examine and make a determination upon material submitted by the defendants explaining why the alleged charges were ill-founded and should not be allowed to proceed to trial. Doubt had been raised regarding certain transactions that required a trial to determine the adequacy or otherwise of the explanations. The court decided, quite properly, that such decisions should not be made on a motion.

More recent cases seem to cast doubt on this line of reasoning, or at least to inject a more stringent requirement regarding the evidence required to prove it is in the interests of the corporation that an action be commenced. For example, in *Daon Development Corporation* Wallace J. required almost conclusive evidence that the alleged wrong had been committed or, at least, that the petitioner show that Daon was "probably insolvent at the time the directors authorized the payment of dividends". He thought that the "possible success of an action against the directors for breach of section 151 of the Company Act is questionable".<sup>69</sup> Thus, he reached the conclusion that it could not be *prima facie* in the interests of the corporation that the action be allowed to be commenced. This again appears to be an unsettling argument, one that might place a higher burden of proof on the plaintiff than is absolutely necessary in these circumstances. It should be recalled that this is only a preliminary application to allow a plaintiff the right to commence an action. It does not apportion liability or make a judgment on the way the company is run or on the alleged wrong. In these circumstances it seems that the onus of proof should remain as light as possible, provided the possibility of a *bona fide* cause of action exists.

Even more recently Batten J. in *Re Berenski*<sup>70</sup> seems to have injected two new requirements for showing that the action is in the interests of the corporation. First, he refused to allow the commencement of a derivative action on the grounds that the plaintiff had not disclosed the circumstances upon which the court should decide that it would be in the interests of the corporation. It is difficult to see why this onus should be on the

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<sup>66</sup> *Ibid.*, at p. 153. (Emphasis added).

<sup>67</sup> *Ibid.*

<sup>68</sup> (1981), 16 B.L.R. 133 (B.C.S.C.).

<sup>69</sup> *Supra*, footnote 36, at p. 242. Cf. the test of O'Leary J. in *Re Marc-Jay Investments Inc.*, *supra*, footnote 61, at pp. 47 (D.L.R.), 237 (O.R.), that it had to be apparent that the action was *bound* to be unsuccessful before leave would be denied.

<sup>70</sup> *Supra*, footnote 56, at p. 185.

plaintiff. If adopted, this requirement will have the effect of shifting the onus of proof from the defendant to the plaintiff. Certainly it dispenses with the presumptions adopted in *Northwest Forest Products Ltd.*<sup>71</sup> and *Marc-Jay Investments Ltd.*<sup>72</sup> that an action is presumed to be in the interests of the company once the applicant has shown *bona fides* and the fact that there is a *prima facie* cause of action. Secondly, Batten J. required the applicant to disclose the financial situation of the corporation. This is a strange requirement on a number of grounds. The financial situation of the company has never been an admitted criterion for assessing the interests of the company. It may well be a relevant factor, but if accepted, this decision broadens quite considerably the criteria upon which the interests of the company are now based. It moves the derivative action increasingly away from a policy-oriented, macro-level to a micro-level measure designed to fit the individual circumstances of a company. Whether such a move is to be welcomed will depend ultimately on one's conception of the corporation. Personally, I would strenuously resist such a move and indeed urge a move in the opposite direction from the micro to the macro level.

The traditional view in company law, that the interests of the company are usually synonymous with the interests of the majority of present shareholders, may be changing, albeit slowly.<sup>73</sup> Certainly the concept is becoming increasingly outdated and has little relevance or justification in relation to the commencement of a derivative action. Even from a fairly narrow perspective, the company must be viewed as a continuing concern which must encompass the interests of past, present and future shareholders, creditors and (one would hope) employees. From a broader perspective, given the major economic force of the modern corporation, it must also have an interest in society's needs and/or at least, economic concerns. Viewed in this light it is nearly impossible to delineate all the criteria and different needs of the various interest groups and then judge which, if any, is the appropriate course of action. Obviously a macro view of the corporate world is required.

The one goal which would serve all groups is to ensure that corporations are well and honestly managed, and if they are not the market place should be informed. As Frankel and Barsky point out:<sup>74</sup>

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<sup>71</sup> *Supra*, footnote 49.

<sup>72</sup> *Supra*, footnote 61.

<sup>73</sup> See *Mills v. Mills* (1938), 60 C.L.R. 150 (H. Ct. Aust.); *Smith v. Fawcett Ltd.*, [1942] 1 All E.R. 542 (C.A.); see also cases cited *supra*, footnote 59. For a view that the attitude is changing, see *Teck Corporation v. Millar*, *supra*, footnote 39.

