Shareholders – Fiction, Rights, and Remedies

By Philip Gardyne*

I. Thesis Statement

The company fiction provides for economic and social benefits, via the light handed regulatory approach to company law. Shareholder intervention supports and challenges the fiction. The Companies Act 1993 (the Act) maintains the fiction by prescribing shareholder rights and obligations. Just and equitable intervention via the Court is necessary to maintain the fiction and best interests of the company.[1] This intervention enhances accountability and protects against an unconscionable breach of a shareholder's *reasonable expectation*, but challenges the fiction.[2]

II. Introduction

The Act provides for the incorporation, organisation and operation of companies by defining the shareholder relationship with the purpose of encouraging efficient and responsible management.[3] The Act is light handed and enabling,[4]it is not a code, but deems the company a 'separate legal personality'[5] distinct from its shareholders.[6]

This paper examines shareholder access to intervention in the context of the legal personality *fiction* perpetuated through the Act.[7] It is acknowledged that there is an inevitable nexus between the rights of shareholders and the obligations of directors'.[8]

The question is to what extent can shareholders legitimately ensure the best interests of the company?

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1 Companies Act 1993 [CA], ss 70, 172, 174(2).

2 CA, Part IX.

3 CA, Long Title.

4 Grantham, 'The Doctrinal Basis of the Rights of Company Shareholders', (1998) 57 *Cambridge Law Journal* 554, 585.

5 *Meridian Global Funds Management Asia Ltd v The Securities Commission* [1995] 3 NZLR 7, 11. Held that '[a] company exists because there is a rule (usually in a statute) which says that a persona ficta shall be deemed to exist and to have certain of the powers, rights and duties of a natural person.'

6 CA, ss 5, 126.

7 This paper is not a complete analysis of the corporate personality concept. Corporate personality is discussed in J Farrar, *Corporate Governance in Australia and New Zealand* (Melbourne: Oxford University Press, 2001) at pp 20–41. In sum, Farrar contends, '*Salomon's* recognition of the concept of the corporation as a legal person is formal reasoning with value and policy consequences that were not adequately addressed ... A corporation is the legal personification of a firm that is a social institution ... To refer to *Salomon's* principle in discussing corporate theory is simply to recognise it as a starting point for reasoning rather than a statement of comprehensive doctrine.' 40–1.

8 An examination of directors' duties is outside the scope of this paper.

A. Shareholders' rights in the company context.

A share is a property interest in a company,[9] there are rights attached to shares.[10] Shareholders elect directors to the board to manage and promote the *best interests* of the company, but this is a nebulous concept.[11] Section 131(1) of the Act mandates:

> a director of a company, ... must act in good faith and in what the director believes to be the best interests of the company.[12]

The obligation prescribes an equitable and subjective test, but it is a duty owed to the company not the shareholder personally.[13] This distinction continues the fiction of a separate legal personality established in *Salomon v Salomon & Co. Ltd*.[14]

The extent that shareholder interests determine the best interests of the company tests the *fiction* of separate legal personality. The blend of statutory prescription, common law, and equitable oversight helps define relationships around the fiction. To perpetuate the fiction the Act prescribes constraints on shareholder enforcement rights.[15] Shareholders,[16] through Part IX of the Act, may apply to the Court to uphold the company's best interests.

The prescriptive nature of the shareholder's 'bundle of rights'[17] reinforces the fiction. The rights restrict shareholder intervention,[18] limit shareholder liability,[19] and only guarantee shareholders a share in the residual surplus liquidated assets.[20] The rights enabling direct involvement in the management of the company are limited.[21] Effectively, outside casting a vote, shareholders must apply to the Court to intervene in the company's management.[22]

The Act prohibits shareholders from taking a *personal* action directly against a director for breach of the duty to act in good faith.[23] Shareholders must seek leave via the Court for an *injunction* or *derivative* action to ensure the company's best interests.[24] Leave to intervene is tested against the prudent business person rationale.[25] The rationale for shareholder intervention on behalf of the company is enhanced accountability and responsible management.

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9 CA, s 35.

10 CA, s 36.

11 J Palmer, 'Understanding the Director's Fiduciary Obligation' (2006) 12 *New Zealand Business Law Quarterly* 315.

12 CA, s 131(1).

13 CA, s 169(3).

14 *Salomon v Salomon & Co. Ltd* [1897] AC 22.

15 CA, Part IX.

16 'Shareholder' is used in the context of s 96 of the Act, it does not include persons who maybe deemed both shareholders and directors unless expressly stated, see s 126.

17 Grantham above n 4 at 582.

18 CA, Part IX.

19 CA, ss 7, 98, 99, 100 and Hansmann & Kraakman, 'The essential role of organisational law', (2000) 110 *Yale Law Journal* 387, in Grantham & Rickett *Company and Securities Law Commentary and Materials* (2002), 96, state in the context of contractarianism, that limited liability is the strongest type of defensive asset partitioning.

20 CA, s 36(1)(b) & (c).

21 CA, Part IX.

22 CA, s 128.

23 CA, ss 69(1), 169(3).

24 CA, ss 64, 165.

25 CA, s 165(2); and *Virj v Boyle* [1995] 3 NZLR 763, 765.

The Act also enables *just and equitable* intervention via the Court as a necessary means of maintaining the best interests of the company.[26] Issues centre on the nature of the relationships of the participants and their various obligations and expectations within the fiction.

Apart from intervention sought on behalf of the company, shareholders may personally seek just and equitable intervention via ss 70, 172, or 174. This equitable intervention centres on the obligation of *good faith* or shareholders' *reasonable expectations*. This juxtaposition of the enabling 'light handed'[27] and equitable provisions indirectly encourages efficient and responsible management, allowing shareholders access to remedial intervention.

B. The focus and structure of the paper

This paper focuses on appreciating the conceptual nexus of the company *fiction* from the shareholders' *rights*, and *remedies* perspective. Therefore, as Taylor and Berkahn contend, this mostly concerns relationships in small to medium sized enterprises (SMEs).[28] The reason for this is that SMEs are prevalent in New Zealand,[29] and are likely to be *closely held* companies.[30] Notwithstanding this, the Act does not distinguish between *private* and *publicly listed* companies.[31]

One consequence of a closely held company relationship is arguably shareholders enjoy greater transparency with increased access to information about the company. Information equals power, which is a critical factor in the context of ensuring compliance. As Berkahn suggests:

> [t]he arguments in favour of a significant role for public enforcement agencies are based primarily on the assumption that private parties have insufficient information and influence on (and therefore little interest in) the internal workings of companies. These factors affect their ability and motivation to successfully enforce corporate rights and duties. Such arguments are only relevant to large, widely held companies, but not to smaller, closely held ones.[32]

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26 CA, ss 70, 172, 174(2).

27 Grantham above n 4 at 585 asserts, '[h]istorically, the state sought to achieve its goals for company law through a strategy of 'command and control' ... . Increasingly, the state has turned to indirect means to achieve its goals. This approach, known variously as constitutive, responsive or light handed regulation, seeks to achieve regulatory goals by creating a self balancing system that creates, and relies upon, incentives for the individuals involved to bring about the desired result or conduct'(footnotes omitted).

28 Taylor, 'The Derivative Action in the Companies Act 1993: An Empirical Study' (2006) 22 *New Zealand University Law Review* 333, 360–1 and Berkahn, *Regulatory and Enabling Approaches to Corporate Law Enforcement*, (Christchurch: The Centre for Commercial and Corporate Law Inc., 2006), 17.

29 Ministry for Economic Development Manatu Ohanga, *SME's in New Zealand: Structure and Dynamics – 2007*, (2007), Ministry for Economic Development, available at <http://www.med.govt.nz/templates/MultipageDocumentPage____28566.aspx> (last accessed 17 August 2007), where it is said '96% of enterprises employ 19 or fewer people ... 87% of enterprises employ 5 or fewer people ... . Firms with 5 or fewer employees accounted for 11% of all employees ... . 11% of people in the labour force were self employed, as at March 2006.' Note the available statistics do not distinguish the form of the enterprise (i.e. Partnership, Sole Trader, or Company).

30 The term *closely held* is derived from the tax treatment afforded in the Income Tax Act 1994 and the Financial Reporting Act 1993. A closely held company has 50% of the voting entitlement held by five or less persons who are shareholders. For this paper is it sufficient to infer from the Ministry for Economic Development findings that 87% of the all enterprises are probably closely held.

31 *Latimer Holdings Ltd v Sea Holdings NZ Ltd* [2005] 2 NZLR 328, paras 98 & 111.

32 Berkahn above n 28 at 17.

This is the rationale for regulating *continuous disclosure* paradigms in *publicly listed* companies.[33] *Listed* companies are subject to a number of other regulatory regimes like, the Securities Act 1978, Securities Markets Act 1988, and the New Zealand Stock Exchange *listing rules*.[34] However, this paper does not examine shareholder rights as prescribed under those regulatory paradigms.

What this paper pragmatically examines is the paradigm of shareholder intervention in the context of the Act. There are three sections to the paper.

The first section is critical to understanding the founding conceptual nexus. This section outlines the concept of corporate personality, the company's best interests, and a summary of the shareholders' rights within the light handed regulatory system. This section discusses the nature of the obligation owed to shareholders. The section identifies the two distinct regimes enacted to ensure shareholder rights and expectations.

