SHAREHOLDER LITIGATION IN AUSTRALIA AND THE UNITED STATES: COMMON PROBLEMS, UNCOMMON SOLUTIONS

*DEBORAH A. DeMOTT**

To what extent should the decisions of companies' directors and controlling shareholders be challenged in litigation brought by disgruntled shareholders? The response in the United States tends to differ from that in Australia and Great Britain and to produce divergent legal rules for the regulation of shareholder litigation. Nonetheless, to some extent these dissimilar legal rules reflect common policy concerns created by shareholder litigation. This article begins with a brief sketch of the development of rules governing shareholder derivative suits, actions in which the shareholder sues on behalf of a company in which he owns shares alleging that the company has failed to pursue an action on account of a wrong done to it. It traces the subsequent evolution of controls imposed on shareholder litigation in each country, using a comparative perspective to illustrate relative strengths and deficiencies.

I Early Developments

People who know little else of the law applicable to shareholder suits in Britain and Australia know—however vaguely—of *Foss* v. *Harbottle* and the continuing legacy of this 1843 case. The rule in *Foss* v. *Harbottle*[1] proceeds from the position that the company itself is the proper plaintiff in an action on account of wrongs done to it; the rule is generally understood to bar a shareholder's suit on account of a wrong allegedly done to a company if the wrong complained of could be approved or ratified by an ordinary resolution (adopted by simple majority vote) of the company's shareholders. Thus, the bar does not reach transactions that are not eligible for validation by a majority vote of the company's shareholders, rendering *Foss* v. *Harbottle* inapplicable to actions alleging an injury to the plaintiff's personal rights or interests rather than rights and interests of the corporation, to actions alleging that the transaction

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* Fulbright Senior Scholar, University of Sydney and Monash University; Professor of Law, Duke University School of Law, Durham, N.C. I am grateful to Professor R. P. Austin and The Hon. Mr. Justice W. M. C. Gummow for their comments on an early version of this manuscript.

[1] (1843) 2 Hare 461; 67 E.R. 189.

was *ultra vires* the corporation, or that the transaction or events constituted a fraud on the minority by a majority of the shareholders. The rule in *Foss* v. *Harbottle* does, however, preclude shareholder suits that challenge directors' and officers' decisions that do not fall into these excepted categories, such as claims of negligent mismanagement of the company's affairs and claims of ratifiable breaches of the fiduciaries' duty of loyalty to the company.

In some respects, the conventional black letter formulation of the rule in *Foss* v. *Harbottle* appears to have overtaken the case itself. Indeed, the case appears to be more about pleading than about conceptions of internal corporate governance or about rules defining plaintiffs' standing to sue. The Vice-Chancellor's judgment tests the adequacy of the plaintiff's bill against the defendants' demurrers, illustrating that "[u]ncertainty is a defect in pleading of which advantage may be taken by demurrer".[2] Among its other deficiencies, the plaintiff's bill failed to allege that the company lacked a governing body, or that no general meetings of shareholders were held, or that the company's directors were not functioning as directors. True, the relevance of these matters to the demurrers suggests some contemporary understanding of restrictions on shareholders' ability to sue, but perhaps one far from the rigidity of the conventional statement of "the rule in *Foss* v. *Harbottle*". For one thing, the Vice-Chancellor's analysis of the deficiencies in the Bill is preceded by the statement that cases may arise of injury to corporations done by some of their members, in which "the claim of justice would be found superior to any difficulties arising out of the technical rules respecting the mode in which corporations are required to sue".[3]

The rule in *Foss* v. *Harbottle* is also attributed in part to an 1847 case, *Mozley* v. *Alston*, in which the defendants' demurrers to the shareholder-plaintiff's bill were granted.[4] Like *Foss* v. *Harbottle*, the judgment in *Mozley* v. *Alston* appears to be concerned with the adequacy of the plaintiff's pleading—in *Mozley* v. *Alston* the plaintiff alleged that a majority of the shareholders agreed with his opinion—and the absence of any reason "to admit a form of pleading which was originally introduced on the ground of necessity alone, to a case in which it is obvious that no such necessity exists".[5] The plaintiff in *Mozley* v. *Alston* was also unable to establish the unavailability of an adequate remedy in law and sought an injunction in a form that, in the Court's assessment, would not be feasible. Nonetheless, the significance of these procedural contexts disappeared from the classic statement of "the rule in *Foss* v. *Harbottle*" given in 1902 in *Burland* v. *Earle*:[6]

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[2] *Id.* 503; 207. *Cf. Estmanco (Kilner House)* v. *Greater London Council* [1982] 1 All E.R. 437, 443 (Ch.Div.) (doubting whether the author of the judgment in *Foss* v. *Harbottle* "foresaw the vigorous and active life which his decision would lead, or the many controversial obscurities that would arise about actual or possible exceptions from the rule that he was laying down.")

[3] *Supra* n. 1 at 492; 203.

[4] (1847) 1 Ph. 790.

[5] *Id.* 801.

[6] [1902] A.C. 83 at 93.

> It is an elementary principle of the law relating to joint stock companies that the Court will not interfere with the internal management of companies acting within their power, and in fact has no jurisdiction to do so. Again, it is clear law that in order to redress a wrong done to the company or to recover moneys or damages alleged to be due to the company, the action should *prima facie* be brought by the company itself. These cardinal principles are laid down in the well-known cases of *Foss* v. *Harbottle* . . . and *Mozley* v. *Alston* . . . .

The desire to read *Foss* v. *Harbottle* and *Mozley* v. *Alston* as cases that lay down cardinal principles, rather than cases concerned with pleading and equitable remedies, probably has explanations that transcend the modest scope of this paper. One consequence of the practice of distilling these cases into "cardinal principles" is that the content of these principles may become indeterminate, as different readers distill different essences from the same context-bound material.[7] The central academic preoccupation then becomes a quest to discover the "true" rule in *Foss* v. *Harbottle*, rather than to recapture the contemporary understanding of mid-nineteenth century legal materials.

The counterpart to *Foss* v. *Harbottle* in the United States—in duration of legacy if not precise analogy of doctrine—is *Hawes* v. *City of Oakland*,[8] decided by the United States Supreme Court in 1882. Many aspects of the current regulation of derivative suits in the United States can be traced to *Hawes*. In *Hawes* the Court did not adopt the rule in *Foss* v. *Harbottle* to preclude shareholder suits raising specified types of claims. Instead the Court, using the power it then had to make rules of general equity jurisprudence, established four procedural regulations for shareholder derivative actions. First, prior to filing suit, *Hawes* required the prospective plaintiff to make a demand on the corporation's shareholders that they take action to resolve his grievance, including perhaps endorsing an action against the prospective defendants or removing them from corporate office. When suit was filed, *Hawes* required that the plaintiff's complaint allege that a demand was made, or the reasons that excused the plaintiff from making the demand, such as its likely futility under the circumstances. Second, *Hawes* imposed a comparable requirement of demand on the corporation's directors as a prerequisite to the initiation of a derivative suit, acknowledging that the demand could be excused if making it would be futile. Third, *Hawes* required the plaintiff's complaint to plead with particularity facts establishing compliance with these requirements, and to allege that the derivative suit had not been instituted as a result of collusion among the parties to create federal

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[7] See Wedderburn, "Shareholders' Rights and the Rule in *Foss* v. *Harbottle*", [1957] *Cam. L.J.* 194 at 195 (noting discrepant formulations of the Rule in twentieth-century texts); see also *Hawkesbury Development Co.* v. *Landmark Finance Pty. Ltd.* [1969] 2 N.S.W.R. 782 at 791-2 (noting dispute as to "real elements" of Rule).

[8] 104 U.S. 450 (1882).

jurisdiction over an action that would otherwise be litigated in state rather than federal court. Fourth, *Hawes* required the plaintiff to allege that he owned shares at the time of the wrong complained of, or that his shares devolved on him by operation of law.

