Institutional Investors and Corporate Governance

Lynden Griggs*

INTRODUCTION

This article will consider the role of the institutional shareholder in monitoring a corporation's compliance with appropriate standards of corporate governance. In recent years this area has attracted significant literature.[1] These writings are in part due to the increasing importance of institutions and fund managers on the share registry of major corporations. This development is being fuelled by the increasing amount of monies available for equities investment because of the domination of superannuation and managed funds as the preferred vehicle for supplementing household savings and providing for the retirement of an ageing population.

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* Lecturer in Law, University of Tasmania; Barrister and Solicitor, Supreme Court of Tasmania, High Court of Australia.

1 For example, see R.J. Gilson and R. Kraakman, 'Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate', (1993) 45 *Stanford Law Review* 985; I.M. Ramsay and M. Blair, 'Ownership Concentration, Institutional Investment and Corporate Governance: An Empirical Investigation of 100 Australian Companies', (1993) 19 *Melbourne University Law Review* 153; Parliamentary Joint Committee on Corporations and Securities Issues Paper, *Inquiry into the Role and Activities of Institutional Investors in Australia: Issues Paper*, November 1994; B.S. Black and J.C. Coffee, 'Hail Britannia? Institutional Investor Behavior Under Limited Regulation', (1994) 92 *Michigan Law Review* 1997; C. Brancato, 'Globalisation, the 21st Century and Corporate Governance', (1994) 10 *Company Director* 7; G.P. Stapledon, 'The Corporate Governance Debate in the United Kingdom', (1993) 11 *Companies and Securities Law Journal* 62; G.P. Stapledon, 'The Structure of Share Ownership and Control: The Potential for Institutional Investor Activism', (1995) 18 *UNSW Law Jounal* 250.

> In Australia public attention on the subject has increased with the growth of the Managed Funds Industry, now linked to a national savings policy through compulsory superannuation. It is also significant to note that the size of the Managed Funds Industry, currently around $250 billion, is larger than the total of all bank deposits in Australia.[2]

This article will look at this issue in a number of parts. The first part will provide a definition of the institutional investor and then describe the quantitative importance of institutional investors on the share registries of Australian companies. The second part will outline what is required in terms of corporate governance — particularly in light of the requirements of the Stock Exchange Listing Rules. Furthermore, this aspect is crucial in determining what should be the role that institutions will have in monitoring the conduct of the board of directors of public corporations.[3] Having identified what the standards of corporate governance are, an outline of the advantages and disadvantages for the institutional shareholder in terms of enforcement will be given. In particular, what will be their role in enforcing corporate wrongs? Are they likely to pursue a derivative action seeking to remedy a wrong done to the corporation where those in control of the corporation, most likely the board of directors, are unwilling or unable to pursue the matter?[4] A discussion of the statutory derivative action as it presently exists in Canada (the jurisdiction on which the proposed Australian legislation is based) will then

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[2] P. Griffin, 'Institutional Investors in Australia: A Shareholders' Perspective', Paper delivered to the Corporate Governance & Australian Competitiveness: The Role of Institutional Investors Conference, 11 November 1993, p. 2. As Stapledon comments: 'Furthermore, between 1984 and 1988 there was rapid growth in real terms in the level of Australian household savings accounted for by superannuation and life-insurance contributions. The introduction of the "superannuation guarantee charge" will almost certainly accelerate this trend.' Stapledon, *supra* n. 1 at 254–5.

[3] On this aspect, consider the role undertaken by major institutions in effective changes to the board of Coles Myer in 1995. 'The financial press contains numerous reports of ousters of top executives, particularly where companies are facing financial difficulties. Perhaps the most notable of these in the United Kingdom have been the replacement of the chairmen of Barclays and BP. Another significant exit was the departure from the board of Lonrho of Mr. Rowland.': E. Boros, *Minority Shareholders' Remedies* (Oxford: Clarendon Press, Oxford, 1995), 50. Institutional investors have also been crucial in the United States in ousters at GM, IBM, American Express, Kodak and Westinghouse. See the comments by C. Brancato, 'Creating Relationships between Institutional Investors and Corporations: The U.S. Experience', Paper delivered to the Corporate Governance & Australian Competitiveness: The Role of Institutional Investors Conference, 11 November 1993, p. 3. See also the example provide by Stapledon, *supra* n. 1 at note 74.

[4] The statutory derivative has been proposed to be introduced in 1996. It has been recommended by a number of law reform bodies. See Report No. 12: *Enforcement of the Duties of Directors and Officers of a Company by Means of a Statutory Derivative Action* (November 1990, Australia); House of Representatives Standing Committee on Legal and Constitutional Affairs (Lavarch Committee), *Corporate Practices and the Rights of Shareholders*, 28 November 1991, Recommendation 26; Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action*, July 1993. See also I.M. Ramsay, 'Corporate Governance, Shareholder Litigation and the Prospects for a Statutory Derivative Action' (1992) 15 *UNSW Law Journal* 149; J. Kluver, 'Derivative Actions and the Rule in Foss v. Harbottle: Do We Need a Statutory Remedy?', (1993) 11 *Companies and Securities Law Jounal* 7.

be undertaken. This article will conclude with a discussion of the future prospects for Australia. In this part the comment will be made that institutional activism is likely to be small, particularly in terms of litigation. Costs will be a significant barrier, as will the presence of a significant non-institutional investor on the share registry of Australian companies. Non-litigious measures are more likely to be dominant and more effective.