<sup>74</sup> T. Frankel and W.M. Barsky, *The Power Struggle Between Shareholders and Directors: The Demand Requirement in Derivative Suits* (1983), 12 Hofstra L. Rev. 39, at p. 55.

The protection of a corporation from fiduciaries' abuse and the efficiency of the markets depend on the information as to how the corporation is managed. A derivative suit is one of the means for conducting a thorough investigation of corporate management. Furthermore, even though shareholders may sell their shares when dissatisfied with management's performance, the sale does not make corporate fiduciaries accountable, except through takeovers.

If one accepts this statement, then the emphasis in the statute on the interests of the company may be misleading. It has drawn attention away from the main thrust and validity of the statutory derivative action: a device to give the shareholders (and perhaps an ever-expanding group?) a handy weapon with which to facilitate and supervise directors' conduct and accountability and, if necessary, enforce compliance with the statutory and common law duties placed on them.<sup>75</sup>

Focusing on whether it is in the interests of the corporation detracts from what I consider should be the pivotal issue with which the section is concerned. Have duties been breached or has a wrong been done to the corporation? If the answer is in the affirmative, the question of whether the action should be allowed to be commenced in terms of time and expense should relate to the severity and extent of the alleged wrongdoing, not to possible prejudice of present shareholders or the corporate interest very narrowly defined. The latter are not unimportant, but it is difficult, if not impossible, to determine whether the refusal to bring an action for wrongdoing can ever be justified as being in the corporation's interests on business grounds if one views the corporation as a continuing concern.

Furthermore, it is not only the individual company and minority shareholders, but society and the marketplace, for which the action was intended. The thrust of the derivative action has been confused and should not become limited in its goals. The recent emphasis on the corporation's financial state of affairs is disturbing. Money or potential prospects of a corporation should not be a determinative, or even a major factor, in bringing wrongdoers to court to pay for their misdeeds. Indeed it could lead to absurd results. Someone who thoroughly raided the corporate coffers may escape sanction because the corporation could not afford to pursue the action, whilst a little less daring manipulator might have to pay the full price (although in the former case the prospects of recovery would of course play an important factor). Whether duties have been breached and deserve sanction should have little, if anything, to do with the corporation's financial health but with the severity of that breach and the probability of success of the action.

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<sup>75</sup> Cf. the Lawrence Committee Report, *op. cit.*, footnote 31, p. 62, at para 7.4.1., which "considered the alternatives . . . and concluded that the derivative action is the most effective remedy to enforce the suggested statutory standard of conduct and care to be imposed upon directors in the exercise of their duties and responsibilities".

Similarly, the concerns regarding the need to weigh the effect on the market of information which might be revealed and the possibility of a drop in share prices are red herrings. The possibility of a drop in share prices could hardly justify non-pursuit of an action. It is not the leakage of information which causes the drop in share prices but the wrongdoing or mismanagement of the directors. To shield present investors or shareholders is to disguise the true values of their shares and overstate the value of the corporation as reflected on a market with full information, and to prejudice future shareholders who buy shares at distorted or inflated prices. The market can only serve its function if laws encourage, not inhibit, the dissemination of information. The present investor merely pays the price for investing in what turns out to be a badly managed, or worse a fraudulently managed, company. The derivative action may even aid the enhancement of share values if misgotten gains are returned to the corporate coffers.

From an economist's viewpoint there can be little justification for allowing directors to choose if, or indeed when, information should be revealed to the market on financial or other grounds of potential present harm. It can only hurt future investors and disturb the allocation of resources and ultimately encourage, at best negligent, at worst fraudulent, management.

Finally, this disturbing move towards examining undesirable and extraneous factors in determining whether to allow derivative action to be commenced could, if taken to its logical conclusion, encourage the introduction and acceptance of special litigation committees in Canada. This is an issue which has merited little attention here, although it has been the subject of great controversy in the United States. Indeed, given the criteria that would need to be evaluated, broadening the base for deciding what is in the "interests of the company" could lead to further support for such committees as the best decision-makers.