Even on an elementary level, the differences between *Hawes* and the rule in *Foss* v. *Harbottle* are noteworthy and pervade the later development of derivative litigation in each country.[9] The demand requirements in *Hawes*, although establishing prerequisites for a derivative suit, do not foreclose the possibility of shareholder litigation of some types of claims, as does the rule in *Foss* v. *Harbottle*. That is, the rule in *Foss* v. *Harbottle* precludes shareholder suits raising certain types of claims, and presumably enables defendants successfully to move to dismiss such actions. In contrast *Hawes* regulates derivative suits by establishing preconditions to the plaintiff's eligibility to sue, but does not exclude claims from litigability. Indeed, *Foss* v. *Harbottle* has been criticized precisely because it is not a demand requirement: the rule turns on whether shareholders *could* ratify the transaction and not on whether they have done so or have explicitly been given the opportunity to do so.[10]

Hawes was decided in an era in which the United States Supreme Court frequently cited and discussed English precedents and often used them as persuasive authority; thus the Court's treatment of *Foss* v. *Harbottle* is of interest in assessing the contemporary (albeit trans-Atlantic) reading of that case. *Hawes* explains that *Foss* v. *Harbottle* asserts the primacy of the company's right to sue, subject to qualification when the "claims of justice" would supervene "the technical rules" regarding the mode of the company's action. The remaining discussion of *Foss* v. *Harbottle* explains why the Vice-Chancellor's judgment found the plaintiff's bill to be fatally defective: it failed to allege the absence of a board of directors who might have brought the suit, while the plaintiff failed to meet its duty to call a shareholders' meeting to obtain the action of a majority of the shareholders on the matters in issue.[11] The latter proposition, of course, comes close to treating *Foss* v. *Harbottle* as support for the requirement of demand on shareholders imposed by *Hawes* itself. Did the Court that decided *Hawes* simply fail to perceive the significant difference between a demand requirement and the rule in *Foss* v. *Harbottle*? A more likely explanation is that the Court read *Foss* v. *Harbottle* as a case interpreting requirements of pleading against facts that did not compel any departure from them. Thus, the nineteenth century reading of *Foss* v. *Harbottle*, at least in Washington, D.C., may not have been as a rigid rule of claim-preclusion.

Hawes also differs from the rule in *Foss* v. *Harbottle* because it regulates derivative suits by imposing as a precondition to suit the require-

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[9] But see A. Afterman, *Company Directors & Controllers* (1970) at 156 (discussing "American version of the Rule").

[10] See L.C.B. Gower, *Modern Company Law* (4th ed. 1979) at 646.

[11] *Supra* n. 8 at 454-56.

ment that the plaintiff make a prior demand on the corporation's directors. By requiring demand on directors, *Hawes* expressly acknowledges a proper role for the corporation's directors in initiating and controlling litigation professedly brought on the corporation's behalf. This may stem in part from the statutory definition of directors' managerial prerogatives in the United States. Corporation statutes in the United States typically provide that directors shall have power to manage the corporation's business and affairs; in contrast, in Australia as in Britain the definition of directors' prerogatives and the division between directors' powers and those of shareholders is accomplished in the corporation's articles. In short, the statutory basis for directors' managerial prerogatives in the United States may enhance the scope of directors' power as it affects litigation brought on the corporation's behalf.

In Australia, the plaintiff in a derivative action must show that the company is unwilling or unable to sue; as making a demand on the directors is the best way of doing so, the Australian regulation of derivative actions embodies an inchoate demand requirement.[12] Finally, the rule in *Foss* v. *Harbottle* may represent the continuing legacy of the long-discarded notion in English company law that directors are merely agents of shareholders[13] because it suggests the shareholders have residual power, by a majority vote, to compel the directors to take actions that fall within the scope of management. If so, the rule is not consistent with the conception of directors' powers that underlies a demand requirement.

In any event, the U.S. cases treat litigation-related questions as falling within the directors' business judgment—as discretionary choices about the management and control of the corporation's business—if the directors act in good faith and are disinterested in the outcome of the litigation. Thus, if the directors refuse the prospective plaintiff's demand, and the plaintiff then brings a derivative suit, the court will dismiss the suit unless the plaintiff can establish that the directors acted wrongfully in refusing the demand.

The directors, if they act in informed good faith, may refuse the plaintiff's demand that they sue upon a claim for a number of reasons, including of course a low likelihood of success on the merits. The directors may also with propriety decide not to sue upon a claim that may succeed on its merits, if the costs of pursuing the action outweigh the likely amount of recovery, or if the action would jeopardize valuable commercial relationships between the corporation and the defendants. Thus, directors may have good faith reasons to decline to sue that are not related to the narrow legal merits of the underlying claim itself.

As noted above, the plaintiff may be excused from making a demand

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[12] *Cf. Hawkesbury Development Co. Ltd.* v. *Landmark Finance Pty. Ltd.* [1969] 2 N.S.W.R. 782, 790-91 (company's receivership does not require departure from rule in *Foss* v. *Harbottle* because its directors, still in office, have capacity to bring action).

[13] *Automatic Self-Cleansing Filter Syndicate Co. Ltd.* v. *Cunninghame* [1906] 2 Ch. 34, rejects the view that a majority of the shareholders could override a directors' decision, except through a regulation adopted by an extraordinary resolution, which would require a super-majority.

on directors if the exercise would be futile. U.S. jurisdictions[14] vary in the stringency with which they define "futility"; the analysis in this paper focuses principally on Delaware because its popularity as a *situs* for incorporation of publicly-held corporations makes the Delaware position more than one among fifty-three equally interesting possibilities. The Delaware test for excuse focuses on the relationship between the directors and the transaction challenged in the suit.

The plaintiff in a derivative suit to which Delaware law is applicable is excused from making a demand on the corporation's directors only if the complaint alleges facts that create a reasonable doubt whether the challenged transaction resulted from a valid exercise of informed business judgment by the directors.[15] Under this test, demand would be excused if a majority of the directors had a personal pecuniary stake in the transaction they approved, for then their approval would not meet the criterion of disinterest posited by the business judgment concept; likewise demand would presumably be excused if the directors' approval of the transaction was insufficiently deliberative and informed to be characterized as an exercise of judgment. But in the absence of such circumstances, Delaware law requires the prospective derivative plaintiff to make a demand on the corporation's directors, thereby acknowledging the directors' power to initiate and control litigation brought on the corporation's behalf. Demand is not excused, moreover, simply because the plaintiff names all directors as defendants.

Despite its more-than-superficial dissimilarities to the rule in *Foss* v. *Harbottle*, the requirement of demand on directors in fact shares an underlying policy rationale. The rule in *Foss* v. *Harbottle* and succeeding Commonwealth precedents are often said to represent a policy of judicial reluctance to interfere in matters of corporate "internal management" and to reflect judicial deference to the existence of defined organs of corporate decision making. Thus, some claims are effectively non-justiciable because they could be the subject of decisions made by the corporation's shareholders. The requirement of demand on directors could be attributed to a comparable deference. That the prospective derivative plaintiff must make a demand on the corporation's directors, unless they have some personal stake in the transaction at issue or are otherwise disqualified from acting, may similarly stem from judicial deference to the corporation's "internal management" vested in its board of directors.

Likewise, comparable policy rationales support other aspects of legal controls on derivative litigation developed in the United States and in the Commonwealth jurisdictions. Common concerns include a fear of repetitious litigation, brought by successive shareholder-plaintiffs against the company, and a concern to suppress litigation that is frivolous or is

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[14] For these purposes, fifty-three jurisdictions are relevant in the United States—the fifty states plus the District of Columbia, the Virgin Islands and the Commonwealth of Puerto Rico, all of which have corporation statutes.

[15] See *Aronson* v. *Lewis* 473 A.2d 805 (Del. 1984).

brought merely to harass. In the United States as well as the Commonwealth, regulations of derivative litigation have attempted to devise a credible mechanism to determine whether the interests of the company itself – or the interests of all or a majority of its shareholders – are best served by the maintenance of the action. To be sure, the details of these regulations differ, in some respects markedly so.

