Comments on the purpose and spirit of derivative actions

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A derivative action allows a shareholder to bring an action on behalf of the corporation. The shareholder effectively "stands in the shoes" of the corporation and prosecutes the action when management of the corporation refuses to do so.

In *1719349 Alberta Ltd v 1824766 Alberta Ltd*, 2023 ABKB 207 (*171 v 182*), the Alberta Court of King's Bench confirmed that courts must be careful not to inappropriately interfere in the management of companies when analyzing a director's decision and deciding whether a derivative action is in the interests of the corporation. This stems from the business judgment rule, which suggests that courts should grant deference to decisions made by directors because directors are often best suited to determine what is the interests of the corporation. In line with this rule, courts should not allow a derivative action to proceed if it arises from a director's decision that falls within the range of reasonable alternatives accessible to the director.

Background

171 v 182 involved a dispute between shareholders and directors of 1824766 Alberta Ltd (182) over a real estate development project (the Project). The Project was completed in December 2015 and was significantly over budget. By 2016, the mortgages on the property had not been paid, and 182 had not repaid 171 for funds owing under the parties' lending agreement. 182 subsequently sold off the units in the Project to pay off the mortgages and builders' liens. The proceeds of these sales were paid in full to 182, which then used part of the proceeds to pay out the mortgages on the units.

The statutory tests for a derivative action

Justice Bensler noted that to bring a derivative action on behalf of a corporation under section 240 of the Alberta *Business Corporations Act*, there are four statutory tests to be met:

- The applicant must meet the requirements to be a "complainant" under the *Business Corporations Act*;

- Adequate notice to the directors of the corporation must be given;
- The complainant must be acting in good faith in bringing the application; and
- The court must be satisfied that the derivative action would be in the interests of the corporation.

Both parties accepted that 171 was a proper complainant under the *Business Corporations Act*, and that adequate notice was given in the application. Accordingly, the issues on the application were based on the third and fourth requirements from section 240, namely:

- Whether 171 acted in good faith in bringing the derivative action application; and
- Whether it was in the interests of 182 to grant leave to bring the derivative action.

The 'good faith' requirement

Justice Bensler highlighted that the primary concern when determining the existence of good faith is whether the proposed derivative action is frivolous or vexatious. A certain level of self-interest by the party proposing the derivative action is permissible, so long as this interest aligns with the interests of the corporation. Animosity alone is also not enough to determine that a complainant lacks good faith. In this instance, although the principals of 171 were potentially motivated by a personal vendetta against the principal of 182, it did not escalate to a level indicating bad faith. As a result, the good faith requirement was satisfied.

The 'interests of the corporation' requirement

Justice Bensler then considered whether the application brought by 171 was in 182's interests. This evaluation requires a balancing exercise, including an analysis of the benefits and costs of bringing the derivative action. While it is never in the interests of a corporation to prosecute an action which is doomed to fail, the complainant must do more than simply demonstrate the action is *not* doomed to fail. For example, where an action will cost far more to prosecute than it can possibly yield in damages, or where pursuing a claim is not worth the reputational damage to the corporation, it is not in the corporation's interests.

Against this foundation, Justice Bensler found at the outset that it was likely the action would be barred by the section 3(1) of the Alberta *Limitations Act*. Pursuant to this section, if a claimant fails to bring an action within two years of when they knew or ought to have known of the existence of the claim, the action is barred, and the defendant is entitled to immunity from the action. In this case, the Court held that 171 would have had knowledge of the sale at the time they occurred in 2016. Because the limitation period expired two years later in July 2018, the derivative action was likely statute-barred and therefore not in 182's interests.

Notwithstanding the limitations issue, Justice Bensler also held that the derivative action was not in 182's interests based a cost/benefit analysis. In particular, she found that the wrongdoing in these circumstances arose from the outstanding amounts owed to 171 under the parties' lending agreement. Conversely, 182 did not suffer any loss as the investment vehicle for the Project because 182 was paid the full purchase price for the units. This meant that the derivative action was in 171's interests as a lender to 182, but

it was not in 182's interests as the corporation which oversaw the development of the Project. In addition, pursuing damages again parties who paid a slightly reduced purchase price in line with market value did not justify the costs required to litigate the derivative action.

Finally, Justice Bensler acknowledged that 182's decision to sell the units was reasonable, given that the construction contractor and the subcontractors were demanding payment and there were outstanding mortgages against the Project units. The business judgment rule exists to prevent courts from inappropriately interfering with business decisions made by directors, so long as the decision lies within a reasonable range of alternatives. In this case, the decision to sell the units was deemed reasonable, particularly because 182's principal was better positioned than the court to determine what served the interests of 182.

The Court's residual discretion

Further to the above analysis, Justice Bensler noted that leave to grant a derivative action is an equitable remedy, meaning the Court retains a residual discretion to refuse a derivative action even where the statutory tests are met. Here, Justice Bensler indicated she would otherwise exercise her discretion and refuse leave for the derivative action because the pleadings failed to demonstrate a wrong to 182 that required redress. Again, the wrong was done to 171 as the unpaid party and not to 182, which was paid in full.

Takeaways

171 v 182 demonstrates that for a derivative action to be in the interests of a corporation, the wrong must be done to the corporation itself, not to an aggrieved individual shareholder (or lender). Moreover, Courts should exercise caution when considering a derivative action against corporate directors, particularly where the directors' decisions fall within a spectrum of reasonable alternatives.

Parties contemplating an application for leave to bring a derivative action will want to take note of Justice Bensler's emphasis on the business judgment rule in determining what is in the corporation's interests, as well as her comments on the Court's residual discretion to decline a derivative action.

BLG's Andrew Pozzobon represented 182 before the Court of King's Bench and will be representing 182 on appeal. In the meantime, for more information on *171 v 182* or considerations when bringing or defending a derivative action, please reach out to one of the key contacts below.

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