The second section examines the provisions in Part IX of the Act. The focus is on ss 64, 165, 170, 172, and 174 because they are the blunt statutory instruments that allow shareholder oversight and intervention. The section references the valuable empirical analysis of Berkahn[35] and Taylor.[36]

The final section makes a brief comparative analysis and discusses the remedial potential of shareholder intervention. This section draws together the problematic conceptual relationships and rationales that perpetuate the fiction.

III. The Foundation Concepts

What is the foundation of the Act? The New Zealand Law Commission (NZLC) considers the proper focus of company law is internal regulation.[37] The NZLC suggests the purpose of the Act is 'striking a balance between enabling use of the company form and regulating to prevent its abuse.'[38] The fiction of the company founded in the Act synthesises managerialism, contractarianism, and communitarian reasoning.[39] Only a simple contextual overview of these theories is included, as analysis is beyond the scope of this paper.

Managerialism contends that the company is an institution with the interests of ownership separated from the power of control. The premise is that shares equate to company ownership, and separating control attenuates accountability. The issue is regulating the potential power of the company, an omnipotent economic institution.[40] Managerialism focuses on the tensions between the interests of owners and management. Berle and Means caution:

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33 Securities Markets Amendment Act 2002, promulgated the continuous disclosure regulation in the Securities Markets Act 1988 effectively from the 1 December 2002.

34 Ministry of Economic Development Manatu Ohanga *Securities Legislation Bill Regulations, Discussion Document*, March 2006, available at http://www.med.govt.nz/upload/32930/bill-regs-disc.pdf (26 August 2006) and New Zealand Stock Exchange Ltd (NZX), available at <http://www.nzx.co.nz> (9 October 2006).

35 Berkahn above n 28 at 17.

36 Taylor above n 28.

37 NZLC, *Company Law Reform and Restatement, Report No. 9,* (NZLC R9), (1989), 4.

38 Ibid at 5.

39 MJ Whincop, *An Economic and Jurisprudential Genealogy of Corporate Law* (2001), 31–38, 70–73 and Grantham above n 19 at 54–108, 241–249.

40 Berle & Means in Grantham above n 19 at 58–64.

> [a] great concentration of power and ... a diversity of interest raise the long fought issue of power and its regulation – of interest and its protection.[41]

The result Grantham and Rickett aver is:

> [n]o individual shareholder had either the power or the incentive to exercise control ... [S]hareholders' rational passivity effectively freed corporate management from direct oversight and accountability to shareholders.[42]

Managerialism argues that the public nature of the company 'justifie[s] and mandate[s] a role for the State in regulating the affairs.'[43]

The contractarian contention describes the company as a *nexus of contracts*, a fiction of private ordering between various human participants.[44]The premise is that shareholders own the company and managements efforts are directed to benefiting shareholder interests. The argument is there is limited justification for State intervention in private ordering. Easterbrook and Fischel argue:

> reference ... [to the nexus of contracts] is just shorthand for the complex arrangements of many sorts that those who associate voluntarily in the corporation will work out amongst themselves.[45]

The issue is as Cheffins contends, '[t]he nexus of contracts characterization is at odds with the legal conceptualization of a company.'[46]

Communitarianism accedes accountability to a greater range of stakeholders, accepting 'the company's economic wealth and social and political power affects many others than merely those contractually related to the company.'[47] As Millon states:

> communitarians differ from contractarians ... in their greater willingness to use legal intervention to overcome the transaction costs and market failures that impede self protection through contract.[48]

Therefore, communitarianism is the foundation of *corporate social responsibility* and *stakeholder* theories.[49] This paper does not focus on these issues. The incorporation of environmental and employment aspects (to name just two), are issues addressed by the State in independent legislation outside the scope of this analysis.[50]

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41 Ibid at 62.

42 Grantham above n 19 at 54.

43 Ibid at 55.

44 Ibid at 55, 77–101.

45 Easterbrook & Fischel 'The corporate contract' (1989) 89 *Columbia Law Review* 1416, in Grantham above n 19 at 80.

46 Cheffins, *Company Law: Theory, Structure and Operation*, (Oxford: Clarendon, 1997) in Grantham above n 19 at 77.

47 Grantham above n 19 at 101.

48 Millon, 'New directions in corporate law: Communitarians, contractarians and the crisis in corporate law' (1993) *Washington & Lee Law Review* 1373 in Grantham above n 19 at 102.

49 P Kotler and N Lee *Corporate Social Responsibility* (New Jersey: John Wiley & Sons Ltd, 2005), 3. State, '[c]orporate social responsibility is a commitment to improve community well being through discretionary business practices and contributions of corporate resources.'

50 Resource Management Act 1991 and Employment Relations Act 2000.

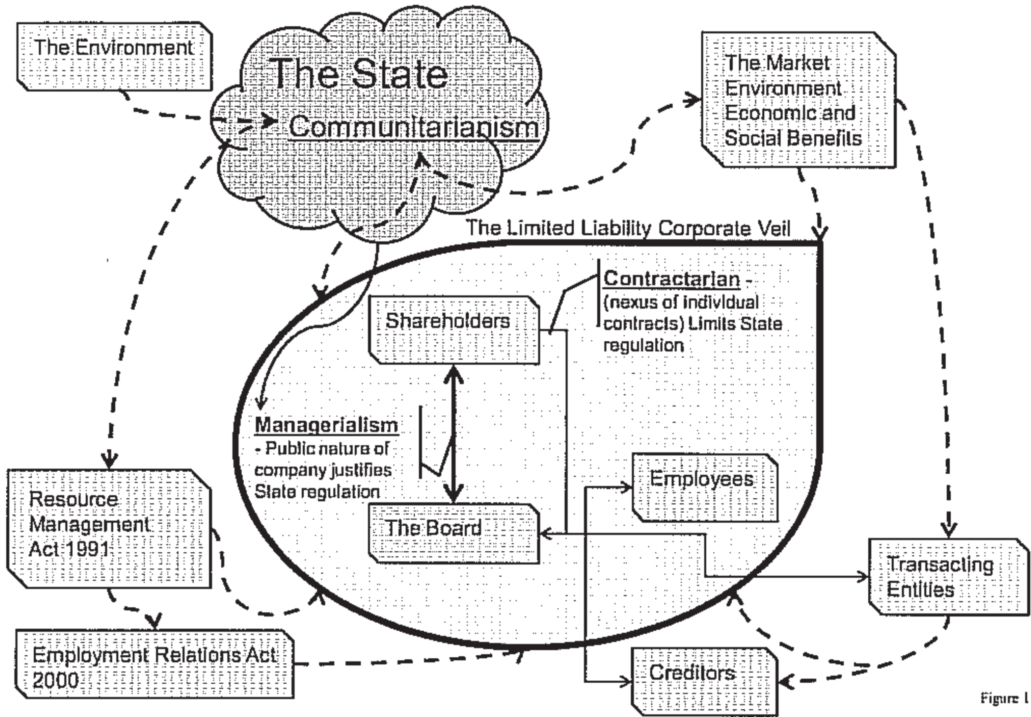

Figure 1 shows the different perspectives from managerialism, contractarianism, to communitarianism.

Mindful of the above theoretical perspectives, what is the pragmatic affect of the company form from the shareholder's perspective?

It is suggested that:

> the position and influence of shareholders has undoubtedly undergone a radical change. Where shareholders once stood at the centre of the corporate universe, with the undisputed right to control the management and direction of the company and to have it run for their exclusive benefit, this century shareholders have become little more than bystanders ... the law has rejected or limited those rights which were crucial to the shareholders' claim to proprietorship.[51]

The Act engenders aspects of managerialism, contractarianism and communitarianism. How then does the Act 'define the relationships between companies and the directors, shareholders, and creditors'?[52]

A. *Separate legal personality from the shareholder perspective*

Based on Farrar's assertion referenced in footnote 7 to this paper, the starting point is the pragmatic fiction of separate legal personality summarised in Lord Macnaghten's speech in *Salomon*:

51 Grantham above n 4 at 575.

52 CA, Long Title (c).

> [t]he company is at law a different person altogether from the subscribers … the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers, as members, liable in any shape or form, except to the extent and in the manner provided for by the Act.[53]

From New Zealand's perspective, the Privy Council accepted and followed the *Salomon* principle in *Lee v Lee's Air Farming Limited*.[54] In *Wairau Energy Centre v First Fishing Company Ltd*[55] the Court of Appeal stated:

> [a] company is a distinct personality from its members. A contract by the members is not a contract by the company.[56]

Section 15 of the Act deems that the company is a legal entity separate from its shareholders. Support for the principle is located in s 128, which mandates the board manage the company, and in ss 7 to 100, which prescribes limits on the shareholder's financial liability, subject to the company's constitution.

The consequence of the separate legal entity fiction is the *veil* of incorporation. The exercise of shareholder rights occurs mostly behind the veil, highlighting the important distinction between the company's internal relationships and external interactions. As Grantham asserts:

> [t]he function of much of company law is thus to forge an analogy between the company and natural persons and to identify when and which natural persons are to be treated as though they were the company.(*footnote omitted*)[57]

This paper is concerned with the affect of shareholder rights, particularly in the context of just and equitable oversight. The analysis is mindful of Lord Wilberforce's recognition of:

> the fact that a limited company is more than a mere legal entity, with a personality in law of its own: that there is room in company law for recognition of the fact that behind it, or amongst it, there are individuals, with rights, expectations and obligations inter se which are not necessarily submerged in the company structure ... The 'just and equitable' provision …does, as equity always does, enable the court to subject the exercise of legal rights to equitable considerations ... which may make it unjust, or inequitable, to insist on legal rights, or to exercise them in a particular way.[58]

Lord Wilberforce's reasoning is adopted in *Thomas v H W Thomas Ltd,* (*Thomas*)[59] the seminal Court of Appeal authority for s 174. The result is that the separate entity fiction is indirectly subject to equitable intervention. This point is examined further throughout the paper.