1. DEFINITION AND IMPORTANCE OF INSTITUTIONAL INVESTORS ON SHARE REGISTRIES OF AUSTRALIAN COMPANIES

An institution investor can be defined as follows:

> Institutions which have as their primary role the professional investment and management of any fund established for the purpose of pooling monies paid by individual investors and invested in financial and non-financial assets.[5]

In Australia, the ten largest institutional investors are as follows: AMP Investments Australia Ltd, Bankers Trust Australia Ltd, State Superannuation Investment and Management Corporation, National Mutual Funds Management, County NatWest Australia Investment Management Ltd, Queensland Investment Corporation, Lend Lease Corporate Services Ltd, Westpac Investment Management Pty Ltd, The Capital Group Inc and CBA Financial Services.[6]

The importance of these institutional investors on share registries of Australian corporations can be seen in Table 1.[7] As the table demonstrates, the life insurance and superannuation bodies together with other financial institutions, particularly the investment companies, own in excess of 33 per cent of the listed equity in Australian corporations.

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[5] Griffin, *supra* n. 2 at 2. In similar terms, Brancato, *supra* n. 3 at 2, defines the institutional investor as an investor with money under professional management. She includes the following categories: public employee pension funds, pension funds of publicly traded corporations, mutual funds and other investment companies, insurance companies and bank funds.

[6] Stapledon, *supra* n. 1 at 258.

[7] Taken from Boros, *supra* n. 3 at 18; sourced from M.J. Heffernan, Chief Economist/Lawyer, Australian Stock Exchange Limited, Adjusted Ownership of Shares, Based on Australian Bureau of Statistics Australia National Accounts — Financial Accounts.

Table 1 Share ownership of Australian listed companies, 1994

Private corporate trading entities	6.5
Banks	2.2
Non-bank financial intermediaries	0.8
Life insurance and superannuation	23.3
Other financial institutions	10.3
Government	2.2
Rest of the world	19.8
Households	34.9
Total	100.0

In the United Kingdom, an even stronger picture of the influence of the institutional investor can be seen from Table 2.[8] The growing importance of the institutional investor is dramatic when it is considered that, in 1963, individuals held 54 per cent of the beneficial equity of UK listed companies.[9]

Table 2 Share ownership of UK listed companies, 1993

Pension funds	34.2
Insurance companies	17.3
Unit trusts	6.6
Banks	0.6
Other financial institutions	3.1
Individuals	17.7
Other personal sector	1.6
Public sector	1.3
Industrial and commercial companies	1.5
Overseas	16.3
Total	100.2

What these figures all demonstrate is that institutional investors are crucial, not merely in terms of a quantitative measure but also in terms of their relative weight and strength within the capital structure of listed companies.[10] They indicate that institutional investors can, because of their sheer size and presence on the share registry of a listed corporation,

[8] Boros, *supra* n. 3 at 17, sources from Share Register Survey 1993, Central Statistical Office.

[9] Boros, *supra* n. 3 at 17. In the United States a similar trend is evident. United States' institutional investors have increased their asset holdings from US$6.3 trillion in 1990 to US$8.2 trillion in 1992: Brancato, *supra* n. 3 at 2. See also the comments by R. Tomasic and S. Bottomley, *Corporations Law in Australia* (Sydney: Federation Press, 1995), 459–60.

[10] See also the comments by Senator M. Beahan, Chair, Joint Parliamentary Committee on Corporations and Securities, 'The Rise of Institutional Investment: A Government Perspective', Conference paper delivered to the Corporate Governance & Australian Competitiveness: The Role of Institutional Investors Conference, 11 November 1993, p. 1.

have a role to play as corporate monitors of the performance of the board.[11]

If, for the moment, we accept the premise that institutional investors do have the strength, capacity and willingness to monitor corporate management and to undertake a form of supervisory role, what are the benefits that can be obtained by shareholder litigation? Obviously and most directly, the benefits can include compensation to those who have been harmed, and through this, it can act as a deterrent to those presently committing the malfeasance.[12] It has also been suggested that shareholder action is the superior manner in which to ensure that directors act for the benefit of all shareholders.[13]

However, the detriment associated with shareholder litigation may outweigh the benefits. First and foremost, there is the cost of litigation. If the action brought by the minority shareholder is a derivative action,[14] the benefits will flow to the corporation.[15] Indirectly, the shareholders may benefit from this, but in effect the shareholder is acting as a *guardian ad litem* — acting on behalf of and for the benefit of all, not just themselves. The derivative action in this sense can be seen as a truly altruistic action.[16] Legal proceedings can also be detrimental to the ongoing performance of the corporation,[17] leading to loss of productivity, and may make it difficult to attract well-qualified people to become directors.[18]

In summary, therefore, the definition of the institutional investor can be reasonably widely drawn: that of the institution whose primary role is the undertaking of funds management on behalf of another. Second, the increasing use of compulsory savings vehicles such as superannuation and managed funds has dramatically increased the importance of the

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[11] See the following literature which examines the correlation between corporate governance measures and company performance: S. Rosenstein and J.G. Wyatt, 'Outside Directors, Board Independence and Shareholder Wealth', (1990) 26 *Journal of Financial Economics* 175; R.S. Chaganti, 'Corporate Board Size, Composition and Corporate Failure in the Retailing Industry', (1985) 22 *Journal of Management Studies* 400; B.E. Hermalin and M.S. Weisbach, 'The Effects of Board Composition and Director Incentives on Firm Performance', (1991) *Financial Management* 101; H. Bird, 'The Rise and Fall of the Independent Director', (1995) 5 *Australian Journal of Corporate Law* 235.

[12] I.M. Ramsay, 'Enforcement of Corporate Rights and Duties by Shareholders and the Australian Securities Commission: Evidence and Analysis', (1995) 23 ABLR 174, 177–8.

