



Précis Paper

Statutory Derivative Actions

A discussion of statutory derivative actions, which enable a shareholder or member of a company to bring an action against a third party in the name of the company.

Discussion Includes

- Commencing statutory derivative actions
- Elements of *s 237 Corporations Act 2001 (Cth)*
- The evidentiary burden in applications for leave
- Seeking access to the books and records of the company under *s247A Corporations Act 2001 (Cth)*
- Who gains the benefit of a successful derivative action?
- Court approval of settlements and compromises
- Costs considerations

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Statutory Derivative Actions

1. In this edition of BenchTV, Paul Folino-Gallo (Barrister, Third Floor Wentworth Chambers, Sydney) and Timothy McGrath (Lawyer, Pateman Legal & Corporate Services, Sydney) discuss the commencement of statutory derivative actions under the *Corporations Act 2001 (Cth)* and the subsequent costs and considerations regarding this type of litigation.

Commencing statutory derivative actions

2. Statutory derivative actions are an evolution of the shareholder's derivative action of *Foss v Harbottle (1843) 67 ER 189*, which governed prior to the *Corporations Act 2001 (Cth)*. The *Corporations Act* has codified a shareholder's ability to bring an action against a third party in the name of a company and governs almost exclusively how these actions are made.
3. The provisions of the *Corporations Act* determine:
 - (a) Who may bring an action
 - (b) The manner in which application is to be brought
 - (c) How application is determined
4. The first relevant consideration for the Court to determine whether or not leave should be granted is who is bringing the application. Under s 236, *Corporations Act 2001 (Cth)*, a member, former member, or a person who is entitled to be recorded in the register can bring an application for leave. An officer or a former officer can also bring an application for leave.
5. It is important to note that there are two discrete and distinct applications - one for leave to commence proceedings, and then the substantive proceedings. The leave application must be heard before proceedings proper can be commenced. Significant preparation is required to bring an application for leave to commence proceedings. In the language of Palmer J in *Swansson v Pratt [2002] NSWSC 583*, an application for leave is not a standard interlocutory application, it is an application for substantive relief and that is the way it has to be dealt with. This has a material impact on the way the evidence is led. It ensures when a practitioner brings an application, it is ready to be heard to finality.
6. Any findings of fact in the leave application are liable to cause embarrassment in the final proceedings, therefore there is very limited scope for cross examination. Courts are reticent to hear factual disputes in the leave application, thus doing away with the need for cross-examination. It should be noted that the Court will not engage in a mini proceedings or mini trial of the substantive proceedings in the leave application.

Elements of s 237, Corporations Act 2001 (Cth)

7. Section 237 of the *Corporations Act* sets out the criteria which must be satisfied in order for the court to make an order for a party to have leave to bring proceedings in the name of a company. If the criteria is not met, leave must be refused - there is no discretion.
8. Under s237(2), the Court must grant the application if it is satisfied that:
 - I. it is probable that the company will not itself bring the proceedings, or properly take responsibility for them, or for the steps in them. For example, in a small company with only a few directors, if a complaint is made against the actions of the majority of the directors, it is unlikely that action will be taken. In those circumstances, the Court could readily infer that action is unlikely to be taken by the company. It will seldom be the case that a company will make an unequivocal statement that it will not commence proceedings itself.
 - li. the applicant is acting in good faith. There is no requirement for the applicant to give evidence that they are acting in good faith. The court considers whether the claim is brought for collateral purpose, whether there are reasonable grounds, and the proceedings evince a reasonable cause of action. The court must satisfy itself that the proceedings are not being brought for a collateral purpose such as to constitute an abuse of process. It is insufficient to simply point to a collateral purpose as a basis for opposing an application for leave. Practitioners must inquire as to why the person wishes to pursue the action, in order to be satisfied of the good faith element. It is the job of the legal practitioner to determine there are no nefarious reasons behind an application.
9. Under s 237(2), the Court must grant the application if it is satisfied that: (c) it is in the best interests of the company that the applicant be granted leave. It is crucial that there must be no alternative mechanism for the company to obtain redress. As a practitioner, it is worth considering alternative means to provide a remedy for a client that wouldn't involve bringing a statutory derivative action. Revisions under s 233 of the *Corporations Act 2001 (Cth)* provide alternative applications. For example, if the shareholder is suffering from an oppression, a compulsory share buyback is an available remedy.

The evidentiary burden in applications for leave

10. As part of the application and the evidence led, a practitioner will be required to put forward draft pleadings to the Court which will form the basis to the substantive

proceedings to be commenced in the name of the company. This application needs to set out factual assertions in support of the proceeding.