B. What is the nature of shareholder rights?

The Act prescribes, '[a] share in a company is personal property.'[60] The Act defines property to include 'tangible or intangible, real or personal, corporeal or incorporeal, and includes rights, interests, and claims.'[61] What is the nature of the rights attached to this property interest? Section 36 of the Act is the foundation for identifying the basic substantive rights in a share. A share is a

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53 *Salomon v Salomon & Co. Ltd* [1897] AC 22, 51.

54 *Lee v Lee's Air Farming Limited* [1961] NZLR 325.

55 *Wairau Energy Centre v First Fishing Company Ltd*. (1991) 5 NZCLC 67379.

56 Ibid at 67, 383.

57 Grantham, above n 4 at 576.

58 *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360, 379.

59 *Thomas v H W Thomas Ltd* [1984] 1 NZLR 686, 694.

60 CA, s 35.

61 CA, s 2.

residual claim to a proportion of the company's assets, not full ownership of the company. This statement acknowledges that a share includes all eleven elements of the *rights claims* mooted by Honoré[62] as necessary for full ownership. The assertion is the full *bundle of rights* in a share relate only to the *share* itself.[63]

Restricting a share to a bundle of rights, legitimises the company as a separate legal entity distinct from its shareholders. This is a change from the earlier ownership and *quasi-partnership* rationales.[64] The shift in paradigm limits the shareholder to a 'voice in both the management and structure of the company'.[65] Therefore, restricting shareholder rights introduces risk. The NZLC in *Company Law Reform and Restatement Report No. 9* (NZLC R9) identifies that:

> shareholders are at risk from the abuses of power by directors. [However, the NZLC asserts] [c]ompany law is largely concerned with containing the risk of abuse within acceptable bounds while not undermining the substantial benefits for investors and for society in general ... [66]

However, there is some protection for shareholders. Parts VI, VII and IX of the Act prescribe the procedural rights associated with shares. The shift away from the persistence of shareholder *ownership of the company* is accommodated by the increased, albeit light handed, oversight by the state.[67] As Grantham asserts:

> shareholders are particularly well suited to serve as an agent of the state as their incentives largely coincide with those of the state. The state's concern to see that companies are managed efficiently and fairly are goals which shareholders as residual claimants also share, albeit for different reasons ... Shareholders are vested with rights not as a consequence of their status, though they are intended to pursue their self interest. Rights are vested in shareholders so that they may perform tasks that would otherwise be undertaken by the state directly.[68]

Shareholders exercise their rights and influence internal relations through voting. Sections 104 to 107, 109, 120 to 122, and 124 prescribe the general extent of shareholder rights to vote and influence the direction of the company. It is important to distinguish the right to vote from the right to manage. The Act prescribes that, subject to the company's constitution, management of the company must be 'by, or under the direction or supervision of, the board of the company.'[69] Directors via the board are directly responsible for controlling the company.[70] Shareholders resolutions appoint members to the board.[71] To ensure accountability, the Board 'must call an annual meeting of shareholders.'[72]

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62 Honoré cited in Becker, *Property Rights* (1997), 19 in University of Waikato, Laws203 Jurisprudence 2005 Materials Book, 57.

63 Becker, above n 62 at 57. The eleven elements of full ownership are: right to possess, to use, to manage, to the income, to the capital, to security, a power of transmissibility, the absence of term, a prohibition of harmful use, liability to execution, and a residuary character.

64 Grantham, above n 4 at 582.

65 Ibid.

66 NZLC R9, 7.

67 Grantham above n 4 at 554, asserts, 'As owners, shareholders were entitled to control the management of the company and to the exclusive benefit of the company's activities. Ownership also served to legitimate the corporate form itself.'

68 Ibid at 586.

69 CA, s 128.

70 CA, ss 27, 128(1) and *Trevor Ivory Ltd v Anderson* [1992] 2 NZLR 517, 526–527.

71 CA, s 36(1)(a).

72 CA, s 120.

The board is subject to review, with the Act prescribing that shareholders 'must [be] allow[ed] a reasonable opportunity ... to question, discuss, or comment on the management of the company.'[73] The argument is that the in house right to review management is in the company's, the shareholders, and indirectly the State's interests. Similarly, a shareholder resolution ensures communication of the collective interest to the board who manage the company. There is ostensibly no intrusion upon the separate entity fiction in these circumstances.

The issue is if shareholders undertake roles outside those prescribed in the Act on behalf of the company. Anecdotally, the distinction between the role of shareholder and the board or company is easily discernable in publicly listed companies; the penumbra exists in respect to closely held companies with the perception of shareholders performing other duties. The undertaking of other duties may deem the shareholder a director as prescribed in s 126(1)(c).

The question is 'whether there has been an assumption of responsibility, actual or imputed.'[74] Natural persons may act on behalf of the company (as agent, director, or employee), or independently. For clarification, an appreciation of the law relating to vicarious liability, agency, identification and attribution is necessary. Examination of these concepts is outside the scope of this paper. It is sufficient to note the significant attribution rationale enunciated in *Meridian Global Funds Management Asia Ltd v Securities Commission* (*Meridian*),[75] and refer to s 18 of the Act. In summary, Lord Hoffmann avers:

> [i]t is therefore a necessary part of corporate personality that there should be rules by which acts are attributed to the company … These primary rules of attribution are obviously not enough to enable a company to go out into the world and do business. Not every act on behalf of the company could be expected to be the subject of a resolution of the board or a unanimous decision of the shareholders. The company therefore builds upon the primary rules of attribution by using general rules of attribution which are equally available to natural persons, namely, the principles of agency.[76]

In sum, shareholders do not own the company; they have a 'constitutional position in the company's scheme.'[77] A full share (as opposed to a preference or different class of share)[78] entitles the holder to vote and oversee the company's structure and management. In this respect, the shareholder may encourage responsible management and help define what constitutes the company's best interests.

C. What is the company's best interest?

The best interests concept is nebulous, with the nexus being the collective expectation of the shareholders. Generically the company's best interest is its ability to continue functioning and achieve its objectives. The NZLC concluded in NZLC R9, that there is confusion over:

> whether 'the best interests of the company', which is the concept which underlies director accountability, requires assessment of 'the company' as the collective shareholders or as the enterprise itself.[79]

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73 CA, s 109(1).

74 *Trevor Ivory Ltd* above n 70 at 527.

75 *Meridian* above n 5.

76 *Meridian* Ibid at 11–12.

77 NZLC R9 above n 37 at 46.

78 CA, s 37.

79 NZLC R9 above n 37 at 45.

The NZLC also notes that shareholder interests do not completely coincide with the company's interests, and that shareholder interests require protection from potential management abuses.[80] Clearly, managerialist concepts and the effects of self interest are evident in the reasoning. The NZLC suggests the solution is a hierarchy of interests.[81]

Consequently, the director's obligation to the company is broadly fiduciary in nature, incorporating a discretionary element as evinced in the purpose of the Act:

> (d) To encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgment while at the same time providing protection for shareholders ... against the abuse of management power;[82]

Part VIII of the Act enacts the directors fundamental duties, specifically s 131(1) prescribes a subjective fiduciary obligation, mandating that:

> a director of a company, ... must act in good faith and in what the director believes to be the best interests of the company.[83]

What constitutes the company's best interest is not enunciated in the Act. Palmer argues the inherent issue with the concept is the presumption that identifying the company and its best interests is readily ascertainable.[84]

Historically, the company's interests were indistinguishable from its shareholder owners. Practically, the shareholder's interests are foremost during company formation, but as the company evolves, the interests of stakeholders become more relevant. This change mirrors the shift from managerialism through to the contemporary communitarian understanding of the company. As Palmer suggests:

> [d]etermining the interests of a company ... requires reference to the interests of interested parties, otherwise known as the stakeholders, and the attribution of those interests to the company.[85]

The Act's long title states, 'the value of the company [is] as a means of achieving economic and social benefits.'[86] It is therefore arguable that *stakeholder* interests may form part of the company's interests. As Corfield argues:

> [e]conomic support for… [stakeholder] theory arises from the view that long term profitability of the company is dependent on more than just concentration on shareholder wealth.[87]

This reasoning is central to the doctrine of maximising *shareholder value*. Notably, a central tenent remains long term *profitability*. Therefore, it is possible to argue that a company, as a separate legal entity, is interested primarily in financial survival and that this is recognised in the Act. Obviously, there is minimal economic or social benefit in companies trading while insolvent and inefficiently consuming resources.

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80 Ibid at 46.

81 Ibid at 46–7.

82 CA, Long Title (d).

83 CA, s 131(1).

84 J Palmer, 'Understanding the Director's Fiduciary Obligation' (2006) 12 *New Zealand Business Law Quarterly* 315, 315.