[13] See the comments of Ramsay, *id.* 178, where he quotes from the American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (1992), 600.

[14] That is, they are deriving their right to sue the wrongdoers from the nominally proper plaintiff, this being the company. See the comments by Ramsay, *supra* n. 12 at 178.

[15] Derivative actions can ultimately be considered an issue of costs. If the minority shareholder is unsuccessful, he or she will incur enormous costs. The practical difficulties of a derivative action are demonstrated in the decision of *Wallersteiner v Moir* [1975] QB 373.

[16] On this aspect see the case of *Nurcombe v Nurcombe* [1985] WLR 370 where it was alleged that the action was brought on behalf of the company. However, the court indicated that the action had been brought for personal reasons and not for the benefit of the company. The plaintiff had acted to increase the monetary value of her shareholding and not to benefit the company's interest.

[17] See the comments by B.R. Cheffins, 'An Economic Analysis of the Oppression Remedy: Working Towards a More Coherent Picture of Corporate Law', (1990) 40 *University of Toronto Law Journal* 775.

[18] *Ibid.*

institutions on the share registries of all companies in the Australian economy. But if it is expected that they will perform a role as corporate monitors or watchdogs, then substantial disincentives, particularly in the area of litigation costs, will need to be overcome.

2. CORPORATE GOVERNANCE AND THE INSTITUTIONAL INVESTOR

Having identified the importance of institutional investors in terms of their size and relative percentage, what is their role in ensuring appropriate standards of corporate governance in the listed public corporation? The questions that need to be addressed are: what is their role, what are the limitations, and are there any prescribed standards that need to be met? It is this last aspect that will be addressed first.

In considering the prescribed standards for the listed public corporation, the primary area of consideration will be the Stock Exchange Listing Rules. The reason for this is that corporate governance listing rules[19] are designed to regulate the 'relationship between the management of the public corporations and their shareholders'.[20] Listing Rule 3C(3)(j) of the Australian Stock Exchange Listing Rules provides that:

> [F]or annual reporting periods ending on or after 30 June 1996, a statement of the main corporate governance practices that the company has had in place during the reporting period [must be made in the annual report]. Where the statement identifies a corporate governance practice that has been in place for only part of the reporting period, the part of the period for which it has been in place must be disclosed. *Note: To assist companies, an indicative list of corporate governance matters is set out at Appendix 33.*

Appendix 33 goes on to provide:

> List of Corporate Governance Matters
> Below is an indicative list of corporate governance matters. A company may take them into account when making the statement in its annual report under Listing Rule 3C(3)(j).
>
> 1. Whether individual directors, including the Chairman, are executive or non-executive directors.
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> 2. The main procedures that the company has in place for —
> (i) devising criteria for board membership,
> (ii) reviewing the membership of the board, and

[19] On this point, see Anon, 'Stock Exchange Listing Agreements as a Vehicle for Corporate Governance', (1981) 129 *University of Pennsylvania Law Review* 1427.

[20] R. Karmel, 'Qualitative Standards for "Qualified Securities": SEC Regulation of Voting Rights', (1987) 36 *Catholic University Law Review* 809, 814.

(iii) nominating directors. ...

5. The main procedures for establishing and reviewing the compensation arrangements for —
   (i) the Chief Executive Officer and other senior executives, and
   (ii) non-executive members of the board. ...

6. The main procedures that the company has in place for —
   (i) the nomination of external auditors, and
   (ii) reviewing the adequacy of existing external audit arrangements, with particular emphasis on the scope and quality of the audit.

7. The Board's approach to identifying areas of significant business risk and putting arrangements in place to manage those risks.

8. The company's policy on the establishment and maintenance of appropriate ethical standards.[21]

The developments which led to this stock exchange listing rule flow from a number of aspects — an examination of these will provide a historical overview of the forces that have (1) led to the introduction of the corporate governance disclosure requirements, and (2) focused attention on institutions and their role in this process. In this first instance, consideration will be made of what has occurred in the United Kingdom, followed by a preview of Australia, this nation having been influenced significantly by developments in the United Kingdom.[22] The position in the United States will also be discussed by way of comparison.

United Kingdom

Discussion of the topic of corporate governance in its modern formulation first came to the fore in the early 1970s. As Boros[23] states: 'The role of institutional investors in corporate governance came to prominence in the United Kingdom in 1973 as the implications of the expansion of institutional shareholding became apparent.'[24] In addition, this year also led to the publication of a government white paper, *The Responsibilities of the British Public Company*,[25] which intimated that institutional shareholders should take a prominent role in acting as a watchdog over the management of public corporations.[26] In response to this, the Institutional Share-

[21] See Bird, *supra* n. 11, where she discusses the equivalent listing rules in the United Kingdom and the United States.
[22] For an overview of this area, see Boros, *supra* n. 3 at Chapter 3.
[23] *Ibid.*
[24] *Id.* 21.
[25] Final Report of the CBI Company Affairs Committee, chaired by Lord Watkinson, 19 September 1973.
[26] *Id.* paras. 27–33.

holders' Committee was formed to act as a governing body for institutional shareholders.