II Inevitable Tensions Evolve

A. *On the U.S. front*

Perhaps inevitably, after *Hawes* v. *City of Oakland* derivative litigation in the United States evolved into a well-established but always controversial institution. Several separate elements in this evolution contributed to the complexity and subject-matter focus of derivative litigation. *Hawes*, as noted above, was a product of the Court's exercise of equitable rule-making power, and, more generally, of an era in which the United States Supreme Court actively determined rules of general federal common law, including principles of equity jurisprudence.[16] This era ended in 1938 with the Court's decision in *Erie Railroad* v. *Tompkins*;[17] thereafter, the development of federal "common law" was restricted to cases raising federal questions, that is those raised by federal statutes or the United States Constitution.[18] *Erie*, and subsequent interpretations of the Court's reasoning in that case, also restricted the Court's ability, through its rule-making powers granted by the federal Rules Enabling Act, to prescribe rules of substantive law in addition to rules regulating procedure in federal court litigation.[19] As a consequence, the "substantive" law applicable to derivative suits brought in federal court is state law, in most instances that of the company's state of incorporation. As it happens, the federal rules of civil procedure contain a rule specifically addressing derivative suits,[20] and whether that rule should be interpreted simply to make applicable the pertinent provisions of applicable state law – such as demand requirements – or whether it imposes of its own force significant regulation of derivative suits, is a question on which federal courts have disagreed,[21] as have commentators.[22] The Supreme Court has not addressed this

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[16] The Court's venture into general federal common law began with *Swift* v. *Tyson* 41 U.S. (16 Pet.) 1 (1842). In *Swift* the Court held that federal courts had power to determine "general" federal common law if no state statute governed the subject, in cases in which federal subject matter jurisdiction was based on the parties' diversity of citizenship. On "local" questions, principally created by disputes involving real property, *Swift* required federal courts to follow state common law.

[17] 304 U.S. 64 (1938).

[18] Debate continues over the scope and source of federal courts' common law powers. See, e.g., Field, "Sources of Law: The Scope of Federal Common Law" 99 *Harv. L. Rev.* 883 (1986).

[19] See, e.g., *Hanna* v. *Plumer* 380 U.S. 460 (1965).

[20] Fed. R. Civ. Proc. 23.1.

[21] Compare *Daily Income Fund* v. *Fox* U.S. (Stevens, J., concurring), with *Shlensky* v. *Dorsey* 574 F.2d 131 at 141-42 (3d Cir. 1978).

[22] Compare J. Moore & J. Kennedy, *Moore's Federal Practice* 23.1.19 (1985) with DeMott, "Demand in Derivative Actions: Problems of Interpretation and Function", 19 *U.Cal.Davis L. Rev.* 461 (1986).

question directly. It has, however, held that in derivative actions raising claims under the federal securities law, state law governs issues concerning the right to control the litigation, unless the state law in question conflicts with the policies represented by the provision of federal securities regulation from which the claim arises.[23] Thus, the residual legacy of *Hawes* must be separated from the era of "general federal common law" when the Court's law-defining powers extended to matters that now quite clearly are seen as properly within the province of state law.

Departing from the legacy of *Hawes*, relatively few of the states continue to require the prospective plaintiff to make a demand on the corporation's shareholders prior to commencing a derivative suit. Although the states differ on the circumstances excusing the demand on directors, in contrast that aspect of *Hawes's* regulation of derivative suits continues to be generally imposed. Two factors explain the decline of demand on shareholders. First, the likely quality of the shareholders' decision, at least in large corporations, may not justify the costs of making the demand. Requiring the demand to be made if the corporation has a large number of shareholders imposes considerable expense and burden on the plaintiff; further the shareholders in such a corporation will not deliberate together in a body but will simply review written materials, not a mode of decision-making likely to produce a deliberate collegiate judgment. Second, if the putative defendants communicate with the shareholders – if, for example, they are the corporation's directors – and the shareholders refuse the demand, the plaintiff under judicial interpretation of federal securities statutes then has an independent right to sue to challenge the accuracy of the communications received by the shareholders.[24] As a result, the derivative suit would be pretermitted but would be replaced by a non-derivative direct action focused on the defendants' communications with the company's shareholders.

Coupled with the decline in the requirement of demand on shareholders, however, is the imposition in many U.S. jurisdictions of additional regulation of derivative suits that is inapplicable to most other types of civil litigation. About one third of the states impose special security for expense requirements on derivative plaintiffs, and most U.S. jurisdictions have rules controlling the settlement or voluntary dismissal of derivative suits and class actions. Each of these requirements in turn responds to somewhat different concerns about derivative litigation.

Security for expense statutes require the plaintiff to post security, out of which the defendants' litigation costs can be paid if the suit is unsuccessful. Most of these statutes are by their terms inapplicable if the plaintiff owns more than a specified amount of stock. They began to be

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[23] See *Burks* v. *Lasker* 441 U.S. 471 (1979).

[24] Rule 14a-9 makes it a violation of the Securities Exchange Act of 1934 to solicit proxies by means of statements that omit or mis-state material facts and thereby are misleading. In *J. I. Case & Co.* v. *Borak* 377 U.S. 426 (1964), the Court held that a private plaintiff had an implied right to sue for money damages and injunctive relief on account of violations of rule 14a-9. S. 14(a) of the Securities Exchange Act confers rule-making authority on the SEC to prescribe rules regulating the solicitation of proxies.

enacted by the states in the 1940's in response to assertions that many derivative suits were frivolous and were brought as "strike suits" to exact a settlement of little benefit to anyone other than the plaintiff's attorney. These statutes represent an exception to the general U.S. rule that parties bear their own expenses in litigation, including attorney's fees, in that they shift the defendants' litigation expenses on to the unsuccessful plaintiff. That most such statutes exempt plaintiffs who are substantial shareholders[25] suggests that these statutes were designed to respond to the suit brought by a plaintiff with a small stake both in the company and in the merits of litigation brought on its behalf. As it has long been customary—and is indeed legal—for attorneys to represent clients in such litigation on a contingent fee basis, the attorney's investment in human capital in pursuing the action may well exceed the value of the plaintiff's equity investment in the company. In practice, however, the security for expense statutes do not appear to deter many plaintiffs, because once the defendant moves to require that the security be posted, the court stays the action to permit the plaintiff to seek additional shareholders as plaintiff-intervenors so as to meet the requisite amount of shareownership to exempt the action from the statutory security requirement. As a result, some defendants omit the demand because the plaintiff's quest for intervenors will lead to greater publicity for the claims alleged in the complaint.

The potential for disparity in economic interest between the plaintiff's attorney and the plaintiff is similarly part of the explanation for the special treatment of voluntary dismissals and settlements of derivative litigation. Although in general parties bear their own litigation costs in the United States, a long-standing convention has permitted the plaintiff's attorney's fees to be taxed to any common fund recovered by the plaintiff on behalf of a class or a company, whether created as a result of judgment after trial or through a settlement agreement. Thus, the plaintiff may have little investment in the company, and no investment in the suit if the attorney has been engaged on a contingent fee basis; the attorney is likely to receive a fee, however, if the action is settled. The individual defendants' interest in negotiating the agreement is to minimize their personal financial contribution and loss.

All these factors combined suggest that the dynamics of settlement negotiation may not adequately protect the interests of the corporation and all of its shareholders because none of the actors in the negotiating process has economic interests that are necessarily closely aligned with those of the corporation. In response, the federal rules of civil procedure, and most states, require judicial approval of any settlement or voluntary dismissal of a derivative suit, and require the court's approval to be preceded by notice to the corporation's shareholders of the terms of the settlement agreement. The notice enables any shareholder who objects to

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[25] See, e.g., N.Y. Bus. Corp. Law s. 627. In contrast, the California security for expense statute leaves to the court's discretion the determination whether under the circumstances of the case security should be required and does not provide a threshold amount for exemption. See Cal. Corp. Code s. 800.

the terms of the settlement to come forward. Most importantly, the court critically reviews the terms of the agreement, including the amount to be paid to the plaintiff's attorney and the basis on which the fee was computed. If these requirements are complied with, the judgment of dismissal or settlement bars relitigation of the same claim by any other shareholder.

One additional development in the United States is crucial to understanding the role presently played by derivative litigation. As in the Commonwealth, special regulations imposed on derivative suits make it attractive, when possible, to litigate individual (or non-derivative) claims rather than derivative claims. Cases in the United States, in contrast to the Commonwealth, have long recognised that the same facts could give rise to individual as well as derivative claims.[26] Further, federal courts have long held that private litigants have implied rights to sue under several sections of the federal securities laws, including the general anti-fraud provision[27] and that regulating proxy solicitations[28] and other communications in connection with shareholder voting or shareholder action. Facts that include an allegedly misleading solicitation of a shareholder vote—as a practical matter amalgamations and other fundamental transactions—create an individual cause of action under the federal securities laws, at least for public companies, and the resulting litigation tends to be an individual or class action raising the federal securities claims rather than a derivative action contesting principally the merits of the transaction itself.