85 Ibid at 335.

86 CA, Long Title (a).

87 A Corfield, 'The Stakeholder Theory and its Future in Australian Corporate Governance: A Preliminary Analysis' (1998) 10 *Bond Law Review*, 213, 213.

Rationally, the company's interest is to return a profit and increase net asset value. Solvency is integral to ensuring economic and social benefits through the company; it is a fundamental consideration for responsible management. The solvency obligation mandates continual financial monitoring in the context of the Financial Reporting Act 1993 (FRA) and assessment of all other material matters that ought to be known to affect the company's value.[88] Compliance with the *solvency test* is not restricted to provisions specifically referencing it;[89] solvency is an overarching concept. As Baragwanath J avers:

> the basic concept of the 1993 reform — abandonment of share capital as the fundamental element of a company in favour of a solvency requirement … is to be inferred from the whole scheme of the Act.[90]

Satisfaction of the solvency test is mandatory prior to shareholders receiving distributions.[91] Also as previously noted, a share equates to entitlement in the surplus assets after liquidation. Therefore, shareholders self interest corresponds with the State's promotion of the company as a financially viable economic entity. As Palmer states:

> [o]ne ... reason ... offered for identifying shareholders as the relevant body of persons from which to ascertain the company's interests is that shareholders are the indirect enforcers of the State's interest in the existence and survival of companies.[92]

Notwithstanding the stakeholder perspective, the practical reality is that the shareholder's self interest is more readily discernable than anyone else's. This paper argues as Palmer concludes pragmatically:

> shareholders' interests are taken to be the relevant interest because, when considered broadly, upholding those interests is the most effective way of ensuring that management is held accountable.[93]

Consequently, the company's interests align with the shareholders. Therefore, it is in the State's interest to regulate the extent of shareholder rights, and thereby indirectly regulate the company. The issue is ensuring accountability, because unlimited shareholder rights would seriously erode the fiction, and possibly enable ratification of self interested undesirable actions.[94] The Act therefore 'vest[s] rights in shareholders where to do so serves the regulatory goals of the state.'[95] Thus, the platform exists for equitable intervention.

88 CA, ss 4, 194.

89 CA, s 4.

90 *Mountfort v Tasman Pacific Airlines of NZ Ltd* [2006] 1 NZLR 104, 112.

91 CA, ss 4, 52, 55, 56.

92 Palmer above n 84 at 329.

93 Ibid at 335.

94 CA, s 177 and Grantham above n 4 at 586.

95 Grantham above n 4 at 586.

IV. Equitable Considerations

In part IX of the Act there are several provisions allowing just and equitable intervention or consequential relief.[96] It is accepted and recently affirmed in *Chirnside v Fay*,[97] that equity intervenes to correct when required.[98] As Glover states:

> [e]quity is not normally concerned with the universal good: the scope of its attention is usually limited to the circumstances in which individual actors are placed ... E]quitable principles ... allow the law giver a lot of leeway to consider the justice of the case.[99]

A. *What are the relevant equitable obligations in company law?*

Equitable intervention or judicious intercession ensures society's moral standard is maintained within relationships.[100] Acknowledging Lord Atkin's *neighbourhood principle*,[101] Finn contends, that moral standard's exist along a *continuum* from selfishness to selfless neighbourhood cooperation. Finn identifies three 'dominant shades on a spectrum'[102] as rationale for equitable intervention, 'unconscionability',[103] 'good faith',[104] and 'fiduciary'.[105] *Dominant shades* best describes the indeterminate nature and boundaries of the individual standards.

A selfless fiduciary duty is most likely to exist within *traditional fiduciary relationships* of loyalty.[106] To a lesser extent, a fiduciary duty may exist outside traditional norms between parties that knowingly enter and maintain relationships of substance founded on loyalty, vulnerability, reliance, or expectation.[107] It is possible for a fiduciary duty to exist concurrently in contract or tort.[108] It is least probable that a fiduciary duty will exist where the parties are *at arms length* or do not require mutual trust and confidence in their dealing.[109] The essential factor is the parties' *reasonable expectation*, 'an amalgam of actual expectations and judicial prescription.'[110] Notwith-

96 CA, ss 64, 170, 172, 174.

97 *Chirnside v Fay* [2007] 1 NZLR 433.

98 Ibid at 460. Blanchard & Tipping JJ aver 'equity imposes an obligation to eschew self interest when the circumstances require. The obligation does not arise only when expressly undertaken.'

99 Glover, *Commercial Equity – Fiduciary Relationships,* (1995) para 1.5.

100 Finn, 'Commerce, The common law and morality' *Melbourne University Law Review* 17 (1989), where it is conceded that morality is a diverse and changing standard and 'legal censure does not … parallel moral censure', 87.

101 *Donoghue v Stevenson* [1932] AC 562, 580.

102 Finn, 'The Fiduciary Principle' in TJ Youdan, (ed) *Equity, Fiduciaries and Trusts* (Toronto: Creswell, 1993), 3.

103 Ibid, Unconscionability accedes one party's self interested pursuit in deference to another, but not their unconscionable exploitation.

104 Ibid, Good faith restricts one party's self interested pursuit to having regard to the legitimate interests of the other party.

105 Ibid, Fiduciary decrees a selfless undivided loyalty to the principal.

106 See the traditional Solicitor Client relationship discussed in *Farrington v Rowe McBride & Partners* [1985] 1NZLR 83, 89.

107 *Chirnside v Fay* [2004] 3NZLR 637, 646–7 at paras 50–51.

108 *Watson v Dolmark Industries Ltd* [1992] 3NZLR 311; *United Dominions Corporation v Brian Pty Ltd* (1985) 60 ALR 741; *Hospital Products Ltd v US Surgical Corp* (1984) 156 CLR 41, 97 and Butler, A. *Equity and Trusts in New Zealand* (2003), 14.2.5, 349–50; 36.4.1, 1080.

109 *Hospital Products* above n 108, 67 and 72; *Arklow Investments Ltd v MacLean* [2000] 2NZLR 1.

110 Finn above n 102, at 6.

standing the above, the fiduciary duty is imposed;[111] the imposing of a fiduciary duty is the exception.[112] In context, director's duties to the company impose analogous fiduciary obligations.

As previously noted, s 131(1) of the Act mandates directors act in good faith. Finn contends the obligation of good faith is equivocal, requiring independent recognition as a unifying principle.[113] Butler suggests the 'debate over good faith ... is ... more appropriately resolved on the contractual, rather than the equitable, side of the dividing line.'[114] What is clear is that good faith is a concept seeking clear recognition. Finn argues good faith encapsulates three elements:

> [1] the promotion of cooperation between parties to a relationship;
>
> [2] the curtailment of the use of one's power over another; and
>
> [3] the extraction of 'neighbourhood' responsibilities in a relationship.[115]

The third standard on the continuum is *unconscionability*. Finn contends, unconscionability is concerned with relationships analogous to contract, where the parties are expected to look after their own interests between themselves, but where one party *knows* and exploits the relative disadvantage of the other who is unable to protect their own interest.[116] It is not possible to catalogue all the likely instances, but there is an element of unfairness within unconscionable conduct. A breach occurs where it is unconscionable for the stronger party to knowingly manipulate or take advantage of the vulnerable weaker party.[117] Unconscionability, Glover cautions may be changing with the development of restitution. Glover suggests:

> [e]xamination of the *fairness of outcomes* may be supplanting equity's traditional concern with the *quality of conduct* ... Traditional equitable liability for unconscionable dealing is based on defendant's fault. Conduct is assessed. Restitutionary liability, ... is a strict liability thing according to the most theoretical expositions. Restitution reverses enrichment according to 'unjust' criteria ...[118]

Mindful of the good faith debate, this paper recognises the important distinction between the imposition of the director's *good faith* obligation to the company, and the company's obligation to shareholders. *Latimer Holdings Ltd v SEA Holdings NZ Ltd* (*Latimer*)[119] highlights the distinction. The Court held in respect to the prejudice provision in s 174:

> [t]he operative words of the provision express a general principle which is directed to 'an unjust detriment to the interests of a member of the company'... That test is an objective one … Relief can be given even if the conduct complained of does not involve a want of good faith or a lack of probity. [Emphasis added][120]

Referring to unjust detriment raises the concept of unjust enrichment and restorative justice, central considerations in the law of restitution. A thorough analysis of the law of restitution is outside the scope of this paper. It is sufficient to note restitution is seen as the 'law's remedial response to

111 Ibid at 54.

112 *Disher v Farnworth* [1993] 3NZLR 390, (CA), 399.

113 Finn (1993) above n 102, at 11 & 24.

114 Butler, *Equity and Trust in New Zealand* (Wellington: Brookers Ltd, 2003) at 36.4.1, 1078.

115 Finn (1993) above n 102, at 11.

116 Ibid at 6.

117 *Nichols v Jessup* [1986] 1 NZLR 226, 233 & 235.

118 Glover, 'Equity and Restitution' in P Parkinson, (ed) *The Principles of Equity,* (Sydney: LBC Information Services, 1996) at 106.

119 *Latimer* above n 31.