In 1982 an organisation for the promotion of non-executive directors (PRONED) began operations.[27] The recession that hit Western economies in the late 1980s provided greater impetus for activity by groups such as the Institutional Shareholders' Committee and led ultimately to the formation in May 1991 of the Committee on the Financial Aspects of Corporate Governance.[28] The key recommendations of the Committee's final report[29] were:

- That separate persons hold the position of chair and chief executive.[30]
- That there be a minimum of three non-executive directors.[31]
- That directors be able to obtain independent advice at the corporation's expense.[32]
- That an audit committee be established.[33]
- That a remuneration committee be established.[34]
- That the remuneration of the chair and chief executive be disclosed.[35]
- That directors report on the corporation's system of internal control.[36]

Following this report, the London Stock Exchange altered its listing rules to require that directors list in their annual report the extent of their compliance with the Code.[37]

Australia

The developments in Australia have followed a similar time frame to that of England. In 1984 an Institutional Shareholders Committee was established. The committee became active towards the late 1980s[38] and was formally constituted as the Australian Investment Managers' Association

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[27] In 1987 they published a Code of Recommended Practice. See the comments by Boros, *supra* n. 3 at 21–23. See also H. Bosch, 'Cadbury Report New Findings', (1993) 9 *Company Director* 23; N. Arthur, 'Chairman, Chief Executive, or Both?', (1993) 9 *Company Director* 20; B. Tricker, 'Rethinking the Role of the Board', (1993) 9 *Company Director* 30.

[28] Known as the 'Cadbury Committee' (the chair being Sir Adrian Cadbury). The Committee was established by the Financial Reporting Council, the London Stock Exchange and the accountancy profession.

[29] Published 1 December 1992.

[30] Cadbury Code, para. 1.2.

[31] *Id.* para. 1.3.

[32] *Id.* para. 2.4.

[33] *Id.* para. 4.3.

[34] *Id.* para. 3.3.

[35] *Id.* para. 3.2.

[36] *Id.* para. 3.1.

[37] Stock Exchange Listing Rules, para. 12.43(j).

[38] See E. Fry, 'Shareholders from Watch-dog Club', *Australian Financial Review*, 4 October 1990. In 1989, PRONED Australia began operations.

(AIMA) in February 1991.[39] In May 1991, the Bosch Committee[40] produced its discussion paper, *Corporate Practices and Conduct*, a second edition of which was published in 1993.[41] As noted, the Stock Exchange Listing Rules have been altered to require listed companies to state in their annual report the extent of their compliance with corporate governance practices.

United States

Corporate governance listing rules had their basis on the New York Stock Exchange in the first half of the 20th century.[42] The New York Stock Exchange presently requires that listed public companies have two outside directors[43] and that they have an audit committee.[44] The impetus for the requirement of outside directors was to bolster trading, shareholding having become increasingly concentrated in the hands of institutions.[45] Accordingly, the desire was to woo the small investor, and 'corporate democracy' was seen as essential to this process.[46] The listing standards introduced at this time were seen to be encouraging broader share ownership.[47] The requirement of audit committees occurred in the era when questionable corporate payments were under scrutiny. Therefore, to improve corporate governance a proposal was established to the effect that each corporation should have an audit committee consisting of independent directors.[48] Most recently, corporate governance in the United States has been heavily influenced by the American Law Institute's *Principles of*

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[39] Evidence to the Joint Committee on Corporations and Securities, *Role of Institutional Investors in Australia's Capital Markets*, was that the crucial event in the formation of the AIMA was when Bond Corporation became involved in the Bell Companies; Official Hansard Report, 18 May 1994, 8.

[40] The Committee was chaired by Henry Bosch and consisted of the Australian Merchant Bankers Association, the Australian Society of Certified Practising Accountants, Australian Stock Exchange Ltd, the Business Council of Australia, the Law Council of Australia (Business Law Section), the Australian Institute of Company Directors, the Institute of Chartered Accountants in Australia and the Securities Institute of Australia.

[41] The recommendations were similar to those of the Cadbury report. For points of distinction, see Boros, *supra* n. 3 at 26.

[42] D.C. Michael, 'Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act', (1992) 47 *The Business Lawyer* 1461, 1465.

[43] New York Stock Exchange, Listed Company Manual, s. 303. The requirement for independent directors was introduced on the New York Stock Exchange in 1956 and on the American Stock Exchange (see r. 121) in 1968.

[44] See the comments by Bird, *supra* n. 11 at 241. The requirement for an audit committee was introduced on the New York Stock Exchange in 1977 (see r. 303) and on the American Stock Exchange in 1980 (see r. 121).

[45] Michael, *supra* n. 42 at 1469.

[46] *Id.* 1470.

[47] NYSE Press Release (3 April 1959).

[48] See H. Kripke, 'The SEC, Corporate Governance, and the Real Issues', 36 *Business Lawyer* 173 (1981).

Corporate Governance: Analysis and Recommendations.[49]

> The [American Law Institute] project recommends that large, public corporations should have a majority of directors who are free from any significant relationship with corporation's senior executives, unless a majority of the company's shares are owned by a single person, a family group or control group, in which case they should have at least three directors who are capable of satisfying this requirement.[50]

As can be seen from this summary, major Western economies are moving towards a more prescriptive model of corporate governance which would require that the board adopt a monitoring role. To achieve this result, it is necessary for the board to have a majority of independent non-executive directors — to have otherwise will only lead to a conflict of interest between the role of the board as watchdogs and their performance as executive personnel. Given this model of corporate governance, where does the institutional investor fit in? What has become clear with the changes in the helm at Coles Myer, IBM, Westinghouse and GM is that institutional investors can be crucial in the role that they play in bringing about changes in the board structure to reflect the modern standards of corporate governance.[51] Thus we have come to a position in 1996 whereby institutional investors have increasingly been seen to have a role in changing boardroom structure. The issue is whether they will go further: i.e. will they institute litigation when they observe corporate malfeasance, for example, will they utilise the derivative action?[52]

3. THE INCENTIVES AND DISINCENTIVES FOR INSTITUTIONAL SHAREHOLDER ACTIVISM[53]

The principal incentive for institutional shareholders to take action is the fact that because of their sheer size and weighting, the ability to just liquidate their investment by selling is markedly reduced. Ironically, in many respects the institutional shareholder with a significant holding in the

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[49] American Law Institute (ALI), *Principles of Corporate Governance: Analysis and Recommendations* (31 March 1992).