In short, the pervasive reach of the federal securities laws, and of the private litigation thereby engendered, means the typical derivative suit in the United States does not arise in a factual context in which a shareholder vote was required to approve a transaction. Derivative actions thus tend to focus on transactions or events of less fundamental significance, those that under state corporation law do not require shareholder approval. Examples are management compensation and self-dealing transactions between the corporation and its directors or controlling shareholders. Those are, however, situations in which the defendants, if they have acted wrongfully, have derived a personal pecuniary benefit through a corporate position. Thus, the factual setting of the typical derivative action may not be a fundamental transaction, but it may well be one in which the defendants have indulged in self-interested diversions from their fiduciary duty of loyalty to the company's interests.

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[26] See *Jones* v. *Ahmanson* 1 Cal. 3d 93; 81 Cal. Rptr. 592; 460 P. 2d 464 (1969); *cf. Goldex Mines Ltd.* v. *Revill* 7 O.R. 2d 216 at 224-26 (Ct. Ap. 1974) (stressing importance of clearly differentiating derivative from direct claims in pleading).

[27] An implied private cause of action under s. 10(b), the general anti-fraud provision in the Securities Exchange Act, was first recognised in *Kardon* v. *National Gypsum Co.* 69 F. Supp. 512 (E. F. Pa. 1946) and was most recently endorsed by the Supreme Court in *Herman & Maclean* v. *Huddleston* 459 U.S. 375 (1983).

[28] See *J. I. Case & Co.* v. *Borak* 377 U.S. 426 (1964).

B. *On the Commonwealth front*

Although not as complicated as developments in the regulation of derivative litigation in the United States, the legacy of *Foss* v. *Harbottle* is troubled in some respects. Of principal concern are the difficulty of determining the plaintiff's right to sue without litigating the merits of the case, the prospect that the costs of the litigation may exceed the benefit realised by the company, and the problematic nature of the shareholders' involvement. An additional awkwardness is caused by the absence of effective prospective regulation of communications to shareholders. The litigation in *Prudential Assurance Co.* v. *Newman Industries Ltd.*, culminating in the Court of Appeal's 1982 judgment,[29] is a useful illustration of all these matters.

At issue in *Prudential Assurance* was a transaction in which Newman purchased the principal assets of another company, TPG, allegedly on the basis of an overvaluation. Two of Newman's directors, who owned 25% of TPG's shares, induced Newman's board to approve the purchase, without disclosing an earlier agreement between Newman and TPG covering some of the same assets, under which substantial cash payments had been made to TPG. As mandated by Stock Exchange listing requirements, the acquisition agreement was submitted to Newman's shareholders, but the circular from the directors omitted to mention (among other things) the prior agreements and payments, as well as one director's dissent from the board's approval of the acquisition.

All in all, not an edifying scenario. The rule in *Foss* v. *Harbottle*, coupled with the nature of securities legislation in Great Britain (and Australia for that matter) meant that the focus of the litigation inevitably became the plaintiff's standing to sue derivatively on behalf of the company. In contrast, and despite its complexity, corporate regulation in the United States has the great advantage of addressing separately the quality of the company's communications with its shareholders, and the process through which their consent to a transaction was obtained. In a public company such as Newman Industries, any material a company's management propose to send to its shareholders to solicit proxies or votes on any matter must be filed in advance of its distribution with the federal Securities and Exchange Commission (the SEC) which reviews the material;[30] the gravity of the omissions and misstatements in Newman's circular make it highly likely that they would be detected by the SEC's staff in its review. The SEC has long had a rule, promulgated under its rule-making authority under the Securities Exchange Act of 1934, making it illegal to solicit a shareholder's proxy using a statement that omits or misstates a material fact.[31] If the company failed to rectify the disclosure problem, the SEC would have power to sue in federal district court for

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[29] [1982] 2 W.L.R. 31 (Ct.App.).
[30] See Rule 14a-6.
[31] Rule 14a-9.

an injunction against the distribution of the defective circular, or against consumnation of the acquisition transaction unless the shareholders approved the transaction on the basis of resolicitation with a proper circular.

Company law and securities regulation in Australia and Great Britain, as they now stand, do not create a comparably simple mechanism for discovering and rectifying the use of "tricky circulars", and in turn derivative actions like *Prudential Assurance*, brought after the transaction has been approved by the shareholders and presumably consumnated, are confused by the history of inadequate or deceptive communication between the company's directors and its shareholders. One result is to complicate the court's differentiation between injuries done to the company and injuries done to the shareholders, because the shareholders' approval of the transaction that allegedly injured the company may have been influenced by the deception but once the deception has occurred, its effect and significance may be difficult to isolate.[32] Some litigation of "tricky circular" questions has occurred in Australia under s. 52(1) of the Trade Practices Act, which prohibits corporations from engaging in misleading or deceptive conduct.[33] Although under s. 80 of the Act "any person" may sue for injunctive relief on account of violations,[34] the absence of a pre-circulation filing requirement differentiates the Australian treatment from proxy regulation in the United States. The English Companies Act 1985 is innocent of reference to these matters.

A central issue in *Prudential Assurance* was the plaintiff's standing to sue on account of the injury inflicted on the company through the allegedly inflated acquisition price, the Court of Appeal having taken the position that the personal and representative claims alleged by the plaintiff concerned injury suffered directly in the first instance by the company itself and thus were not independent claims.[35] In the Chancery Division, Vinelott, J. held that the exception to the rule in *Foss* v. *Harbottle* permitting a derivative action when the prospective defendants control the company (and thus make shareholder action in general meeting not a credible decision) should be interpreted broadly, so that the plaintiff could sue derivatively if the defendants own a majority of the shares, or

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[32] This problem is illustrated by *Winthrop Investments* v. *Winns* [1975] 2 N.S.W.L.R. 666 at 706 (discussing "artificial basis" on which court must evaluate disclosure made to shareholders' meeting).

[33] See *Bell Resources Ltd. & Anor* v. *The Broken Hill Proprietary Co. Ltd.* (1986) A.T.P.R. 40-702 (Fed. Ct., 27 May 1986). At issue in *Bell Resources* was a profit forecast communicated to BHP's shareholders that, in the plaintiff's view, misled shareholders as to the company's profitability and the completeness of the information in the forecast. In a seventeen page judgment, the court dismissed the applicants' claim for relief; one explanation for the length of its judgment is the difficulty of applying the general statutory language to a type of corporate communication that is not the principal focus of trade practices regulation.

[34] Under s. 82, any person who suffers loss or damage as a result of a violation may recover that loss or damage in an action. The court's ability to grant *injunctive* relief under s. 80 is expressly made independent of any necessity to show a likelihood of substantial damage, for s. 80(4)(c) provides that the court's power to grant an injunction restraining a person from engaging in conduct may be exercised "whether or not there is an imminent danger of substantial damage to any person" if the conduct occurs.

[35] *Supra* n. 29 at 48-49 (characterising plaintiffs' personal action as "a means of circumventing the rule in *Foss* v. *Harbottle*").

through other means by manipulation of their position in the company could ensure that the action was not brought by the company.[36] In general, Vinelott, J. said, the court should be able to "have regard to any . . . circumstances which show that the majority cannot be relied upon to determine whether it is truly in the interests of the company that proceedings should be brought".[37] Vinelott, J. also interpreted the rule in *Foss* v. *Harbottle* to permit an exception whenever the interests of justice would otherwise be frustrated.[38] The consequence, however, was that the plaintiff's standing to sue could not be determined independently of litigation on the merits of the action. The breadth of this exception to *Foss* v. *Harbottle* is called into question by the judgment of the Court of Appeal, which reasons that the "independent justice" exception cannot realistically be applied without trying the case on its merits, thereby undercutting the basic litigation-avoiding rationale of *Foss* v. *Harbottle* itself.[39] Vinelott, J.'s views on control, however, appear not to have been rejected, at least not explicitly.[40]

Relatedly, the Court of Appeal held that Vinelott, J. also erred in failing to resolve the question of the plaintiff's standing as a preliminary issue prior to the plaintiff's presentation of its case. Prior to proceeding, the Court of Appeal held, the plaintiff must establish a *prima facie* case that the company is entitled to the relief claimed, and that the action fits within the proper boundaries of the exception to the rule in *Foss* v. *Harbottle*.[41] This solution, at least formally, avoids the problem of the trial-within-a-trial created by an open-ended "interests of justice" exception. It does, however, preface the trial with a fact-finding prelude by imposing an evidentiary burden on the plaintiff that inevitably reaches to the substance of many issues of fact underlying substantive claims. But problems of this sort are inevitable unless *Foss* v. *Harbottle* is to admit of no exceptions other than those created by questions unrelated to factual inquiries.