120 Ibid at 346–7.

some other cause of action'.[121] The principle of fairness and justice is central in actions for restitution.[122] There are three fundamental elements:

1. the defendant is enriched,
2. the enrichment is at the plaintiff's expense, and
3. the enrichment is unjust.[123]

The critical concepts are *unjust* and *enrichment*. Unjust is a term largely unconstrained, implying illegitimacy or an action lacking legal sufficiency.[124] Enrichment is analogous to recognising a benefit or gain, the issue is the nature, quantification, and realisation of the enrichment.[125] *Unjust enrichment* is the unifying foundation of restitution law.[126] As Lord Hope of Craighead states:

> [t]he essence of [unjust enrichment] ... is that it is unjust for a person to retain a benefit ... received at the expense of another, without any legal ground to justify its retention, which that other person did not intend him to receive.[127]

In sum, imposing an equitable obligation on the shareholder relationship is a consequence of reposed loyalty, the parties' reasonable expectations, or the existence of known vulnerability and potential for manipulation. Where there is a cause of action, the Court may consider it *just and equitable* to remedy the *unjust enrichment* as it thinks fit.

V. Summary

The shareholder relationship to the company is complex. Figure 2 depicts the complexity of the relationship in the context of the fiction and intervention paradigms.

121 Grantham & Rickett, *Restitution Commentary and Materials*, (2001), 19.

122 *National Bank of New Zealand Ltd v Waitaki International Processing (NI) Ltd* [1999] 2 NZLR 211, 230.

123 Grantham (2001) above n 121 at 77.

124 Ibid at 40–1 & 78.

125 Ibid at 79.

126 *National Bank of New Zealand Ltd* above n 122 at 215.

127 *Kleinwort Benson Ltd v Lincoln City Council* [1999] 2 AC 349, 408.

Shareholders influence on the company fiction

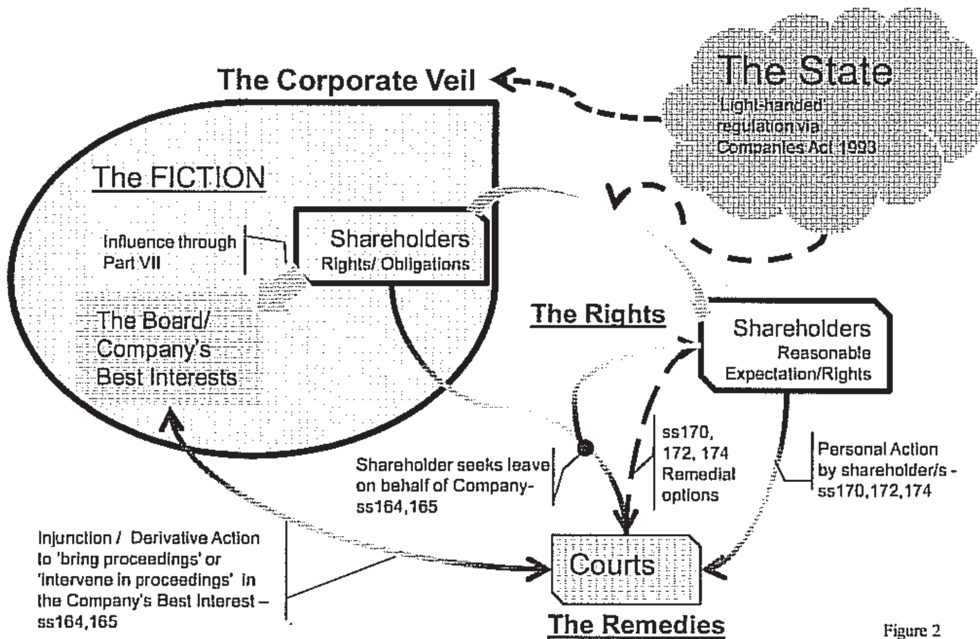

Figure 2

Figure 2 depicts the relationship between the problematic concepts: corporate personality, best interests, shareholder rights, and remedial intervention.

Shareholders are shown behind the corporate veil and in front of it. Within the veil, shareholders influence the board and company's interest in accord with their rights in Part VII of the Act. Shareholders are able to initiate an injunction or derivative action on behalf of the company from inside of the veil. Outside the veil, shareholders seek to personally enforce rights against the company via the Court where it is just and equitable. The argument is the State sanctions shareholder intervention in the company fiction. The light handed regulatory model relies on the shareholder's self interest indirectly corresponding with the overall economic rationale. Shareholders are ideally positioned (particularly in SMEs or closely held companies) to monitor and encourage responsible management. Typically, the Court is the central mechanism for shareholder action when internal management mechanisms fail. Intervention via the Court preserves the fiction and monitors the use of the blunt injunction and derivative instruments in the interests of the company. Section two describes and examines the prevalent use of these remedial instruments.

VI.

This section examines the application of the enforcement provisions in Part IX of the Act from the shareholder's perspective. There are two distinct categories of intervention in Part IX. The first category prescribes intervention on behalf of the company. The second category allows shareholders the right to initiate personal actions against the company or its directors. The analysis

examines the specific provisions in the context of the recent empirical studies by Berkahn[128] and Taylor.[129] The contention of this paper is the *enforcement* provisions are remedial and therefore principally restorative in nature.

VII. Injunctions And Derivative Actions

Injunctions and derivative actions represent the initial foray outside the veil in the remedial process that ensures the best interests of the company. Injunctions and derivative actions are central to the State's light handed regulatory rationale. These provisions grant a shareholder or director standing to engage the objective assistance of the Court, independent of the company's management. They are blunt instruments to deter irresponsible management.

A. *Injunctions*

In the Act, the s 164 injunction is in essence an independent discretionary equitable remedy and not ancillary to equity.[130] An injunction is the independent action of an individual affecting control over the company's conduct. Section 164 authorises the company, a director, shareholder, or 'entitled person'[131] to make an application to the Court for a *restraining* injunction.[132] The purpose of an injunction is to prohibit or prevent the company or a director from continuing or engaging in conduct that contravenes the company's constitution, the Financial Reporting Act 1993 (FRA), or the Act.[133] Therefore, shareholders have standing to petition the Court in either their own or the company's the best interests, with the intention of prohibiting or preventing *unauthorised* conduct.

The conduct in question must be contemplated or occurring; the Court cannot make an order to prohibit conduct that is finished.[134] The Court has discretion to grant either a final or interim order.[135] While the jurisdiction is statutory, the Court is likely to have regard to the 'two stage balancing test'[136] incorporating the overall interests of justice.[137] The Court upon granting an injunction may also grant any 'consequential relief as it thinks fit.'[138]

Berkahn's empirical study focuses on the *public versus private* debate in regulatory approaches to corporate law.[139] The New Zealand data analysed was collected from *New Zealand Company*

128 Berkahn above n 28.

129 Taylor above n 28.

130 *JJ International Ltd & Ors v Streetsmart Ltd & Ors* (2005) 9 NZCLC 263,784 para 19.

131 CA, s 2.

132 CA, s 164(1) & (2).

133 CA, s 164(1).

134 CA, s 164(4).

135 CA, s 164(5).

136 *American Cyanamid Co v Ethicon Ltd* [1975] 1 All ER 504, 510.

137 *JJ* above n 130 at [21]; *Shell (Petroleum Mining) Co Ltd v Todd Petroleum Mining Co Ltd* (unreported, Court of Appeal, 3 August 2005, CA70/05), paras 91–93 and *Klissers Farmhouse Bakeries Ltd v Harvest Bakeries Ltd* [1985] 2 NZLR 129, 142.

138 CA, s 164(3).

139 Berkahn above n 28.

Law Cases and the inherent limitation is that action must result in at least one judgment.[140] Applications considered or commenced but not proceeded with escape capture.

Berkahn's analysis discloses that in the period 1986–93 eight injunctions were *commenced*.[141] Of the eight, shareholders initiated two. Berkahn classified the shareholder initiated injunctions as relating to 'inadequate notice of meeting [and] restraining entry into service contract with director.'[142] In the following 1994–98 period there were four injunctions initiated. Shareholders initiated one injunction in respect to 'restraining share forfeiture'.[143] In the period 1999–2002 there were three shareholder initiated injunctions. They related respectively to restraining share transfers, share issue, and voting by interested shareholder.[144]

Interestingly, following the periods identified in Berkahn's empirical analysis, Keane J commented in *JJ International Ltd & Ors v Streetsmart Ltd & Ors (JJ)*[145] '[t]here is no New Zealand case of which I am aware in which s 164, in particular has been applied.'[146]

JJ related to an incorporated joint venture Smart Recycling Ltd. The shareholders were JJ International Ltd (The principle shareholder being Forbes) and Streetsmart Ltd (The principle shareholder being Christian). Justice Keane's judgment focuses extensively on the relationships between Forbes and Christian, presumably because their actions are attributed to the shareholder companies. That shareholder relationship, soured to the extent of a complete rift. Mr Christian acted unilaterally in ejecting Forbes from the premises and firing the manager Newman. JJ International Ltd and Forbes sought both interim and permanent injunctive relief in accord with s 164. One issue was whether to restore Newman as manager and therefore restore the apparent 'state of corporate dysfunction.'[147]

Justice Keane referenced Palmer J's reasoning in *Australian Securities Commission v Mauer-Swisse Securities Ltd,*[148] before acceding that an injunction must ultimately contemplate its utility or purpose.[149] Justice Keane concluded:

> [t]he s 164 power is conferred to provide a remedy where the integrity of a company is being or is likely to be compromised, unless that would be futile, or the company is trading at an increasing loss.[150]

In *JJ* the Court granted an interim order in the terms applied for pending a fixture. In *Shell (Petroleum Mining) Co Ltd v Todd Petroleum Mining Co Ltd* (*Shell*)[151] the Court of Appeal in an obiter comment stated:

> [s]ection 164 has received little attention in New Zealand. In *JJ International Limited v Streetsmart Limited* ... Keane J ... accepted that the s 164 jurisdiction was independent of the normal equitable jurisdiction and was to be exercised for the purposes of the Act, so that the Court was not constrained by the usual equitable considerations. This did not mean, however, that the balance of convenience and interests of

140 Ibid at 8.

141 Ibid at 113.

142 Ibid at 113–4.

143 Ibid at 116.

144 Ibid at 119.

145 *JJ* above n 130.

