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Maximization of value: expanding the test for derivative actions

Those wishing to bring a derivative action against a corporation should take note of the recent decision of *Melnyk v Acerus Pharmaceuticals Corporation*, which provides further guidance on the test for being granted leave to bring a derivative action.

That case was brought by Eugene Melnyk. While at one time Melnyk owned 61.5% of the outstanding shares of Acerus Pharmaceuticals Corporation, his ownership had shrunk to 0.015% by 2016, with a market value of approximately $5,000. Despite this minimal interest in the corporation, Melnyk commenced two actions: an individual action, and a second action which he sought to commence as a derivative action on behalf of the corporation against certain of Acerus's officers and directors.

The Court ultimately dismissed Melnyk's motion for leave to bring a derivative action on behalf of Acerus against some of its officers and directors.

In dismissing Melnyk's application, Justice Wilton-Siegel considered the test for granting leave to bring a derivative action as set out in *Re Marc-Jay Investments Inc and Levy.* Justice Wilton-Siegel held that the "interests of the corporation" test in *Marc-Jay Investments* has been incorrectly interpreted as limiting the court's inquiry to determining whether the proposed derivative action action appears to be frivolous or vexatious. This, according to Justice Wilton-Siegel, was a misreading of *Marc-Jay Investments* and, in any event, is too narrow a test. Moreover, Justice Wilton-Siegel held that *Marc-Jay Investments* incorrectly expressed the "interests of the corporation" in terms of the interests of shareholders.

Adopting *Crescent (1952) v Jones,* the Court in *Melynk* held that the test for being granted leave to bring a derivative action must consider the maximization of the value of the corporation. Inherent in any concept of maximization is the comparison between two or more alternative courses of action. In a motion under s. 246(2) of the *Ontario Business Corporations Act*, the alternatives are either to proceed with the action or to refrain from doing so, either absolutely or for a period of time.

Justice Wilton-Siegel held that the proper test requires an assessment of potential costs and benefits of each course of action. Ultimately, the inquiry is to determine whether

prosecution of a proposed action “appears to be in the interests of the corporation”. This in turn requires an assessment of the probable impact on the market value of the corporation of the costs associated with prosecuting the action relative to the probability of a successful outcome in the litigation that would increase the market value of the corporation.

Justice Wilton-Siegel considered the facts before the Court and held that granting leave to bring the action did not appear to be in the interests of Acerus.

First, Acerus was in the development stage. The use of the Acerus’s funds on litigation could adversely affect its ability to raise money.

Second, the principal allegations Melnyk raised were based solely on his belief and were not supported by any specific documentary or factual evidence. Melnyk acknowledged that he would require access to the Acerus’s records and would need to conduct examinations for discovery of relevant witnesses to compile the evidence he would rely on. Both processes would be time-consuming and expensive, factors considered by the Court.

Finally, given that Melnyk had no financial interest in the outcome, there would be no restraint on or control over the resources the Acerus would have to expend to pursue the action. As such, the prosecution of the action would necessarily involve diverting considerable time and resources without any countervailing factor that would impose a regime of proportionality on the investigations and expenditure of resources caused by Melnyk.

Justice Wilton-Siegel weighed these considerations against the possible benefit to Acerus. He also took into account that no shareholder had communicated support for or interest in the litigation. While the position of the other shareholders of a corporation may not be determinative in the context of a private corporation, Justice Wilton-Siegel held that it is a very important factor in the context of a public corporation and, in this case, should be regarded as determinative.

While Melnyk’s motion was denied, it was done so on the specific facts before Justice Wilton-Siegel. The Court acknowledged that such a determination must be done on a case-by-case basis. Accordingly, litigants should be aware that merely establishing that an action is not frivolous or vexatious will be insufficient to establish that a derivative action is in the best interests of the corporation. In light of the expanded test, applicants and defendants must ensure their motion record adequately addresses the issues raised by Justice Wilton-

Siegel in this decision.

With notes from Kate Costin