Seeking access to the books and records of the company under s 247A, Corporations Act 2001 (Cth)

11. It is often worthwhile for practitioners to bring an application under s 247A along with the s 237 application if a shareholder no longer has access to important evidence. Section 247A provides that a Court can compel a company to allow access to the books and records of the company. By bringing an application under s 247A, one can satisfy the Court that the lacuna in the evidence will be remedied. Discovery or inspection of the books and record, can take place prior to the pleadings closing.
12. Judicial direction from Justice Palmer has identified that a practitioner should lead evidence as to the character of the company that is the subject of the dispute. Context of the dispute is key to these applications with the Courts being reticent to intervene in the management decisions of discrete companies. The Court is also reticent to grant statutory derivative actions and eager to see whether alternative avenues of action. For instance, these types of applications are not to be used if there is a deadlock between members of a joint venture company to try and vindicate the position of one of the partners over the other.
13. One of the criteria that the Court will consider is the nature of any business carried on by the company and the general financial situation of the company. This will provide the Court with all the facts and circumstances that help to satisfy that the litigation will bear fruit.
14. The Court will consider whether there is any other means or mechanisms by which to obtain the redress being sought by the applicant. Due to this, practitioners need to give consideration whether or not there are alternatives since this type of relief should be sought only as a last resort. An alternative relief undertaken by a practitioner could be to seek specific performance of a contract.
15. The Court will consider whether the defendant has the substantial capacity to satisfy the orders for relief being sought against them. Practitioners should undertake research into the prospective defendants to establish whether they have the capacity to satisfy a judgment. This research could be day-to-day actions such as property searches or insolvency searches in the case of a company. For an individual, practitioners should research to determine if their client has been subject to any previous bankruptcy cases. Section 247A applications may also reveal information with respect to the financial circumstances of any prospective defendants.

Who gains the benefit of a successful derivative action?

16. Assuming there is a successful application for leave and there is a successful litigation that ensued, any fruits of the litigation vest in the company, not in the applicant shareholder. A practitioner needs to make clear to a client that an applicant may not necessarily see a benefit to themselves.

Court approval of settlements and compromises

17. Section 240 of the *Corporations Act 2001 (Cth)* requires the leave of the court is required before proceedings can be settled, discontinued or otherwise compromised. A practical reality of this provision is that the applicant is hamstrung to proceedings until their conclusion. This ensures that an applicant cannot use these proceedings to leverage out a resolution which is beneficial to them. Since this is the case, a practitioner should advise a potential client that there are significant costs consequences to bringing a successful derivative action.

Costs considerations

18. Section 242, *Corporations Act 2001 (Cth)* vests in the Court the power to make costs orders that it considers appropriate. Practitioners should advise to their client that it is not a corollary of being successful in the leave application or in the substantive application that they would be restored to their costs. Statistically very few applicants are awarded the costs of the leave application itself. Since this type of litigation can take years to resolve and costs can accrue increasingly, the client needs to be made aware of the potential costs of the application process.
19. Evidence should also be led that shows the applicants ability to indemnify the company for the legal costs that the company incurs. This evidence must show the capacity to pay the legal costs of the substantive application. Often, once leave is granted, an application for security for costs will be made by the defendants. Legal practitioners should be looking to the financials of the prospective applicant before the application is filed.
20. Section 237(2)(d), *Corporations Act 2001 (Cth)*, indicates whether or not there is a serious question to be tried. That should be something that is evidenced from the draft pleadings that would be attached to the evidence put to the Court. In a general sense, the relevant test is the same as the considered interlocutory injunctions.
21. Under s 237(2)(e), it is in the interest of the applicant to give 14 days written notice so that both parties should be afforded the opportunity to discuss the matter prior to the proceedings commencing to try to come up with a commercial resolution. The Court wants to know that all the issues and allegations in detail are being outlined at the

earliest possible opportunity. Potentially many concerns may be met simply with the production of documents or provisions of further information. This also displays to the Court that the applicant is acting in good faith.

22. Finally, there may be significant costs implications to an applicant who wishes to proceed under the requirements set out under s 273(3), where there is a rebuttable presumption. Where the proposed statutory derivative action is against a third party, and where there has been a decision made by the directors in good faith not to pursue a claim, leave will not be granted. An applicant who wishes to make an application for leave in the name of the company under these provisions should be made aware by practitioners of the potential high legal costs in relation to both the leave application and the proceedings that follow.

BIOGRAPHY

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Paul Folino-Gallo was called to the NSW Bar in 2007 and has over 10 years of experience in commercial law. Paul is a specialist trial and appellate advocate appearing in courts and tribunals across both state and federal jurisdictions. He has also found time to publish and present a number of legal papers.

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Legislation

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