

**THE STATUTORY DERIVATIVE ACTION
UNDER THE COMPANIES ACT OF 2008:
GUIDELINES FOR THE EXERCISE OF THE JUDICIAL DISCRETION**

By

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ABSTRACT

Dr Maleka Femida Cassim

The Statutory Derivative Action under the Companies Act of 2008: Guidelines for the Exercise of the Judicial Discretion

Section 165 of the Companies Act 71 of 2008 introduces the new statutory derivative action. The section confers a pivotal function on the courts as gatekeepers to the derivative action, with an important filtering or screening function to weed out applications for derivative actions that are frivolous, vexatious or without merit. The vital judicial discretion to grant leave to an applicant to bring a derivative action entails a tension between two equally important policy objectives. A proper balance between these two underpinning policy objectives depends on the appropriate judicial interpretation and application of the three vague, general and open-textured criteria or gateways for the grant of leave to institute a derivative action. The courts have been entrusted by s 165 to flesh out the details, the contours, the ambit and the scope of these criteria. This crucially gives the courts a dominant and a decisive role in shaping the effectiveness of the new statutory derivative action. This thesis makes an original contribution to knowledge in three main respects. First, this thesis focuses on the three guiding criteria for leave, and their many nuances, interpretations and applications in certain foreign jurisdictions that have exerted an influence on the provisions of s 165. Based on experience garnered from Australian, Canadian and New Zealand law, as well as the United Kingdom and the USA, guidelines are suggested for the approach that the South African courts should adopt to the three preconditions for a derivative action. Secondly, it is submitted that the real weakness in s 165 lies in the rebuttable presumption in s 165(7) and (8), which contains a fatal flaw that renders the remedy defective and calls for legislative amendment. Pending such amendment, proposals are suggested for the proper judicial approach in the meantime to the troublesome presumption. These proposals are supported by both reasoned argument and original research on experience in certain foreign jurisdictions, particularly the USA. Thirdly, and equally importantly, a framework is suggested in this thesis for the proper exercise of the judicial discretion to make orders of costs, which is known to have plagued minority shareholders wishing to bring derivative proceedings against miscreant directors who have wronged the company. The issue of the costs of the legal proceedings is the most formidable obstacle for minority shareholders who wish to litigate derivatively to vindicate the rights of the company. It is imperative that the South African courts exercise their judicial discretion both cautiously and with wisdom in making orders of costs. Bearing in mind that the issue of costs is a major obstacle though not the only obstacle to the derivative action, this thesis also addresses (albeit briefly) other important obstacles and other aspects related to costs. These matters include the legal costs of the defendant directors in derivative actions, who are generally protected by means of indemnification and directors' and officers' insurance policies; the minority shareholder's obstacle of lack of access to corporate information; and the role of public enforcement of company law as a mechanism to surmount both the obstacle of costs and the obstacle of access to information.

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CHAPTER 1: INTRODUCTION: ANCHORING POLICIES AND PRINCIPLES

1.1 INTRODUCTION

A fundamental principle of corporate law is that one who becomes a shareholder in a company generally undertakes to be bound by the lawful decisions of the majority shareholders on the affairs of the company.¹ The principle of majority rule must, however, be balanced against the need for the protection of minority shareholders. The effective protection of minority shareholders is widely recognised as a cornerstone of a sophisticated corporate law system. Pivotal to the minority shareholder's armoury is the statutory derivative action.

The Companies Act 71 of 2008 ('the Act') accordingly introduces a new streamlined statutory derivative action. It concurrently excises the common law derivative action from our legal system and in one worthy stroke of the legislative pen banishes the infamous rule in *Foss v Harbottle*² together with the exceptions to the rule to the annals of history. The procedural barriers and hindrances, and the problematic concepts of fraud on the minority, wrongdoer control and the ratifiability principle which constituted hostile deterrents to the protection of minority shareholders are all jettisoned.

Under the new statutory derivative action in terms of s 165 of the Act, the court is entrusted with a key function. The court serves as the gatekeeper to derivative actions under s 165, and plays a vital screening role in the exercise of its discretion to grant or refuse permission to a minority shareholder (or other suitable stakeholder) to pursue derivative litigation on behalf of the company, when those in control of it improperly fail or refuse to do so. The discretion of the court is a filtering mechanism designed to screen out claims that are frivolous, vexatious or meritless. The court is required to

¹ *Sammel v President Brand Gold Mining Co Ltd* 1969 (3) SA 629 (A) at 678.

² (1843) 2 Hare 461, 67 ER 189.

exercise its discretion with reference to the three vague guiding criteria or gateways set out in s 165(5)(b).

Instead of rigid and detailed technical legal requirements, the legislature has enacted guiding criteria that are general and open-textured, and has left it to the courts to flesh out the details and the practical application of these criteria. The result is that the judiciary has a dominant and a decisive role in deciding the fate of the statutory derivative action. The approach that the courts adopt in interpreting the guiding criteria will have a supreme impact on the success or failure of the new statutory derivative action in South African law.

The scope and object of this thesis are aimed at developing guidelines to inform, in three main respects, the exercise of the judicial discretion in the field of the statutory derivative action. First, the focus of this thesis lies on the three guiding criteria or gateways to the derivative action, and on their many nuances, interpretations and applications particularly in relevant foreign jurisdictions. The importance of these three criteria must not be underestimated—they are the crux of the new statutory derivative action. Guidelines will respectfully be suggested for the proper judicial approach to these preconditions for a derivative action, with reference to existing principles in South African common law, recent developments and decisions of the South African courts on s 165 of the Act, and valuable lessons gleaned from other comparable jurisdictions such as Canada, Australia, New Zealand, the USA and the United Kingdom, all of which have influenced the pertinent provisions of the Companies Act of 2008.

Secondly, it will be shown in this thesis that the real weakness of s 165 lies in the rebuttable presumption in terms of s 165(7) and (8) of the Act, which contains a serious flaw that renders the remedy defective and calls for legislative amendment. Pending such amendment, guidelines are suggested in this thesis for the proper judicial approach to be adopted in the meantime to the troublesome presumption. Prophylactic measures are also recommended

to mitigate the practical dilemmas that would otherwise arise. These guidelines and prophylactic measures are supported by original research based both on the experience in the USA and reasoned analysis.

Thirdly and equally importantly, this thesis proposes a framework for the proper exercise of the judicial discretion to make orders of costs. Section 165(10) of the Act confers on the court a wide discretion to make, at any time, any order it considers appropriate relating to the costs of derivative proceedings. The risk of liability for the costs of the legal proceedings has always been and continues to be one of the most formidable impediments to the commencement of a derivative action by minority shareholders and other applicants. For the new derivative action to be a success, the courts must robustly confront the hurdle of costs, and not be reticent to tackle the issue. The framework for costs orders takes into account existing principles in South African common law, guiding principles derived from the jurisprudence developed in other comparable jurisdictions and, most importantly, the underlying policies and principles that are essential for a full understanding of the issues surrounding orders of costs—particularly the twin rationales of the derivative action, and the vital link between costs orders and the other safeguards against abuse of the new statutory derivative action. These underlying principles (both the rationale of the derivative action and the safeguards against abuse) are not only vital for a proper understanding of the policy issues underlying costs orders, but are also taken directly into account in formulating the framework for costs orders and indemnity orders.

Finally bearing in mind that orders of costs are widely acknowledged to be a major hurdle—though not the only hurdle—to the derivative action, it also forms an integral part of the scope of this thesis to briefly address other important hurdles to the derivative action and other significant aspects that form part of the wider context of the research issue on legal costs. This is essential in order to provide a comprehensive analysis. These related matters are, firstly, the issue of the legal costs of the defendant directors in derivative actions. In stark contrast with the *plaintiff* who faces a costs hurdle, the

defendant director is invariably protected against legal costs and expenses, by means of indemnification and directors' and officers' insurance policies. Secondly, the applicant's hurdle of lack of access to inside corporate information on which to base his claim has been long-recognised to be a major obstacle to the derivative action, with severe practical ramifications. This thesis thus evaluates the extent (if any) to which the new Companies Act improves the position of the applicant or plaintiff. Moreover, the hurdle of access to information impacts directly on the leave application for derivative proceedings and, more specifically, on the second guiding criterion or gateway to the derivative action (as explained in Chapter 3). Thirdly, to complete the discussion of legal costs and other hurdles and obstacles to the derivative action, this thesis discusses the role of public enforcement. Public enforcement is an innovative and useful mechanism introduced by the new Companies Act that has the potential to overcome both the cardinal hurdles faced by derivative litigants, namely the hurdle of legal costs and the hurdle of access to information. Public enforcement is quite clearly of great importance to minority shareholders who wish to have a derivative action launched.

Before turning to an exploration of the guiding criteria for leave to institute derivative proceedings, it is instructive to first consider certain foundational policies and principles relating to the statutory derivative action. While the core policies and principles are discussed below in this chapter, they are further reinforced and elaborated on in the context of each chapter of this thesis.

Chapter 2 examines the particularly elusive guiding criterion or precondition of 'good faith'. A framework for the requirement of 'good faith' in South African law is proposed, and further fundamental facets of good faith are explored. The two important preconditions that the proposed derivative action must involve the 'trial of a serious question of material consequence to the company' and that it must be 'in the best interests of the company' are discussed in Chapter 3 and Chapter 4, respectively, where guidelines are

suggested for the appropriate interpretation and the application of these preconditions for the grant of leave by the courts.

The focus of Chapter 5 lies on the rebuttable presumption in terms of s 165(7) read with (8) of the Act. This is the weakest point or Achilles heel of the new statutory derivative action, which has the potential to strangle the use of the remedy where it is most greatly needed. The shortfalls and defects of the rebuttable presumption and its practical effects are canvassed, and proposals are submitted for the reform and the amendment of the relevant provisions of the Companies Act of 2008 to cure these defects. Guidelines are also suggested for the judicial approach to the rebuttable presumption, until such time as the suggested amendments to the Act are effected.

Chapter 6 discusses the role and the relevance of shareholder ratification of a particular wrong done to the company. The Act significantly adopts the commendable and modern approach that shareholder ratification or approval is now merely one of the factors that the court may take into account, as opposed to a mechanical rule that automatically arrests a derivative action. The provision on shareholder ratification, which is contained in s 165(14) of the Act, likewise requires legislative amendment, failing which a court may on a literal interpretation easily condemn it to be nonsensical (as explained in Chapter 6).

Chapter 7 canvasses the heated issue of orders of costs as well as other important hurdles and obstacles to the derivative action. Unless the judicial discretion with regard to costs orders is exercised in a balanced and flexible manner, it could cause the early demise of the new statutory derivative action and effectively reduce s 165 to a dead letter in our law. A framework is proposed in Chapter 7 for the exercise of the judicial discretion to make orders of costs. An important component of this framework for costs orders is the pertinent foundational policies and principles, particularly the dual rationale of the derivative action and the safeguards against shareholder abuse. These policies and principles consequently form a crucial part of Chapter 7. A central

theme of the framework for costs orders is that, since a full spectrum of modernised and more effective safeguards against shareholder abuse is now built into the new statutory derivative action, it is submitted that it is no longer necessary for the courts to continue to use adverse costs orders as a safeguard against abuse. In order to justify this contention, the numerous other safeguards against shareholder abuse are also discussed in Chapter 7. Besides the obstacle of costs orders, Chapter 7 also discusses other important hurdles, obstacles and barriers to the derivative action as well as closely related issues that form part of the wider context of the research question relating to costs. These interrelated matters (as discussed above) are the legal costs of the directors who are defendants in derivative actions and who are generally insulated against legal costs by indemnification and insurance; the plaintiff's or applicant's daunting obstacle of obtaining access to information; and the potential role of public enforcement which may be used to surmount both the obstacle of costs and the obstacle of access to information. It will, furthermore, be contended in Chapter 7 that the absence of an established agency or institution for the public enforcement of South African company law is a key policy factor that the courts must be cognisant of and must bear in mind when exercising their judicial discretion to grant leave for statutory derivative actions and when making orders of costs or indemnity orders.

1.2 ANCHORING POLICIES AND PRINCIPLES

1.2.1 The Need for and Purpose of the Derivative Action

It must be borne in mind that a derivative action is brought by an applicant (such as a minority shareholder,) on behalf of a company, in order to protect the legal interests of the company. The derivative action is so called because the shareholder 'derives' his right of action from that of the company, to

redress a wrong done to the company.³ In other words, the shareholder is seeking to protect not his own rights but the company's rights. This is distinct from the situation where shareholders wish to enforce their own personal shareholder rights, in which case they would have personal redress and would thus rely on a personal action rather than a derivative action.

It is trite that where a wrong is done to the company, the 'proper plaintiff' to take legal action in respect of the wrong is the company itself, and not individual shareholders. As stated by Lord Davey in *Burland v Earle*,⁴ 'in order to redress a wrong done to the company ... the action should prima facie be brought by the company itself'. The proper plaintiff rule stems from 'the elementary principle that A cannot, as a general rule, bring an action against B to recover damages or secure other relief on behalf of C for an injury done by B to C'.⁵ The basis of the rule is the cardinal tenet of company law that a company is a separate legal entity, distinct from its shareholders.⁶ Closely related to the proper plaintiff rule is the democratic principle of majority rule and the internal management principle, that the affairs of a company are decided by the rule of the majority and that the courts will not intervene in the internal affairs of the company at the instance of an individual shareholder when the majority acts lawfully. As stated in *Sammel v President Brand Gold Mining Co Ltd*,⁷ 'by becoming a shareholder in a company a person undertakes ... to be bound by the decisions of the prescribed majority of the shareholders, if those decisions on the affairs of the company are arrived at in accordance with the law, even where they adversely affect his own rights as a shareholder'. The proper plaintiff principle and the principle of majority rule are compositely⁸ referred to as the rule in *Foss v Harbottle*.⁹

³ According to US jurisprudence; see *Schiowitz v IOS Ltd* (1971) 23 DLR (3d) 102; see also the English case *Estmanco (Kilner House) v Greater London Council* [1982] 1 WLR 2 QBD.

⁴ [1902] AC 83 (PC) at 93.

⁵ *Prudential Assurance Co Ltd v Newman Industries Ltd* (No 2) [1982] Ch 204 at 210.

⁶ As laid down in *Salomon v Salomon & Co* [1897] AC 22.

⁷ *Supra* note 1 at 678.

⁸ See KW Wedderburn 'Shareholders Rights and the Rule in *Foss v Harbottle*' (1957) 194 *Cambridge Law Journal* 194 at 198.

Despite the abolition of the common law derivative action by s 165(1) of the Act, the proper plaintiff rule continues to apply in South African law in the absence of circumstances justifying the grant of leave by the court to bring a derivative action. To this extent, the abrogation by the Act of the rule in *Foss v Harbottle* is more correctly regarded as a partial abrogation. While the proper plaintiff rule in *Foss v Harbottle* still applies, it is the exceptions to the rule in *Foss v Harbottle*—which related to the circumstances in which a common law derivative action could be instituted—that are no longer directly relevant in our law consequent on the abolition of the common law derivative action by s 165(1).

The company's power to commence litigation is vested in the board of directors, by virtue of s 66(1) of the Act which provides that, subject to the Memorandum of Incorporation, the business and affairs of a company must be managed by the board, which has the authority to exercise all the powers and perform any function of the company. The prerogative of the board of directors to manage the company includes the decision to involve the company in litigation. The decision to litigate is a commercial one which should be made by the board of directors (which manages the company) rather than the shareholders of the company. This power may of course be conferred by the company's Memorandum of Incorporation on its shareholders instead of the board of directors.

There is however a well-established common-law exception to this general principle, in that the shareholders in general meeting may intervene in the powers of the board where the board refuses or is unable, for example because of a deadlock, to institute legal proceedings on behalf of the company.¹⁰ Whether this would still apply under the new company law regime, remains to be seen. On the one hand, there is a presumption or canon of construction that a statute does not alter the existing common law more than is

⁹ See also *Edwards v Halliwell* [1950] 2 All ER 1064 at 1066 for the classic statement of the rule in *Foss v Harbottle* supra note 2.

¹⁰ *Alexander Ward & Co Ltd v Samyang Navigation Co Ltd* [1975] 2 All ER 424 (HL); see also *Marshall's Valve Gear Co v Manning Wardle & Co Ltd* [1909] 1 Ch 267.

necessary.¹¹ However, on the other hand, it is debatable whether this common law reserve power of shareholders in general meeting would override s 66(1) of the Act in the absence of an explicit provision in a company's Memorandum of Incorporation conferring on shareholders control of the decision whether or not to enter into litigation. There is Australian authority in *Massey v Wales*; *Massey v Cooney* that rejects the view that shareholders in general meeting may have this default power over legal proceedings.¹²

On the face of it, the theoretical rule that the company is the proper plaintiff to bring a legal action when it is the wronged party, is a sound and logical approach. But the rule gives rise to practical problems and may be the cause of injustice and inequity. The potential for abuse arises where the wrongdoers, who commit a wrong against the company, are the directors themselves, for instance where the directors defraud the company by usurping for themselves a corporate opportunity that belongs to the company. The classic case or the genesis of the derivative action is where the alleged wrongdoers who have harmed the company are the controllers of the company, so that the wrongdoers subsequently use their control to prevent the company from instituting legal proceedings against them to remedy the wrong that they themselves have perpetrated on the company. The danger is particularly acute when the wrongdoers have control of both the board of directors as well as the shareholders in general meeting. This occurs, for instance, where the wrongdoers are the majority on the board of directors (or are otherwise able to dominate or influence the board of directors) and are concurrently the majority shareholders of the company—so that the wrongdoers are able to exploit both their dominant position on the board as well as the shareholders in general meeting to frustrate any decision or resolution by the company to institute legal proceedings against them. For this purpose, the wrongdoers need not even hold a majority of the company's voting rights themselves; the spectrum could extend to control of a majority of

¹¹ See eg *Casserley v Stubbs* 1916 TPD 310 at 312.

¹² See eg *Massey v Wales*; *Massey v Cooney* (2003) 57 NSWLR 718 CA (NSW). There are pertinent similarities between the Act and the Australian legislation, as discussed further below.

the votes held in combination by the miscreant directors themselves and those voting with them as a result of their influence, support or simply apathy.¹³ This is the classic case for a derivative action. The need for a minority shareholder to bring a derivative action on behalf of the company, to redress a wrong done to the company, generally arises where the company itself does not institute legal action to redress the wrong done to it.¹⁴ As elucidated by Lord Denning in *Wallersteiner v Moir (No 2)*:¹⁵

‘The [proper plaintiff] rule is easy enough to apply when the company is defrauded by outsiders. The company itself is the only person who can sue. Likewise, when it is defrauded by insiders of a minor kind, once again the company is the only person who can sue. But suppose it is defrauded by insiders who control its affairs—by directors who hold a majority of shares—who then can sue for damages? Those directors are themselves the wrongdoers. If a board meeting is held, they will not authorise proceedings to be taken by the company against themselves. If a general meeting is called, they will vote down any suggestion that the company should sue themselves. Yet the company is the one person who is damnified. It is the one person who should sue. In one way or another, some means must be found for the company to sue. Otherwise the law would fail in its purpose. Injustice would be done without redress.’