[50] Bird, *supra* n. 11 at 242. On the whole, the approach of the American Law Institute has been to define the responsibilities of the board as a whole rather than the approach of individual directors. It should also be noted that in Canada the following report on corporate governance has been released: Toronto Stock Exchange Committee on Corporate Governance, *Where Were the Directors?: Guidelines for Improved Corporate Governance in Canada* (Draft Report, 16 May 1994).

[51] See *supra* n. 3.

[52] It has been proposed that Australia introduce the statutory derivative action. See *supra* n. 4. Also see Ramsay, *supra* n. 4; Kluver, *supra* n. 4; L. Larose, 'Suing in the Right of the Corporation: A Commentary and Proposal for Legislative Reform', (1986) 19 *University of Michigan Journal of Law Reform* 499.

[53] For an overview of this area see Boros, *supra* n. 3 at 31–39.

public corporation is in many ways in a similar position to the minority shareholder in the private corporation — locked in and unable to realise their investment, or at best the realisation of their shareholding at a value less than what it is seen to be worth.[54] Another basis for intervention by institutional shareholders is a downturn in the economy or, further, a recession. Obviously, when times are buoyant and institutional investors are obtaining a return on their investment, they are less likely to interfere with the management of a corporation. Public pressure can also act as an incentive to institutional investors to increase their public standing within the community.[55]

Despite these incentives to take legal action, there are many disincentives.[56] First, as mentioned, the costs of taking action, or indeed of adopting a monitoring role of the corporation, may exceed the benefits. This will be particularly so where the economy is strong and profits are buoyant. There will be little incentive to intervene if the financial returns are good. In addition, the competition amongst the major equity managers is intense and the costs associated with monitoring will not be justified should this lead to lower returns than the competitor who is not adopting any watchdog role. Similarly, many equity managers may be required by market pressures to provide quarterly returns, regular payment of dividends and short-term profits — this being mandated by competitors in the industry.[57] Institutional shareholders have been said to:

> Take a short-term view, thus undermining managerial interest in the long-term development of the business. Institution managers' readiness to sell out, when an above-market bid price is offered, intensifies managers' preoccupation with the short-term.[58]

Another disincentive for institutional shareholders in taking an active role is their potential to be labelled as directors[59] and the possible liability

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[54] For a discussion of the position in the private company, see L. Griggs, 'The Relationship of the Rule in Foss v. Harbottle to the Statutory Remedies for Minority Shareholders' (unpublished LLM thesis, University of Tasmania, 1993).

[55] As Boros, *supra* n. 3 at 31, comments: 'The passive stance taken by institutions in the corporate collapses of the 1980s has attracted widespread criticism, particularly in Australia.'

[56] For an overview of this area, see Boros, *supra* n. 3 at 32.

[57] If one company is providing quarterly returns and regular dividend distributions, the onus will then be on the competitors to do likewise. On this point, see J. Coffee, 'Liquidity versus Control: The Institutional Investor as Corporate Monitor', (1991) 91 *Columbia Law Review* 1277.

[58] As indicated by the Australian Securities Commission in its submission to the House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (Canberra: AGPS, 1991), 145–6. Stapledon, *supra* n. 1 at 251, note 4, where he outlines the incentives and disincentives for institutional investors to take a proactive role in the management of a corporation.

[59] See s. 60 of the *Corporations Law* which provides that a director is a person 'in accordance with whose directions or instructions the directors ... are accustomed to act.' There is the potential for institutional investors to be considered directors within this meaning should they adopt a monitoring role.

that may flow from this.[60]

The disincentives of institutional activism are most dramatically shown by the decision of *Prudential Assurance Co. Ltd v Newman Industries Ltd (No. 2)*.[61] Prudential held 3 per cent of the shares of Newman Industries. They alleged that two of the directors of Newman Industries had defrauded the corporation of over £400,000. Whilst Prudential was successful at first instance, the Court of Appeal in allowing the appeal in part stated:

> We were invited to give judicial approval to the public spirit of the plaintiffs who, it was said, are pioneering a method of controlling companies in the public interest without involving regulation by a statutory body. In our view the voluntary regulation of companies is a matter for the city. The compulsory regulation of companies is a matter for Parliament. We decline to draw general conclusions from the exceptional circumstances of the present case. But the results of the present action give food for thought.[62]

Whilst there is no doubt that the disincentives are significant, institutional shareholders can have a proactive role in the management of corporations. Furthermore, given their relative weighting on the share registry of major corporations, the option of simply liquidating their investment may be less appealing now than in the past,[63] or it simply may not be possible.[64] Indeed, it has been demonstrated with corporations such as Coles Myer, IBM and Westinghouse that institutional shareholders can take an important role in altering the board structure of a corporation. By contrast to the small shareholder, institutional investors by reason of 'their large shareholdings and economies of scale minimise the disincentive to act as effective monitors'.[65]

A survey of Australian public corporations in 1990–91 found that they were especially sensitive to institutional investors. Institutional shareholders could therefore be a potential 'third force' in corporate decision-making, alongside the board and the general meeting. Because of their significant stake in individual corporations, it is argued that institutional shareholders could discourage board actions that serve to benefit managers at the expense of shareholders. This could be achieved by threatening

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[60] Once an institution is considered to be a director, the whole range of directors' duties and responsibilities are potentially applicable to them. These include the duty to act honestly (*Corporations Law*, s. 232(2)); the duty to take reasonable care (*Corporations Law*, s. 232(4)); and the duty not to make improper use of position or information (*Corporations Law*, s. 232(5) and (6)). In addition, directors must be mindful of the insolvent trading provisions (*Corporations Law*, s. 588G).