#### IV. *Special Litigation Committees*

To my knowledge the use of special litigation committees has never really raised its complex head in Canada, although perhaps the case of *Re Bellman and Western Approaches Limited*<sup>76</sup> lends some indirect support to the possibility. The facts of the case were quite simple. Feuding between different control groups of Western Approaches had made corporate discussions difficult. The Bellman group were bringing the action. They alleged, *inter alia*, that an information circular distributed by the directors of Western contained untrue statements of material facts and omitted to state material facts as required by the Federal Act and regulations; and that the directors had exercised their powers oppressively to the plaintiffs

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<sup>76</sup> *Supra*, footnote 44.

and in complete disregard of their interests. The company attempted to divert the action by referring the matter to their lawyers, who advised that Price Waterhouse and Company, independent auditors, scrutinize the corporate records of Western to determine whether there were:<sup>77</sup>

- a) any instances where directors did not act honestly or in good faith or exercise the skill and diligence of a reasonably prudent person; for example, directing that payments be made which were not made for the benefit of the company;
- b) any material contracts to which the company was a party, in which the directors had an interest, and whether such interest was disclosed;
- c) any trading in shares or other use of confidential information by an insider or CanWest Communications Corporation or CanWest Capital Corporation whereby a loss was incurred by any security holder or a benefit was gained by an insider.

Price Waterhouse and Company carried out the requested investigation and answering, it appears, on a very restricted basis, reported that there were in effect no undue excessive billings or contra accounts settlements that were unrecorded. Having reviewed this evidence, counsel for Western advised that there was no action to be taken against the accused directors, but that the directors of Western should consider the matter themselves. Accordingly the next day, after reviewing the Price Waterhouse evidence, Western's board of directors decided not to commence an action as requested by the plaintiffs and resolved not to do so.

One of the issues before the court was whether or not the recommendation by the board of directors (the named defendants refraining from voting) not to proceed with the action should be taken as conclusive evidence that such an action would indeed not be in the interests of the corporation. It is noteworthy that the court premised its remarks on the "interests of the corporation" test by stating that the section does not say that the court must be satisfied that it is in the interests of the corporation. The requirement states only that no action may be brought unless the court is satisfied that it *appears* to be in the interest of the corporation to bring the suit.<sup>78</sup>

Having said this however, Nemetz C.J.B.C. considered that the first item to be regarded in deciding whether this test was met was the decision of the directors. The only question that was asked was whether the refusal to pursue the action was given impartially. In this particular case, looking at all the circumstances of the resolution and the directors who passed that resolution, it was decided that the vote was not impartial. Four directors were not independent because they had been elected by the Duke group, the people under investigation. Although their decision was based on the independent reports of accountants and outside lawyers, the court considered that the limited ambit of these investigations was insufficient to determine the decision one way or another. In conclusion, Nemetz C.J.B.C.

<sup>77</sup> *Ibid.*, at pp. 197-198 (D.L.R.), 50 (B.C.L.R.).

<sup>78</sup> *Ibid.*, at pp. 201 (D.L.R.), 53 (B.C.L.R.).

decided that "the directors did stand in a dual relation which prevented them from exercising an unprejudiced judgment".<sup>79</sup>

Obviously, this is a correct decision. As with many judicial decisions, it is far more interesting and puzzling by what it omits to say as what it actually says. In particular, the decision at times appears to presuppose that if in fact the board of directors who took the decision not to pursue the action could have been shown to have been independent and impartial, then their refusal would have decided the issue because the court "must first look to the decision of the directors".<sup>80</sup> This is a startling proposition, even more so because there does not seem to be any jurisprudence on the matter in Canadian law. In many ways it appears to be reverting back to the common law position with its servitude to the internal autonomy of corporations,<sup>81</sup> where the decision of the directors, or failing that the shareholders in general meeting, reigned supreme in company matters.

No other court in Canada has addressed the issue of whether a disinterested board of directors (or committee thereof) can or should be able to determine, perhaps conclusively, whether a proposed action is in the interests of the corporation. If the criteria on which the decision to allow an action becomes more "business biased" there is bound to develop more support for special litigation committees than now exists in Canada. Whether this would serve the corporation and business community well is a matter of much debate.

In the United States this has been and continues to be a hotly debated issue. Many companies do as a matter of course set up so-called special litigation committees whenever a demand is made upon the corporation to pursue an action; it is becoming "a clear trend in corporate law".<sup>82</sup> Such a committee usually consists of disinterested directors, and occasionally outsiders, who investigate the alleged wrongdoing and decide whether the corporation will commence legal action. Their decision has often been held determinative of the issue,<sup>83</sup> following the business judgment rule:

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<sup>79</sup> *Ibid.*, at pp. 204 (D.L.R.), 56 (B.C.L.R.).

<sup>80</sup> *Ibid.*, at pp. 203 (D.L.R.), 56 (B.C.L.R.).