The statutory derivative action is thus a paramount protective measure for minority shareholders. It enables a minority shareholder, who knows of a wrong done to the company that has remained unremedied by management (often because they are the wrongdoers), to institute proceedings on behalf of the company. The derivative action is directed not only at enabling the minority shareholder to recover damages or property for the company when the

¹³ See eg *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] 1 All ER 354 at 364.

¹⁴ See eg Maleka Femida Cassim ‘Shareholder Remedies and Minority Protection’ in Farouk HI Cassim, MF Cassim, R Cassim, R Jooste, J Shev & J Yeats *Contemporary Company Law* 2ed (2012) at 776; B Welling *Corporate Law in Canada: The Governing Principles* 3ed (2006) at 509.

¹⁵ [1975] All ER 849 (CA) at 857.

directors have improperly refused to do so, but is regarded progressively as a fundamental corporate governance tool to monitor corporate conduct and to deter managerial or directorial wrongdoing.¹⁶

But the new streamlined statutory derivative action in terms of s 165 is much wider than this and its reach extends beyond instances of wrongdoer control of the company, in contradistinction with the now obsolete common law derivative action as laid down in *Foss v Harbottle*.¹⁷ Section 165 is available to a wider class of applicants than just minority shareholders. Moreover its use is not limited to wrongs that are committed by the management or the controllers of the company—it even extends to wrongs that are committed by third parties or outsiders. This, significantly, includes those outsiders against whom the controllers of the company decline to act because they are related parties or because of their association with the outsider or their desire to shield the outsider. (Practically, however, it could be more difficult to bring a derivative claim against third parties, in view of the rebuttable presumption in s 165(7) and (8) that the grant of leave is not in the best interests of the company if the proceedings, inter alia, involve a third party).¹⁸

1.2.2 *The Discretion of the Court to Grant Leave for a Derivative Action*

A registered shareholder or a person entitled to be registered as a shareholder of the company or a related company, a director or prescribed officer of the company or a related company, a registered trade union representing employees of the company or another employee representative, or a person who has been granted standing by the court may pursue a derivative action on behalf of the company, but only with the leave of the court in the exercise of its

¹⁶ See eg the decision of the Ontario Court of Appeal in *Richardson Greenshields of Canada Ltd v Kalmacoff* [1995] BLR (2d) 197 (CA) at 205; the USA case *Diamond v Oreamuno* 24 NY 2d 494, 248 NE 2d 910, 301 NYS 2d 78 (1969); JC Coffee 'New Myths and Old Realities: The American Law Institute Faces the Derivative Action' (1992 – 1993) 48 *The Business Lawyer* 1407 at 1428 – 9. This issue is discussed further in para 1.2.3 below.

¹⁷ *Supra* note 2.

¹⁸ Maleka Femida Cassim *op cit* note 14 at 788 – 90; see further Chapter 5.

discretion. The court is thus entrusted with a pivotal role in the statutory derivative action under s 165 of the Act. It has a crucial filtering function or screening function in deciding whether or not to permit the applicant to institute derivative proceedings on behalf of the company. This judicial screening mechanism is essential, since the company itself has chosen not to sue and the institution of a derivative action would involve the company in litigation against its will. The requirement of the leave of the court provides a safeguard against unwarranted interference by disgruntled shareholders, individual directors or other applicants in the internal management of the company, and prevents them from improperly arrogating the management function which is vested in the board of directors. This approach, moreover, averts opening the floodgates to a multiplicity of actions—if the leave of the court were not required, multiple actions could be brought by a multitude of individual shareholders and other applicants concerning the same wrong inflicted on the company.¹⁹

There are five statutory prerequisites, all of which must be satisfied, for the court to grant leave for derivative proceedings. (It must be emphasised at the outset that the first two prerequisites for leave fall outside the scope of this thesis, as they are not of direct relevance to the exercise of the judicial discretion to grant leave.) First, a shareholder or other applicant with standing under s 165(2), who knows of a wrong done to the company and who wishes to see it rectified, must serve a demand on the company to institute or to continue legal proceedings to protect its own legal interests. Although s 165(2) of the Act states that ‘a person *may* [not must] serve a demand’ [my insertion], the requirement of a demand (when read with s 165(5))²⁰ is clearly a mandatory requirement for a derivative action.²¹ The court, in exceptional

¹⁹ See eg RP Austin & IM Ramsay *Ford's Principles of Corporations Law* 14ed (2010) 729; *Hercules Managements Ltd v Ernst & Young* [1997] 2 SCR 165, 211; Maleka Femida Cassim op cit note 14 at 784.

²⁰ Section 165(5) permits only a ‘person who has made a demand in terms of subsection (2)’ [my emphasis] to apply to a court for leave to bring derivative proceedings.

²¹ See Maleka Femida Cassim op cit note 14 at 784; this was recently confirmed in *Mouritzen v Greystone Enterprises (Pty) Ltd* 2012 (5) SA 74 (KZD) at para 24.

circumstances, may waive the requirement of a demand.²² Secondly, the company must serve a notice refusing to comply with the demand, or alternatively, the company must have failed to take any particular step required by s 165(4) (relating to the investigation of the demand and its response to the demand), or have appointed an investigator or committee who was not independent and impartial, or have accepted a report that was inadequate in its preparation or was irrational or unreasonable in its conclusions or recommendations, or have acted in a manner that was inconsistent with the reasonable report of an independent, impartial investigator or committee.²³ Without this requirement of inaction or improper action by the board, the power and authority of the board of directors to manage the company would be flouted or undermined. The decision to litigate is a commercial decision which is vested in the management of the company, and a shareholder or other relevant stakeholder cannot be permitted to litigate derivatively to protect the company's legal interests unless the board of directors as a corporate organ is aware of the complaint but has refused to take action or to take diligent action. Parallel recognition is given in other jurisdictions to the requirement of inaction by the board. For instance, in the Ontario legislation²⁴ it is a precondition to the grant of leave that the directors of the corporation will not bring the action, and in terms of the Australian legislation²⁵ the court must be satisfied that it is improbable that the company will itself bring the proceedings or properly take responsibility for them.²⁶ Interestingly, the requirement in the South African legislation is stricter than its Australian equivalent. While the Australian Corporations Act states that it must be 'probable'²⁷ that the company will not itself bring the proceedings, the South African Act requires an explicit notice of refusal by the company and grants the company a period of up to 60 business days, ie twelve weeks, in

²² In terms of s 165(6).

²³ Section 165(5)(a).

²⁴ Ontario Business Corporations Act R.S.O. 1990, c. B.16, s 246(2)(a).

²⁵ Australian Corporations Act 2001, s 237(2)(a).

²⁶ In terms of the New Zealand Companies Act, 1993, the court in deciding whether to grant leave must consider any action already taken or intended to be taken by the company (see s 165(2)(c) and (3)(a)).

²⁷ Supra note 25.

which to serve it (or an even longer period if the court permits).²⁸ This stricter requirement under the Act is perhaps unnecessarily rigorous, and could foreseeably lead to practical difficulties.

The remaining three prerequisites for the judicial grant of leave for a derivative action are that the court must be satisfied, in terms of s 165(5)(b), that the applicant is acting in good faith; that the proceedings involve the trial of a serious question of material consequence to the company; and that it is in the best interests of the company that the applicant be granted leave. Notably, ratification or approval by shareholders of any particular wrongdoing is not a bar to a derivative action, although the court may take this into account.²⁹ The judicial discretion to grant or refuse leave for derivative proceedings must be exercised with reference to the three guiding criteria set out in s 165(5)(b). If these criteria are satisfied, the court 'may' grant leave; in other words, the court retains a residual discretion to refuse leave even if all these criteria are met. But conversely, in order for the court to grant leave, all these criteria must be met. In this regard, s 165(5) states that the court may grant leave 'only if' these criteria are satisfied. Once an applicant has been granted leave, he is then in a position to commence or continue the derivative action on behalf of the company.

The approach that the courts adopt in exercising their discretion to grant leave is a matter of supreme importance, that will have a major impact on the effectiveness (or lack of effectiveness) of the new statutory derivative action. Due to the open-textured nature of the guiding criteria in s 165(5)(b), the approach that the courts take in interpreting and applying the criteria will largely determine the fate of this remedy in South African law. It is to be hoped that the courts will deal with leave applications in a flexible and robust manner so as to advance and promote the use of s 165, as opposed to a narrow or restrictive interpretation of the leave criteria that would stultify the use of the statutory derivative action and relegate it to a redundant status as a 'white

²⁸ Section 165(4)(b).

²⁹ Section 165(14).

elephant’.

1.2.3 The Exercise of the Court’s Discretion in the Light of the Purpose and Objects of the Derivative Action

Good and effective legal protection for minority shareholders is a central pillar of a well-developed corporate law system. This applies even more so in light of recent developments and the increasing emphasis on minority shareholder protection in the context of corporate governance. The derivative action is increasingly viewed as a significant corporate governance mechanism, which is directed not only at obtaining compensation for the company from errant directors and others who cause harm to it, but also at the deterrence of future misconduct by directors.³⁰ It is important that the potential for shareholders to play a valuable role in corporate governance be fully realised, through the effective use of the statutory derivative action as an instrument for shareholder control of corporate misconduct.

The dual nature of the statutory derivative action was expressed by the Ontario Court of Appeal in *Richardson Greenshields of Canada Ltd v Kalmacoff* as follows:³¹

‘[A] derivative action brought by an individual shareholder on behalf of a corporation serves a dual purpose. First, it ensures that a shareholder has a right to recover property or enforce rights for the corporation if the directors refuse to do so. Second, and more important for our present purposes, it helps guarantee some degree of accountability and to ensure that control exists over the board of directors by allowing shareholders the right to bring an action against directors if they have

³⁰ See further Chapter 7 for a more detailed discussion of the rationale and the purposes of the derivative action.

³¹ *Supra* note 16 at 205. The statutory provisions of Canadian legislation relating to the statutory derivative action have exercised a strong influence on the South African statutory derivative action. Canadian jurisprudence is accordingly relevant in the South African context. This is discussed further in para 1.2.4 below. See in this context s 5(2) of the Act.

breached their duty to the company’.

Similarly, the USA case *Diamond v Oreamuno*³² proclaimed that the purpose of the derivative suit is not merely to compensate the company, but also to deter. A successful derivative action has the added benefit of deterring *future* misconduct by directors, to the advantage of the shareholders. It also would deter misconduct by directors of other companies.³³ The real prospect of liability, with attendant financial loss, reputational loss and loss of social status,³⁴ serves as a deterrent to directorial wrongdoing and violations of the duties owed by directors to their companies, and would thereby ensure some degree of accountability by directors and managers of companies. The derivative action could potentially be very useful in promoting good corporate governance in South African law, provided that it is given a full life as an effective remedy by which shareholders may hold corporate management accountable and punish managerial misconduct.³⁵

In light of these vital purposes of the derivative action, the courts must not impose artificial confines on its availability. Without effective mechanisms to enforce the fiduciary and statutory duties of directors and prescribed officers, directors would be immune from legal control and accountability.³⁶ The previous common law derivative action was hampered to a large extent by an underlying judicial policy and attitude of hostility to minority shareholder litigation, which resulted in the imposition by the courts of various procedural barriers and obstacles to minority shareholders seeking redress.³⁷ As long ago

³² Supra note 16.

³³ Coffee op cit note 16 at 1428 – 9.

³⁴ Ibid.

³⁵ See further Chapter 7 for a more comprehensive discussion of the role of the derivative action in corporate governance.

³⁶ This is not to suggest that shareholder litigation is the primary or initial mechanism for corporate governance, nor that it is the only mechanism for holding directors accountable. Other mechanisms—all of which significantly have their own flaws—include social and market forces, the market for takeovers or market for corporate control, and shareholder voting.

³⁷ Eg issues relating to standing, the problematic concept of wrongdoer control of the company, the ratifiability principle, the confusion between a wrong done to the company and a wrong done to the shareholder. See eg AJ Boyle *Minority Shareholders’ Remedies* (2002) 7 – 10 and 12 - 13; LS Sealy ‘The Problem of Standing, Pleading and Proof in Corporate Litigation’ in BG Pettet (ed) *Company Law in Change* (1987) 1 – 3; LS Sealy ‘The rule in Foss v Harbottle: the Australian experience’ (1989) 10(3)

as 1970 the Van Wyk de Vries Commission³⁸ had recognised the strong need for a change in policy in the arena of the derivative action. More recently, the policy paper of the Department of Trade and Industry, entitled 'Company Law for the 21st Century',³⁹ highlighted the importance of directorial accountability, the protection of shareholder rights, the advancement of shareholder activism and the need for enhanced protection for minority shareholders.⁴⁰ For the new statutory derivative action to play a useful role as a watchdog in policing boards of directors, it must be given teeth by the courts by means of a liberal and robust interpretation.

A robust judicial interpretation of the leave criteria is buttressed by the stated purposes of the Act. Among the relevant purposes of the Act are the encouragement of high standards of corporate governance,⁴¹ the encouragement of the efficient and responsible management of companies,⁴² and balancing the rights and obligations of shareholders and directors within companies.⁴³ The promotion of these purposes of the Act by means of an efficient and effective derivative action would, in turn, strengthen investor confidence⁴⁴ and promote investment in the South African markets, which is yet another object of the Act.⁴⁵ It would also promote an effective environment

Company Lawyer 52. The Australian courts, in contrast with the English (and South African) courts, were willing to adopt a more liberal attitude to minority shareholder litigation. This was evidenced for instance by the development in the Australian case *Biala Pty Ltd v Mallina Holdings Ltd (No 2)* (1993) 11 ACLC 1082 (WA) of a fifth exception to *Foss v Harbottle*, in the interests of justice. (See also *Aloridge Pty Ltd v Western Australian Gem Explorers Pty Ltd* (1995) 13 ACLC 196 and *Christianos v Aloridge Pty Ltd* (1995) 131 ALR 129).

³⁸ Van Wyk de Vries Commission of Enquiry into the Companies Act, Main Report RP 45/1970 para 42.13 – 14.

³⁹ *Government Gazette* 26493 of 23 June 2004 at para 2.2.3, para 4.4.1

⁴⁰ See also *Memorandum on the Objects of the Companies Bill, 2008*, Companies Bill [B 61D--2008] at para 1.2.4.

⁴¹ Section 7(b)(iii).

⁴² Section 7(j).

⁴³ Section 7(i).

⁴⁴ The provision of effective remedies to deter managerial misconduct and maintain good corporate governance is essential to investor confidence. See eg the Australian Corporate Law Economic Reform Program (CLERP) Proposals for Reform, *Directors' Duties and Corporate Governance: Facilitating Innovation and Protecting Investors*, Paper No 3, 1997 at 7 – 11; Companies and Securities Advisory Committee, *Report on a Statutory Derivative Action*, (July 1993) at 4; American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* (1994) at 597 and s 7.10(b).

⁴⁵ In terms of s 7(c).

for the efficient regulation of companies.⁴⁶ Significantly, the court is enjoined by s 158(b)(i), when determining a matter or making an order in terms of the Act, to promote the spirit, purpose and objects of the Act.

As a practical matter of administration and enforcement, it must be borne in mind that South Africa currently does not have a strong established state body or enforcement agency which rigorously enforces company law. The imposition of personal liability on directors for wrongdoing and breach of their duties depends largely on shareholder enforcement. It is envisaged⁴⁷ or hoped that part of the burden would ultimately be shifted from shareholder enforcement to enforcement by the Companies and Intellectual Property Commission (and the Takeover Regulation Panel), and in this spirit s 165(16) usefully clarifies that the right to apply to court for leave for derivative proceedings may be exercised by the Companies Commission (or Takeover Regulation Panel) on behalf of a minority shareholder or other suitable applicant. Nevertheless, presently in South Africa the success of the statutory derivative action largely depends on shareholders (and other suitable applicants) to enforce the rights of the company and to play an active role in the legal control of directors, often at their own personal expense, time and convenience. In striking contrast is Australia with its Australian Securities and Investments Commission (ASIC), which is a prominent state regulatory body, also responsible for the investigation and enforcement of the provisions of the Corporations Act, 2001, including the general statutory duties of directors under ss 180 – 184 of the Corporations Act. This is a further practical factor which the South African courts must take into account in dealing with applications for leave under s 165 that are brought by shareholders who are prepared to take the initiative to protect the legal interests of the company.

But in applying the judicial discretion to grant or refuse leave, it is an equally important policy consideration that there should be checks and

⁴⁶ As required by s 7(1).

⁴⁷ 'Company Law for the 21st Century' *Government Gazette* 26493 of 23 June 2004 at para 2.2.3, para 4.4.1. The issue of public enforcement is discussed further in Chapter 7.

balances to prevent the abuse of the derivative action. There is a risk of minority shareholders and other applicants bringing frivolous or vexatious proceedings to harass the management of the company. There also exists the potential for opportunistic shareholders (and other applicants) to exploit s 165 by using it for 'strike suits' or 'greenmail',⁴⁸ in order to extract personal benefits for the applicants themselves as opposed to benefits for the company (as discussed further below). The prime control measure or safeguard is that the leave of the court is required to commence or continue derivative proceedings. This enables the court to weed out nuisance claims that are frivolous, vexatious or unmeritorious. The three criteria for leave in terms of s 165(5)(b) are designed to curtail frivolous and vexatious claims.⁴⁹

The judicial discretion to grant leave for derivative proceedings thus involves a tension between two equally important policy objectives, which must be balanced against each other. On the one hand is the benefit of a right of redress, whereby a stakeholder may seek redress on the company's behalf where the company or those in control of it improperly fail or refuse to do so, and on the other hand is the indisputable need to protect companies and their directors from nuisance actions by stakeholders that are frivolous or vexatious or without merit. The friction or tension between these two opposing policies is an underlying theme of s 165, which may be expected to cause difficulties and complexities in practice.⁵⁰

⁴⁸ See Maleka Femida Cassim op cit note 14 at 777, 795.

⁴⁹ See eg Maleka Femida Cassim op cit note 14 at 777, 786; see further Chapter 2 below; see also Chapter 7 for a discussion of the checks and balances contained in s 165 to prevent the abuse of the derivative action by shareholders and others.

⁵⁰ See eg *Cohen v Beneficial Industrial Loan Corp* (1949), 337 US 541; see also *ibid*.