To be sure, this type of problem is not unique to derivative litigation in Great Britain; the resolution of other "preliminary" issues creates the same potential for relitigation of the same factual matters, albeit under different guises. An analogous preliminary issue in derivative litigation in the United States arises if the action is brought in federal district court on the jurisdictional basis of the parties' diversity of citizenship; the question that may arise is whether the corporation should be realigned as a party-plaintiff or maintained as a party-defendant, with realignment as a plaintiff destroying diversity jurisdiction if any remaining defendant

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[36] *Prudential Assurance Co.* v. *Newman Industries Ltd.* [1980] 3 W.L.R. 543 at 583-84 (Ch. Div.).
[37] *Id.* 583.
[38] *Id.* 581-82.
[39] *Supra* n. 29 at 47.
[40] *Id.* 47-48. See also Note, "Directors' Duties and the Rule in *Foss* v. *Harbottle*", (1983) 10 *Syd. L.R.* 156 at 158-60.
[41] *Supra* n. 29 at 48. This approach was followed in *Estmanco (Kilner House) Ltd.* v. *Greater London Council* [1982] 1 All E.R. 437 at 477 (Ch. Div.).

is a citizen of the same state as the corporation. In *Smith* v. *Sperling* the federal district court conducted a fifteen-day hearing to determine whether the interests of the corporation were sufficiently antagonistic to those of the plaintiff to maintain its alignment as a defendant. The court determined that they were not and realigned the corporation as a plaintiff.[42] Inevitably, the hearing examined the transactions challenged in the derivative suit to try to determine whether management's decisions were adverse to the corporation's interests. The United States Supreme Court, *per* Douglas, J. observed that the district court's effort had been a "time consuming, wasteful exercise of energy on a preliminary issue in the case", which had been eight years in the federal court system solely on the issue of federal subject matter jurisdiction. Instead, the Court held that antagonism was sufficiently established when the corporation's management defended a course of conduct attacked by the stockholder-plaintiff, thereby making the corporation through its management hostile to the enforcement of the claim. In the Court's view, whether a "real collision" is present between the parties can be determined by the district court through an assessment of the pleadings and the nature of the dispute set forth therein; the merits of the suit need not be tried to resolve the jurisdictional dispute.

Should the *prima facie* showing required by the Court of Appeal in *Prudential Assurance* to establish the plaintiff's standing be characterized as a "time-consuming, wasteful exercise of energy on a preliminary issue"? If the plaintiff succeeds in surmounting the hurdle of establishing its standing to sue, at least some of the factual issues explored in the trial on the merits will touch upon if not overlap completely with the factual content of the "*prima facie*" showings. Likewise, relitigation of factual issues would be the lot of the successful plaintiff under the district court's approach to determining proper alignment of parties in *Smith*. But if the only practicable alternative is that chosen by Vinelott, J., that is, awaiting the conclusion of litigation on the merits to determine whether the interests of justice require that the plaintiff have standing to sue, treating the standing issue as preliminary, and chancing some relitigation may well be preferable. Another solution is the Court's in *Smith* v. *Sperling*: requiring that "preliminary" or jurisdictional issues be resolved on the basis of the pleadings. The Court of Appeal expressly rejects this possibility in *Prudential Assurance*, without much explanation[43] but perhaps because the plaintiff might otherwise be tempted to allege "fraud" or

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[42] 354 U.S. 91 at 93 (1957). The alignment problem arises because the Court determined early in its adjudication of diversity jurisdiction cases that "complete" diversity among the parties was required—that is, if citizens of the same state were plaintiffs and defendants, the presence of diversity in citizenship among the parties to the action would be defeated. See *Strawbridge* v. *Curtiss* 7 U.S. (3 Cranch) 267 (1806).

[43] *Supra* n. 29 at 47-48. The Court of Appeal proposes that the court might stay the action to permit a shareholders' meeting so that the Court's resolution of whether the action falls within an exception to *Foss* v. *Harbottle* can be informed by the conduct of, and proceedings at the meeting. *Id.* at 48. Something of the same procedural dilemma is created by the pleading burden currently imposed in Delaware to excuse the making of a demand on directors. In *Aronson* v. *Lewis, supra* n. 15 the Delaware Supreme Court made applicable to excuse a requirement of "particularized pleading" of factual allegations; a practical difficulty this creates is that the plaintiff is not entitled to take discovery on demand issues.

"control" in the complaint. Indeed, the difficulty of developing a workable test for plaintiffs' standing without creating the necessity for a trial within or prior to the trial on the merits, suggests that the rule in *Foss* v. *Harbottle* reposes too much of the regulation of shareholder litigation on the standing issue.[44] Developments in the United States after *Hawes* present problems of their own, but they have the advantage of giving segmented or differentiated treatment to different issues and concerns. The statutory regulation of derivative actions in Canada requires the prospective plaintiff to satisfy the court that pursuit of the action will be in the company's best interests.[45] This requirement likewise creates the potential for relitigation of factual issues. The extent to which relitigation does occur, however, depends on the court's interpretation of its mandate. Similarly, in requiring the plaintiff to make "*prima facie*" showings, *Prudential Assurance* uses a standard whose meaning has been defined differently by many judges in varied contexts.[46]

The development of the *Prudential Assurance* litigation also illustrates that the costs of maintaining and successfully prosecuting a derivative suit may, when the suit is eventually concluded, far exceed the financial benefit realized by the corporation. The Court of Appeal finally determined that the defendants, by dishonestly concealing the earlier acquisition agreements and the payments made under them, caused £45,000 in damage to the company, a not insignificant amount, but one that paled in comparison to the "small fortune" running into six figures apparently spent by the plaintiffs on legal fees.[47] As *Prudential Assurance* was settled prior to the court's resumption of hearings on the costs question, and as the English practice does not require the court to review the terms of a settlement of a derivative suit, the extent to which the plaintiff's costs were paid by the defendants is unknown.

Extreme disparities between the plaintiff's costs and the benefit to the corporation are less likely to arise in derivative litigation in the United States. One control is the personal economic self-interest of the plaintiff and her lawyer. As noted above, even victorious parties bear their own litigation costs in the United States, excepting exceptional circumstances; successful derivative litigation is an exception in that it produces a "common fund" for the corporation and all its shareholders, to which the plaintiff's attorney's fees may be charged. Thus, the plaintiff's attorney has a strong disincentive against investing human capital in the action beyond the probable amount of recovery likely to be realised in a settlement agreement or after trial. Further, any settlement or voluntary dismissal

[44] One Australian judgment acknowledges the necessity, in appropriate cases, of distinguishing the standing issue from the liability issue, see *Hurley & Anor.* v. *B.G.H. Nominees Pty. Ltd.* (1982) 1 A.C.L.C. 387 at 390 (S.A. Sup. Ct., King C.J.), and of conducting the inquiry on standing on the assumption that the allegations pleaded in the statement of claims are true.

[45] The Canadian statutes also require the would-be plaintiff to satisfy the court that the corporation's directors would not diligently prosecute the action and that the prospective plaintiff is acting in good faith. See, e.g., Canada Business Corporations Act, s. 232(2)(a).

[46] See R. P. Meagher, W. M. C. Gummow & J. R. F. Lehane, *Equity: Doctrines and Remedies* (2nd ed. 1984) at 563-70.

[47] *Supra* n. 29 at 61.

requires court approval in most jurisdictions, and an element of the court's analysis is the relationship between the amount of attorneys' fees and the economic benefit retained by the corporation.