<sup>81</sup> Indeed, Nemetz C.J.B.C. remarks specifically, *ibid.*, at pp. 203 (D.L.R.), 56 (B.C.L.R.), that "the logic of the common law in cases of this kind [must not] be disregarded". Although it is not entirely clear whether he is referring to the application of the business judgment rule in the U.S. in such cases or the reason why *Foss v. Harbottle* left the decision to the internal organization, it is clear that he is approving the right of the corporation and its board of directors to make the decision.

<sup>82</sup> *Lewis v. Anderson*, 615 F.2d 778, at p. 783 (9th Cir., 1979); and see K.A. Rubin, *Zapata Corp. v. Maldonado: "Steering a Middle Course" May Spell Deep Water for Business Judgement Application in Shareholder Derivative Suits* (1981), 6 *Nova L.J.* 191, at p. 199.

<sup>83</sup> The matter does, of course, vary from state to state as does the weight attached to the decision by the courts. Some U.S. courts have applied the business judgment rule

To permit judicial proving of such issues [decisions not to sue] would be to emasculate the business judgment doctrine as applied to the actions and determinations of the special litigation committee. Its substantive evaluation of the problem posed and its judgment in their resolution are beyond our reach.<sup>84</sup>

The decision does, however, remain subject to judicial scrutiny regarding the impartiality of the committee and the procedures employed to reach the decision, both of which must evidence good faith.

The role of the special litigation committee in the derivative action in the United States has had mixed reaction from commentators. Some have hailed it as the optimum solution to balancing the conflicting interest of corporation and shareholders, or as a welcome means by which firms can contract around or opt out of derivative suits,<sup>85</sup> others see it as tolling the death knell of the derivative action.<sup>86</sup>

Canadian courts should consider the full implications of the introduction of such committees before allowing them to creep in through the back door and perhaps become determinative of whether an action is in the interests of the company or not. As with many attractive propositions, there are inherent dangers in wholesale acceptance. The development should be carefully watched, evaluated, and perhaps judicially or legislatively supervised or controlled.

Advocates of the special litigation committees have put forward good reasons for supporting their introduction into the process.<sup>87</sup> They save time and expense to corporations, both precious commodities. By allowing a committee to make its own determination a proper result will be reached with lower transactions costs. There will often be savings on the amount of resources and expenditures involved in the process. Furthermore, the time taken by the directors if they are tied up in long and

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literally: *Auerbach v. Bennett*, 393 N.E. 2d 994, 47 N.Y. (2d) 619 (N.Y.C.A., 1979). Others have taken a middle position, taking the view that the merits of the directors' decision should be looked at: *Zapata Corp. v. Maldonado*, 430 A.2d (Del. Sup. Ct., 1981). Others refused to consider it: *Burks v. Lasker*, 441 U.S. 471 (1979). For a complete discussion of the U.S. approach, see J.C. Coffee and D.E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform* (1981), 81 Colum. L. Rev. 261; K.W. Kossoff, *Director Independence and Derivative Suit Settlements*, [1983] Duke L.J. 645; Krysinski, *loc. cit.*, footnote 46; Fischel and Bradley, *op. cit.*, footnote 27.

<sup>84</sup> *Auerbach v. Bennett*, *ibid.*, at p. 634.

<sup>85</sup> See Fischel and Bradley, *op. cit.*, footnote 27, p. 52; J.D. Cox, *Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of Zapata and the Ali Project*, [1982] Duke L.J. 959; R. Smith, *Shareholders' Derivative Suits and Shareholders' Welfare: An Evaluation and Proposal* (1983), 77 N.W.U.L. Rev. 856.

<sup>86</sup> G.W. Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?* (1980), 75 N.W.U.L. Rev. 96; M.I. Steinberg, *The Use of Special Litigation Committees to Terminate Shareholder Derivative Suits* (1980), 25 U. Miami L. Rev. 1.

<sup>87</sup> See the articles referred to, *supra*, footnote 85.

cumbersome law suits can be detrimental not only in terms of expense, but also in the efficiency with which the corporation is run. Nevertheless time and expense are matters which have to be weighed in every law suit, and there does not appear to be any particular reason why they are more important in this specific instance. Of course, these are not insignificant factors and should be taken into account in deciding whether or not an action should be pursued, but they should not be overriding nor given undue weight. Private ordering must have its limitations, especially when dishonesty or gross mismanagement are at issue.

A less convincing argument which is made in favour of using committees is that not to do so would cause corporations to lose, or not use to full potential, good directors.<sup>88</sup> Directors, fearful of unmeritorious or frivolous actions being brought against them for minor breaches of company regulations, will resign, refuse appointments or, worse still, remain and become risk-averse. If this were true it would be a consideration to be taken into account, especially in a country in which one of the major complaints of management is that it is not sufficiently aggressive.<sup>89</sup> Regulations should encourage dynamic directors and not inhibit the possibility that companies may be able to attract and foster them.