1.2.4 *Comparable Jurisdictions*⁵¹

This section discusses, in broad terms, the foreign jurisdictions that have been selected for the comparative studies within this thesis, and the reasons for this. Additionally and more importantly, each discrete chapter of this thesis addresses in greater detail precisely which foreign jurisdictions are relied on for purposes of the comparative analysis of the topic covered in that particular chapter, together with a full motivation and explanation of the reasons for this.

It is noteworthy that the South African statutory derivative action is based on models similar to those adopted in some Commonwealth jurisdictions, notably Australia, Canada, New Zealand and Singapore, all of which centre on the need to obtain the leave of the court before commencing a derivative action. Consequently, useful lessons may be gleaned from the experience and decisions of the courts on leave applications in these jurisdictions. This view is reinforced by s 5(2) of the Act, which enjoins the courts to consider foreign law, to the extent appropriate, in interpreting or applying the Act.

The South African provisions, however, are unique in a material respect. In terms of s 165 of the Act, there is a dual screening mechanism for a derivative action: first, an investigation must be conducted by an independent and impartial person or committee appointed by the board of directors of the company, and secondly, the leave of the court must be obtained. While the latter requirement is based on the Commonwealth models, the former requirement is inspired by American law, which depends not on judicial supervision but rather on the supervision of the derivative action by a committee of independent directors.⁵²

⁵¹ See Appendix 1, which contains extracts of the statutory provisions on derivative actions of those foreign jurisdictions that are particularly relevant to this thesis and that form the basis of the comparative study, namely Australia, Canada, New Zealand and the United Kingdom. Although US law is also discussed in this thesis, it is the US case law that is relevant rather than the US legislation or statutory law.

⁵² As indicated above, insofar as this thesis examines the exercise of the judicial discretion, it does not discuss the first screening mechanism in detail (save where it is directly relevant to the exercise of the judicial discretion), and focuses instead on the second mechanism.

Historically South Africa was one of the earliest common law countries to enact a statutory derivative action, in terms of the previous Companies Act 61 of 1973, following Ghana, which was the first common law country to do so in its Companies Code, 1963. These early models, however, differ in significant ways from the new South African statutory derivative action and are not directly relevant to its interpretation.

The most influential model of the statutory derivative action is the Canadian model, which has inspired the modern trend in common law countries to enact statutory derivative actions rather than to rely on an ineffectual common law derivative action. This has formed part of Canadian legislation since the 1970s and centres on an application to court for leave combined with judicial oversight of the remedy. Canada was perhaps positively influenced by USA law, in which the derivative action is long-standing, having originated from common law principles established in 1882 in *Hawes v City of Oakland*,⁵³ which are now found in statutory form.⁵⁴ The Canadian prototype served as the basis for the New Zealand derivative action which was introduced in its Companies Act, 1993, and which similarly controls access to the remedy by tight judicial supervision. Singapore, at around the same time as New Zealand, enacted a statutory derivative action⁵⁵ which too was modelled on the Canadian version. In turn Australian law, informed by the New Zealand version, followed suit by introducing the remedy into its Corporations Act with effect from 2000.

Although similar trends and undercurrents may be discerned in all these Commonwealth models which were based on the Canadian model, some significant variances exist in the criteria for the grant of leave. But it is instructive to note and it must also be stressed that despite these variations, ultimately the courts in all these jurisdictions emphasise and take account of

⁵³ 104 US 450 (1882) (US Supreme Court). The derivative action was first recognised in the USA in 1855; see *Dodge v Woolsey* 59 US (18 How) 331 (1855) (US Supreme Court).

⁵⁴ Model Business Corporation Act; American Law Institute *Principles of Corporate Governance* Pt VII, Ch 1 (1994); rule 23.1 of the Federal Rules of Civil Procedure, 1966.

⁵⁵ Companies Act 1994 Cap 50, s 216A and B.

strikingly similar considerations in their overall assessment of whether or not to grant leave. The South African Act, insofar as the provisions on the guiding criteria for the grant of leave are concerned, is most closely aligned with the Australian model of the derivative action.⁵⁶

The United Kingdom, which had formulated the problematic common law derivative action and the rule in *Foss v Harbottle*, enacted its statutory derivative action at a relatively late stage, in the Companies Act, 2006. Similarly, Hong Kong only recently enacted a court-supervised statutory derivative action in 2005. All the above models without exception depend on court supervision of the remedy, in stark contrast with the USA model.

Appendix 1 of this thesis contains extracts of the statutory provisions on derivative actions of those foreign jurisdictions that are particularly relevant to this thesis and that form the basis of the comparative study, namely Australia, Canada, New Zealand and the United Kingdom. (Although US law is also discussed in this thesis, it is the US case law that is relevant rather than the US legislation or statutory law. As stated above, the derivative action in the USA was developed from the common law principles established by the courts.)

1.3 CONCLUSION

The discretion of the court to grant leave to institute derivative proceedings, as discussed above, entails a conflict between two equally important principles; first, the benefit of a right of redress by a stakeholder on behalf of the company and, secondly, the prevention of nuisance actions by stakeholders. The three leave criteria in s 165(5)(b) are designed to lay the foundation for a proper balance between the use of the remedy for the protection of minority shareholders and the abuse of the remedy by minority shareholders. This ultimately turns on the appropriate interpretation and application by the courts

⁵⁶ Compare in this regard s 237(2) – (4) of the Australian Corporations Act, 2001, and s 165(5), (7) and (8) of the Act.

of the vague, general and open-textured preconditions for the grant of leave.

CHAPTER 2: THE CRITERION OF GOOD FAITH

2.1 INTRODUCTION

This chapter focuses on the problematic requirement that the court, in order to grant leave for derivative litigation, must be satisfied that the applicant is acting in good faith. Guidelines are suggested below for the proper interpretation and application of the precondition of good faith, based on underlying corporate law principles in South African law, as well as the experience and jurisprudence of the courts in comparable jurisdictions, particularly Australia, Canada and New Zealand and, where relevant, the United Kingdom.

2.2 A FRAMEWORK FOR GOOD FAITH

2.2.1 The Meaning and Interpretation of Good Faith in South African Law

An applicant who seeks leave to institute derivative proceedings must satisfy the court that he is acting in good faith (in terms of s 165(5)(b)(i)). ‘Good faith’ is an elusive concept, the precise meaning and ambit of which is difficult to pinpoint. It is submitted that in the context of s 165 the concept of good faith may be interpreted with reference to well-established common law principles on the meaning of good faith in South African company law. These principles are rooted both in the (now abolished) common law derivative action as well as the fiduciary duty of directors to act in good faith in the best interests of the company. Just as a director has a duty to act in good faith in conducting the affairs of the company, so an applicant who wishes to pursue litigation on behalf of the company in terms of s 165 ought to act according to a similar standard of good faith. This analogy is now reinforced by the recent case *Mouritzen v*

Greystone Enterprises (Pty) Ltd,¹ in which the Kwazulu-Natal High Court stated as follows: '[the] fiduciary duty entails, on the part of every director, the same duty as required of an applicant under s 165(5)(b), namely to 'act in good faith' and 'in the best interests of the company'.'² Based on an adaptation and an extension of existing common law principles, it is submitted that the good faith criterion in s 165 comprises two facets, which are as follows:

The first facet is that the test of good faith is subjective, not objective, and relates to the applicant's state of mind. The test of good faith depends principally, but not exclusively, on honesty.³ Although honesty is subjective, there are limits to the subjective test. In the context of the duty of directors to act in good faith, the test as formulated in *Charterbridge Corporation Ltd v Lloyds Bank Ltd*,⁴ is whether an intelligent and honest person in the position of the director could, in the whole of the circumstances, have reasonably believed that he was acting in the interests of the company.⁵ These principles relating to the fiduciary duties of directors may be suitably adapted for the statutory derivative action. It may consequently be said that the quintessence of the good faith criterion in s 165 is that it is a subjective criterion, qualified by an objective criterion. The subjective aspect is that the applicant must honestly believe that the company has a valid cause of action, while the objective test is whether a reasonable person in the position of the applicant, and in light of the circumstances, could reasonably have believed that the company has a valid cause of action. In the absence of reasonable grounds for believing that the company has a valid cause of action, the applicant in derivative proceedings may be found to be subjectively lacking in good faith.⁶

To this extent, the assessment of the good faith requirement overlaps

¹ 2012 (5) SA 74 (KZD).

² Ibid at para 60.

³ Farouk HI Cassim 'The Duties and the Liability of Directors' in Farouk HI Cassim et al *Contemporary Company Law* 2ed (2012) 524, in the context of the duty of directors to act in good faith.

⁴ [1970] Ch 62 at 74. See also *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd* [1927] 2 KB 9; *Teck Corp Ltd v Millar* (1972) DLR (3d) 288 (BCSC).

⁵ Farouk HI Cassim op cit note 3 at 524 - 5.

⁶ This approach matches up with the test for the duty of directors to act in good faith in the best interests of the company.

with the requirement that the court in granting leave must be satisfied that the proposed derivative proceedings involve the trial of a serious question of material consequence to the company (in terms of s 165(5)(b)(ii)). In this regard, if the proposed derivative action does not involve the trial of a serious question and consequently has no apparent merit, then the applicant is unlikely to be acting in good faith.

It is submitted that the second facet of the good faith criterion relates to the purpose or the motive of the applicant in bringing the proposed derivative action. Bearing in mind that the purpose of a derivative action is to do justice to the company and to protect the company's legal interests (not directly those of the applicant), the good faith criterion must entail that the applicant's actions are motivated by the honest purpose of protecting the legal interests of the company, and not by the ulterior purpose of pursuing his own private interests or pursuing some advantage for which the derivative action was not conceived.⁷ This typically applies if the derivative action is used, for instance, as 'a strike suit', whereby the shareholder institutes derivative proceedings with the purpose of blackmailing or 'greenmailing' the management of the company into a settlement of the claim in which he obtains some private benefit such as the purchase of his shares at above market price. Where an applicant acts for a collateral purpose or has an ulterior motive in bringing a derivative action, it is tantamount to an abuse of the derivative action and the applicant would be in bad faith.

This submission concerning the second facet of good faith under s 165 is supported by and is consistent with the principles on good faith under the (now abolished) common law derivative action. In this regard, a plaintiff was disqualified from bringing a common law derivative action by a lack of good faith if he did not sue in the interests of the company but for some collateral purpose. For instance, in *Barrett v Duckett*⁸ (concerning the common law derivative

⁷ This submission is based on an adaptation and extension of the reasoning of the court in *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 (PC).

⁸ [1995] 1 BCLC 243 (CA).

action in English law, on which South African law was previously based), a shareholder was barred by the court from bringing a derivative action on the basis that she had a collateral purpose in pursuing the action as part of a personal vendetta against the defendant, and the action was consequently not in the interests of the company. The issue of a collateral purpose is pertinent to good faith not only in the sphere of the common law derivative action but also in the field of the fiduciary duty of directors to act in good faith. At common law the duty to act in good faith and the duty to act for a proper purpose are regarded as separate and distinct, yet also cumulative.⁹ This is now reinforced by the statutory duty of directors in terms of s 76(3)(a) of the Act, which couples the directors' duty to act in good faith with the duty of directors to act for a proper purpose. The duty to act for a proper purpose at common law has always meant that a power must be exercised for the objective purpose for which the power was conferred and not for a collateral or ulterior purpose.¹⁰ There is accordingly ample authority in South African company law in support of the contention that the duty of good faith under s 165(5)(b) encompasses the absence of any collateral purpose on the part of the applicant.¹¹

In this respect, the assessment of good faith overlaps with the best interests requirement, ie that the court must be satisfied that it is in the best interests of the company that the applicant be granted leave for the proposed derivative proceedings (in terms of s 165(5)(b)(iii)). If the proposed derivative action is not in the best interests of the company itself, the applicant's motives are likely to be suspect and the court may more readily conclude that the applicant is driven by a collateral purpose.

A collateral purpose is thus present if an applicant is using the derivative

⁹ Farouk HI Cassim op cit note 3 at 525.

¹⁰ Ibid.

¹¹ The issue of a collateral or ulterior purpose must not be confused with self-interest in the outcome of the action nor with personal animosity on the part of the applicant. While a collateral purpose amounts to an abuse of the derivative action and negates good faith, the same does not necessarily apply to self-interest or personal animosity. This is discussed further below in para 2.3 entitled 'Further Facets of Good Faith'. (A collateral purpose entails that the applicant's actions are motivated, not by the proper purpose of protecting the company's interests, but by an improper purpose involving the pursuit of some other interest for which the derivative action was not conceived.)

action not as a means of protecting the company's legal interests but as a means of seeking some other personal advantage for which the derivative action was not intended. A collateral purpose was found to exist in the context of the common law derivative action in *Portfolios of Distinction Ltd v Laird*,¹² where minority shareholders who had participated in and had benefited from the wrongful conduct brought a derivative action for the collateral purpose of drawing attention away from their own wrongdoing, and in *Konamaneni v Rolls-Royce Industrial Power (India) Ltd*¹³ where a derivative action was used as a tactic in a battle for control of the company. Other illustrations of typically bad faith derivative actions that are motivated by ulterior purposes are actions brought with the real object of disrupting the company's business in order to benefit a business competitor, and actions brought by competitors as a tactic to gain access to confidential corporate information by means of discovery.

The purpose of the good faith criterion accordingly is to protect the company against frivolous, vexatious and unmeritorious claims, and to foster the litigation of genuine grievances that are in the interests of the company. The good faith requirement will serve to filter out the abuse of derivative actions to pursue the personal purposes of the applicant himself, rather than the interests of the company as a whole.

Besides the two facets of good faith discussed above, other considerations may also be germane to determining the good faith of the applicant. These would no doubt be built up by the courts on a casuistic basis, as relevant circumstances arise. A number of further important aspects of good faith are canvassed below.

The framework of the good faith criterion proposed above is founded on an adaptation of well-grounded common law principles in South African corporate law. This framework of good faith in the statutory derivative action is bolstered further by foreign authority on the meaning of good faith.

¹² [2004] EWHC 2071 (Ch).

¹³ [2002] 1 WLR 1269.

2.2.2 Good Faith in Australia, Canada, New Zealand and Other Jurisdictions

Good faith is also a precondition for the grant of leave for derivative actions in Australian and Canadian law.¹⁴ It is not, however, an explicit requirement in the New Zealand legislation, nor in the USA under the Federal Rules of Civil Procedure. The criteria for the grant of leave under the South African Act are similar to those under the equivalent Australian legislative provisions, and the latter would accordingly be of much assistance in the interpretation of the former.¹⁵ Resort may also usefully be had to decisions of the Canadian and New Zealand courts.

The Australian *Explanatory Memorandum to the Corporate Law Economic Reform Programme Bill*¹⁶ envisaged that a court in assessing good faith would consider, first, whether there was any complicity by the applicant in the matters complained of and, secondly, whether the application is made in pursuit of a private interest rather than the interests of the company. This explanation of good faith was referred to by the court in *Fiduciary Limited v Morningstar Research Pty Limited*.¹⁷ The leading Australian case *Swansson v R A Pratt Properties Pty Ltd*¹⁸ laid down that there are two inter-related questions in determining good faith: first, whether the applicant honestly believes that a good cause of action exists and that it has a reasonable prospect of success, and secondly, whether the applicant is seeking to bring the derivative suit for a collateral purpose. These two factors will in most cases—though not always—overlap.¹⁹ The approach of Palmer J in *Swansson v Pratt* was approved in

¹⁴ Canada Business Corporations Act, R.S.C. 1985 c. C-44, s 239(2)(b); Ontario Business Corporations Act R.S.O. 1990, c. B.16, s 246(2)(b); Australian Corporations Act 2001, s 237(2)(b).

¹⁵ Maleka Femida Cassim ‘Shareholder Remedies and Minority Protection’ in Farouk HI Cassim et al *Contemporary Company Law* 2ed (2012) at 785; the High Court in *Mouritzen v Greystone Enterprises (Pty) Ltd* supra note 1 has in fact relied recently on legal principles developed in Australian law.

¹⁶ *Explanatory Memorandum to the Corporate Law Economic Reform Programme Bill 1998* at para 6.34 – 6.48.

¹⁷ [2005] NSWSC 442.

¹⁸ (2002) 42 ACSR 313.

¹⁹ Ibid at para 36 - 37.

*Mahe v Honeysett & Mahe Electrical Contractors Pty Ltd*²⁰ and has since been followed in numerous cases, including *Charlton v Baber*, *Goozee v Graphic World Group Holdings Pty Limited* and *Fiduciary Limited v Morningstar Research Pty Limited*.²¹ Australian courts have also stated that good faith means that the application is being made in good faith having regard to the interests of the company.²² *Cannon Street Pty Ltd v Karedis* declared that the concept of good faith is inextricably linked with the duty to act honestly and for no ulterior purpose.²³

There are clear congruencies between the inter-related factors on good faith in Australian law, as proclaimed by *Swansson v Pratt*, and the twin aspects of the good faith criterion in the South African context (which are derived from existing common law principles in South African law, as discussed above). The Australian approach to good faith should therefore be regarded as strongly persuasive in South African law.²⁴ The Kwazulu-Natal High Court in *Mouritzen v Greystone Enterprises (Pty) Ltd*²⁵ has recently quoted with approval the test of good faith laid down in *Swansson v Pratt*.

In considering whether the applicant honestly believes that a good cause of action exists and has a reasonable prospect of success, the Australian court in *Swansson's* case added that '[c]learly, whether the applicant honestly holds such a belief would not simply be a matter of bald assertion; the applicant may be disbelieved if no reasonable person in the circumstances could hold that belief.'²⁶ This clearly harmonises with the submission made above that the test of good faith in the South African setting is a subjective test qualified by an objective criterion. This dictum is relevant also to the proof of good faith, which

²⁰ [2005] NSWSC 859.

²¹ *Charlton v Baber* [2003] NSWSC 745; *Goozee v Graphic World Group Holdings Pty Limited* [2002] NSWSC 640; *Fiduciary Limited v Morningstar Research Pty Limited* supra note 17; see also *Carpenter v Pioneer Park Pty Limited (in liq)* [2004] NSWSC 1007.

²² *Cannon Street Pty Ltd v Karedis* [2004] QSC 104 at paras 169 - 175; *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* [2001] QSC 324 at para 27.

²³ Supra note 22 at para 175.

²⁴ See Maleka Femida Cassim op cit note 15 at 785.

²⁵ Supra note 1 at para 58.