Prudential Assurance is of further significance because it calls into question the feasibility and credibility of shareholder involvement in decisions concerning derivative litigation. The rule in *Foss* v. *Harbottle*, as described above, barred derivative litigation of claims that could be the object of shareholder action in general meeting; it precluded litigation independent of whether the shareholders had taken action or had an opportunity to take action formally presented to them. In more recent English cases, the court has stayed the litigation pending submission of the claim to a shareholder meeting.[48] This has the great advantage of assuring that the shareholders have actual notice of the claim and a formally-presented opportunity to act upon it; effectively it converts the litigation-precluding rule in *Foss* v. *Harbottle* into a requirement of demand on shareholders comparable to that imposed by the United States Supreme Court in *Hawes*.

Of separate concern, however, is the credibility of the shareholders' response. Vinelott, J.'s judgment in *Prudential Assurance* doubts the probative value of any shareholder resolution addressed to the claims raised derivatively:

> Given that the board were deceived and, at least in part, as a result of that deception viewed [the dissentient director's] conduct in this hostile way, there was in my view no real possibility that the question whether proceedings should be commenced by the company would ever be put to the shareholders in a way which would enable them to exercise a propr judgment as to whether it was in the interests of the company that the litigation should be commenced.[49]

The shareholders' ability to make a "proper judgment" would be vitiated by their dependence on the directors for guidance, while the directors, having earlier been deceived themselves, still seemed to ally themselves with the individual defendants who had earlier deceived them. The decline in the United States of the requirement of demand on shareholders acknowledges on similar grounds the vulnerability of the shareholders' response to the demand. If the individual defendants, as in *Prudential Assurance*, appear likely to be in effective control of the channels of communication between the corporation and its shareholders, inevitably scepticism attaches to the shareholders' rejection of the demand and the process culminating in the rejection.

But in what direction shoud this scepticism lead? One alternative, as in the majority of U.S. jurisdictions, is the elimination of a separate

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[48] E.g., *Hogg* v. *Cramphorn* [1967] Ch. 254. In *Prudential Assurance* the Court of Appeal suggests that a stay of proceedings to permit a shareholders meeting to be held "may well be right". [1982] 2 W.L.R. 31 at 61.

[49] *Supra* n. 36 at 585-86.

role for shareholder plebescites in connection with claims raised in derivative suits. Another is a return to the traditional claim-preclusion form of the rule in *Foss* v. *Harbottle*. This second outcome has the drawback of postulating that shareholders have full knowledge of, and opportunity to act upon, claims on behalf of their company, which as a factual assumption may not always be true. On the other hand, it has the advantage of not encouraging the view that the shareholder meeting is an institution capable of well-informed decision making on a collective basis. If, as Vinelott, J. suggests, one should have profound doubts about the quality of the decisions made at a shareholder meeting controlled or strongly influenced by the defendants, a rule which requires resort to this ritual has little—other than additional ritual—to recommend it.

III Current Dilemmas

A. *Litigation committees*

At present in the United States the most controversial issue in derivative litigation concerns the use of "litigation committees". As this question is one controlled by state law, and only five state supreme courts have addressed the litigation committee device, further evolution of the law is inevitable. Consider a situation in which, even under the most stringent requirements, the plaintiff would be excused from making a demand on the corporation's directors prior to instituting a derivative suit. Under the Delaware test described above, the plaintiff would be excused from making the demand if the complaint makes allegations raising a reasonable doubt whether the transaction under attack was the product of an exercise of the directors' business judgment. Demand would obviously be excused under this test if the plaintiff alleges that a majority of the corporation's directors received a personal pecuniary benefit from the transaction in question.

Although one might then suppose the plaintiff, freed of the demand requirement, would file suit and would then be able to litigate the case on its merits, this supposition would be mistaken, at least in some U.S. jurisdictions. In 1979, in *Auerbach* v. *Bennett*, the New York Court of Appeals held that, even in a demand-excused case, the corporation's directors had power to appoint a committee of disinterested directors to consider whether maintenance of the derivative suit would be in the corporation's best interests.[50] Disinterest for these purposes requires directors who were not named as defendants in the suit; the practice in many instances has been to appoint directors who were not serving on the board at the time of the transaction challenged in the derivative action. In *Auerbach* the court held the committee's recommendation should be

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[50] 419 N.Y.S. 2d 920 (1979). In *Roberts* v. *Alabama Power Co.* 404 So. 2d 629 (Ala. 1981), without much elaboration, the Alabama Supreme Court appears to adopt this test. In *Alford* v. *Shaw* N.C. 349 S.E. 2d 41 (1986) the North Carolina Supreme Court followed *Auerbach*, but imposed on the plaintiff the burden with regard to the committee's good faith.

accorded the judicial deference due a business judgment; thus the derivative suit should be dismissed if the committee so recommends, the court's review being limited to whether the committee members were independent and whether they acted in good faith, taken in this context to include whether their investigation on its face appears to be adequate.

In *Auerbach* the complaint alleged that the corporation's directors and outside auditors had been negligent in their failure to detect payments made by corporate officers to officials of foreign governments. In essence, then, the claim in *Auerbach* was that the directors failed to fulfill their obligation to use appropriate care in their supervision of the corporation's affairs. *Auerbach* itself, however, does not limit the litigation committee device to such claims, and other courts have applied the "business judgment" standard articulated in *Auerbach* to cases in which the plaintiff's claim was premised on a breach of the defendants' duty of loyalty to the corporation, through a transaction tainted by self-dealing or conflict of interest.[51]

Auerbach's extension of the business judgment concept to encompass litigation committees has been rejected entirely by the Iowa Supreme Court, and in part by the Delaware Supreme Court. In the Delaware case, *Zapata Corp.* v. *Maldonado*, the court held that a court reviewing a litigation committee's recommendation had discretion whether to review the merits of the committee's position, to apply its own "independent business judgment" in determining whether the suit should be dismissed rather than deferring entirely to the judgment of the committee.[52] Although infelicitous in phrasing, the court's response to the use of litigation committees is grounded in practical reality: *Zapata Corp.* articulates the fear that committee members will so empathize with the plight of their fellow directors—the defendants—that they will be unable fairly to assess the merits of the suit. Indeed, some commentators have questioned whether the court itself will be able to play a sufficiently rigorous role in reviewing the committee's recommendation, given the ability of the committee to present its recommendation in a palatable—or at least presentable—guise.[53]

Whether the committee can generate a palatable rationale in support of its recommendation turns to a considerable extent on the sophistication and style with which it operates. Customarily litigation committees retain as special counsel a law firm that does not ordinarily represent the corporation. To permit the committee, aided by its counsel, to investigate the plaintiff's claims, the court will stay other actions in the derivative suit once the litigation committee is appointed. The product of the committee and its counsel may triumph eventually through its sheer bulk: the Delaware chancellor has estimated that most committees ultimately

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[51] E.g., *Lewis* v. *Anderson* 615 F.2d 778 (9th Cir. 1979), cert. denied, 444 U.S. 869 (1980).

[52] 430 A. 2d 779 (Del. 1981).

[53] See Cox, "Searching for the Corporation's Voice in Derivative Suit Litigation: A Critique of *Zapata* and the ALI Project", 1982 *Duke L.J.* 959.

produce reports of at least 150 pages and that litigation is on average delayed by two years.[54]

In *Miller* v. *Register & Tribune Syndicate*, the Iowa Supreme Court held that, if on the facts of the case the plaintiff would be excused from making a demand on the corporation's directors, the directors as a result lack power to control the derivative litigation and consequently have nothing to delegate to a litigation committee.[55] In effect, under *Miller's* reasoning, the interest of the directors which disqualifies them from acting on demand disqualifies them as well from participating in the selection of a committee. *Miller* suggests that the court could select the committee's members, if it desired non-party advice as to the merits of the suit; although the court's opinion does not expressly reject the possibility, that non-defendant directors could separately act to select a litigation committee is called into question by the court's reasoning, which stresses the awkwardness of the litigation committee's posture in dealing with claims against fellow directors.