However, it is highly unlikely that the introduction of litigation committees would increase good management potential. The existing procedural requirements for statutory derivative actions are more than adequate to prevent unwarranted actions. Good managers are unlikely to be inhibited in their management style by the existence of the derivative action. Aggressiveness and wrongdoing are not synonymous. Indeed the derivative action may enhance managerial effectiveness by keeping management on its toes, ensuring that it is not careless in its undertakings. Even if this were not the case, directors will often be protected from personal liability for most negligent actions, with insurance coverage paid for by the corporation.<sup>90</sup>

Special litigation committees are also advocated because they are considered to be best able to allocate risk efficiently.<sup>91</sup> Derivative actions distribute risks ineffectively by placing the entire risk upon directors

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<sup>88</sup> Smith, *loc. cit.*, footnote 85, at p. 890; Fischel and Bradley, *op. cit.*, footnote 27, pp. 14-15; Krysinski, *loc. cit.*, footnote 46, at p. 156.

<sup>89</sup> See *e.g.*, S. Globerman, Mergers and Acquisitions in Canada: A Background Report, Study Number 34, for the Royal Commission on Corporate Concentration (1977), p. 4, commenting on the importance of mergers because of "the relative scarcity of aggressive and innovative managers in Canada . . .".

<sup>90</sup> The C.B.C.A., *supra*, footnote 2, s. 119 and B.C.C.A., *ibid.*, s. 152(4) both permit purchase of insurance. Although the C.B.C.A. prohibits coverage for fiduciary breaches of duty the B.C.C.A. has no such limitation.

<sup>91</sup> See Fischel and Bradley, *op. cit.*, footnote 27, pp. 14-15; Smith, *loc. cit.*, footnote 85, at p. 890.

rather than the more efficient risk bearers in this situation, shareholders. This could have unfortunate side-effects, encouraging management to become less risk adverse and commensurately less effective and productive in the long term. Shareholders, it therefore follows, will benefit more by spreading the risk among themselves. However it is difficult to appreciate why shareholders should choose to bear the burden of the misconduct of others. In the long-term it is surely just as likely to encourage inefficient or bad management (no controls and no deterrent) and thus produce less. The rejoinder could be made that there are already adequate market controls<sup>92</sup> to ensure that this does not happen, particularly the possibility of shareholders voting with their feet and the threat of take-overs. These controls are, however, of dubious value. What evidence there is suggests that the former has little or no effect on management,<sup>93</sup> whilst the latter are quite rare occurrences and management has built up (and continues to build) numerous defences to prevent them from happening.<sup>94</sup> They also seem to be an extremely crude and expensive way of ensuring managerial accountability.

It should be noted that all of the arguments which have been canvassed so far in favour of special litigation committee decision-making assume that a committee will automatically refuse to commence an action. All of the advantages claimed only accrue if in fact no action is taken. Accordingly, these in effect appear to be arguments in favour of abolition of all controls upon management and certainly of the derivative action, rather than advocating the benefits of committees in the statutory derivative action (except perhaps as private ordering mechanisms). If so, these assumptions should be stated openly and not used as an indirect method to sabotage the derivative action.

This article proceeds on the assumptions that some control of, and accountability by management is required and desirable; that the derivative action is or could be a useful tool in ensuring a degree of managerial accountability; and that accordingly the special litigation committee should be evaluated upon whether it would be a superior decision-making body than the court in deciding whether an action is in the interests of the company. In this context, the most pressing, yet difficult and ideologically uncertain, assertion by advocates of special committees is that the board of directors, or at least a committee of business people, are the people best able to determine whether or not it really is in the interests of the corporation to bring an action.<sup>95</sup> This is the argument which will ultimately decide this issue.

<sup>92</sup> Smith, *ibid.*, at pp. 866-876; Fischel and Bradley, *ibid.*, at pp. 20-25.

<sup>93</sup> See Frankel and Barsky, *loc. cit.*, footnote 74, at p. 55.

<sup>94</sup> *E.g.*, see F. Iacobucci, Planning and Implementing Defences to Take-Over Bids: The Directors' Role (1981), 5 C.B.L.J. 131.