²⁶ Supra note 18 at para 36.

is a vital matter that is addressed further below. With regard to the issue of a collateral purpose, the Australian court has held that acting for a collateral purpose means to act ‘in pursuit of interests other than those of [the company]’.²⁷ An applicant acts for a collateral purpose, for instance, if his true objective is to force the defendant directors to either pay dividends or alternatively arrange for the purchase of his shares, as occurred in *Goozee v Graphic World Group Holdings Pty Ltd*.²⁸

Turning to Canadian law, according to the Report of the Dickerson Committee,²⁹ the purpose of the requirement of good faith is to preclude private vendettas. Good faith is found to exist where there is prima facie evidence that the complainant (or applicant) is acting with proper motives such as a reasonable belief in the claim.³⁰ The assessment of good faith, as laid down in *L&B Electric Ltd v Oickle*³¹ and in *Winfield v Daniel*,³² is essentially a question of fact to be determined on the circumstances of each case. The concept of good faith is founded on honesty.³³ Strategic motives for applying for leave are indicative of bad faith.³⁴ Good faith has been said to relate to the intention of the applicant, that is, whether the application is brought with the motive and intention of benefiting the company or whether it is brought for some subliminal purpose or benefit outside that interest.³⁵ A complainant who uses the derivative action for an improper purpose, such as to exact a personal advantage from the company, or is motivated by a personal vendetta will not in

²⁷ *Fiduciary Limited v Morningstar Research Pty Limited* supra note 17.

²⁸ *Goozee v Graphic World Group Holdings Pty Ltd* supra note 21; see also *Maher v Honeysett & Maher Electrical Contractors Pty Ltd* supra note 20; *Ehsmann v Nutectime International Pty Ltd* (2006) 58 ACSR 7051; *Magafas v Carantinos* [2006] NSWSC 1459.

²⁹ Dickerson, Howard & Getz *Proposals for a New Business Corporations Law for Canada* (1971) para 482.

³⁰ *Winfield v Daniel* [2004] AF No 37, 352 AR 82 (QB).

³¹ [2006] NSJ No 119, 15 BLR (4th) 195 (CA)

³² Supra note 30.

³³ *1172773 Ontario Ltd v Bernstein* [2000] OTC 758, [2000] OJ No 4102 (QL) (Sup Ct J).

³⁴ *Abraham v Prosoccer Ltd* (1981) 119 DLR (3d) 167 (Ont HC); *Vedova v Garden House Inn Ltd* (1985) 29 BLR 236 (Ont HC).

³⁵ *Tremblett v SCB Fisheries Ltd* (1993) 116 Nfld & PEIR 139, [1993] NJ No 348 (QL) (SC).

Canadian law be regarded as being in good faith.³⁶ The same applies when an action is frivolous or vexatious. It is thus evident that Canadian law gives weight to similar factors as those suggested for South African law and espoused in Australian law.

The New Zealand legislation does not, as stated above, incorporate an explicit requirement of good faith. Good faith is not a mandatory consideration in New Zealand law, unlike the position in the Australian, Canadian and South African legislation. Despite this, the question of a collateral purpose is of paramount importance to the New Zealand courts, which do take account of whether the applicant has an ulterior motive in seeking leave to litigate derivatively.³⁷ An ulterior motive has been held to mean more than mere self-interest in the outcome of the derivative action,³⁸ and relates instead to whether there is an abuse of process.

2.3 FURTHER FACETS OF GOOD FAITH

The fundamental framework of good faith, comprising the two main facets highlighted above, forms the thrust of the inquiry into good faith under s 165. Besides these twin aspects of good faith, other elements may also be pertinent to the assessment of the good faith of an applicant who seeks leave to institute derivative proceedings. These further facets of good faith are likely to be built up by the courts on a case-by-case basis as the need and the opportunity arises. Likewise in Australian law, in *Chahwan v Euphoric Pty Ltd*³⁹ it was held that the inquiry into the applicant's good faith is not necessarily limited to the two main factors elucidated in *Swansson v Pratt*. Other key factors that are likely to be considered are discussed immediately below.

³⁶ See generally *Primex Investments Ltd v Northwest Sports Enterprises Ltd* [1995] 13 BCLR (3d) 300 (SC); *Discovery Enterprises Inc v Ebco Industries Ltd* [1997] 40 BCLR (3d) 43 (SC); *Jennings v Bernstein*, 2000 Carswell Ont. 4039 (SC).

³⁷ *Needham v EBT Worldwide Ltd* (2006) 3 NZCCLR 57 (HC); *Tweedie v Packsys Ltd* (2005) 2 NZCCLR 584 (HC).

³⁸ *Discovery Enterprises v Ebco Industries Ltd* [1999] 4 WWR 56 (BCCA).

³⁹ (2008) 65 ACSR 661; see also *Swansson v Pratt* supra note 18 at para 35.

2.3.1 *Complicity or participation in the wrongdoing*

An essential aspect of good faith is whether the applicant was complicit in the wrong of which he complains. In relation to the (recently eradicated) common law derivative action, there is clear authority that any complicity by the shareholder or participation or acquiescence in the wrong of which he complained, would preclude the shareholder from bringing a derivative action by reason of his bad faith.⁴⁰ It is submitted that complicity or participation by the applicant in the wrongdoing would probably continue to destroy good faith for the purpose of instituting the new statutory derivative action.

It must be borne in mind that where leave is denied on the ground that the applicant was involved in the commission of the wrong done to the company or on the ground that the applicant has a collateral purpose, this is because the applicant, being in bad faith, is not a suitable person to litigate on the company's behalf. But the applicant's bad faith and the resultant denial of leave to him should not be permitted to automatically signal the end of all prospects for a derivative action on the matter. If the proposed action is a valid one which is in the best interests of the company, then leave to institute derivative litigation should be granted to another more suitable applicant who seeks leave under s 165 of the Act. The purpose of a derivative action is to enforce a right that in substance is vested in the company itself, and not a right that personally belongs to the individual applicant. Consequently the company should not be penalised or wholly barred from obtaining relief by reason of the misconduct or the bad faith of any particular applicant. To permit this, would unfairly prejudice the company and improperly protect the wrongdoer or wrongdoers.

Regarding the position in comparable jurisdictions, in Australian law the requirement of good faith, as stated above, was designed inter alia to prevent

⁴⁰ See for instance *Portfolios of Distinction Ltd v Laird* supra note 12; *Nurcombe v Nurcombe* [1985] 1 All ER 65 (CA) at 69; *Towers v African Tug Co* [1904] 1 Ch 550 (CA); *Eales v Turner* 1928 WLD 173 at 181. But see further the discussion of the 'clean hands' doctrine in para 2.3.4 below.

derivative proceedings being used where there was any complicity by the applicant in the matters complained of.⁴¹ An applicant will not be permitted by means of the derivative action to benefit from his own wrongdoing.⁴² If an applicant was a direct and knowing participant in the injury inflicted on the company, the court will refuse to grant leave to the applicant to bring a derivative action on behalf of the company, since the applicant seeks to receive a benefit which, in good conscience, he should not receive. A useful illustration is provided by the facts of *Swansson v Pratt*,⁴³ in which the court refused to grant leave to a plaintiff (who was both a shareholder and director of the company) to bring derivative litigation against a former director of the company, who was also her ex-husband, for an alleged breach of his fiduciary and statutory duties. The plaintiff alleged that the defendant had concluded transactions on behalf of the company while benefiting himself and other companies in which he held an interest, and in which the plaintiff herself also held an interest. The court was not satisfied that the plaintiff was acting in good faith or that the action was in the company's best interests, and accordingly refused leave for a derivative action.

The Canadian courts have similarly held that a complainant who had participated in a decision taken by the directors in breach of their fiduciary duties, could not be granted leave as an appropriate complainant.⁴⁴

There is thus authority not only in South African law but also in other comparable jurisdictions in support of the assertion that complicity by an applicant in the wrong of which he complains, or participation by an applicant in the wrong inflicted on the company, would destroy good faith and would result in the refusal of leave for the particular applicant to bring a derivative action.

It is further submitted that this, however, should not inevitably obstruct the commencement or continuation of the derivative action by another more

⁴¹ *Explanatory Memorandum to the Corporate Law Economic Reform Programme Bill 1998* at para 6.34 – 6.48.

⁴² *Swansson v Pratt* supra note 18 at para 43.

⁴³ Supra note 18.

⁴⁴ *Gartenberg v Raymond* [2004] BCJ No 2012 (CA).

suitable applicant who is acting out of pure and genuine motives.

2.3.2 *Personal animosity, acrimony or malice*

A distinction must be drawn between applicants who are driven by a collateral purpose on the one hand, and on the other hand, applicants who have an acrimonious relationship or personal animosity or hostility against the respondents. Where an applicant has personal disputes with or bears ill-feeling against the board of directors of the company or the majority of the shareholders (or other respondents), this of itself would not necessarily amount to bad faith. As so cogently stated in *Barrett v Duckett*,⁴⁵ in the context of the common law derivative action, if personal animus prohibited a shareholder from bringing a derivative action, most derivative actions would be thwarted.

This approach is further supported and reinforced by foreign judicial authority. The Australian courts have compellingly stated that ‘it is not the law that only a plaintiff who feels goodwill towards a defendant is entitled to sue’.⁴⁶ In *Swansson v Pratt* the court drew a distinction between an applicant who is spurred on by ‘intense personal animosity, even malice’, against the respondent and an application that is brought ‘for the purpose of satisfying nothing more than the applicant’s private vendetta’.⁴⁷ While the former applicant may nevertheless be in good faith, the latter applicant would clearly not be acting in good faith. The issue of personal hostility also surfaces when determining whether the action is in the best interests of the company. The Australian law courts in *Maher v Honeysett & Maher Electrical Contractors Pty Ltd* and *Ehsman v Nutectime International Pty Ltd*⁴⁸ have found that the fact that an applicant has an element of self-interest in the outcome of the action or a high level of acrimony against the other shareholders of the company will not

⁴⁵ [1995] BCC 362 at 372.

⁴⁶ *Swansson v Pratt* supra note 18 at para 41.

⁴⁷ *Ibid.*

⁴⁸ *Maher v Honeysett & Maher Electrical Contractors Pty Ltd* supra note 20; *Ehsman v Nutectime International Pty Ltd* supra note 28.

necessarily be conclusive or even significant in assessing whether an application is in the best interests of the company, because this would occur frequently in the kinds of disputes which lead to derivative actions.

Comparable trends may be observed in Canadian and New Zealand law, which differentiate between mere self-interest and an ulterior purpose or personal vendetta. Self-interest in the outcome of the derivative action does not of itself constitute bad faith, whereas an ulterior purpose or a personal vendetta does.

The Canadian courts have thus held that self-interest does not necessarily negate good faith.⁴⁹ Instituting a derivative action may permissibly have a subsidiary benefit for the applicant.⁵⁰ Self-interest does not constitute bad faith when it coincides with the interests of the corporation.⁵¹ Furthermore, a quarrel between shareholders does not necessarily mean that either of them is in bad faith.⁵² Similarly, the New Zealand courts have held that an ulterior motive means more than mere self-interest in the outcome of the derivative action⁵³—it relates to whether there is an abuse of process.

In practice, however, the line between (permissible) intense personal animosity and the (impermissible) pursuit of a private vendetta may in certain instances be a fine distinction to draw. It is a question of fact that depends on the circumstances of each case. The court may use evidence to draw inferences about the applicant's motives and purpose in applying for leave, and the evidentiary burden may vary depending on the particular applicant's personal interest in the company and his incentive to sue on behalf of the company. (The issue of the proof of good faith is discussed further below.) The question must ultimately depend on the merits of the action from the vantage point of the best interests of the company itself. If the action has merit and it is

⁴⁹ *1172773 Ontario Ltd v Bernstein* supra note 33.

⁵⁰ *Tremblett v SCB Fisheries Ltd* supra note 35.

⁵¹ *Primex Investments Ltd v Northwest Sport Enterprise Ltd* supra note 36; *McAskill v TransAtlantic Petroleum Corp* [2002] AJ No 1580 (QB); *Abraham v Prosoccer Ltd* supra note 34; *Vedova v Garden House Inn Ltd* supra note 34.

⁵² *Armstrong v Arbour* [1994] BCJ No 1548 (SC).

⁵³ *Discovery Enterprises v Ebco Industries Ltd* supra note 36.

in the best interests of the company itself, the applicant's self-interest or motives should be of little relevance. But in contrast, if the applicant is driven by an ulterior purpose and is seeking a collateral advantage for which the derivative action was not intended, then this would be an abuse of process; in these cases good faith should be found lacking and the court should refuse leave for derivative proceedings.

The crisp question should thus be whether the action has merit and whether it is in the best interests of the company. If the action is in the company's best interests, the applicant should not be barred from instituting derivative litigation by reason of his personal animosity towards the respondents. But in the absence of a serious question to be tried, a court may be inclined to infer that the applicant could not reasonably believe that a good cause of action exists, in other words, that he lacks good faith. The merits of the case and the inquiry as to whether the proposed action is in the best interests of the company may shed light on the applicant's purpose and motive in seeking leave, which are central to the good faith inquiry. To this extent the three criteria for the court to grant leave in terms of s 165(5)(b) are linked and closely interwoven with each other.⁵⁴

2.3.3 Where an applicant is motivated by a collateral purpose but the action is in the company's best interests

In the majority of cases in which applicants for leave are motivated by an ulterior or collateral purpose, the proposed derivative proceedings will usually not be in the best interests of the company but will instead be aimed at securing the private interests of the applicant. But this is not invariably the state of affairs. The conundrum arises whether the South African courts should grant leave to an applicant, who is driven by a collateral purpose, to bring a derivative action

⁵⁴ See eg *Maier v Honeysett* supra note 20; *Goozee v Graphic World Group Holdings Pty Limited* supra note 21; *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 21; *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* supra note 22.

that is nevertheless in the best interests of the company and that is a meritorious action with good prospects of success. Two divergent approaches emerge from an analysis of judicial decisions and other authorities.

One line of reasoning is that an applicant who has a collateral purpose and who thus seeks to use the derivative action for some personal benefit for which the remedy was not conceived, should plainly be refused the leave of the court under s 165 on the basis that to grant leave in these circumstances would be to permit an abuse of process or an abuse of the derivative action. Support for this view may be derived from the Australian case *Swansson v Pratt*,⁵⁵ which states that if an applicant seeks by the derivative action to receive a benefit which, in good conscience, he should not receive (for example, if the applicant has participated in the wrongdoing with the alleged wrongdoers), the application is not made in good faith *even though the company itself stands to benefit if the derivative action is successful*. It seems that Australian law will not permit the applicant to derive a benefit from his own wrongdoing.⁵⁶

The second and opposing line of reasoning is that, since the purpose of the derivative action is that it is meant to be a watchdog over the management of the company and the rights of the company, the ulterior motives of the applicant should not be allowed to penalise the company. Maloney⁵⁷ contended, in questioning the need for the requirement of good faith in Canadian law, that if a wrong has been done to the company and the other prerequisites are satisfied, it should make little difference whether or not the applicant has pure motives. A parallel approach seems more recently to have been espoused by the English courts⁵⁸ in their interpretation of the statutory derivative action under the English Companies Act of 2006.⁵⁹ In contrast with their approach to the common law derivative action, the judicial attitude to the new English statutory

⁵⁵ Supra note 18 at para 43.

⁵⁶ Ibid.

⁵⁷ MA Maloney 'Whither the Statutory Derivative Action?' (1986) 64 *Canadian Bar Review* 309 at 320.

⁵⁸ See eg *Franbar Holdings Ltd v Patel* [2008] EWHC 1534; *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526; *Stainer v Lee* [2010] EWHC 1539 (Ch); *Stimpson v Southern Provate Landlords Association* [2009] EWHC 2072 (Ch).

⁵⁹ Section 263.

derivative action, as asserted by Mujih,⁶⁰ is apparently that an ulterior or collateral purpose or motive does not necessarily entail an absence of good faith, provided that the action is for the benefit of the company. Where the claim is for the benefit of the company as a whole, this is likely to override the ulterior motive of the applicant and it is likely to pass the test of good faith in English law.

It is submitted that the better approach for South African law to adopt would be the former one. In other words, where an applicant has an ulterior or collateral purpose which amounts to an abuse of the derivative action, he should be refused leave to bring a derivative action, notwithstanding the fact that the claim is a valid one that is in the best interests of the company. There are three reasons for this submission.

First, to do otherwise would effectively be to allow applicants to abuse the derivative action, bearing in mind that the applicant in a derivative action must litigate not to protect his personal rights but the rights of the company. The object of the derivative action must be to achieve justice for the company, and a court should not sanction any exploitation of the remedy for the acquisition of some other private advantage or benefit.

Secondly, as discussed above, where leave is denied on the basis that the applicant is driven by a collateral purpose, this is because the particular applicant is not a suitable or a qualified person to bring an action on the company's behalf. But the misconduct of an individual applicant ought not to automatically disable the company from obtaining any relief, given that the purpose of a derivative action is to enforce a right that is in substance vested in the company itself and not in the applicant personally. If the action is a meritorious one and it is in the best interests of the company, then it is submitted that it ought to remain open to *another* suitable applicant, who is

⁶⁰ EC Mujih 'The new statutory derivative claim: a paradox of minority shareholder protection (Part 2)' (2012) 33(4) *The Company Lawyer* 99 at 102 – 103; see also A Keay and J Loughrey 'Derivative Proceedings in a Brave New World for Company Management and Shareholders' [2010] *JBL* 151 at 165 – 168.

indeed acting in good faith and with proper motives, to successfully apply for leave under s 165 of the Act.

Thirdly, it must be kept in mind that in terms of s 165 of the Act, the requirements that the applicant must be acting in good faith and that the proposed derivative proceedings must be in the best interests of the company are separate and distinct prerequisites for the grant of leave. Both requirements must be independently satisfied before leave may be granted to an applicant for derivative proceedings. The South African Act is cast in an entirely different mould to the English legislation, and gives more weight to the criterion of good faith as a firm and mandatory precondition for the grant of leave for a derivative claim. In contrast, the English statutory provision⁶¹ lists good faith as merely one of the relevant criteria that the courts must take into account in considering whether to permit a derivative claim, and not as a mandatory condition for leave. Accordingly, a conflation of the requirements of good faith and the best interests of the company, in a similar vein to the approach of the English courts, would be inappropriate and misguided in the specific context of the South African Act.

There may, as discussed above, be some intersection between the criterion of good faith and the criterion of the best interests of the company. If a claim is in the best interests of the company, this could serve as a sign or an indication (though not conclusive proof) to the court of the applicant's good faith and his motives in seeking leave; whereas if the claim is not in the company's best interests, the court is more likely to reach the contrary conclusion. But notwithstanding any such linkage between the two criteria, the requirements of good faith and the best interests of the company must both be independently satisfied in order for a South African court to grant leave under s 165. This is clear from the drafting and the wording of s 165(5)(b). In this regard, s 165(5)(b) provides that the court may grant leave 'only if' it is satisfied, *inter alia*, that the applicant is acting in good faith (in terms of s 165(5)(b)(i)) '*and*' [my emphasis]

⁶¹ English Companies Act of 2006, s 263(3)(a).

that it is in the best interests of the company that the applicant be granted leave to commence or continue the proceedings, as the case may be (s 165(5)(b)(iii)).