Of assistance in evaluating these disparate responses to litigation committees is almost a decade of experience with litigation committees since *Auerbach* legitimated their use in 1979. No committee has ever recommended that a derivative suit in its entirety be continued. A few committees have found merit in portions of claims against individual defendants and recommended that those claims be settled,[56] and in a few instances after a litigation committee's investigation the corporation itself has pursued claims against former employees. The credibility of the institution, however, is called into question by the uniformity with which committees determine derivative actions not to be in the corporation's best interests. Surely in eight years some claims worth pursuing were raised derivatively. Indeed, in some reported cases, the committee's recommendation appears to have been at odds with the advice as to the merits of claims received from its counsel.[57]

Even under the Delaware standard of review, the mere availability of the litigation committee device appears to have created temptations to use such a committee in situations where its recommendation will simply not be credible. For example, in *Lewis* v. *Fuqua*, the complaint alleged that all directors save one had usurped an opportunity properly belonging to the corporation itself to invest in the common stock of another corporation.[58] After the plaintiff filed the derivative action, the directors appointed a litigation committee comprised of their one fellow director who had not himself invested in the common stock. He had close business and social ties to the board's chairman, a defendant in the suit. Even though the Chancery Court in Delaware found that the one-member

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[54] See *Kaplan* v. *Wyatt* 484 A.2d 501 (Del. Ch. 1984) aff'd, 501 A.2d 572 (Del. 1985).

[55] 336 N.W. 2d 709 (Iowa 1983).

[56] See *Alford* v. *Shaw* 324 S.E. 2d 878 at 886 (N.C. App. 1985), rev'd N.C. 349 S.E. 2d 41 (1986).

[57] See, e.g., *Miller* v. *Register & Tribune Syndicate* 336 N.W. 2d 709 (Iowa 1983); *Watts* v. *DesMoines Register & Tribune* 525 F. Supp. 1311 at 1321-22 (S.D. Iowa 1981).

[58] See 502 A. 2d 962 (Del. Ch. 1985).

committee lacked sufficient independence, and in this respect acted to affirm one's confidence in its discriminatory ability, any institution that creates such temptations is problematic. Likewise, in some cases in which all directors were named as defendants, the board nominated to the litigation committee "expansion directors" added to the board in the wake of the derivative litigation.[59]

This history calls into question whether the litigation committees function to discriminate between meritorious claims that should be pursued by the corporation itself or on its behalf derivatively, and claims that should be dismissed summarily. In light of the exacting standards applicable to demand on directors, at least in Delaware the derivative suits in which a litigation committee would be created are ones in which the original transaction at issue was not approved by directors in an exercise of informed business judgment, or in which a majority of the directors had a personal pecuniary interest. In all other situations the plaintiff is required to make a demand on directors. Given the demand threshold, what does the litigation committee contribute to a credible assessment of the merits of the action? The problems created by litigation committees would be reduced somewhat by a draft proposal from the American Law Institute's Project on Corporate Governance. Although the proposal essentially endorses the use of litigation committees, subject to Delaware-style judicial review, it would not permit a defendant to retain a personal pecuniary benefit if a derivative action is dismissed at the behest of a litigation committee. This proposal would restrict the effect of a litigation committee's recommendation where the risk of apparently improper bias in the committee's action is probably at its greatest: the retention of personal financial benefits realised by fellow directors and other defendants.

Finally, given all of these difficulties with the litigation committee device, one might wonder about the underlying causes of its attractiveness to the U.S. jurisdictions that have enthusiastically embraced it. A number of explanations come to mind. First, the court's ability to dispose summarily of the typical claim asserted derivatively is limited. Most such claims turn substantially on factual questions, and courts have long been unwilling to grant motions for summary judgment in such cases. Thus, even if a claim has little prospect of ultimate success on its merits, summary disposition is still unlikely and the litigation committee might thus appeal as a device to fill a perceived procedural interstice. A difficulty with this argument is that it presupposes the desirability of encouraging summary disposition of the types of claims likely to be raised derivatively. One might easily reject this presupposition and conclude that summary disposition of such claims ought not to be encouraged because they frequently involve issues of subjective intent.[60]

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[59] E.g., *supra* n. 56.
[60] See *id.* at 886 (summary disposition not favoured for claims involving issues of subjective intent).

In addition, derivative suits as a group, and the plaintiffs' bar, have qualities that might make some courts unduly susceptible to the appeal of the litigation committee. The prototypical plaintiff is a small shareholder, and a noticeable number of such plaintiff are repeat players who appear in such actions frequently. The economic interest of the plaintiff's attorney may be so transparently at stake in the litigation that the court is insufficiently sceptical of devices like litigation committees that do not appear to function well to discriminate between meritorious and less meritorious claims. Indeed, the strong self-interest of the plaintiff's bar appears to serve as a control on bringing actions that are so unlikely to succeed that their settlement value is minimal.

Moreover, the circumstances under which demand on the board should be excused have not been defined with great clarity in many jurisdictions. If demand is excused only when the transaction at issue is one in which a majority of the directors have a personal financial interest, the occasion for the appointment of a litigation committee is restricted to cases that on their face raise serious questions about the focus of the directors' loyalties. Other cases are subject to the demand requirement, so long as the plaintiff is unable to allege facts raising a reasonable doubt whether the challenged transaction was the product of the directors' business judgment. Unless the directors, under current Delaware law, acted with gross negligence,[61] or unless they had a personal economic interest in the transaction, the effect of the demand requirement is to place the control of suits raising claims on behalf of the corporation within the directors' discretionary business judgment. In jurisdictions with less exacting versions of the demand requirement,[62] more derivative actions elude the demand requirement, and some of these are actions challenging the directors' competence rather than their loyalty. Finally, some courts' acquiescence in the litigation committee as an instrument of the directors' "business judgment", even in demand-excused cases, may simply represent a transcendence of rhetoric over reality. The reality is a private non-judicial device to bring about the termination of litigation;[63] the rhetoric is derived from a prudent judicial deference to decisions about the operation of business enterprises. The gap between the two is obvious, and the litigation committee device ought not to commend itself to Australia or to the other Commonwealth jurisdictions.

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[61] See *Smith* v. *Van Gorcom* 488 A.2d 858 (Del. 1985). No Delaware case yet considers the demand issue in the context of a plaintiff's allegation that the directors' behaviour was grossly negligent but not self-interested; indeed *Smith* v. *Van Gorcom* itself was litigated as a class action. *Dicta* in an English opinion, *Daniels* v. *Daniels*, reasons that such an allegation would not fit within an exception to the rule in *Foss* v. *Harbottle*, so that only if the directors' negligence benefits themselves will the shareholder-plaintiff have standing to sue on the company's behalf. [1978] 2 W.L.R. 73, 79-80.

[62] See, e.g., *Barr* v. *Wackman* 36 N.Y. 2d 37; 329 N.E. 2d 180 (1975).

[63] As the Vice-Chancellor observed in *Lewis* v. *Fugua*, the litigation committee is "[t]he only instance in American Jurisprudence where a defendant can free itself from a suit merely by appointing a committee to review the allegations of the complaint". See 502 A. 2d at 967.

B. *Statutory Remedies for Oppression*

An unresolved question about shareholder litigation in Commonwealth countries is the scope of statutory oppression remedies, which are not subject to the limits imposed by the rule in *Foss* v. *Harbottle*. For example s. 320(1) of the Australian Companies Code authorises an application to a court for an order in relation to a company by a member who believes its affairs "are being conducted in a manner that is oppressive or unfairly prejudicial to, or unfairly discriminatory against, a member or members, or in a manner that is contrary to the interest of the members as a whole", or by a member who has analogous beliefs about an act or omission of the company, or a resolution of a class of members, or a proposed act, omission or resolution. S. 320(2) grants broad remedial power to the court to make orders, and, in contrast to comparable legislation in New Zealand, the court's ability to grant a remedy is not premises on a requirement that it find granting the remedy to be "just and equitable". Like the New Zealand statute, s. 320(4A) defines oppression or unfair prejudice against a person who is a member to include actions with those effects against the person "whether in his capacity as a member or in any other capacity . . . ." Under s. 320(2)(g) the court may make an order directing the company to institute, defend or discontinue proceedings or it may authorise a member to take these steps in an action "in the name and on behalf of the company". The section does not specify the criteria the court should use in deciding whether to make such an order.