<sup>95</sup> Cox, *loc. cit.*, footnote 85, at p. 961, comments that there is "no substitute for the

From a philosophical point of view, there is much to be said in favour of allowing a committee to make the decision as to whether a corporation should pursue a particular action against any of its directors. Fuller describes this type of activity as "managerial direction" which is specifically useful for certain types of social ordering.<sup>96</sup> Managerial direction is different from legislation in that it can be more specific, and consequently more precise ends may be pursued. The focus is on specified acts and people. In these types of circumstances, where a full knowledge of the corporation and the types of acts that have gone before are essential for an equitable and fair resolution to the problem, then it may be the most acceptable solution. Managerial direction is also used where standards are necessarily vague and allocative decisions are made, as here, in a "cobweb" of cause and effect.

Directors are in a far better position than the courts to verify and evaluate the alleged wrongdoing. Moreover, they are more suitably equipped in knowledge, experience and expertise to assess the possible detriment that might accrue to the corporation because of the action. There are a myriad of business factors which need to be assessed in a determination of whether an action should be pursued.

In particular, the consequences of bringing the action should be considered. For example, share prices may well fall if the company's reputation suffers. Institutional investors will be less likely to invest in a corporation which has pending law suits or appears to have been badly (or even fraudulently) managed.<sup>97</sup> Directors or a committee can best balance the conflicting interest of corporation and individual shareholders. By refusing to pursue a corporate action they may choose to protect the present shareholders from a drop in share prices and possibly a contraction of the market on which to sell their shares. At the same time, preserving share prices may enable the corporation to attract investors and creditors to obtain the funds it needs to pursue its economic activities.

Moreover, the special circumstances of the corporation may be of vital importance in determining the issue. A new product may be about to be launched; a takeover or merger initiated; or the financial position of the corporation may not warrant launching an expensive action. Only those with an intimate knowledge of the corporation, of its hopes and aspirations, its future plans and objectives, are able to make the optimum decision based on full information. Directors may be hesitant about bringing such matters before a court for fear of the adverse publicity which

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unique capability of the board of directors to analyze the costs and benefits of the suit from the corporate perspective".

<sup>96</sup> L. Fuller, *The Morality of Law* (2nd ed., 1969).

<sup>97</sup> But *cf.* Fischel and Bradley, *supra*, footnote 27, p. 30, who concluded from a very limited empirical analysis that derivative actions have little if any effect on share values.

would surround such disclosure and which might only serve to accentuate the damage already done by the very commencement of the action.

Finally and importantly, a decision to sue is fundamentally a managerial decision, one that should be taken by those best placed to take it, management. Settlement, expulsion from the board or indeed ignoring the misconduct, may be a far more effective and discrete means of resolving the difficulty than resorting to the courts. Only an intimate knowledge of the corporation and the vagaries of the business world will allow an informed and appropriate weighing of the complex factors. This is the most powerful argument of those who favour special committees, but as we shall see later, it misses the essential purpose of the derivative action.

Cogent arguments have also been made against special committees, particularly that they will effectively destroy the real utility and purpose of the derivative action.<sup>98</sup> The main thrust of the derivative action is to serve as a deterrent, ensuring that directors carry out their fiduciary duties. Special committees in the United States are notorious for deciding not to pursue actions against directors.<sup>99</sup> Duties must be enforced if they are to be carried out. The derivative action achieves a simple and relatively inexpensive way of allowing misdeeds to come to light and be remedied in full public view. It ensures that shareholder remedies do not remain illusory. Compensation to the corporation for wrongs done to it may also benefit the corporation, especially if the coffers have been raided by wrongdoing directors; but the primary rationale of the derivative action must remain its deterrent value.<sup>100</sup>

Most of these arguments against the special committees are again premised on the notion that they will decide no action should be taken. Thus, most of the complaints or fears could be said to revolve around the possible bias of the members of the committee rather than the actual concept of the committee. It has been suggested that this problem could be resolved, not by stifling the advent of the special committee in Canada, but by ensuring that its membership is unbiased and perhaps representative.<sup>101</sup> If it is, and more importantly seen to be such, then it will be an effective and more efficient way of enforcing directorial duties than the courts. Who then should be the members of such a committee?

Undoubtedly those named as defendants in an action cannot sit upon the committee. The conflict of interest is quite clear. Even this prohibition could give rise to problems. Plaintiffs would simply name all and

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<sup>98</sup> See Coffee and Schwartz, *loc. cit.*, footnote 83; Dent, *loc. cit.*, footnote 86.

<sup>99</sup> See Cox, *loc. cit.*, footnote 85, at pp. 962-963.

<sup>100</sup> See Coffee and Schwartz, *loc. cit.*, footnote 83, at pp. 302-309.

<sup>101</sup> Coffee and Schwartz, *ibid.*, at p. 321 *et seq.*

sundry as defendants to ensure that no directors are able to sit on the committee,<sup>102</sup> but in Canada at least this could be controlled by civil procedure rules, particularly by the award of costs against the applicant to each named defendant.