[61] [1982] Ch 204.

[62] *Id.* 224. Compare decisions such as *Re Northern Engineering Industries plc* [1993] BCLC 1151; *Walker v Standard Chartered Bank plc* [1992] BCLC 535; and *Re Marco (Ipswich) Ltd* [1994] 2 BCLC 354 where arguably the judges demonstrated a greater awareness of the need for appropriate corporate governance principles.

[63] Because there is no person willing to pay what the institution is demanding.

[64] There may be no buyer(s) for such a significant stake in a company.

[65] Tomasic and Bottomley, *supra* n. 9 at 309.

to exercise voting power in a particular way at a general meeting — for example, in support of a resolution to remove directors from the boards. Another method would be for the institution to threaten to sell its shareholding in the corporation, with the consequent effect on the market price of the corporation's securities. Moreover, because of their significance in the investment market, institutional shareholders can keep the board aware of the market's assessment of its performance.[66]

There is, however, empirical evidence which suggests the institutional investors are not performing this role,[67] the reasons being previously outlined.[68] Furthermore, institutional investors have obligations first and foremost to their own clients and only then to the corporation in which they have invested. This may lead to potential conflicts of interest should they adopt a monitoring role.[69]

There is also further evidence that even if institutional investors take a more proactive role in the management of corporations, shareholder litigation will be, and is, rare, and the situation will not alter if Australia introduces the statutory derivative action. Experience from the United States is that shareholder derivative actions are infrequent despite the presence of contingency fees.[70]

> [L]itigation commenced by shareholders appears to be a relatively rare occurrence in Australia. Out of the approximately 900 judgments reported in the *Australian Corporations and Securities Reports* for the period September 1989 to March 1994 only 93 judgments involved litigation which was commenced by a shareholder.[71]

The real problem in Australia in terms of shareholder litigation is likely to be costs. Contingency fees are not permitted to the same extent as in the United States, and with more advantageous cost rules for litigation in that jurisdiction one suspects that the likelihood of shareholder litigation in this country will remain rare, despite the introduction of the statutory derivative action and the presence of greater institutional presence on share registries. The question now to be addressed is the extent to which the statutory derivative action which has been utilised in Canada can overcome the problems for the institutional shareholder in correcting corporate malfeasance.

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[66] *Ibid.*

[67] See the comments by Ramsay and Blair, *supra* n. 1.

[68] See Part 2 of this article.

[69] See the comments by B. Black, 'Agents Watching Agents: The Promise of Institutional Investor Voice', (1992) 39 *UCLA Law Review* 811.

[70] Ramsay, *supra* n. 12 at 175, comments that: 'One study of 179 public companies in the United States found that, on average, a company is involved in a shareholder derivative action or shareholder class action only once every 17.5 years. The author of the study found that larger companies tend to be more involved in shareholder litigation. However, even for this group of companies (the largest 40 companies) the incidence of shareholder litigation, adjusted for multiple suits, was only one incidence of shareholder litigation every 11.9 years.'

[71] *Ibid.*

4. STATUTORY DERIVATIVE ACTION

Canada has (unlike New Zealand, Australia and England) enacted a statutory derivative action for the use of minority shareholders. This was adopted in Canada following the recommendations of various law reform committees such as the Lawrence Committee[72] and the Dickerson Committee.[73] In the words of the Dickerson Committee, the new statutory provision:

> ... requires a shareholder who seeks to bring a derivative action to obtain a court order before commencing legal proceedings. At one stroke, this provision circumvents most of the procedural barriers that surround the present right to bring a derivative action and, incidentally, minimises the possible abuse of 'strike suits' that might otherwise be instituted as a device to blackmail management into a costly settlement at the expense of the corporation. ... In effect this provision abrogates the notorious rule in *Foss v. Harbottle* and substitutes for that rule a new regime to govern the conduct of derivative actions. In the preface (page v) to the second edition of this text, *Modern Company Law* Professor Gower states that '... an attempt has been made to elucidate the mysteries of the rule in *Foss v. Harbottle*. I believe that I now understand this rule, but have little confidence that readers will share this belief.' We have been so persuaded by Professor Gower's elucidation of these 'mysteries' that we have relegated the rule to legal limbo without compunction, convinced that the alternative system recommended is preferable to the uncertainties — and obvious injustices — engendered by that infamous doctrine.[74]

The *Canada Business Corporations Act* (CBCA) introduced the statutory derivative action in 1974. The section reads:

> 232(1) Subject to subsection (2) a complainant may apply to a court for leave to bring an action in the name and on behalf of the corporation or any of its subsidiaries, or intervene in an action to which any such body corporate is a party, for the purpose of prosecuting, defending or discontinuing the action on behalf of the body corporate.
>
> (2) No action may be brought and no intervention in an action may be made under subsection (1) unless the court is satisfied that:
>
> (a) the complainant has given reasonable notice to the directors of the corporation or its subsidiary of his intention to apply to the court under subsection (1) if the directors of the corporation or its subsidiary do not bring, diligently prosecute or defend or discontinue the action;
>
> (b) the complainant is acting in good faith; and

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[72] Interim Report of the Select Committee on Company Law, Ontario, 1967.

[73] Proposals for a New Business Corporations Law for Canada, Information Canada, Ottawa, 1971.

[74] *Id.* para. 482.

(c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.[75]

Is the Statutory Derivative Action Personal or Derivative?