146 Ibid at para 17.

147 Ibid at paras 12 and 23.

148 *Australian Securities Commission v Mauer-Swisse Securities Ltd* (2002) 42 ACSR 605.

149 *JJ* above n 130 at para 19.

150 Ibid at para 47.

151 *Shell* above n 137.

> justice tests were to be ignored, although they assumed less importance. We note these conclusions were reached without argument against the contention that s 164 mandated a different approach.[152]

In sum, there are limited instances of remedial action via s 164. The reality is the provision is not fully tested. The provision is there to ensure compliance with the Act, constitution, or FRA. Arguably, the best interests and integrity of the company are the main concern in light of the fiction. Any consideration given to shareholder interests is secondary to those of the company. Therefore, shareholder detriment will need to be sufficiently serious and outside other remedial options to offset a legitimate company interest. It is probable that the Court will have regard to the equitable principles expressed in *Klissers Farmhouse Bakeries Ltd v Harvest Bakeries Ltd* (*Klissers*)[153] but will not be constrained by them.

B. Derivative actions

The derivative action paradigm is designed to ensure that there is judicial scrutiny of the shareholder *democracy*. A derivative action allows either a shareholder or director to apply to initiate litigation in the best interests of the company. The provision acts as a deterrent for future wrongdoers within the company and as a method for remedying harm done to the company. The relevant inter related sections in the Act are:

- s 165 Derivative Actions,
- s 166 Costs of Derivative Action to be met by company,
- s 167 Powers of Court where leave granted, and
- s 168 Compromise, Settlement, or Withdrawal of Derivative Actions.

The derivative action is the only provision in which the shareholder is 'entitled to bring or intervene in any proceedings in the name of, or on behalf of, a company.'[154] Only a director or shareholder has standing under this provision.[155] An application for a derivative action is granted at the Court's discretion subject to mandatory requirements.[156]

The first mandatory prescription is the evaluation principles the Court shall have regard to, they are:

> (a) The likelihood of the proceedings succeeding:
>
> (b) The costs of the proceedings in relation to the relief likely to be obtained:
>
> (c) Any action already taken by the company or related company to obtain relief:
>
> (d) The interests of the company or related company in the proceedings being commenced, continued, defended, or discontinued, as the case may be.(emphasis added)[157]

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152 Ibid at para 92.

153 *Klissers* above n 137.

154 CA, s 165(6).

155 CA, s 163 (A shareholder's or director's personal representative may apply), s 165(1).

156 CA, s 165(1), (2), & (3).

157 CA, s 165(2).

Subsection 165(2) mirrors s 209X(2) in the earlier Companies Act 1955. Subsection 165(2)(a) identifies that a derivative action is not a trial on the merits.[158] The subsection is the genesis for adopting from *Smith v Croft*[159] the *prudent business person* test.[160]

Vrij[161]dealt with a derivative application under s 209X of the Companies Act 1955. As Fisher J noted:

> [t]he gravamen of the complaint ... is that Mr Boyle is effectively diverting away from the original business custom and other benefits which ought to have remained ...[162]

Vrij[163] is the seminal decision, in which Fisher J held a derivative action is not an interim trial on the merits, and that the test is the prudent business person test. Justice Fisher avers:

> [t]he appropriate test is that which would be exercised by a prudent business person in the conduct of ... [their] own affairs when deciding to bring a claim. Such a decision requires one to consider such matters as the amount at stake, the apparent strength of the claim, likely costs and the prospect of executing any judgment.[164]

The test described by Fisher J aligns with the factors in s 165(2) and incorporates elements within the general experience of the Court. The argument against the inclusion of a prudent business person test is that the Court is required to exercise a degree of business reasoning. This arguably requires an understanding of specific market and economic factors as applicable to the circumstances. On balance, the prudent business person test is an adequate measure to offset indiscriminate or blunt use of the derivative instrument. Mindful of the potential argument that the shareholder's majority reflects the prudent business persons position, the Court's function is to objectively evaluate the conduct without the bias of self interest.

As an aside, Fisher J commented that in principle simultaneous derivative and oppression claims were possible before reserving leave and urging the parties to seek mediation.[165]

A important factor in considering a derivative application, is that the Court is restricted to granting leave only where:

> (a) The company ... does not intend to bring, diligently continue or defend, or discontinue the proceedings ... or
>
> (b) It is in the *interests of the company* ... that the conduct of the proceedings should not be left to the directors or to determination of the shareholders as a whole.(emphasis added)[166]

The purpose of this subsection is to mitigate situations where the democratic majority's self interest usurps the best interests of the company. The section reflects the State's light handed regulatory role while conceding the wider economic benefits of *stakeholder* interests. The provision

158 *Virj v Boyle* [1995] 3 NZLR 763 (*Virj*).

159 *Smith v Croft* [1986] 1 WLR 580, 590.

160 *Virj* above n 158 at 765.

161 Ibid at 765.

162 Ibid at 764.

163 Ibid at 765.

164 Ibid.

165 *Virj* above n 158 at 767–8 and *Bendall v Marshall & Ors* (2005) 9 NZCLC 263 772, Wild J followed *Virj* at [6].

166 CA, s 165(3).

recognises the right to ratification[167] and the previous limitations under the common law rule in *Foss v Harbottle*.[168]

The applicant is obligated to serve notice of the application on the company.[169] Upon notification, the company must inform the court of its intention 'to bring, continue, defend, or discontinue the proceedings.'[170] The company 'may appear and be heard.'[171]

Sections 166 to 168 address procedural matters and ensure continued judicial scrutiny upon granting a derivative action. On application from the shareholder or director, to whom leave is granted, the Court may order that the company meet part or all reasonable costs.[172] Section 167 allows the Court the opportunity to structure and control the nature of the intended proceedings, this scope is not limited. Section 168 ensures that subsequent to a grant of leave, no proceedings are *settled* without the Courts approval. This provision illustrates that the overall rationale for the derivative action is to ensure the company's best interests.

Berkahn's empirical analysis discloses that in the period between 1986–93 there were two derivative actions *commenced*.[173] The nature of those causes of action were, a shareholder initiated '[r]ecovery of debt owed to company'[174] and a directors claim in respect to an '[i]nvalid appointment of receiver.'[175]

Berkahn's analysis for the 1994–98 period shows an increase in the number of litigation actions *commenced*. There were five derivative action applications commenced by shareholders under s 165.[176] The nature of those applications were '[d]irector's conflict of interest', two claims of '[b]reach of fiduciary duties', '[e]xcessive director's salaries', and '[m]isappropriation of company funds.'[177] Similarly, there were three director initiated derivative applications.[178] They were for '[b]reach of fiduciary duties ... [d]irector's conflict of interest, ... [and] ... [u]nauthorised use of company funds.'[179]

In the 1999–2002 period there were four shareholder initiated derivative applications. Two allege *director conflict of interest* and two *breaches of fiduciary duty*.[180] In the same period, Berkahn records two director initiated derivative actions. Those applications alleged *breach of shareholders agreement* and *misleading or deceptive conduct*.[181]

In comparison, Taylor analysed derivative application proceedings for the 1994–2006 period.[182] Taylor's analysis focuses on searching electronic databases for relevant authorities and sub-

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167 CA, s 177.
168 *Foss v Harbottle* (1843) 2 Hare 461, 492.
169 CA, s 165(4).
170 CA, s 165(5)(b).
171 CA, s 165(5)(a).
172 CA, s 166.
173 Berkahn above n 28 at 113.
174 Ibid.
175 Ibid.
176 Ibid at 116.
177 Ibid.
178 Ibid.
179 Ibid.
180 Ibid at 119.
181 Ibid.
182 Taylor above n 28.

jecting those authorities to analysis under eight headings.[183] Taylor's analysis discloses a number of very interesting facts. Foremost is that 91.3 per cent of the 23 derivative applications were from *closely held* companies.[184] Further, that approximately 40 per cent of the applicants were shareholders, 50 per cent shareholder/director, and ten per cent directors.[185] Taylor identifies that:

> [a] clear majority of ... [the proposed claims against defendants] allege that directors are in breach of a duty owed to the company. A further point of note is the lack of sole reliance by applicants on directors' duties as specified in the Companies Act 1993: a significant proportion of claims (70.8 [per cent] ...) are based wholly on or in part on the fiduciary duties imposed on directors in equity.[186]

Taylor's tabulation shows 59 per cent of the defendants were directors, with 22 per cent of the defendants being shareholders (nine of the 41 claims).[187] This statistic merits further discussion in the context of the fiction.