For the above three reasons, it is submitted that the South African courts should refuse leave to an applicant to bring a derivative action where he has an ulterior or collateral purpose amounting to an abuse of the derivative action, albeit that the proposed derivative claim is a valid one that is in the best interests of the company.

2.3.4 'Clean Hands' Doctrine

Whether the 'clean hands' doctrine would apply to the good faith inquiry under the new statutory derivative action in terms of s 165 of the Act is a fundamentally important issue.

Under the (recently abolished) derivative action at common law, the 'clean hands' principle was certainly relevant.⁶² If a shareholder did not come to court with 'clean hands', he would be barred by the court from bringing a common law derivative action on the basis of a lack of good faith. The gist of the 'clean hands' principle, as laid down in *Nurcombe v Nurcombe*,⁶³ was that a minority shareholder had behaved in such a way that it would be unjust to allow a claim brought by him to succeed. To use the facts of *Nurcombe's* case as an example of the clean hands doctrine, a shareholder, who had received a lump sum in a divorce settlement which had made allowance for certain misappropriated company assets, was not allowed to bring a derivative action in respect of the misappropriated assets of the company. The effect of the clean hands principle was that if a minority shareholder had, for instance, participated in or acquiesced in the wrong of which he complained,⁶⁴ or if he sued not in the interests of the company but for an ulterior purpose,⁶⁵ he could not be regarded

⁶² *Nurcombe v Nurcombe* supra note 40; *Towers v African Tug Co* supra note 40; see also *Eales v Turner* supra note 40.

⁶³ Supra note 40; see also *Towers v African Tug Co* supra note 40.

⁶⁴ Ibid.

⁶⁵ See eg *Barrett v Duckett* supra note 8.

as being in good faith and would be disqualified from bringing a derivative action on the ground that he lacked ‘clean hands’. The precise scope of this doctrine was, however, uncertain and undefined. *Loosley v National Union of Teachers*⁶⁶ proclaimed that there must be an element of dishonesty or sharp practice.

It is questionable whether the ‘clean hands’ principle would at all be relevant to the assessment of the good faith of a person who seeks leave to bring a statutory derivative action in reliance on s 165 of the Act. If it is applicable, the effect would be to *automatically* disqualify any applicant who does not come to court with ‘clean hands’.

It is submitted that the South African courts should steer clear of mechanically applying the ‘clean hands’ doctrine to the statutory derivative action. The ‘clean hands’ concept is a defence that exists between an applicant personally and the wrongdoers; because the applicant’s conduct is tainted or the applicant has not acted with propriety, he is disqualified from bringing the action. It would consequently be anomalous in principle, as cogently maintained by Payne,⁶⁷ if the wrongdoers were permitted to rely on the ‘dirty hands’ of the applicant as a defence in a derivative action that is brought against them to vindicate rights that belong effectively or in substance to the wronged company, which is a separate legal person from the applicant himself. In short, there is no reason why the applicant’s failure to come to court with clean hands should be allowed to affect the legal interests of the company. This is not to say that all applicants with ‘dirty hands’ would be permitted to bring derivative actions. In instances where an applicant is motivated by a collateral purpose, or where an applicant has been a participant in the wrong which is the subject of the complaint, leave ought to be withheld—but the legal basis for the refusal of leave should not be the ‘clean hands’ principle. There are other more suitable legal bases (as discussed above) on which to refuse leave, besides the ‘clean hands’ principle.

⁶⁶ [1988] IRLR 157 (CA).

⁶⁷ J Payne “‘Clean Hands’ in Derivative Actions” [2002] 61(1) *Cambridge Law Journal* 76.

A rejection of the clean hands doctrine in the sphere of the statutory derivative action would also be in accordance with the guideline laid down by the Australian court in *Magafas v Carantinos*,⁶⁸ which has ruled that the courts are not to scrutinise whether the applicant has clean hands or whether there are matters that are prejudicial to the credit of the applicant.

It is notable, however, that a converse trend appears to be emerging in English law, in that the court in the English case *Iesini v Westrip Holdings Ltd*⁶⁹ did indeed refer to the clean hands concept in the context of the English statutory derivative action. The South African courts, with respect, and for the reasons advocated above, should carefully sidestep the 'clean hands' approach.

2.3.5 Proving good faith

The onus lies on the applicant to satisfy the court, on a balance of probabilities, of his good faith and of his fulfilment of the other prerequisites for leave as set out in s 165(5)(b).⁷⁰ The proof of good faith presents challenges.

The question arises as to the level of evidence that is required to establish good faith. Must the applicant actually prove that his application is brought in good faith, in which case the onus of proof is a weighty one, or will the courts presume that the applicant is acting in good faith unless the facts and circumstances of the matter show a lack of good faith? It is submitted that the better approach for the South African courts to espouse would be the latter approach. Where a derivative action appears to have merit and is in the best interests of the company, it should be presumed that the applicant is acting in good faith, unless there are objective facts and circumstances to establish otherwise. To require the applicant to positively prove his good faith would be to

⁶⁸ See *Magafas v Carantinos* supra note 28 at para 23.

⁶⁹ Supra note 58.

⁷⁰ In Australian law see eg *Swansson v Pratt* (supra note 18 at para 26) which held that the applicant bears the onus of satisfying the court that, on the balance of probabilities, the requirements for leave have been fulfilled. See also *Mouritzen v Greystone Enterprises (Pty) Ltd* supra note 1 at para 59.

impose a restrictively heavy burden that would discourage prospective applicants from seeking permission to litigate to protect the company's legal interests. More importantly, it would also give rise to the problem of how the applicant is to prove his good faith and what type of evidence would suffice, bearing in mind that good faith is largely a subjective test which depends on the applicant's state of mind or his honest belief that the company has a good cause of action. As discussed above, although the proposed test for good faith is a subjective one, it is limited or qualified by an objective inquiry; if a reasonable person, in the light of the objective circumstances of the matter, could not reasonably have believed that the company has a valid cause of action with reasonable prospects of success, the applicant's assertion of his honest belief and good faith stand to be rejected. This submission (ie an applicant in South African law should be presumed to be in good faith unless there are objective facts and circumstances to the contrary) is buttressed by considerable authority in other comparable jurisdictions, especially Canada and Australia. It is nonetheless noteworthy that even in these jurisdictions this issue has elicited conflicting approaches by both the Canadian and Australian courts.

In this regard, in Canadian law, good faith has been held to exist where there is prima facie evidence that the applicant has proper motives such as a reasonable belief in the claim.⁷¹ The issue of good faith is a question of fact to be determined on the circumstances of each case.⁷² Numerous Canadian cases have adopted the view that the applicant will be presumed to be acting in good faith where the proposed action appears to have merit. The onus then shifts to the respondents to show a lack of good faith, for instance, by showing that the applicant is pursuing a private vendetta or some other collateral purpose.⁷³ There are, however, other Canadian decisions that have espoused a divergent approach, and have ruled that a substantial onus lies on the

⁷¹ *Winfield v Daniel* supra note 30.

⁷² *L&B Electric Ltd v Oickle* supra note 31; *Winfield v Daniel* supra note 30.

⁷³ See eg *Primex Investments Ltd v Northwest Sport Enterprise Ltd* supra note 36; *Discovery Enterprises Inc v Ebco Industries Ltd* supra note 36.

applicant who must prove positively that he is acting in good faith.⁷⁴

Similar trends may be observed in Australian law. The general attitude of the Australian courts by and large is that the applicant is to be regarded as acting in good faith unless there is some factor that indicates bad faith.⁷⁵ The applicant may generally prove his honest belief that a good cause of action exists and has a reasonable prospect of success, on fairly low evidence. But this would not simply be a matter of 'bald assertion', as proclaimed in *Swansson v Pratt*.⁷⁶ The applicant may be disbelieved if no reasonable person in the circumstances could hold that belief.⁷⁷ This was approved in *Maher v Honeysett & Maher Electrical Contractors Pty Ltd*,⁷⁸ where the court added further that there are no particular means by which to prove the applicant's state of mind or honest belief, because applicants rarely know whether or not a good cause of action exists or of its prospects of success. The applicant is generally dependent on the advice of legal counsel. Accordingly a sworn statement of the applicant's good faith would usually carry little weight. '[T]he objective facts and circumstances will speak louder than the applicant's words'.⁷⁹

Although this is the approach commonly followed by the Australian courts, there are a few cases which have differed, by deciding that in the absence of any evidence to support the applicant's claims of good faith, the court will find that there was no honest belief and therefore no good faith.⁸⁰ Such an honest belief can be proved, for instance, by reliance on legal advice from counsel which is reasonably based on factual evidence.⁸¹

Accordingly, as submitted above and as fortified by authority in leading jurisdictions, the better route for South African courts to take is to presume that the applicant is acting in good faith, unless there are objective circumstances

⁷⁴ See eg *Tkatch v Heide* [1998] BCJ No 2613 (CA).

⁷⁵ See eg *BL & GY International Co Ltd v Hypec Electronics Pty Ltd* [2001] NSWSC 705; *Braga v Braga Consolidated Pty Ltd* [2002] NSWSC 603.

⁷⁶ *Supra* note 18 at para 36.

⁷⁷ *Swansson v Pratt* *supra* note 18 at para 36.

⁷⁸ *Supra* note 20 at para 33.

⁷⁹ *Maher v Honeysett* *supra* note 20 at para 33.

⁸⁰ *Goozee v Graphic World Group Holdings Pty Ltd* *supra* note 21.

⁸¹ *Carpenter v Pioneer Park Pty Ltd (in liq)* *supra* note 21.

that establish otherwise.

While an applicant's self-interest will not necessarily destroy his good faith (as discussed above), the absence of any self-interest may conversely be taken to show an absence of good faith. This certainly applied under the common law derivative action, under which it was more difficult to establish good faith if the shareholder had little incentive to sue on behalf of the company. For instance in *Harley Street Capital v Tchigirinsky (No 2)*⁸² where a shareholder, who sought to bring a common law derivative action, held less than one per cent of the company's shares, which it had purchased only after the alleged wrongdoing had entered the public domain (and thus at a price which reflected the market response to the alleged wrongdoing), the court found that the shareholder lacked good faith. Pure altruism is rarely the motive for costly and lengthy derivative litigation, particularly bearing in mind that it is the company that will benefit from the success of the action while the applicant benefits only indirectly from the enrichment of the company.

A similar trend may be gleaned from Canadian and Australian law, in which useful signposts may be unearthed to navigate the way for South African courts. In this regard, in assessing whether an applicant has a collateral purpose, the Australian courts may rely on evidence to draw inferences about the applicant's motives, and the extent to which the courts scrutinise the good faith criterion varies depending on the applicant's financial interest in the company and his incentive to sue on behalf of the company, in other words, his self-interest. According to *Swansson v Pratt*,⁸³ when an applicant has nothing obvious to gain by the success of the derivative action, the court may have reason to be more circumspect in scrutinising the good faith criterion. Conversely, good faith may be more easily established, for instance, when the applicant in a derivative claim seeking the recovery of the company's property is currently a shareholder in the company with more than a token shareholding,

⁸² [2006] BCC 209, an English case concerning the common law derivative action (on which South African common law was previously based).

⁸³ *Swansson v Pratt* supra note 18 at para 39; see also *Fiduciary Ltd v Morningstar Research Pty Ltd* supra note 17 at 740.

with the consequence that the derivative action, if successful, would increase the value of the applicant's shares. This occurred in *Magafas v Carantinos*⁸⁴ where the applicant held 50 per cent of the company's shares and the success of the derivative claim would result in an increase in the value of the shares. Similarly, if an applicant is a current director or officer of the company, good faith may be proved by showing that he has a legitimate interest in the welfare and good management of the company, and that the purpose of the derivative action is to protect these interests. This would be sufficient to justify derivative litigation to recover the company's property or to ensure that the majority of the shareholders or board of directors do not act unlawfully to the detriment of the company as a whole.⁸⁵ On the other hand, it may be more difficult to establish good faith if the applicants are shareholders with merely a token shareholding in the company, or if the applicants have nothing obvious to gain by the success of the statutory derivative action or otherwise have little incentive to sue on behalf of the company. When an applicant has little to gain and little incentive to sue on behalf of the company, he is more likely to be found to be motivated by a personal vendetta amounting to an abuse of process, for example, where there is a history of grievances against the majority shareholders or the board of directors of the company. In contrast, an applicant who stands to gain by the success of a derivative action is more likely to be found to be acting in good faith even if he is spurred on by intense personal animosity or malice against the defendant.⁸⁶

According to *Chahwan v Euphoric Pty Ltd*,⁸⁷ the test is whether as a (current or former) shareholder or director of the company, the applicant would suffer a real and substantive injury if a derivative action were not permitted, provided that the injury was dependent on or connected with the applicant's status as such shareholder or director and the remedy afforded by the derivative action would reasonably redress the injury. This test may provide a

⁸⁴ Supra note 28.

⁸⁵ *Swansson v Pratt* supra note 18 at para 38.

⁸⁶ *Swansson v Pratt* supra note 18 at para 39 - 41.

⁸⁷ *Chahwan v Euphoric Pty Ltd* supra note 39; *Swansson v Pratt* supra note 18 at para 42.

valuable point of reference for the South African courts. The Australian legislation⁸⁸ gives standing to both current and former shareholders and directors, in contrast with the South African legislation⁸⁹ which does not grant standing to former shareholders or former directors (unless they obtain the leave of the court to proceed as applicants under s 165(2)(d)). Consequently the test in *Chahwan's* case must be modified in the South African context so as to apply only to current, but not to former, shareholders or directors of the company or a related company. The test may also be extended so as to apply to the employees who are represented by the registered trade unions (and the other employee representatives) who apply for leave to institute derivative proceedings under s 165(2)(c).

Although the court may be more circumspect in scrutinising the good faith criterion where the applicant has nothing obvious to gain,⁹⁰ it nevertheless remains possible for an applicant to satisfy the requirement of good faith with neither a financial interest in the company nor any involvement in its present management. But this would be difficult to establish and additional evidence to show bona fides may be required. For example, in *Charlton v Baber*,⁹¹ a shareholder who was formerly a director of the company brought a derivative action in circumstances where, because of the company's debts, it was unlikely that in his capacity as a shareholder he would receive any financial benefit from the action. The court held that if in his capacity as a former director he had a sense of responsibility to creditors who had suffered losses, this would be consistent with good faith.

Turning to Canadian law, in a similar vein, the absence of a personal interest on the part of the applicant has been raised as evidence of a lack of good faith. In *Richardson Greenshields of Canada Limited v Kalmacoff*⁹² it was contended (albeit unsuccessfully) that the applicant, who was an institutional

⁸⁸ Australian Corporations Act 2001, s 236(1)(a).

⁸⁹ Section 165(2) of the Act.

⁹⁰ *Swansson v Pratt* supra note 18; see also *Fiduciary Ltd v Morningstar Research Pty Ltd* supra note 17.

⁹¹ *Charlton v Baber* supra note 21.

⁹² [1995] BLR (2d) 197 (CA).

investor, had no personal stake in the matter and must therefore have had ulterior objectives.⁹³ In *Discovery Enterprises Inc v Ebco Industries Ltd*⁹⁴ where the complainant (or applicant) would not receive a direct monetary benefit from the derivative action, a similar issue was raised as to his good faith. The court found, however, that the applicant had an interest in ensuring that the company was financially strong and was not acting for a collateral purpose.

It appears that in Canadian law evidence of ongoing participation by the applicant in corporate affairs would assist in proving good faith.⁹⁵ On the other hand, good faith may be negated by proof of a delay by the applicant in pursuing the matter, or by a refusal by the applicant to have regard to explanations by the alleged wrongdoers, or by strategic motives for applying for leave.⁹⁶

These are all useful guidelines for South African courts to bear in mind in interpreting and applying the open-textured criterion of good faith under the new statutory derivative action which is presently in its germinal stage of development in South African law. The principles highlighted above have common threads with familiar and accepted legal principles in South African law, and would assist in the groundwork for laying down a firm foundation for the interpretation of the concept of good faith in South African law.

2.4 CONCLUSION

In conclusion, the good faith criterion serves to protect the company against frivolous and vexatious claims, and to encourage the institution of genuine claims that are aimed at protecting the interests of the company. The good faith

⁹³ The court held that the applicant by bearing the costs and risks would promote its relationship with its clients.

⁹⁴ (1997) 40 BCLR (3d) 43 (SC).

⁹⁵ *Appotive v Computrex Centres Ltd* (1981) 16 BLR 133 (BSC); *Johnson v Meyer* (1987) 62 Sask R 34 (Sask QB).

⁹⁶ *LeDrew v LeDrew Lumber Co* (1988) 223 APR 71; *Churchill Pulpmill Ltd v Manitoba* [1977] 6 WWR 109 (Man CA); *Benarroch v City Resource (Can) Ltd* (1991) 54 BCLR (2d) 373 (BCCA); *Abraham v Prosoccer Ltd* supra note 34; *Vedova v Garden House Inn Ltd* supra note 34.

requirement is designed to function as a screening mechanism to prevent the abuse of derivative actions for the pursuit of the private objectives and purposes of the applicant.

It is submitted that two key criteria lie at the heart of the inquiry into good faith, while further fundamental facets of good faith also come to light.

In view of the elusive nature of the concept of 'good faith', the approach that the courts adopt in its interpretation will have a very significant impact on the efficacy of the derivative action. It is to be hoped that the courts will adopt a liberal approach that will advance and promote the use of the statutory derivative action. A narrow, restrictive or onerous interpretation that would emasculate the derivative action would serve only to frustrate the underlying object of the new statutory provisions relating to derivative actions.

In retrospect, it is clear from this analysis that South African company law will now be placing more reliance on guiding principles from other jurisdictions, such as Australia, Canada, New Zealand and the USA and, to a lesser extent, from the UK. The courts will undoubtedly have to rely on decided cases in these jurisdictions in order to properly interpret and apply the provisions of the South African Companies Act of 2008 relating to derivative actions.

CHAPTER 3: TRIAL OF A SERIOUS QUESTION

3.1 INTRODUCTION

This chapter discusses the second gateway or guiding criterion that the court, in order to grant leave for a derivative action under s 165 of the Act, must be satisfied that the proposed action involves the ‘trial of a serious question of material consequence to the company’. With reference to underpinning principles in South African law, and the jurisprudence developed by the courts in comparable jurisdictions, namely Australia, Canada and New Zealand, guidelines are respectfully suggested for the proper judicial approach to this gateway for a derivative action.