Beck states that:

> The critical threshhold question in shareholder litigation ... is whether the action is personal or derivative. It was the answer to this question that tripped the plaintiffs in *Farnham v. Fingold* which was potentially the most significant corporate action ever launched in Canada, and which has bedevilled the course of action in *Goldex Mines Ltd v. Revill et al.*[76]

In *Farnham v Fingold*[77] the minority shareholders sought to share in the premium that the controlling shareholders had received on the sale of their shares. The action was brought by a minority shareholder on behalf of himself and all other shareholders, except the defendants, alleging a breach of fiduciary duty owed by the majority to the minority. The defendants sought to strike out the action on the basis that the action was derivative, and therefore it could only be brought pursuant to the legislative provision dealing with statutory derivative actions, and this required leave of the court.

The Ontario Court of Appeal held that the statement of claim was concerned with damage allegedly suffered by the corporation and therefore, leave should have been requested to bring a statutory derivative action, rather than the instituting of a personal action. 'It was clear in Farnham that the plaintiffs were not themselves sure as to whether their claim was personal or derivative and they tried to have it both ways.'[78] The case is therefore important because it indicates that it is the responsibility of the plaintiff to correctly identify whether the cause of action is personal or derivative.

Goldex Mines v Revill concerned a fight for control of Probes Mines Ltd. At issue was misconduct by the directors and defendant shareholders, including misleading proxy solicitation; however, it was not clearly stated whether the claim was personal or derivative. Leave to bring an action had not been sought. This was the central issue. Was leave required?

The Ontario Court of Appeal ultimately concluded that the endorsement was deficient as it failed to differentiate between personal claims

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[75] Many of the provinces of Canada have statutory derivative actions which are similar to the federal provisions: see *Alberta Business Corporations Act 1981*, s. 232; *Manitoba Business Corporations Act 1976*, s. 232; *New Brunswick Corporations Act 1981*, s. 164; *Ontario Business Corporations Act 1981*, s. 245; *Saskatchewan Business Corporations Act 1978*, s. 232; and *British Columbia Company Act 1979*, s. 225.

[76] S.M. Beck, 'The Shareholders Derivative Action', (1974) 52 *Canadian Bar Review*, 157 at 169.

[77] [1972] 3 OR 688; 33 DLR (3d) 156 (Ont. CA).

[78] Beck, *supra* n. 76 at 181.

and derivative claims. The case is therefore authority for the proposition that, while derivative and personal actions may be joined in the one writ, it is necessary to distinguish each cause of action in the statement of claim.

These two cases establish that if an institutional minority shareholder wants to seek redress for misconduct, it will be vitally important to determine whether the cause of action is personal or derivative and to correctly endorse the statement of claim. This will become of crucial importance if the statutory derivative action is introduced into Australia.[79]

Standing to Bring a Derivative Action

Section 231 of the CBCA provides for an application for a statutory derivative action to be made by 'complainants'. This term includes past and present shareholders and creditors and anyone considered a 'proper person' at the court's discretion. The term 'proper person' was considered by Wallace J in *Re Daon Development Corp.*[80] His Honour stated:

> The section requires that the category ['proper person'] be composed of those persons who have a direct financial interest in how the company is being managed and are in a position — somewhat analogous to minority shareholders — where they have no legal right to influence or change what they see to be abuses of management or conduct contrary to the company interest.[81]

Adopting this definition, Wallace J refused to allow a debenture holder standing to bring a statutory derivative action. The view of Wallace J has been criticised as being 'unnecessarily restrictive and one which it is hoped will not be followed by future courts'.[82] In particular, it could be submitted that employees should have standing to bring a statutory derivative action. They stand to lose their livelihood through mismanagement, a consequence not likely to happen to an investor with a diversified portfolio.[83]

> Finally and importantly, the category of applicants should not remain or become static. The changing face of capitalism and the role which corporations play in furthering its aims dictate the necessity of flexibility. ... Any fears

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[79] In Canada the right to bring a common law derivative action has been excluded by the legislation introducing the statutory derivative action. See *Shield Development Co. Ltd v Snyder* [1976] 3 WWR 44 (BCSC). The distinction between personal and derivative actions also arises with the oppression remedy. See J.G. MacIntosh, 'The Oppression Remedy: Personal or Derivative?', (1991) 70 *Canadian Bar Review* 29.

[80] (1984) 54 BCLR 235.

[81] *Id.* 243.

[82] M.A. Maloney, 'Whither the Statutory Derivative Action?', (1986) 64 *Canadian Bar Review* 309, 318.

[83] *Id.* 318–19.

> regarding floodgate possibilities or limitless applicants can be dealt with by the other procedural or substantive requirements.[84]

The Prerequisites for Bringing a Statutory Derivative Action

The prerequisites for the complainant to bring a statutory derivative action are (1) that the complainant give reasonable notice to the directors of the corporation, (2) that the complainant be acting in good faith, and (3) that it is in the interests of the corporation that the action be brought.

Notice

The requirement of notice has been loosely interpreted. In *Armstrong v Gardner*,[85] letters sent to the managing director, detailing the minority shareholders' complaint but without any particularity, were held to be sufficient.[86]

The Good Faith Requirement

This requirement could be used to disallow suits brought by disgruntled minority shareholders in the hope that the company will settle the matter quickly, rather than pursue litigation which is time-consuming and expensive.