An analysis of the *shareholder as defendant* data discloses the following the claims alleged were:

[i] Breach of alleged fiduciary duty – 1

[ii] Recovery of overdrawn current account and breach of contract – 1

[iii] Recovery of unpaid share purchase price and term loan – 1

[iv] Negligence as bailee of company property –2

[v] Unauthorised receipt of funds from company bank account – 1

[vi] Breach of shareholders agreement – 1

[vii] Knowing receipt and/or knowing assistance with respect to breach of duty by company director –1[188]

In all but three (ii, iii and vi) of the alleged claims, if established, the errant shareholder has assumed an obligation arguably outside the *normal* shareholder role. The limitation in this assertion is the generic nature of the summarised allegations recorded. One inference from the shareholder initiated applications is that neither the company, nor a director, were commencing the action. The assumption is the applicants were in minority positions.

The two final statistics that Taylor discloses are notable from a practical perspective. The first is that 69.6 per cent of the derivative applications were successful.[189] The second interesting fact is summarised by Taylor:

> [i]t appears that in only one instance has an applicant obtained a judgment in a subsequent derivative action and the action been successful.[190]

That case is *Kawhia Offshore Services Ltd v Rutherford* (*Kawhia*).[191] In *Kawhia,* Rutherford a managing director converted a maturing business opportunity away from the company for per-

183 Ibid.

184 Ibid at 351, (Table 1).

185 Ibid at 352, (Table 3).

186 Ibid at 353.

187 Ibid at 353 (Table 4).

188 Taylor above n 28 at 353 (Table 6).

189 Ibid at 354 (Table 7).

190 Ibid at 356.

191 *Kawhia Offshore Services Ltd v Rutherford* (unreported, High Court Hamilton 24 April 2004, CP61/99).

sonal benefit, breaching the fiduciary obligation to act in good faith and in the company's best interests. The Court held both Rutherford and the related Marine Mooring Consultants Ltd were liable to account for profits.[192]

In sum, a shareholder has standing to apply for a derivative action. The derivative application is not a substantive hearing on the merits. The Court exercises its residual discretion to control unfair use of the blunt interim instrument. The Court must consider the matters in subs 165(2) and (3). The test is whether a prudent business person would take the action.[193] Leave is granted where the company itself is not actively engaged or contemplating proceedings, or there is sufficient risk of a majority self interest conflict arising to warrant judicial oversight.

IX. Personal Actions By Shareholders

Initiating a personal action is the strongest statement by a shareholder of the right to protect their self interest and reasonable expectation. The predominant personal statutory remedy is the *prejudiced shareholder* provision.[194] There are four general statutory provisions a shareholder may invoke.[195]

A. *The general provisions*

Three of the personal remedy options indirectly enforce the company or board to act. Section 170 authorises shareholders to apply in spite of the prescription in s 169, where it is just and equitable, for an order requiring a director to act in the interests of the company.[196] Relief is available under this provision as the Court thinks fit.[197] Section 172 is similar but the order granted is directed to the board.[198] Section 171 authorises an action against the company to enforce a duty owed to shareholders. This section should be read in conjunction with s 169. Database searches did not identify any judgments relating to these provisions. Arguably, this is because ss 64, 165 and 174 provide ample scope for equitable intervention.

B. *Prejudiced shareholders*

Section 174(1) allows a shareholder, former shareholder, or *entitled person* to apply to the Court for an order where prejudicial conduct is alleged. The provision allows an application for past, present, or anticipated conduct. The conduct complained of must be 'oppressive, unfairly discriminatory, or unfairly prejudicial'[199] to a shareholder, former shareholder, or entitled person.

The Court has a just and equitable discretion to consider in making any order it thinks fit.[200] The Act prescribes some of the remedial options, but the list is not exhaustive.[201] The Court may

192 Ibid at para 79.

193 *Virj* above n 158 at 765; *MacFarlane v Barlow* (1997) 8 NZCLC 261 471 and *Re Mega-Merger Housing Ltd* (unreported, High Court Auckland, 16 November 2004, CIV 2004–404–1453).

194 CA, s 174.

195 CA, ss 70–172, 174.

196 CA, s 170.

197 CA.

198 CA, s 172.

199 CA, s 174(1)

200 CA, s 174(2)

201 CA.

order that the company or any other person, acquire the shares, or pay compensation.[202] The Court may regulate the company's future conduct or alter its constitution.[203] The Court may appoint a receiver, rectify records, put the company into liquidation, or set aside an action.[204] The company must be a party to proceedings for the Court to make an order against it.[205] Section 175 prescribes 13 general circumstances where conduct is deemed prejudicial. The Court of Appeal avers, 'the section … [is] remedial and enabling … designed to transcend the limitations of the former law.'[206] It is suggested the concern is whether the section prescribes a sufficiently principled approach for commercial reality.

Berkahn's empirical analysis discloses that between 1986–93 there were 11 *oppression* actions, six lodged by shareholders and five by director/shareholders'.[207] The actions under s 209 of the Companies Act 1955 were for, share allotment, sale to director at undervalue, share forfeiture, directors acting in own interests, management deadlock, preferring majority interests over minority, and withholding dividends.[208]

The corresponding analysis for 1994–98 shows there were ten s 174 applications.[209] Shareholders lodged two applications, one for share forfeiture, and the other for excessive director salaries. The eight director/shareholder actions were for conflict of interest, exclusion from management, and financial mismanagement.[210]

Analysis for 1999–2002 shows there were 14 s 174 applications.[211] *Shareholders* lodged two applications, one for excessive director salary and inadequate dividend, and the other for delaying a requested meeting.[212] The twelve director/shareholder actions were for conflict of interest, inadequate dividends, exclusion from management, financial mismanagement/ diversion of funds, and management deadlock.[213]

It is clear from Berkahn's data that there is a marked increase in the number of actions taken despite the shorter time period. The other trend observed is the prevalence of director/shareholder initiated actions. This reflects a greater involvement and understanding of the company's management by director/shareholder's.

Taylor's analysis for 1984–94 discloses that there were 23 claims for oppression, with 65.2 per cent coming from closely held companies.[214] Similarly, in the 1994–2006 period there were 25 claims, with 93.1 per cent lodged against closely held companies.[215]

The statistics of both Berkahn and Taylor indicate that claims under the *oppression* remedy are popular when compared to injunctions or derivative actions discussed earlier. A potential explana-

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202 CA, s 174(2)(a) & (b).
203 CA, s 174(2)(c) & (d).
204 CA, s 174(2)(e)–(h).
205 CA, s 174(3).
206 *Latimer* above n 31 at para 64.
207 Berkahn above n 28 at 113.
208 Ibid.
209 Ibid at 116.
210 Ibid.
211 Ibid at 119.
212 Ibid.
213 Ibid.
214 Taylor above n 28 at 356.
215 Ibid at 358.

tion is the strong self interest perspective associated with the claim and the broad interpretation of the section.

In 2005, the Court of Appeal in *Latimer*[216] noted there were British empirical studies but were not aware of any similar study on *oppression* proceedings in New Zealand.[217] The Court stated, in that respect, there have been:

> close to 50 decisions of our Courts since legislation of this character was created. There has been no concern expressed in those judgments as to the essential approach adopted in *Thomas*.[218]

Thomas[219] is the seminal case; the case acknowledges Lord Wilberforce's equitable intervention rationale in *Ebrahimi v Westbourne Galleries Ltd*.[220]Justice Richardson's judgment explored the background of the analogous s 209 of the Companies Act 1955, before analysing the operative terminology. The Court's discussion and ruling remains relevant.[221] In *Thomas* it was held that the expressions *oppressive*, *unfairly discriminatory*, and *unfairly prejudicial* overlap, and should be read together.[222] Further, that:

> they reflect the underlying concern of the subsection that *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 *is a legitimate foundation for a complaint* (emphasis added) [223]

Justice Richardson, reconciled the three *compendious* expressions in subsection (1) with the just and equitable standard in subsection (2) by focusing on the essential overlapping expressions.[224] Importantly, in applying a balancing test of potentially conflicting interests, it was stated that, '[f]airness cannot be assessed in a vacuum or simply from one member's point of view.'[225] *Thomas* has received all round affirmation as remaining good authority for s 174. As noted, the Court of Appeal in *Latimer* held, [t]wenty years after *Thomas*, in our view the general approach laid down … is still appropriate'.[226] *Latimer* affirmed that:

> [t]he operative words [s 174] express a general principle which is directed to 'an unjust detriment to the interests of a member of the company.'[227]

Latimer did consider the reasoning in *O'Neill v Phillips*[228] before distinguishing the stricter *legitimate expectation* from the preferred *reasonable expectation* test.[229] The Court noted the developing trend in company law toward a greater recognition of shareholder rights.[230] In *Lusk v Archive*

216 *Latimer* above n 31.
217 Ibid.
218 Ibid.
219 *Thomas* above n 59.
220 *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360, 379.
221 *Latimer* above n 31 at para 112.
222 *Thomas* above n 59 at 693.
223 Ibid at 693.
224 Ibid.
225 Ibid at 694.
226 *Latimer* above n 31 at para 112.
227 Ibid at [113].
228 *O'Neill v Phillips* [1999] 1 WLR 1092.
229 *Latimer* above n 31 at para 96.
230 Ibid at para 110.