3.2 ANCHORING POLICIES AND PURPOSES

Leave may be granted to an applicant for derivative litigation only if the court is satisfied that the proposed proceedings (which the applicant seeks to commence) or the continuing proceedings (which the applicant seeks to intervene in or continue) involve the trial of a serious question of material consequence to the company (s 165(5)(b)(ii)). The exact interpretation of the requirement of a ‘trial of a serious question’ is a matter that falls to be decided by the courts and remains to be seen. This prerequisite for leave is a threshold test, concerning the evidence that the applicant must establish in support of his claim.

As a matter of principle, it is imperative that the courts in applying this guiding criterion steer a middle course between sifting out frivolous, vexatious, unmeritorious or unworthy actions and, equally, avoiding the danger of escalating the leave application into a ‘mini-trial’ or an interim trial of the merits of the case. The courts must thus find and then preserve the proper balance between the conflicting interests of the applicant and the company.

To elaborate, from the perspective of the company, a derivative action may have an adverse impact on the conduct of its business. Not only are legal costs incurred, but in addition a legal action would divert the time and distract the attention of the management and employees of the company, thereby disrupting its business. It could also potentially damage the company's image or reputation. There is the further possibility of adverse costs orders if the litigation is unsuccessful. The courts must consequently require some evidence that the claim does have merit.

Conversely, from the vantage point of the minority shareholder or other applicant, it is vital that leave applications be kept relatively simple, short and inexpensive. If the courts become embroiled in mini-trials of the merits, or conduct prolonged and in-depth examinations of the substantive issues of the case at the initial stage of the leave application, this would not only be inappropriately lengthy and time-consuming but would also be dissuasively costly. It must, furthermore, be borne in mind that the applicant at this stage would not have had discovery of the documents of the company and/or the true defendants (such as the miscreant directors of the company). To turn the leave application into an interim trial of the merits, without discovery, would clearly be unseemly.

Similar trends may be garnered from the (now abolished) common law derivative action and the previous statutory derivative action under the Companies Act 61 of 1973. In terms of s 266 of the Companies Act 61 of 1973, a member (or shareholder) at the initial stage of a statutory derivative action, when applying for a court order to appoint a provisional curator ad litem, was required to show that there were prima facie grounds for the proceedings. The court in *Van Zyl v Loucol (Pty) Ltd*¹ and *Thurgood v Dirk Kruger Traders (Pty) Ltd*² explicitly recognised the fundamental need for a court, in exercising its

¹ 1985 (2) SA 680 (NC) at 685.

² 1990 (2) SA 44 (E).

discretion, to prevent frivolous and vexatious applications.³

As an essential aspect in creating a satisfactory balance between the two policies discussed above—namely safeguarding against the abuse of the statutory derivative action by nuisance claims and concurrently sidestepping the risk of conducting interim trials on the merits—the test of a serious question to be tried or ‘the trial of a serious question’ is a welcome and commendable improvement in the Act. It is not the same as the standard of a *prima facie* case,⁴ but may instead be a lower and a more lenient threshold to surmount. A *prima facie* test⁵ is inappropriate in the context of the derivative action, as it carries the risk that the merits of the action may be assessed or tried at the stage of the application for leave to institute the derivative action. A lighter standard of proof, as represented by the test of a serious question to be tried, resonates better with the nature and the purpose of the derivative action.

In this regard, as discussed in Chapter 1 above, the derivative action is both a remedial and a deterrent device; it is designed both to rectify and to prevent management abuses, and to protect minority shareholders and other stakeholders.⁶ The potential for shareholders to play a valuable role in promoting good corporate governance in South African law could also be realised, by giving the remedy a full life as an effective tool by which shareholders may monitor corporate misconduct and hold corporate management accountable, particularly in the light of the increasing global emphasis on minority shareholder protection in corporate governance. In view of the vital objects of the derivative action, the test of ‘the trial of a serious

³ See also *TWK Agriculture Ltd v NCT Forestry Co-operative Ltd* 2006 (6) SA 20 (N) at 26. In *Brown v Nanco (Pty) Ltd* 1976 (3) SA 832 (W) at 835 and *Thurgood v Dirk Kruger Traders (Pty) Ltd* (supra note 2) it was held that in the context of the statutory derivative action, the *prima facie* test at the initial stage did not necessitate proof of a probability of success.

⁴ *Beecham Group Ltd v B-M Group (Pty) Ltd* 1977 (1) SA 50 (T).

⁵ See the approach to the degree of proof formulated in *Webster v Mitchell* 1948 (1) SA 1186 (W) at 1189, as subsequently qualified by the Cape Provincial Division in *Gool v Minister of Justice* 1955 (2) SA 682 (C); see also *Beecham Group v BM Group (Pty) Ltd* supra note 4 at 579A-G.

⁶ See eg the decision of the Ontario Court of Appeal in *Richardson Greenshields of Canada Ltd v Kalmacoff* [1995] BLR (2d) 197 (CA) at 205; the USA case *Diamond v Oreamuno* 24 NY 2d 494, 248 NE 2d 910, 301 NYS 2d 78 (1969); JC Coffee ‘New Myths and Old Realities: The American Law Institute Faces the Derivative Action’ (1992 – 1993) 48 *The Business Lawyer* 1407 at 1428 – 9. See further Chapter 7.

question' is a laudable improvement in the legislation, provided that it is properly applied. In interpreting this test, the courts must not impose unnecessary restrictions and limitations on the scope and the availability of the remedy. For the new statutory derivative action to play an effective role in monitoring boards of directors, the courts must give a liberal and robust interpretation to the guiding criteria for leave.

3.3 MEANING OF 'TRIAL OF A SERIOUS QUESTION' IN SOUTH AFRICAN LAW

The key question arises as to the benchmark for the merits or the standard of proof before the court may grant leave for a derivative action. The test of a serious question to be tried has been used in several South African cases on constitutional matters⁷ to determine whether interim relief should be granted.⁸ To satisfy the test of a 'serious question to be tried', according to the judgment of Heher J in *Ferreira v Levin*⁹ relying on the decision of the House of Lords in *American Cyanamid Co v Ethicon Ltd*,¹⁰ the applicant must establish that his claim is neither frivolous nor vexatious, that is to say, that there is a serious question to be tried.¹¹ The approach in the *American Cyanamid* case, as originally articulated by Lord Diplock,¹² is that: 'The court no doubt must be satisfied that the claim is not frivolous or vexatious; in other words, that there is a serious question to be tried.'

This is plainly relevant to the interpretation of the phrase 'the trial of a serious question of material consequence to the company' in the context of s

⁷ Maleka Femida Cassim 'Shareholder Remedies and Minority Protection' in Farouk HI Cassim, MF Cassim, R Cassim, R Jooste, J Shev & J Yeats *Contemporary Company Law* 2ed (2012) at 787.

⁸ See eg *Ferreira v Levin*. *Vryenhoek v Powell* 1995 (2) SA 813 (W) per Heher J; *Reitzer Pharmaceuticals (Pty) Ltd v Registrar of Medicines* 1998 (4) SA 660 (T); see also *Pikoli v President of the Republic of South Africa & Others* 2010 (1) SA 400 (GNP). However, other decisions approached interim interdicts in constitutional matters using the traditional approach that the applicant must show a *prima facie* right to the relief sought. See also *Beecham Group Ltd v B-M Group (Pty) Ltd* supra note 4.

⁹ Supra note 8.

¹⁰ [1975] AC 396; [1975] 1 All ER 504 (HL).

¹¹ See also *Chief Nchabeleng v Chief Phasha* 1998 (3) SA 578 (LCC), per Dodson J; *Van der Walt v Lang* 1999 (1) SA 189 (LCC); *Beecham Group Ltd v B-M Group (Pty) Ltd* supra note 4.

¹² Supra note 10 at 510 C – F.

165(5)(b)(ii) of the Act, notwithstanding the fact that the application for leave to institute a derivative action under s 165 is a final application and not an interim one.

The test of the trial of a serious question or a serious question to be tried has the great advantage of preventing mini-trials or interim trials on the merits at the preliminary stage of the leave application for derivative proceedings. As stated by Lord Diplock in the *American Cyanamid* case:¹³

‘It is no part of the court’s function at this stage of the litigation to try to resolve conflicts of evidence on affidavit as to facts on which the claims of either party may ultimately depend nor to decide difficult questions of law which call for detailed argument and mature considerations. These are matters to be dealt with at the trial.’

With reference to *American Cyanamid Co v Ethicon Ltd*,¹⁴ the South African court in *Nchabeleng v Phasha*¹⁵ similarly proclaimed that the test of a serious question to be tried ‘will usually free the court considering such an application from trying to decide difficult factual issues on affidavit and having to go a long way towards pre-judging issues which are best left to the trial of the matter.’

The test of a serious question to be tried is manifestly not the same as the standard of a prima facie case.¹⁶ It is more favourable and better suited to the statutory derivative action than the prima facie test. The criterion of a serious question to be tried avoids the danger inherent in the prima facie test that the merits of the action could be assessed or tried at the stage of the leave application and a heavier burden of proof could thereby be imposed on the applicant. As candidly stated in *Hurley v BGH Nominees (Pty) Ltd*,¹⁷ ‘in many cases a hearing to determine whether there was a prima facie case would be almost as long as a full trial and a good deal less satisfactory.’

¹³ Ibid.

¹⁴ Supra note 10.

¹⁵ Supra note 11.

¹⁶ *Beecham Group Ltd v B-M Group (Pty) Ltd* supra note 4.

¹⁷ (1982) 1 ACLC 387 at 394.

In contrast, the modern criterion of ‘the trial of a serious question’ is in keeping with the policy principle that leave applications for derivative actions should be relatively simple, short and inexpensive. It promotes the underpinning policy that an application for leave to bring derivative proceedings should not be turned into a trial of the substantive issues without the applicant having had the benefit of discovery. The enactment of a lower threshold test on the merits in terms of the Act is thus a commendable and welcome step by the legislature. It would, nonetheless, be preferable had the legislature adhered to the familiar phrase of a ‘serious question to be tried’, as opposed to the ‘the trial of a serious question’ in s 165 of the Act—although there seems to be little difference in meaning between the two formulations, the adherence to the more familiar formulation would have removed any room for lingering doubt on whether there is a difference in the standard or the threshold of the two tests. It is to be hoped that the courts in applying this test, would avoid becoming enmeshed in detailed investigations into the merits at the initial stage of the application for leave.

But by the same token, it is crucial that the courts do not permit s 165 to be used by minority shareholders and other applicants to conduct fishing expeditions. Rather than broad or bare allegations or mere suspicions of liability, an applicant must be required to make specific allegations of wrongdoing and ought to be able to identify the legal rights that are in issue. Bearing in mind the potentially adverse effects of a derivative action on the company and its directors, an applicant should be able to particularise his claim or allegations, supported by sufficient documentary evidence and material, to satisfy the court that the claim is viable and that there is indeed a serious question to be tried.

In practice this may present a stumbling block for prospective applicants. A minority shareholder or other applicant would only be able to make specific allegations and show that the claim has some merit if he has access to the relevant information. But this information usually is in the hands of the controllers of the company who, in the vast majority of derivative claims, are

also the alleged wrongdoers. Access to information is not particularly problematic in owner-managed companies, where minority shareholders may also have access to the relevant company information in their capacity as directors. But it is the dilemma or pitfall in larger companies where, due to the split between ownership and control, shareholders do not have ready access to information, books, records and documents of the company. The hurdle of access to information remains one of the greatest predicaments in leave applications for derivative proceedings. Although a person to whom leave has been granted has the right under s 165(9)(e) of the Act to inspect any books of the company for any purpose connected with the derivative litigation, this right applies only to successful applicants who have already been granted leave by the court—this right is of no use to an applicant in preparing his application for leave. It may however be open to the applicant, if it is applicable in the particular circumstances, to make a request for information in accordance with the Promotion of Access of Information Act 2 of 2000.¹⁸

The requirement as stated in s 165(5)(b)(ii) is that the proposed derivative proceedings must involve ‘the trial of a serious question of material consequence to the company’. Regarding the phrase ‘of material consequence to the company’ the word ‘material’, when used as an adjective, is unhelpfully defined in the Act as ‘significant in the circumstances of a particular matter, to a degree that is of consequence in determining the matter, or might reasonably affect a person’s judgment or decision-making in the matter’.¹⁹ The requirement that the issue must be of ‘material consequence to the company’ would serve to block superfluous derivative actions, such as proposed claims for the recovery of trifling, negligible or nominal amounts, or claims brought to abash or disparage directors and prescribed officers who have made imprudent, yet honest, decisions that have caused little harm to the company.

There is a significant degree of overlap between the requirement that the

¹⁸ See eg *Davis v Clutchco (Pty) Ltd* 2004 (1) SA 75 (C). See further Chapter 7 at paragraph 7.6 for a more detailed discussion of the hurdle of access to information.

¹⁹ Section 1.

question must be of 'material consequence to the company', and the third guiding criterion in s 165 that the grant of leave must be 'in the best interests of the company' (in terms of s 165(5)(b)(iii)). In assessing the criterion of the best interests of the company, relevant factors include the amount at stake and the potential benefit to the company, as discussed further in Chapter 4 below. It is submitted that these considerations are best grappled with in considering whether the grant of leave under s 165 is in the best interests of the company.

Finally, insofar as s 165 requires an applicant to seek leave to either commence legal proceedings on behalf of the company or to continue existing legal proceedings on behalf of the company, the test of the trial of a serious question of material consequence to the company would frequently be more easily satisfied in the latter instances ie where an applicant seeks to continue existing derivative proceedings, as opposed to seeking to initiate new derivative proceedings. This is because, in respect of existing derivative proceedings, leave under s 165 would already have been granted, albeit to another applicant, with the implication that the test of a serious question to be tried has already been met. This, of course, would apply only where an applicant seeks to continue existing derivative proceedings, and would not pertain to applications to continue existing legal proceedings to which the company itself is a party.

3.4 GUIDELINES FROM AUSTRALIA, CANADA AND NEW ZEALAND

When considering applications for leave for derivative actions and particularly in assessing the threshold test that the proceedings must involve the trial of a serious question of material consequence to the company, the courts may usefully resort to the decisions of the Australian courts for constructive guidelines. The Canadian and New Zealand decisions are also instructive to some extent. The submissions made in paragraphs 3.2 and 3.3 above on the anchoring purposes and the interpretation in South African law of the statutory threshold test on the merits (as represented by the test of a serious question to be tried,) are buttressed by legal authority in these comparable jurisdictions.

The South African Act has evidently adopted the Australian approach to the standard of proof. The Australian Corporations Act²⁰ similarly requires an applicant to satisfy the court that there is a serious question to be tried before leave will be granted for the institution of derivative proceedings on the company's behalf. The Australian experience and jurisprudence hold valuable lessons for the South African courts on the standard of proof for the assessment of the merits of the claim, especially in view of s 5(2) of the Act which enables a court in interpreting or applying the Act to consider foreign law. The criterion of a serious question to be tried is construed in Australian law as simply requiring the applicant to show that proceedings should be commenced, as opposed to actually proving the substantive issues (for instance, a breach by directors of their duties to the company). As such, this criterion is intended to prevent abuse of the derivative action by frivolous or vexatious claims.²¹ The test of a serious question to be tried is a low threshold test in Australian law.²² It is similar to the well-known test used in that jurisdiction for interlocutory (interim) injunction applications, according to the leading case of *Swansson v Pratt*.²³ Although it does call for some consideration of the merits of the case, the courts diligently avoid turning this into a mini-trial of the issues, and consequently do not examine the merits of the proposed derivative action in any great depth. Significantly, cross-examination of the merits has been allowed, but only with the leave of the court and then too, only to a limited extent.²⁴

Regarding the degree of specificity of the applicant's allegations, *Ragless v IPA Holdings Pty Ltd (in liq)*²⁵ laid down that the applicant must establish that there is a real question to be tried, that is to say, he must be able to specify the legal rights to be determined at the trial. An applicant must show

²⁰ Australian Corporations Act 2001, s 236(2)(d).

²¹ *Explanatory Memorandum to the Corporate Law Economic Reform Programme Bill, 1998* at para 6.46.

²² *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313 at para 25; see also *Maher v Honeysett & Maher Electrical Contractors Pty Ltd* [2005] NSWSC 859 at para 19; *Carpenter v Pioneer Park Pty Limited (in liq)* [2004] NSWSC 1007.

²³ *Supra* note 22.

²⁴ *Swansson v Pratt* *supra* note 22 at para 25; *Maher v Honeysett* *supra* note 22 at para 19; see eg *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* [2001] QSC 324.

²⁵ (2008) 65 ACSR 700 at [40]

that there is a serious question to be tried with reference to the infringement of some legal right or the commission of some legal wrong.²⁶

It has been held in Australian law that the applicant must at least provide the court with sufficient evidence and material to enable it to determine whether there is a serious question to be tried.²⁷ This could, for instance, be a comprehensive legal opinion on the merits of the action incorporating an analysis of the documentary evidence and the applicable legal principles.²⁸ The approach of the Australian courts suggests that a reasonable body of reliable evidence is required to convince the court that the proposed action is viable,²⁹ or that it appears 'to have a solid foundation in terms of giving rise to a serious dispute',³⁰ although the merits of the action will not be canvassed in any great detail.³¹ The Australian approach plainly reinforces and harmonises with the submissions made above on the interpretation in South African law of the criterion of the trial of a serious question (in terms of s 165(5)(b)(ii)) of the Act. Moreover, it yields useful lessons on the practical application of the test, which the South African courts may use as a springboard.

Similar trends may be discerned from an analysis of the legal position in New Zealand and Canada. The threshold tests for the grant of leave in the New Zealand and Canadian legislation are framed quite differently to that in South African and Australian law. Yet despite the differences in the legislative wording, conspicuously similar trends may be found in the judicial expositions and approaches to the various threshold tests in all these Commonwealth models of the statutory derivative action. This is perhaps unsurprising, given the shared history of the derivative action in these jurisdictions. In this regard, the influential Canadian model served as the fountainhead for the statutory

²⁶ *Goozee v Graphic World Group Holdings Pty Limited* [2002] NSWSC 640; *Ragless v IPA Holdings Pty Ltd (in liq)* supra note 25.

²⁷ *Charlton v Baber* [2003] NSWSC 745; see also *Maher v Honeysett* supra note 22 at para 19.

²⁸ *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 22.

²⁹ *Herbert v Redemption Investments Ltd* [2002] QSC 340.

³⁰ *BL & GY International Co Ltd v Hypec Electronics Pty Ltd* [2001] NSWSC 705 at para [75].

³¹ *Charlton v Baber* supra note 27; *Chapman v E-Sports Club Worldwide Ltd* (2000) ACSR 462; *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 22.

derivative action in New Zealand, Australia and other jurisdictions, and is apparently also the wellspring of the modernised South African statutory derivative action. A cursory survey of the judicial experience and guiding principles in Canada and New Zealand is apposite. These jurisdictions have had more experience with the statutory derivative action than Australia, which introduced its statutory derivative action a mere decade ago.

