

RECTIFYING SHAREHOLDER GRIEVANCES: DERIVATIVE ACTIONS

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In the Summer 2007 issue of Letter of the Law, we outlined two statutory remedies that offer shareholders the ability to protect their interests in a company — the “oppression remedy” and a “derivative action.” In that article we discussed the oppression remedy, which relates to correcting conduct within a company that is “oppressive” or “unfairly prejudicial” to shareholders in their personal capacity as shareholders. The second remedy — and the subject of this article — is a derivative action, which is, by contrast, used to address wrongs directed at the company itself by external forces.

Historically, when a wrong was done to a company, only the company itself could seek a remedy for that wrong. There was usually little a shareholder — particularly a shareholder holding a minority position — could do to seek a remedy, even in situations where the company’s board of directors were the ones who injured the company. This was a particular problem in closely-held companies that suffered from the deprivations of insiders.

The Government of British Columbia has now rectified that unfairness. A shareholder can apply to the court under Section 233 of the British Columbia Business Corporations Act (BCA) for leave to initiate a derivative action — a legal proceeding brought by a shareholder on behalf of a company to enforce a right, duty or obligation owed to the company. The BCA states that a court may grant leave to bring a derivative action when the following circumstances apply:

- The shareholder has made reasonable efforts to cause the directors of the company to commence or defend a legal proceeding.
- Notice of the shareholder’s application has been given to the company.
- The shareholder is acting in good faith.
- It is in the company’s best interest to bring or defend a legal proceeding.

In considering these factors, a court needs to be assured that the proposed lawsuit has arguable merit and is in the best interests of the company. The court will weigh the pros and cons of the proposed lawsuit to determine whether the lawsuit has a reasonable prospect of success and whether the company should become involved in litigation that its board of directors does not want to pursue or defend.

Two cases over the past two years serve to show circumstances in which B.C. courts have granted minority shareholders leave to bring a derivative action. In a 2005 case, *Carr v. Cheng*, Mr. Carr and Mr. Cheng incorporated a company with each becoming a director and owning 50 per cent of the shares. Approximately one third of the shares were then sold to investors, with Mr. Carr and Mr. Cheng giving equally of their shares. As the business progressed, Mr. Cheng took over more of the operations of the business.

Mr. Carr became increasingly concerned about certain financial transactions and requested information from Mr. Cheng, who had also obtained sufficient proxies to remove Mr. Carr as a director. Mr. Carr then retained a chartered accountant whose limited review of the financial information provided by Mr. Cheng suggested significant irregularities in the company's financial dealings, including director's fees and expenditures paid to Mr. Cheng but not to Mr. Carr. Mr. Carr successfully obtained leave to bring a derivative action to seek a judgment against Mr. Cheng for improper disposal of company assets.

In a 2006 case, *Bassett-Smith v. Protech Consultants (1989) Ltd.*, Mr. Bassett-Smith and Mr. Maddock each had a 40% share in Protech, while Mr. Boyczuk had a 20% share. Mr. Maddock was the sole director and Mr. Maddock's wife was the company's salaried secretary. Mrs. Maddock incorporated Ideal Ventures Ltd., which acquired some equipment that it leased to Protech. Protech also occupied premises owned by Mr. Maddock. Mr. Bassett-Smith became concerned about the distribution of Protech's profits, payments to Mrs. Maddock for salary and expenses, the competitiveness of the lease payments to Ideal Ventures and the rising rent payments to Mr. Maddock. Mr. Bassett-Smith successfully obtained leave to bring a derivative action on behalf of Protech to seek recovery of monies that he alleged Mr. and Mrs. Maddock obtained by improper means.

Neither case has yet gone to trial for adjudication.

A derivative action can be an important remedy in circumstances where a minority shareholder seeks to address wrongs directed against a company in which they own shares. The critical feature to understand however is that a shareholder must first try to have the directors of the company address the wrong. If the directors decline to do so, the shareholder must obtain leave of the court before initiating or defending a derivative action on behalf of a company.