Security Ltd (*Lusk*)[231] Gallen J referenced the Privy Council's upholding of Henry J's reasoning under the previous provision in *Vujnovich v Vujnovich*[232] and Lord Wilberforce's discussion. Justice Gallen noted:

> the necessity to take into account the different rights, expectations and obligations of the constituent shareholders, but [also] that these may be considered in terms of considerations of a personal character arising between one individual and another. There is also a certain emphasis on the expectations and what is contemplated by the parties at the initiation of the relationship.[233]

Notably, in both *Thomas* and *Latimer* the Court did not find that the minority shareholders were *unjustly prejudiced*. In *Thomas* the minimal dividend policy, balanced against the increasing capital investment and appellant's failure to investigate alternative exit options, did not equate to being *locked in*.[234] In *Latimer* the appellant shareholders were found to have invested in the company with their *eyes open* and aware of the management strategy. Notably the Court concluded:

> the appellants seek not just exit, but exit conferring upon them a handsome profit (in a relatively short time) for their investment. What they are really seeking, is to achieve through the Court what they cannot achieve through the market … They cannot legitimately look to this Court to generate their profit for them.[235]

This equitable reasoning is analogous to,[236] but not conflated with, the reasoning employed in terms of unjust enrichment. It is unjust for the shareholder appellant to profit in circumstances where there is an appreciation of the risk and no unconscionable conduct. This reasoning also accords with s 169(2), prohibiting personal action simply for effected share value as a result of *proper* company action. The focus on exit options links the reasonable expectation of shareholders and the objective economic rationale of the fiction. The rationale for just intervention is to protect against abuses of influence or control.

X. Summary

Three prevalent shareholder remedies allow the shareholder to independently apply to the Court to exercise their rights and expectations. The injunction paradigm is used the least; it is restricted to continuing or contemplated company conduct. The derivative action relies on a prudent business person test where there is the risk of self interest or conflict within the company, impeding the company ensuring proper proceedings. The oppression provision allows a shareholder a just and equitable personal remedy. It negates the possibility of *fraud against the minority* ensuring the shareholder's reasonable expectations.

231 *Lusk v Archive Security Ltd* (1991) 5 NZCLC 66 979.

232 *Vujnovich v Vujnovich* [1989] 3 NZLR 513.

233 *Lusk* above n 231 at 66 988.

234 *Thomas* above n 59 at 696.

235 *Latimer* above n 31 at paras 122–123.

236 Equitable in that it follows the maxims; 'equity follows the law', 'equality is equity', and 'equity will not allow a statute to be made the instrument of fraud.'

XI.

This section will address two further related issues before concluding. The first is a brief identification of the comparative Australian provisions. The second draws the discussion together by focusing on shareholder remedies.

XII. The Corporations Act 2001

Unsurprisingly, the regulatory regime prescribed by the Australian Corporations Act 2001(Commonwealth) (the CA01) is similar to that in New Zealand. The paradigm distinguishes between the *general law*, the CA01, and contractual regimes affecting company law.[237] There is a statutory injunction available against a person via s 1324 for a breach of the CA01. This section focuses on the actions of individual's not the company itself.

Whereas s 236 of the CA01 codifies a similar prescription as s 165(1) in the New Zealand derivative action. Section 237(2) of the CA01 addresses the granting of leave. The provision expands on the test prescribed in s 165(3) of the New Zealand Act. The important additional feature is the recognition of the elements of good faith and the company's best interests in the provision.[238] The inclusion of these tests tends to negate action taken for a collateral purpose.[239] Section 237(3) of the CA01 prescribes the rebuttable presumptions for the Court to consider. The rationale of s 237 is expressed in the explanatory memorandum which states, its intention is:

> to strike a balance between the need to provide a real avenue for applications to seek redress on behalf of a company where it fails to do so and the need to prevent actions proceeding which have little likelihood of success.[240]

This in effect is the objective of the *prudent business person* test prescribed in s 165(2) of the New Zealand Act and interpreted by Fisher J in *Virj*.

The CA01 prescribes an oppression remedy at s 232. Standing under the section is expansive. There are two limbs to the section covering actual or proposed conduct. Effectively the conduct must be either:

> (d) contrary to the interests of the members as a whole; or
>
> (e) oppressive to, unfairly prejudicial to, or unfairly discriminatory against, a member or members ...[241]

In respect to subsection (e), Richardson J's contention in *Thomas* that the three expressions overlap was followed in *Re George Raymond Pty Ltd; Salter v Gilbertson*.[242] The distinguishing feature in the CA01 is subsection 232(d), effectively combining the director's duty under s 131 and with the oppression remedy in s 174 in the New Zealand Act. The remedies available via s 231(1) of the CA01 for breaching s 232 are analogous to s 174(2) of the Act. Notably, both the New Zealand and Australian jurisdiction refer to the reasoning of Lord Wilberforce in *Ebrahimi* discussed above.

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237 S Woodward, H Bird, & S Sievers, *Corporations Law in principle* (Sydney: Lawbook Co, 2005), 261–6 and H Ford, R Austin, & I Ramsay, *Ford's Principles of Corporations Law* (2003), 545–6.

238 Corporations Act 2001, s 237(2)(b)&(c).

239 *Swansson v RA Pratt Properties Pty Ltd* (2002) 42 ASCR 313 and *Charlton v Barber* (2003) 47 ASCR 31.

240 Corporations Act 2001, s 237, Explanatory Memorandum.

241 Corporations Act 2001, s 232(d)&(e).

242 *Re George Raymond Pty Ltd* and *Salter v Gilbertson* (2000) 18 ACLC 85, 90.

By way of comparison, Berkahn's Australian analysis identifies that; in 1986–93 shareholders or director/shareholders commenced eight injunctions, four derivative actions and 30 oppression applications.[243] In the 1994–98 period similarly there were four derivative actions, and 12 oppression actions.[244] For the 1999–2002 period there were two injunctions, eight derivative actions, and ten oppression actions.[245] The trend is clearly the preference for actions alleging oppression.

In summary, the provisions in the CA01 present a greater challenge to the company fiction than the New Zealand regime. Shareholders may initiate independent action against other members or the company without first seeking judicial oversight. Notwithstanding, there are options for compensation for frivolous claims.

XIII. Shareholder Remedies – The Duty In Summary

The primary focus of the Act is to achieve economic and social benefits by ensuring the company's best interests. The company's best interests align with the shareholders. The duty to ensure the company's best interests is one of the directors' fiduciary duties to the company. Prescriptive shareholder rights and obligations ensure there is accountability while restricting the scope for intervention. Part IX of the Act prescribes the platform for statutory and equitable intervention. The empirical studies show that from the shareholder's perspective, Part IX provisions are critical, if not always effective.

The potential remedies in Part IX are extensive. There is a nexus between the shareholder's relationship to the company and the nature of the remedial action available. Shareholders are not owners, nor are they owed a fiduciary obligation. Whether the contractarian or communitarian model describes the shareholder relationship, the concession is that the relationship incorporates a reasonable expectation. The concept of reasonable expectation is contractual. Further, when shareholders enter a shareholder company relationship it is at a known relative *disadvantage* to the company and the board. Notwithstanding that, the company is expected to act in its own interests; this interest may align with the shareholders, who are expected to look after their own interests.

Premised on that understanding, the relationship of the shareholder to the company is analogous to Finn's third standard on the continuum, requiring *fairness* to the disadvantaged party and avoidance of unconscionable conduct.

Without conflating the three separate provisions and their respective tests, unconscionable conduct is the critical factor in any just and equitable assessment. There is then an argument for the inclusion of an unjust enrichment rationale also as the basis for shareholder remedies. Unjust enrichment is the central foundation for the law of restitution. Restitution principles adequately address *unjust detriment* and ensure reasonable expectations.[246] In *Latimer* the Court noted it is not appropriate for shareholders to unjustly profit via a Court action.[247] The courts are disposed to finding a remedy that in the first instance maintains the company fiction. The remedies prescribed in s 174(2) are expansive. The acquisition of shares is the most prevalent remedy.[248] The reality

243 Berkahn above n 28 at 122–3.

244 Ibid at 126–7.

245 Ibid at 130.

246 *Latimer* above n 31 at para 113.

247 Ibid at para 123.

248 *Lusk* above n 231 at 66994; *Cornes v Kawerau Hotel (1994) Ltd* (1999) 8 NZCLC 261817, 261826; *Re Environmental Products (New Zealand) Ltd* and *Power v Sands* (2005) 9 NZCLC 263779, para 72.

is that some situations dictate that the company is unable to continue and winding up is the only option.[249]

XIV. Conclusion

This paper has endeavoured to highlight the practical nexus between maintaining the concept of the company fiction and ensuring shareholders reasonable expectations. The problematic concepts include, the company fiction, identifying the company's best interests, and just and equitable intervention.

The Act's light handed regulatory regime relies on robust shareholder remedies to promote the economic and social benefits of the company fiction. Shareholder monitoring encourages responsible management. There is a presumption of shareholder self interests within the Act, whether through voting or applying for an injunction, derivative action, or ultimately a remedy for oppression.

Shareholders are able to initiate an injunction or derivative action on behalf of the company from inside of the veil. Outside the veil, shareholders seek to personally enforce rights against the company via the Court where it is just and equitable.

The State sanctions shareholder intervention in the company fiction. Intervention via the Court preserves the fiction and monitors the use of the *blunt* injunction and derivative instruments in the interests of the company. The balance is established through just and equitable oversight. As Lord Wilberforce's seminal speech identifies, equity will pierce the corporate veil to acknowledge the rights existing behind the barrier.[250]

249 *Vujnovich* above n 232 at 519.

250 *Ebrahimi* above n 220 at 379.