In New Zealand the relevant statutory criterion is ‘the likelihood of success’. The New Zealand legislation states³² that the court shall have regard to the ‘likelihood of the proceedings succeeding’. Unlike South African law, this is not an indispensable precondition or sine qua non for the grant of leave for a derivative action, but is merely a factor that the court must consider. The test of ‘the likelihood of success’ at first blush appears to impose a higher threshold or standard of proof than the South African (and Australian) test of a serious question to be tried. However, in the application of this test, the New Zealand courts have effectively liberalised and lowered the threshold. This was settled in *Vrij v Boyle*,³³ the first New Zealand case on the statutory derivative action.

The court in *Vrij v Boyle*, in adopting the test laid down in the English case *Smith v Croft*,³⁴ did not consider the ultimate merits of the case. Instead it clearly proclaimed that it was not for the court to conduct an interim trial on the merits.³⁵ The importance of avoiding a full assessment of the merits of the claim and of the supporting evidence at the stage of the leave application has received equal recognition in later cases, for instance, *Techflow (NZ) Ltd v Techflow Pty Ltd*³⁶ and *Needham v EBT Worldwide Ltd*.³⁷

In assessing the ‘likelihood of the proceedings succeeding’, *Vrij v Boyle* declared that ‘[t]he appropriate test is that which would be exercised by a prudent business person in the conduct of his or her own affairs when deciding

³² New Zealand Companies Act, 1993, s 165(2)(a).

³³ [1995] 3 NZLR 763.

³⁴ [1986] 1 WLR 580.

³⁵ Supra note 33 at 765.

³⁶ (1996) 7 NZCLC 261, 138.

³⁷ (2006) 3 NZCCLR 24 (HC).

to bring a claim.³⁸ Although the test of a ‘prudent business person’, purely on its wording, appears to signal a conservative and rigorous approach, the test when actually applied in *Vrij v Boyle* and generally by the New Zealand courts involves a lighter standard of proof and a much lower threshold than a prudent business person might employ.³⁹ In this regard, Fisher J in *Vrij v Boyle* focused chiefly on the legal and evidential basis of the claim in assessing the likelihood of success by means of the prudent business person test, and accepted that leave would be granted if there was sufficient evidence that ‘might be thought to take the claim some distance’.⁴⁰ As contended by Fitzsimons⁴¹ this is an even less rigorous test than ‘an arguable case’ or ‘reasonable prospects’. Subsequent New Zealand cases have adopted the approach laid down in *Vrij v Boyle*, including *MacFarlane v Barlow*⁴² and *Techflow*.⁴³ Accordingly the threshold test in New Zealand law is a fairly liberal standard and, as such, it is broadly in tandem with the low standard of proof that is likely to be required by the South African and Australian test of a ‘serious question to be tried’.

Regarding the particularisation of the claim, the New Zealand courts, similarly to the Australian courts, require the applicant at the time of the leave application to be able to adequately particularise his claims and to provide sufficient evidence to enable the court to assess in a general manner the credibility of the allegations made.⁴⁴ An applicant may not, for instance, simply state that the discovery process is likely to yield the necessary evidence.

Turning to the legal position in Canada, the Canadian legislation—in marked contrast with the South African, Australian and New Zealand legislation—does not contain an express threshold test. Instead, the Canadian

³⁸ Supra note 33 at 765. The court stated further that ‘[t]his decision must take account of matters such as the amount at stake, the apparent strength of the claim, the likely costs and the prospect of executing any judgment’ (at 765).

³⁹ P Fitzsimons ‘The Companies Act 1993: A New Approach to Shareholder Litigation in New Zealand’ (1997) 18 *Company Lawyer* 306 at 308.

⁴⁰ Supra note 33 at 766.

⁴¹ Op cit note 39 at 311.

⁴² (1997) 8 NZCLC 261,470.

⁴³ Supra note 36.

⁴⁴ *Rasheen v People & Project Solutions Ltd HC Christchurch CIV-2003-409-2877*, 4 March 2004.

judiciary simply relies on the criterion that the claim must appear to be ‘in the interests of the corporation’⁴⁵ to assess the strength of the case and to conduct a preliminary review of the merits of the proposed derivative action. The criterion of the best interests of the company, in South African law, is a separate and distinct precondition from that of a serious question to be tried, both of which must be independently satisfied in order for the court to grant leave for a derivative action.

Generally Canadian legislation requires merely that ‘the court is satisfied that it *appears* to be in the interests of the corporation’ [emphasis added] that the action be brought. This is the case, for instance, under both the Canada Business Corporations Act and Ontario Business Corporations Act.⁴⁶ However the statutes of some Canadian provinces⁴⁷ differ and provide that it must appear ‘prima facie’ to be in the corporation’s interests. Despite these differences in legislative wording among the various Canadian statutes, the courts in evaluating the strength of the case do not generally require an applicant to make out a prima facie case, but merely an arguable case that is not bound to fail.⁴⁸ This may be contrasted with Canadian injunction proceedings, in which an applicant must show a prima facie case on the merits. In other words, injunction proceedings involve a higher threshold on the merits than derivative proceedings.

The Canadian threshold test for derivative proceedings, of an arguable case that is not bound to fail, is also described in some cases as an arguable case⁴⁹ with reasonable prospects of success.⁵⁰ The ‘reasonable prospects’ aspect of the test may at first blush be misleading, in that it may be more

⁴⁵ Canada Business Corporations Act, R.S.C. 1985 c. C-44, s 239(2)(c); Ontario Business Corporations Act R.S.O. 1990, c. B.16, s 246(2)(c).

⁴⁶ Supra note 45.

⁴⁷ Such as the previous British Columbia Company Act, RSBC 1996, c 62, s 201(3)(c). But this has now been changed by the more recent Business Corporations Act RSBC 2002, c 57, s 232.

⁴⁸ *Re Northwest Forest Products Ltd* [1975] 4 WWR 724 (BCSC); *Primex Investments Ltd v Northwest Sports Enterprises Ltd* [1995] 13 BCLR (3d) 300 (SC).

⁴⁹ *Re Bellman and Western Approaches Ltd* (1981) 33 BCLR 45 (BCCA).

⁵⁰ *Re Bellman and Western Approaches Ltd* supra note 49; *Title Estate v Harris* (1990) 67 DLR (4th) 619 (Ont HC); *Re Marc-Jay Investments Inc & Levy* (1974) 5 OR (2d) 235 (HCJ).

stringently construed to mean that the proposed action must have a reasonable chance of success (as occurred for instance in *Intercontinental Precious Metals v Cooke*⁵¹ where the court imposed a higher burden of proof on the complainant by requiring proof of ‘a reasonable prospect of success’, and in *Re MacRae and Daon Development Corp*⁵²). The Canadian courts have since shed light on the matter, and the test has been clarified. In this regard, *Primex Investments Ltd v Northwest Sports Enterprises Ltd*,⁵³ proclaimed, quoting with approval the leading case *Re Marc-Jay Investments Inc & Levy*,⁵⁴ that the court does not attempt to try the case, but rather to evaluate ‘whether the proposed action has a reasonable prospect for success or is bound to fail.’ This was significantly qualified by the court as follows: ‘[i]t is not necessary for the applicant to show that the action will be more likely to succeed than not’.⁵⁵ The judicial approach accordingly is not to try the action, but to conduct a preliminary review of the merits only insofar as is necessary to avoid a proposed action that is ‘frivolous or vexatious or is bound to be unsuccessful’.⁵⁶

The courts require applicants to adduce sufficient evidence which ‘on the face of it’ discloses that it is in the interest of the company to pursue the action.⁵⁷ The real issue is whether it is *prima facie* in the interests of the company that the action be brought—it does not require that the applicants prove a *prima facie* case.⁵⁸ This is an important distinction that needs to be emphasised.

Canadian courts may thus take into account the apparent merits of the claim, although the court may not decide the merits at the stage of the application for leave.⁵⁹ The function of the court at this stage is not to try the

⁵¹ (1994) 10 BLR (2d) 203.

⁵² (1984) 54 BCLR 235 (SC of BC).

⁵³ Supra note 48 at paras 39-41.

⁵⁴ Supra note 50.

⁵⁵ *Primex Investments Ltd v Northwest Sports Enterprises Ltd* supra note 48 at paras 39 – 41, quoting with approval *Re Marc-Jay Investments Inc v Levy* supra note 50.

⁵⁶ Ibid.

⁵⁷ *Re Northwest Forest Products Ltd* supra note 48.

⁵⁸ *Re Bellman and Western Approaches Ltd* supra note 49.

⁵⁹ *Commonwealth Trust Co v Canada Deposit Insurance Corp* [1990] 79 CBR (NS) 183 (SC).

case, for it should not be a mini-trial or a trial within a trial.

With regard to the degree of specificity of the applicant's allegations, it has been held that a mere suspicion of detriment to the company⁶⁰ or a loose or generalised allegation of liability will not suffice to obtain leave for a derivative action in Canadian law. The pleadings must clearly stipulate some interest of the company that is in issue.⁶¹ Specific allegations of wrongdoing must be made and sufficient evidence must be disclosed to satisfy the court that the claim has merit.⁶² Judges require some affirmative evidence that the corporation's legal rights have been violated.⁶³ The Canadian standard of proof for the grant of leave for derivative proceedings and the underpinning principles espoused by the courts thus broadly parallel the approach proposed above for South African law, and the principles adopted in Australian and New Zealand law.

It is noteworthy that notwithstanding the lenient standard of proof stemming from the liberal interpretation of the test on the merits by the Canadian courts, in practice the merits of the action (at least in British Columbia) have become complicated, expensive and time-consuming battlefields in applications for leave. Leave applications for derivative actions frequently involve extensive affidavits, cross-examinations on affidavits, document production applications and numerous other applications and orders.⁶⁴ This has been triggered, not by strict judicial standards for leave, but rather by the dynamics and tactics between the parties involved in intra-corporate disputes.⁶⁵ It is to be hoped that such undesirable practices do not take root in South African law.

From the above discussion, it is clear that parallel lines of reasoning and broadly similar judicial approaches emerge from Canada, Australia and New

⁶⁰ *Re Loeb & Provigo Inc* (1978) 20 OR (2d) 497 (Ont HC).

⁶¹ See also *Re Besenski* (1981) 15 Sask R 182 (Sask QB); *Re Loeb & Provigo Inc* supra note 60.

⁶² *Re Jolub Construction Ltd* [1993] OJ No 2339, 21 CBR (3d) 313 (Gen. Div. in Bankruptcy); *Peddie v Peddie* [1996] AJ No 994, 38 Alta LR 434 (QB).

⁶³ *Re Besenski* supra note 61; *Re Loeb & Provigo* supra note 60.

⁶⁴ See W Kaplan and B Elwood 'The Derivative Action: A Shareholder's "Bleak House"?' (2003) 36 *University of British Columbia Law Review* 459 at 460 – 461.

⁶⁵ *Ibid.*

Zealand. These trends and guiding principles may serve as valuable building blocks to craft a suitable South African judicial approach to this problematic gateway to the derivative action.

3.5 CONCLUSION

The Australian, New Zealand and Canadian approaches thus reinforce the submissions made above that the criterion of the trial of a serious question under s 165 of the Act must be or ought to be interpreted by the South African courts as a low and lenient threshold. To grant leave to an applicant to institute derivative proceedings, the court must essentially be satisfied that the claim is not frivolous or vexatious, in other words, that there is a serious question to be tried. Although this requires the courts to engage in some consideration of the apparent merits of the case, the courts must exercise caution to avoid becoming embroiled in lengthy and disruptive mini-trials on the merits at the stage of the application for leave. But conversely, to achieve a healthy equilibrium between the interests of the company and those of the applicant, and to guard against the abuse of the statutory derivative action by frivolous, vexatious or unmeritorious claims, the applicant must at least be required to identify the legal right (or legal wrong) in question, supported by reasonable evidence and material to prove to the court that the action is viable and that there is a serious question to be tried. The applicant must be able to particularise his allegations of wrongdoing, as opposed to merely making mere bald allegations or attempting to use the derivative action to conduct fishing expeditions in the hope that discovery will later reveal the relevant details and suspected wrongdoing. A detailed legal opinion on the merits of the action including an evaluation of the documentary evidence and the applicable legal principles could, for instance, be necessary in certain cases.

CHAPTER 4: THE BEST INTERESTS OF THE COMPANY

4.1 ANCHORING POLICIES AND THE MEANING OF 'BEST INTERESTS OF THE COMPANY' IN SOUTH AFRICAN LAW

The best interests of the company is a key criterion or gateway for the courts to take into consideration. A court may not grant leave to commence or continue proceedings on behalf of the company unless it is satisfied that it is in the best interests of the company that the applicant be granted leave (in terms of s 165(5)(b)(iii)).

In assessing the best interests of the company, the rebuttable presumption in s 165(7) of the Act applies in certain circumstances. The rebuttable presumption echoes the well-established policy principle that the courts should have regard to the properly deliberated views of the company's directors on commercial matters, in line with the business judgment rule.¹

The most clear-cut cases in which a derivative action is likely to be in the best interests of the company are where the directors fail, without any legitimate grounds, to take action for breach of fiduciary duty, for instance, because they themselves are the wrongdoers who have caused harm to the company. But in many instances legitimate commercial or business reasons may come into play. Litigation may be undesirable on commercial grounds despite the presence of valid legal grounds for the action. The criterion of the 'best interests of the company' enables the court to take such business considerations into account.

While the criterion of the 'trial of a serious question of material consequence to the company' centres on the legal viability of the claim and the strength of the case, the criterion of the 'best interests of the company' focuses on the commercial viability of the claim. Nevertheless, the strength of the case and its prospects of success are relevant to and are interwoven with the 'best

¹ The rebuttable presumption is discussed in detail in Chapter 5.

interests' inquiry—if the proposed action is a tenuous one with little prospect of success, it is unlikely to be in the best interests of the company to grant leave for the derivative action.² Notably the Canadian courts when considering whether the grant of leave 'appears to be in the interests of the corporation'³ focus primarily on the strength of the case.⁴

The 'best interests of the company' is a familiar concept in the field of directors' duties. In the context of the duty of directors to act in the best interests of the company, the concept of the 'best interests of the company' as a general rule refers to the interests of the shareholders as a general body.⁵ It reflects the interests of the collective body of shareholders as a whole, including future shareholders.⁶ There is no reason in principle why this recognised interpretation of the test of the best interests of the company, in the sphere of the fiduciary duties of directors, should not also be imported into the domain of the statutory derivative action. Just as a director has a duty to act in the best interests of the company in conducting the company's affairs, so a minority shareholder or other qualified applicant who wishes to institute legal proceedings on behalf of the company under s 165 of the Act ought to act according to a similar standard hinged on the best interests of the company. This analogy is now buttressed by the recent case *Mouritzen v Greystone Enterprises (Pty) Ltd*,⁷ in which the Kwazulu-Natal High Court stated as follows: '[the] fiduciary duty entails, on the part of every director, the same duty as required of an applicant under section 165(5)(b), namely to 'act in good faith'

² See eg the Australian cases *Herbert v Redemption Investments Ltd* [2002] QSC 340; *Carpenter v Pioneer Park Pty Ltd (in liq)* [2004] NSWSC 1007; *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* [2001] QSC 324.

³ Canada Business Corporations Act, R.S.C. 1985 c. C-44, s 239(2)(c).

⁴ As discussed above, under the South African Act the guiding criteria of the best interests of the company and the strength of the case are separate and distinct preconditions for the grant of leave. In contrast, the Canadian legislation does not contain an express threshold test on the merits and the judiciary generally assesses the strength of the case by using the criterion that the proposed claim must appear to be in the interests of the corporation.

⁵ *Greenhalgh v Arderne Cinemas Ltd* [1950] 2 All ER 1120 (CA); *Ngurli Ltd v McCann* (1953) 90 CLR 425; *Parke v Daily New Ltd* [1962] 2 All ER 929 (ChD).

⁶ *Gaiman v National Association for Mental Health* [1970] 2 All ER 362; *Miller v Bain Sub Nom Pantone 485 Ltd* [2002] BCLC 266 (ChD); see further FHI Cassim 'The Duties and the Liability of Directors' in FHI Cassim et al *Contemporary Company Law* 2ed (2012) 514 – 516.

⁷ 2012 (5) SA 74 (KZD).

and '*in the best interests of the company*'.⁸

Consequently, the criterion of the best interests of the company should not encompass inquiries into the personal characteristics or circumstances of the applicant himself, such as whether the applicant has personal disputes with or personal animosity against the shareholders or directors of the company or whether the applicant is self-interested in the outcome of the matter. Bearing in mind that a derivative action is brought to enforce a right that is, in substance, vested in the company itself and not personally in the applicant, it would be detrimental to the 'best interests of the company' to exclude applicants who apply for leave on the basis of a genuine and valid grievance merely because they have a personal interest in the outcome of the proposed action or a personal animus against the respondents. In any event, such factors come into play in the good faith inquiry when the court must assess, as a precondition for the grant of leave for a derivative action, whether the applicant is acting in good faith (under s 165(5)(b)(i) of the Act).

The prerequisite of the 'best interests of the company' is an open-textured criterion, which may be subject to varying interpretations. Significant factors in the inquiry into the best interests of the company under s 165 of the Act would include the following: the strength of the claim and its prospects of success (as discussed above); the costs of the proposed proceedings; the amount at stake, or the potential benefit to the company; the defendants' financial position and their ability to satisfy a judgment in favour of the company; the disruption of the company's operations and the conduct of its business by having to focus on the litigation, including the distraction of the attention and diversion of the time of the company's directors, management and employees; the potential damage to the company's reputation; negative effects on the company's relationship with its suppliers, customers and financiers, and adverse impacts on the share price of the company; and the availability of

⁸ At para 60.

alternative means to obtain the same relief.⁹ These elements are discussed further below.

The judicial assessment of the commercial viability of the claim is not entirely new to the statutory derivative action in South African law. Under the previous statutory derivative action in terms of s 266 of the Companies Act 61 of 1973, the court, for instance, refused to grant leave for a derivative action in *Brown v Nanco (Pty) Ltd*¹⁰ even though there were valid legal grounds for it. The court, based on the report of the curator ad litem, took account of commercial factors that made the action undesirable, such as the consideration that the proposed action would impose a strain on the fabric of the company and particularly on the relationship between the company and the defendant directors, and that this would prejudice the future of the company. (It is noteworthy, however, that the fact that the applicants had sold their shares and were no longer shareholders in the company, and that all the other remaining shareholders in the company were unanimously opposed to the action, were vital considerations in the decision of the court.)