Other than this general and sensible prohibition, it has usually been considered that, provided directors are not parties to the alleged wrong or cited in the writ, then they should be allowed to sit on the committee if so chosen. Yet there are obvious problems with directors sitting and judging their own peers. Even discounting tangible bias, (for example of a director elected by or at the behest of one or more of the alleged wrongdoers, as in the *Bellman* case),<sup>103</sup> there are more subtle yet forceful pressures. Directors may feel an understandable loyalty and attendant sympathy toward their alleged wrongdoing colleagues. Obvious problems of socialization exist or, as one author has coined it, "structural bias".<sup>104</sup> The onus of proof required to impress such a sympathetic committee would weigh very heavily indeed upon the applicant. As already mentioned, this may be evidenced by the fact that such committees have invariably recommended termination of derivative actions in the United States.

Improvements could, of course, be made to the system whereby outsiders are invited to sit and participate in the decision. This might include outside lawyers, accountants and indeed anybody in the community the directors consider might be able to make an unbiased and helpful decision in this matter. Many groups of people from diverse backgrounds and varying expertise could be brought onto the committee, a step which would have the incidental benefit of introducing wider views into the corporation, perhaps opening the way to greater participation of special-interest and independent outside directors.<sup>105</sup> Although this is one way of alleviating the problem of bias, it appears that such a constituted committee, whilst obviously more independent, or at least having the appearance of more independence, loses much of the claimed benefits of the proposed system. The *raison d'être* of the special litigation committee in effect becomes illusive. It should be recalled that the prime motivation behind allowing such a committee to judge whether or not the action should be brought against the company is that its members are best able to take business decisions involved in this area. If the people elected are not members of the company and accordingly not familiar with its affairs,

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<sup>102</sup> Coffee and Schwartz, *ibid.*, at p. 279; and see *Galef v. Alexander*, 614 F.2d 51 (2d Cir., 1980).

<sup>103</sup> *Supra*, footnote 44.

<sup>104</sup> Krysinski, *loc. cit.*, footnote 46, at p. 171.

<sup>105</sup> Indeed, Coffee and Schwartz, *loc. cit.*, footnote 83, at p. 321, consider this a reason for allowing the S.L.C. board the "power to terminate" as it can be used as "an important incentive to encourage the trend towards independent boards".

hopes and aspirations, they are in no better position than the court to decide whether the action should be commenced or terminated.

Indeed they may be considerably less effective, as the time and information available to them will be limited. The information they receive will often be entirely from management, which raises the possibility of conscious or subconscious bias in presentation. Furthermore they do not have the power to compel witnesses or the production of material. Hence valuable information may be hidden from them. Third parties will also have the opportunity to frustrate or delay the process. There may also be motivational problems. Any thorough investigation will be time-consuming and lengthy. Outsider directors by definition have other business interests which take up the majority of their time.

There are also of course problems with the selection of outside members, and the possibility, indeed probability, that they will have ties, social or economic, to insiders and perhaps the wrongdoers themselves cannot be discounted. The business community is relatively small and close-knit in Canada.<sup>106</sup> Substituting selection of outsiders by shareholders instead of management might be a possible, albeit expensive, solution to this problem, but even so would not entirely solve it. Management will generally have control of the voting power in any event, often directly in a closely-held company by virtue of personal shareholdings, or indirectly by control of the proxy machinery in a widely-held corporation. In these circumstances, the court or some specialized tribunal is likely to be much more capable of making sounder decisions.

Nevertheless, the case against the introduction of special committees in Canada need not and should not be rested on the obvious and considerable practical difficulties of being able to select and maintain an impartial and unbiased committee membership. Even if it were possible to constitute expert yet unbiased committees, their introduction may not be advisable. The arguments concentrating on the membership of the committee assume that the major problem is one of bias, not an inability or unsuitability of such committees to deal with the issue. Regardless of membership, such a committee should not be allowed to make a determinative decision. The criteria upon which the decision should be based are far more suited to judicial than managerial decision-making.

The decision which has to be made regarding whether an action should be commenced is not a managerial decision; it does not require business specialists or those with an intimate knowledge of the corporation. As already mentioned, the decision should rest entirely upon the severity of the breach of duty and the possibility of success in suing for that breach. These are not managerial decisions, they are legal decisions,

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<sup>106</sup> See Walter Stewart, *Towers of Gold: Feet of Clay* (1983); W. Clement, *The Canadian Corporate Elite, An Analysis of Economic Power* (1975).

and as such the courts are eminently situated to decide them. As Schendel has commented:<sup>107</sup>

Business judgments weighing costs against benefits that are perfectly relevant to the decision not to sue third parties have little or no relevance to stockholder's interests in ridding corporate governance of corruption and carelessness.