> Indeed it is difficult to justify the need for the good faith requirement in any case. If a wrong has been committed and the other prerequisites fulfilled, it should make little, if any, difference whether a plaintiff's motives are pure or not. This is all the more the case if the main reason for allowing statutory derivative actions is to ensure some watchdog role over corporate management which society cannot do or does not wish to undertake for administrative and expense reasons. The other procedural devices already deal adequately with malicious or unmeritorious actions.[87]

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[84] *Id.* 319.
[85] (1978) 20 Ontario Report (2nd) 648.
[86] See also *Bellman v Western Approaches Ltd* (1981) 33 BCLR 45.
[87] Maloney, *supra* n. 82 at 320.

The Interests of the Corporation Must be Served by Bringing the Action

The section requires that the court be satisfied that it is in the interests of the corporation that the action be brought, prosecuted, defended or discontinued. Does this allow a court to reject a valid cause of action if they consider that it is not in the interests of the company to continue the action? In the Canadian context this issue was discussed in *Bellman v Western Approaches Ltd.*[88] In this case the minority shareholders alleged that the directors had breached their fiduciary duty. The board of directors requested a law firm to investigate the allegations. The conclusion of the law firm was that there was no evidence to support the allegations. The minority shareholders sought leave to commence a derivative action.

The court held that the legal report was inconclusive as regards the substantive issues and that it could not be said that the resolution by the directors following this report was impartial. Accordingly, it was in the interests of the company that the action be brought.

Maloney criticises this requirement:

> It moves the derivative action increasingly away from a policy-oriented, macro-level to a micro-level measure designed to fit the individual circumstances of a company. ... Even from a fairly narrow perspective, the company must be viewed as a continuing concern which must encompass the interests of past, present and future shareholders, creditors and (one would hope) employees. From a broader perspective, given the major economic force of the modern corporation, it must also have an interest in society's needs and/or at least, economic concerns. Viewed in this light it is nearly impossible to delineate all the criteria and different needs of the various interest groups and then judge which, if any, is the appropriate course of action. Obviously a macro view of the corporate world is required.[89]

Ratification

Section 242 of the CBCA states that an action shall not be:

> ... stayed or dismissed by reason only that it is shown that an alleged breach of a right or duty owed to the corporation or its subsidiary has been or may be approved by the shareholders of such body corporate, but evidence of approval by the shareholders may be taken into account by the court in making an order. ...

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[88] *Supra* n. 86.

[89] Maloney, *supra* n. 82 at 328.

Treating ratification as something to be taken into account, yet not to be determinative of the matter, allows the premise of majority rule to remain yet gives the minority shareholder a remedy if his or her 'rights, expectations and obligations' have been infringed. It will allow the judiciary flexibility and discretion in determining the boundaries of majority rule.[90]

Schreiner comments that:

> ... the courts will now have to formulate new criteria of permissible conduct on the part of directors, and set new limits to the extent to which they will intervene in the so-called internal affairs of companies. ... What is important to note here is that the mere fact of or potential for ratification will not automatically prevent a suit being heard.[91]

Conclusion on the Statutory Derivative Action

There is no doubt that the statutory derivative action has an important role to play in the correction of abuses by directors:

> The next decade may prove decisive for the fate of the statutory derivative action. It is only hoped that the courts will fully grasp its significance and role in society. As corporations become increasingly powerful, as management becomes increasingly isolated from criticism and accountability, the derivative action may be one of the few remaining methods of ensuring some accountability. The courts, with the help of the legislature, should attempt to ensure that the derivative action plays the pivotal role for which it was designed.[92]

In Australia the introduction of the statutory derivative action would greatly increase the range of remedies for the minority shareholder. It could then play a pivotal role in correcting abuses of management. The statutory derivative action also has some advantages over the oppression remedy. To correct a wrong done to the company via s. 260 of the *Corporations Law* requires proving some form of injustice to obtain an order that the company institute proceedings against the wrongdoers. In essence, you go to court to obtain an order for further litigation. It is obviously a circuitous route to correct wrongs to the company. In this sense the statutory derivative action provides a quicker and more efficient way to correct wrongs to the corporation. Having said this, the likely use of

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[90] *Id.*

[91] O.C. Shreiner, 'The Shareholder's Derivative Action: A Comparative Study of Procedures', (1979) 96 *South African Law Journal* 203, 235. See also the comments of the Dickerson Committee, *supra* n. 73 at 487.

[92] *Id.*

the statutory derivative action is still likely to be small. The incentives and benefits that flow from institutional activism are not yet apparent, particularly when the risk liability for costs remains.[93]

5. CONCLUSION

The landscape for managerial control of companies has altered with the growth of superannuation and managed funds in that it allows greater institutional involvement in Australian public corporations. What we have seen so far has been a desire to implement appropriate corporate governance procedures to ensure the transparency and accountability of public enterprises. The attention is now being focused on the role of the institutional shareholder in this matter. However, because of the cost associated with the litigation, the competition between managed funds and the disincentive to interfere in profitable times, actions by institutional shareholders are likely to be limited to non-litigious measures. Are we likely to see any alteration with the introduction of the statutory derivative action? One suspects not. Shareholder litigation is rare, and the desire for institutions to become involved in the management of corporations has not been demonstrated. Indeed, if appropriate corporate governance principles are to be undertaken by corporations, the impetus is likely to come not from litigious pressures but from non-litigious measures.

[93] Another possibility for activism against corporate wrongdoers is for action to be taken by the Australian Securities Commission pursuant to s. 50 of the *Australian Securities Commission Law*. This provision allows for the ASC to take action in the public interest in the name of the company for the recovery of damages for fraud, negligence, default, breach of duty or other misconduct. For a discussion of this provision, see D. Richardson, 'Section 50 of the Australian Securities Commission Act 1989: White Knight or White Elephant?', (1994) 12 *Companies and Securities Law Journal* 148.