The members' right to sue under s. 320 and its Commonwealth counterparts is independent of the factors defining standing under the rule in *Foss* v. *Harbottle*. Whether the action succeeds is of course a separate question from the member's right to bring it. In *Wayde and Anor* v. *New South Wales Rugby League Ltd.*,[64] the High Court of Australia interpreted s. 320 to require a showing of unfair prejudice to the interests of the member, if the corporation's directors concededly made the decision adversely affecting the member's interests in good faith. The test used in the judgment of four of the justices was whether no board of directors acting reasonably could have made the decision contested in the member's action, which was to exercise the directors' power to determine member clubs' eligibility for a major rugby league competition so as to exclude a club from participating. Brennan, J.'s separate judgment acknowledges that under s. 320 the directors' good faith is "relevant to but not conclusive of the question whether relief should be granted"; whether to intervene under s. 320 is a question of "fact and degree" which the court should answer by inquiring whether reasonable directors (possessed of any special skill of the company's actual directors) would have decided the action was unfair in the disadvantage or burden imposed thereby on the member.[65] The test of unfairness is an objective one, according to Brennan, J., a

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[64] *Wayde & Anor* v. *New South Wales Rugby League Ltd.*, (1985) 3 A.C.L.C. 799 (High Court).
[65] *Id.* 806.

test that defines unfairness by looking to ordinary standards of reasonableness and fair dealing.

New Zealand's counterpart legislation to s. 320 was interpreted by the Court of Appeal in *Thomas* v. *H. W. Thomas Ltd.* to be concerned with "conduct of the company which is unjustly detrimental to any member of the company whatever form it takes and whether it adversely affects all members alike or discriminates against some only . . ."[66] Thus, the judgment states it is unnecessary for the plaintiff to point to an "actual irregularity or to an invasion of his legal rights or to a lack of probity or want of good faith towards him on the part of those in control of the company."[67] *Thomas* thus interprets the scope of the oppression remedy to reach actions affecting all members, and that in turn reaches shareholders' claims that might otherwise be litigated as derivative suits on behalf of the company, so long as the "unjust detriment" standard is satisfied. The High Court's judgments in *Wayde & Anor* do not expressly address the application of s. 320 to decisions affecting the interests of all members, but the judgments likewise do not restrict the scope of s. 320 to actions adverse to fewer than all of a company's shareholders.

C. *Injunctive relief under s. 574*

The restrictions on shareholders' standing to sue imposed by the rule in *Foss* v. *Harbottle* may be inapplicable to actions for injunctive relief brought under s. 574 of the Australian Companies Code. Under s. 574, the court may grant an injunction against conduct that constitutes or would constitute a breach of the code, upon the application of the Commission or of "any person whose interests have been, are or would be affected by the conduct".[68] The court's power to grant the injunction is expressly made independent of any finding of imminent danger of substantial damage to any person.

Although s. 574 has been interpreted to confer standing on a target company to contest the adequacy of the take-over document circulated to its shareholders,[69] its application to a suit brought by an individual shareholder appears not to have been determined.[70] Further, the usefulness of s. 574 to a shareholder plaintiff may be limited in some situations. First, the action must involve conduct by the defendants that would constitute a breach of the Code. Obviously s. 229 of the Code will cover much of the ground of typical derivative litigation in the United States. However, in shareholder actions brought against defendants who are not officers or directors of the corporation, the claim asserted on the corporation's behalf may not involve any alleged breach of the Code. Second, s. 574 provides that the court "may" grant the injunction and may

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[66] *Thomas* v. *H. W. Thomas Ltd.* [1984] 1 N.Z.L.R. 686 at 693.
[67] *Ibid.*
[68] See s. 574(1)(b).
[69] See *Broken Hill Proprietary Co. Ltd.* v. *Bell Resources Ltd.*, (1984) 8 A.C.L.R. 609.
[70] See H. Ford, *Principles of Company Law* (4th ed. 1986) at 490.

in substitution or in addition require the defendant to pay damages to any person;[71] the court thus appears to have discretion to determine whether to award any remedy, and s. 574 itself does not prescribe standards by which that discretion should be exercised. Finally, s. 574 contemplates that private plaintiffs will be required to give undertakings as to damages as a condition to the court's aware of an interim injunction because it expressly provides that no such undertaking may be required when the Commission seeks an injunction. Thus, whether s. 574 effectively abolishes the rule in *Foss* v. *Harbottle* turns on the nature of the claim asserted by the particular plaintiff and, if interim injunctive relief is sought, on the plaintiff's ability to invest in the undertaking as to damages. The plaintiff's willingness to make any investment in the suit is, of course, reduced by the fact that the award of any relief under s. 574 is within the court's discretion. But the undertaking is not given unless an injunction is granted; it serves as the consideration for the order. Those qualifications aside, s. 574 defines with striking breadth both the court's power to grant injunctive relief and prospective plaintiffs' eligibility to sue. This breadth is evidenced by the fact that persons are eligible to sue under s. 574 who would not have standing to bring a derivative action in most U.S. jurisdictions, which require the plaintiff at least to have been a shareholder at the time of the wrong alleged.[72] Many U.S. jurisdictions additionally require the plaintiff to continue as a shareholder throughout the pendency of the litigation.[73] Thus, the impact of s. 574 on the law of standing is not limited to its effect on the rule in *Foss* v. *Harbottle*, free as it is of any requirement that plaintiffs demonstrate contemporaneous or continuing shareholding.

IV Conclusion

As the preceding discussion illustrates, the regulation of derivative litigation in the United States has long differed from the Commonwealth tradition, although in both systems common policy concerns, broadly defined, can be said to underlie diverse legal rules. Further, statutory developments in Australia now enable some claims to be litigated, free of the controls traditionally imposed on derivative litigation. Although the precise extent of this liberation is unknown, it parallels the treatment of many claims arising under the federal securities laws in the United States.

It would, however, be a profound mistake to think that these Commonwealth developments will produce the volume or style of shareholder litigation that has long typified the United States. Indeed, even if Commonwealth parliaments were to unequivocally repudiate the rule in *Foss* v. *Harbottle* in all respects, institutional differences that transcend legal rules would continue to discourage extensive shareholder litigation

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[71] See s. 574(8).
[72] See, e.g., Rule 23.1 of the Federal Rules of Civil Procedure.
[73] See D. DeMott, *Shareholders' Derivative Litigation*, s.4:03 (1987).

in Commonwealth jurisdictions. The relevant institutional differences define the economic attractiveness of shareholder litigation to the actors involved in bringing it. The legality of contingent fee representation in the United States has encouraged the development of a specialised plaintiff's bar for securities and derivative litigation, a bar whose services are available to a plaintiff with a plausibly meritorious claim who need not make any investment to finance the litigation. Further, an unsuccessful shareholder-plaintiff would not under the United States practice pay the defendants' attorneys fees.[74] The practical effect of the state security for expense statutes, which would shift these costs on to the unsuccessful plaintiff, is effectively limited, as explained above. The limited downside risk to the plaintiff in the United States, coupled with the entrepreneurial quality of the plaintiff's bar, would always make shareholder litigation – at least of some types of claims – more attractive than in the Commonwealth.

Whether this is desirable raises somewhat larger questions than can be addressed here. Conventional wisdom in the United States has long accepted the utility and legitimacy of private litigation as a supplement to official actions to enforce compliance with the law.[75] One need not be entirely sanguine about all aspects of the litigation-favouring legal culture of the United States, however, to think that corporations' directors and controlling shareholders ought not to evade entirely the legal accountability furthered by shareholder litigation.

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[74] In some circumstances, the plaintiff may not incur this liability in England. In *Wallersteiner* v. *Moir (No. 2)*, the Court of Appeal held that a company could be ordered to indemnify the plaintiff against his costs in bringing a derivative suit on its behalf, and that if the action failed, the company itself should be liable for the defendants' costs if the plaintiff had reasonable grounds for bringing the action. See [1975] 1 All E.R. 849 at 858-59 (C.A.).

[75] This is sometimes referred to as the "private attorney general" concept. The Supreme Court first applied the concept to private actions under the federal securities laws in *J.I. Case & Co.* v. *Borak* 377 U.S. 426 (1964).