The only foreseeable circumstances in which a special litigation committee should perhaps be able to make a determinative decision regarding a decision to sue would be in a situation where an applicant is attempting to pressure the corporation to bring or defend an action against a third party, which has arisen in the normal course of business of the corporation, and which does not involve any of the directors, their friends, family or associates. In these circumstances, where business factors are highly relevant, for example continuing long-term contractual relationships or high enforcement costs, special committees, or indeed the board of directors, may be entirely appropriate decision-making bodies, and maybe the courts should accept the decision of the directors. These situations are of course extremely rare. Indeed it may be, as Frankel and Barsky suggest, that in essence "[o]ne component of every derivative claim [is that it] implicitly or explicitly charges the corporate directors and officers with breach of their fiduciary duties".<sup>108</sup> In any event, derivative actions in Canada have always involved directors or their associates. In such cases, special litigation committees should not be allowed to make determinative decisions of whether an action is in the interests of a company. If such a committee is set up and does investigate an individual complaint the court should, of course, consider this as information which might aid its own decision. It should not be given undue weight; it should be yet another piece of evidence that the courts will take into account. Perhaps the best solution is to enact a statutory provision regarding the evidentiary weight of the decision of a special litigation committee, similar in substance to the shareholder ratification provision which provides that shareholder ratification may be taken into account, but that it is by no means conclusive.<sup>109</sup>

### Conclusion

The recent cases dealing with derivative actions seem to illustrate a disturbing trend of making the procedural hurdles more onerous perhaps than they need be. Flexibility and a willingness to allow actions to proceed on fairly insubstantial evidence are essential if the statutory deriva-

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<sup>107</sup> R.T. Schendel, *Corporations—The Stockholders' Independent Right to Sue Derivatively—Maldonado v. Flynn and Its Progeny* (1980-81), 29 Univ. Kansas L. Rev. 135, at p. 142.

<sup>108</sup> *Loc. cit.*, footnote 74, at p. 46. Because even attempting to get the directors to sue a third party is questioning the standard of care and skill a director is exercising.

<sup>109</sup> *Cf. C.B.C.A., supra*, footnote 2, s. 235(1); B.C.C.A., *ibid.*, s. 225(7).

five action is to play the role which it so obviously can and was designed to do. In particular, statutory amendments are required to both acts to widen the concept of "proper person", and additionally in the case of British Columbia to abolish the contemporaneous requirement. Furthermore the *bona fides* of the *applicant* should be irrelevant to the decision. The court should only look to whether a *prima facie* cause of action exists.

The demand requirement should be modified in the case of the British Columbia Act to place an onus on the applicant to give reasonable notice only, and not to make active "efforts" to get the action pursued. Both acts should consider the feasibility of dispensing with this requirement when such a demand would be futile.

Finally, and perhaps most importantly, the entire concept of the "interests of the corporation" should be reviewed with a view to discerning what objectives are sought to be achieved by the statutory derivative action. If they are, as I suggest, to enhance managerial accountability, the concept of "interests of the company" should be eliminated and a statutory test of fraud or gross mismanagement, or even more simply, evidence of a *prima facie* cause of action should replace it.

Even if this suggestion, as is likely, is not followed, the courts should severely restrict and carefully evaluate the introduction of new and further criteria upon which to evaluate the decision. To the extent this is not achieved the derivative action will lose much of its focus, ceasing to ensure efficacy and managerial accountability, and becoming a rather cumbersome and unfulfilling minority shareholder remedy. This will lead in turn to a different emphasis and evidence, possibly opening the door to the acceptance of special litigation committees. To the extent the decision becomes based on business factors, the time and expense involved in court decisions become less justifiable. To prevent the possibility of special litigation committees becoming determinative decision-makers in this area, a clause should be added to the legislation that the decision of a special litigation committee, like that of shareholders in general meeting, is not binding on the court. Of course any extra information should be welcome by the courts to ensure informed decision-making.

The next decade may prove decisive for the fate of the statutory derivative action. It is only hoped that the courts will fully grasp its significance and role in society. As corporations become increasingly powerful, as management becomes increasingly isolated from criticism and accountability, the derivative action may be one of the few remaining methods of ensuring some accountability. The courts, with the help of the legislature, should attempt to ensure that the derivative action plays the pivotal role for which it was designed.