Turning to the onus and the standard of proof, it is submitted that the burden of proof lies on the applicant (who wishes to institute derivative proceedings) to satisfy the court, on a balance of probabilities, that the grant of leave is in the best interests of the company. This evidently is the intention of the legislature, as appears from the wording of the Act that the court must be satisfied that 'it *is* in the *best* interests' [emphasis added] of the company for leave to be granted (in terms of s 165(5)(b)(iii)). This means that the court must be satisfied, 'not that the proposed derivative action *may be, appears to be, or is likely to be* in the best interests of the company, but that it *is* in the best interests', as observed in the Australian case *Swansson v Pratt*,¹¹ and quoted with approval in the recent South African case *Mouritzen v Greystone*

⁹ The authorities are discussed further below.

¹⁰ 1977 (3) SA 761 (W).

¹¹ *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313.

*Enterprises (Pty) Ltd.*¹²

The Kwazulu-Natal High Court in *Mouritzen v Greystone* did not consider in any depth or detail the criterion of the best interests of the company, and instead focused primarily on the criterion of good faith. The statement of the court that ‘[i]n most, but not all, instances this requirement [ie the best interests of the company] will overlap with the requirement of good faith’¹³ is, with respect, most regrettable. This is because, as pointed out above, the inquiry into the best interests of the company relates to the welfare of the *company*; the personal characteristics or circumstances of the applicant himself are not relevant to the assessment of this requirement. The focus should, and must, be on the company. As previously stated, there may be some overlap between the two criteria, insofar as a finding that leave is in the best interests of the company may shed some light on the applicant’s good faith and motives in seeking leave.¹⁴ However, the two requirements are nevertheless separate and distinct criteria, to be independently satisfied. The criteria should not be conflated by the courts, as was done in *Mouritzen v Greystone*. This view is also reinforced by authority in Australian law and other jurisdictions, as canvassed further below.

4.2 GUIDELINES FROM AUSTRALIA AND OTHER COMPARABLE JURISDICTIONS

4.2.1 Legal Position in Australia, Canada, New Zealand and Other Jurisdictions

The South African condition precedent that the grant of leave for a derivative action must be in the best interests of the company is apparently modelled on

¹² Supra note 7.

¹³ Supra note 7 at para 63; see also para 64.

¹⁴ See eg the Australian cases *Maher v Honeysett* [2005] NSWSC 859; *Goozee v Graphic World Group Holdings Pty Limited* [2002] NSWSC 640; *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 2; *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* supra note 2.

the Australian legislation. The Australian Corporations Act¹⁵ similarly requires the court to be satisfied that the grant of leave for a proposed derivative action 'is' in the 'best interests' of the company. The Australian case of *Swansson v R A Pratt Properties Pty Ltd*¹⁶ has consequently stipulated that the applicant must establish on a balance of probabilities that the proposed action is in the best interests of the company, and not merely make out a prima facie case. *Carpenter v Pioneer Park Pty Limited (in liq)*¹⁷ spelled out further that the inquiry is 'not an inquiry into possibility or potential'. These dicta are instructive on the interpretation of the parallel South African provision relating to the criterion of the best interests of the company.

While this precondition in the South African Act is sourced from the Australian legislation, it differs significantly from the Canadian legislation. Canadian legislation contains a more lenient test, namely that 'it *appears to be* in the *interests* of the corporation' [emphasis added].¹⁸ That the action must 'appear to be' in the corporation's interests clearly entails a lower standard of proof than the South African equivalent. The crux of the matter in Canadian law is whether it is prima facie in the interests of the company that the action be brought.¹⁹ The test according to the Canadian courts is whether the applicant has adduced sufficient evidence which on the face of it discloses that it is in the interests of the corporation to pursue the action.²⁰

The New Zealand judiciary, like the Canadian courts, has also considered the interests of the company on a prima facie basis.²¹ The New Zealand legislative provision is at odds with the South African one, in that the New Zealand Companies Act refers to 'the interests of the company' as opposed to its best interests. Furthermore, the New Zealand court is required

¹⁵ Australian Corporations Act 2001, s 237(2)(c).

¹⁶ Supra note 11.

¹⁷ Supra note 2 at para 19.

¹⁸ Canada Business Corporations Act, R.S.C. 1985 c. C-44, s 239(2)(c); Ontario Business Corporations Act R.S.O. 1990, c. B.16, s 246(2)(c).

¹⁹ *Re Bellman and Western Approaches Ltd* (1981) 33 BCLR 45 (BCCA). See further the discussion in Chapter 3 above on the threshold test or strength of the case in Canadian law.

²⁰ *Re Northwest Forest Products Ltd* [1975] 4 WWR 724 (BCSC).

²¹ *Vrij v Boyle* (1995) 3 NZLR 763; *Techflow (NZ) Ltd v Techflow Pty Ltd* (1996) 7 NZCLC 261,138.

merely to 'have regard to the interests of the company'.²² This, too, is not a firm precondition or sine qua non for the grant of leave, as in South African law, but is simply a relevant factor to be taken into consideration. (The only prerequisite for the grant of leave for a derivative action in New Zealand law is that it must be in the interests of the company that the conduct of the proceedings should not be left to the directors or the determination of the shareholders as a whole, or alternatively, that the company itself does not intend to bring proceedings.)²³ This is a less exacting test than its South African equivalent.

The United Kingdom Companies Act, 2006, requires the court to consider the importance that a person acting in accordance with s 172, that is, the duty to promote the success of the company, would attach to continuing the claim. This duty arises in two subsections of the legislation. First, permission for a derivative action must be refused if the court is satisfied that a person acting in accordance with s 172 would not seek to continue the claim. Secondly, in considering whether to give permission for the derivative action, the court must take into account the importance that a person acting in accordance with s 172 would attach to continuing it.²⁴ The duty to promote the success of the company under s 172 is linked with the concept of acting in the best interests of the company. Certain principles laid down by the UK courts may consequently serve as useful guidelines in the interpretation and application of the best interests of the company criterion in South African law.

The South African provision is thus aligned most closely with the Australian provision, both of which provide that the claim *must* be in the *best interests* of the company, and not merely that the claim appears prima facie to be in the interests of the company (as is the case in Canadian and New Zealand law). The interpretation of this criterion by the Australian courts is accordingly of particular interest and relevance in informing the interpretation of

²² New Zealand Companies Act 1993, s 165(2)(d). The New Zealand courts must also have regard to the likelihood of the proceedings succeeding, the costs in relation to the likely relief and any action already taken by the company to obtain relief (s 165(2) of the New Zealand Companies Act, 1993).

²³ New Zealand Companies Act 1993, s 165(3).

²⁴ United Kingdom Companies Act, 2006, s 263(2)(a) and s 263(3)(b), respectively.

the South African equivalent.

4.2.2 *Lessons from Australia and Other Comparable Jurisdictions*

The Australian experience and the body of case law on the issue of the best interests of the company may furnish indicators for the interpretation and application of this criterion in South African law. It may also shed light on the foreseeable difficulties which are likely to crop up. The requirement that a derivative action must be in ‘the best interests of the company’ has been the most problematic for the Australian courts. According to the *Explanatory Memorandum to the Corporate Law Economic Reform Program Bill*,²⁵ as referred to in *Fiduciary Limited v Morningstar Research Pty Limited* and *Maher v Honeysett & Maher Electrical Contractors Pty Ltd*,²⁶ this requirement acknowledges that there may be sound business reasons for a company not to pursue a legal action open to it. In some circumstances, pursuing a cause of action would be contrary to the best interests of the company, for instance, a breach of duty by a director may have resulted in an insignificant or nominal loss to the company, with the effect that the costs of legal proceedings could outweigh any potential benefit to the company. The best interests clearly criterion involves a weighing up of the benefit of an action against any potential detriment.

The phrase ‘best interests of the company’ is concerned with the welfare of the *company*.²⁷ Consequently in *Goozee v Graphic World Group Holdings Pty Ltd*,²⁸ where the applicant sought a remedy entailing the winding-up of a group of companies that were trading profitably, the court found that this could not be in the best interests of those companies, for their best interests would clearly entail continuing to trade profitably.

²⁵ 1998, at para 6.38 – 6.39.

²⁶ *Fiduciary Limited v Morningstar Research Pty Limited* [2005] NSWSC 442; *Maher v Honeysett & Maher Electrical Contractors Pty Ltd* supra note 14.

²⁷ *Charlton v Baber* [2003] NSWSC 745; *Fiduciary Limited v Morningstar Research Pty Limited* supra note 26 at para 46; *Maher v Honeysett* supra note 14.

²⁸ Supra note 14.

The personal qualities of the applicant do not come into play in determining this requirement, for the focus is on the company.²⁹ A personal interest or personal animus should not be decisive or even be significant in determining whether an application is in the best interests of the company, as held in *Maier v Honeysett & Maier Electrical Contractors Pty Ltd*³⁰ and *Ehsmann v Nutectime International Pty Ltd*,³¹ as this is commonly a feature in the types of disputes that lead to derivative actions.³²

There are clear congruencies between the principles propounded by the Australian courts and the guidelines submitted above on the meaning in South African law of the 'best interests of the company' criterion, as adapted from existing common law principles in South Africa.

Turning to the factors that are pertinent in evaluating the best interests of the company, an applicant must give evidence at least of the following matters, as laid down in *Swansson v Pratt*³³ and *Ragless v IPA Holdings Pty Ltd (in liq)*:³⁴

- the character of the company or the nature of its operations, for instance, whether the company is a small private family-owned company or a large listed public company. In a closely held family company, the effect of the proposed derivative action on the purpose of the company and on its shareholders may be material; but these elements would, conversely, be immaterial in a listed public company. Another example is that in a joint venture company in which the parties are deadlocked, it would be apt to consider whether the proposed derivative litigation is being used

²⁹ *Maier v Honeysett* supra note 14 at paras 46 - 49.

³⁰ Supra note 14 at para 45.

³¹ (2006) 58 ACSR 7051.

³² The court may consider the benefit that will be gained by the applicant for leave. In *Transmetro Corp Ltd v Kol Tov Pty Ltd* [2009] NSWSC 350 it was held that it would be contrary to the best interests of the company to grant leave to an applicant where this would put him in a position of breaching his directors' duties owed to another company.

³³ Supra note 11 at para 57 - 60.

³⁴ (2008) ACSR 700.

inappropriately to vindicate the position of one side;³⁵

- the business of the company. The effect of the proposed litigation on the proper conduct of the company's business must be understood;
- the ability of the defendant to meet any judgment in favour of the company, or even a substantial part of it. This enables the court to ascertain whether the proposed litigation would have any true practical benefit for the company;
- whether there are other means of obtaining substantially the same redress, so that the company does not have to be brought into litigation against its will. This important issue is discussed separately below.

These factors may be usefully considered by the South African courts in the inquiry into the best interests of the company in terms of s 165(5)(b)(iii) of the Act.

Many of the commercial and business factors that play a role in Australian law have also gained a foothold in the United Kingdom. This combined collection of elements may be useful in setting the legal landscape in the South African environment. In the United Kingdom the court in *Franbar Holdings Ltd v Patel*³⁶ was faced with an application for permission for a derivative action. In assessing the importance that a hypothetical director would attach to continuing the claim when acting in accordance with s 172 or the duty to promote the success of the company—which (as discussed above) is linked with the concept of acting in the best interests of the company—the court identified a useful list of factors. These include the prospects of success of the claim; the ability of the company to recover any award of damages; the disruption to the company's business caused by the claim; the costs of the proceedings; and any damage to the company's reputation if the proceedings

³⁵ See eg *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* supra note 2.

³⁶ [2008] EWHC 1534 (Ch) at para 36; see also *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch) at para 86.

were to fail. In *Wishart v Castlecroft Securities Ltd*³⁷ the court added to this list of factors the amount at stake, and the prospects of obtaining a satisfactory result without litigation. This range of matters is, however, intended to be neither comprehensive nor exhaustive.³⁸

Similar elements feature in decisions of the New Zealand judiciary. Over and above this, in evaluating whether the grant of leave would be in the interests of the company, the New Zealand judicial decisions suggest that the potential for adverse publicity and damage to the company's reputation is likely to be given little weight by the court.³⁹ This possibly applies also to the adverse effects of the derivative action on the company's operations and trading contracts. However, the exception would be where the negative publicity in question is likely to have a financial impact on the company, for instance, by causing a fall in the market price of the shares of a publicly-traded company⁴⁰—a factor that would indeed be germane to the inquiry into the interests of the company.

It is noteworthy that the Canadian courts focus largely on the strength of the case in assessing the statutory criterion whether it appears to be in the interests of the corporation for a matter to be litigated derivatively. The strength of the case in South African law is primarily dealt with by the criterion of the 'trial of a serious question of material consequence to the company' (as discussed in Chapter 3 above), although there is some interlink or overlap between the strength of the case and the best interests of the company.

The inquiry into the best interests of the company thus involves a weighing up of the benefit of the proposed derivative action against any potential detriment. This guiding criterion gives due recognition to solid commercial and business reasons for companies declining to pursue legitimate legal claims. For instance, the time spent on litigation might be more beneficially

³⁷ [2009] CSIH 65.

³⁸ *Stimpson v Southern Private Landlords Association* [2010] BCC 387.

³⁹ *McFarlane v Barlow* (1997) 8 NZCLC 261 (HC).

⁴⁰ *Presley v Callplus Ltd* [2008] NZCCLR 37 (HC).

used elsewhere and may consequently be detrimental to the conduct of the company's business, in the light of the nature of its business and operations, or the wrongdoers because of a lack of financial means may be unable to meet the judgment even if the litigation is successful, or the loss to the company may have been minor or trivial, or the costs of legal proceedings may outweigh the potential benefit or recovery and may thus be inadvisable.

4.3 FURTHER FACETS OF THE 'BEST INTERESTS OF THE COMPANY'

4.3.1 A 'Cost-Benefit' Analysis?

The thorny question must inevitably arise whether the inquiry into the 'best interests of the company' entails a 'cost-benefit' analysis. In other words, if the costs of the litigation are likely to outweigh any potential benefit to the company, is the court bound to refuse leave for a derivative action on the ground that a derivative action would not be in the company's best interests?

It is submitted that this is a narrow and restrictive approach that should be firmly shunned in South African law. The inquiry into the best interests of the company in South African law is not intended to be a purely 'cost-benefit' analysis. The wording of the Act does not require it, and it would be consistent with neither the purposes of the Act nor the intention of the legislature. The approach of the South African courts should be to weigh up the benefit of the action against the potential detriment, in the sense of benefit and detriment that go beyond the direct costs of the litigation and the purely economic or financial benefits. Far less emphasis should be placed on comparing or weighing up the economic costs of the derivative action against the possible economic return—the importance of this point cannot be overstressed.

Not only is it difficult to predict or assess the economic costs and benefits accurately but, more importantly, to limit the best interests criterion to a strict 'cost-benefit' analysis would be to adopt an overly rigid approach, which would

shackle and frustrate the objectives and purposes of the derivative action. The statutory derivative action is not only purposed at corporate compensation but also at deterrence. It enables minority shareholders and others to recover damages, property or other compensation for the company from miscreant directors and others who harm the company. Moreover, as an effective weapon for shareholder control of directorial misconduct, it also deters future misconduct by directors and managers of companies.⁴¹ On the basis of a strict cost-benefit rule, leave is granted for a derivative action only if the likely corporate recovery outweighs the likely costs of litigation—this clearly pertains to derivative actions that are motivated by a compensatory rationale. On the other hand, if the likely recovery is outweighed by the likely litigation costs, a strict cost-benefit approach would maintain that the court must withhold leave for a derivative action. In other words, if the objective of corporate compensation would be unfulfilled, leave for a derivative action must be refused; a purely deterrent objective would not suffice for derivative proceedings, on a strict cost-benefit approach. This is clearly unsatisfactory particularly in the South African context.

The objects and purposes of the Act, as well as the growing emphasis on good corporate governance and the protection of minority shareholders, call for a full recognition of the twin objects of the statutory derivative action. Besides the remedial objective of corporate compensation, the new derivative action is designed as a corporate governance instrument for shareholder policing of corporate misconduct, so as to deter wrongdoing by directors and to enhance managerial accountability. Even if the costs of a derivative action would outweigh the likely recovery, and would consequently not benefit the company in economic or compensatory terms, leave to bring the action should not be automatically refused. If the action has merit, there could be value to it—even in the absence of any overall economic benefit to the company—by the deterrence of future directorial misconduct and mismanagement. In certain

⁴¹ See further the discussion of the purposes and objects of the derivative action in Chapter 1 and Chapter 7.

circumstances, even if the recovery or compensation for the company would be significantly less than the financial costs of the action, a derivative action may still serve a vitally important purpose as a warning and a deterrent to future wrongdoing by both the board of the company itself as well as the directors of other companies. The public benefits of the long term deterrent value of the derivative action and the social and economic value of enhanced confidence in the integrity of the corporate system could outweigh the company's private economic interests.⁴²

This, however, is not to say that a cost-benefit analysis is entirely irrelevant in the South African context. At some point a line must be drawn—where the costs of the action too heavily outweigh the likely recovery, the pursuit of the objective of deterrence becomes inequitable, and leave for derivative proceedings should then be withheld.⁴³ A balance must thus be struck between the two objectives of compensation and deterrence. This would depend on the circumstances of each case. For example, in instances of self-dealing and intentional violations of law, the rationale of deterrence is perhaps more compelling. The courts should accordingly encourage parties to adduce evidence of the costs and the benefits of the proposed derivative action, but subject to the overriding qualification that the assessment of the best interests of the company should not be fettered by a cost-benefit analysis alone. It should instead incorporate a wider assessment of all the factors and considerations discussed above.

As opposed to the South African Act which does not refer to a 'cost-benefit' analysis, the New Zealand legislation explicitly requires it. The New Zealand Companies Act⁴⁴ specifically states that the court must have regard to

⁴² JC Coffee & DE Schwartz 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform' (1981) 81 *Columbia Law Review* 261 at 308; American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* (1994) at 597; see also s 7.10(b) of the *Principles* which provides that even if a derivative action will not produce a net financial recovery for the company, it cannot be dismissed if dismissal would permit a defendant to retain a 'significant improper benefit' and if certain other conditions are met. This takes into account the public interest as well as the deterrent rationale of the derivative action. See further Chapter 7, para 7.2.1.

⁴³ Coffee & Schwartz op cit note 42 at 308.

⁴⁴ New Zealand Companies Act 1993, s 165(2)(b).

‘the costs of the proceedings in relation to the relief likely to be obtained’. This is an entirely separate statutory provision from the criterion of the ‘interests of the company’.⁴⁵ The former provision involves a cost-benefit analysis.⁴⁶ It requires the court to consider ‘the economics of taking a derivative action relative to any possible return’.⁴⁷ The term ‘costs’ in this context refers to the ‘litigation costs of the proposed proceedings’.⁴⁸ When assessing the relief likely to be obtained by the company, the ability of the defendant to meet any judgment given against him is also taken into account. Moreover, the consideration of ‘the costs of the proceedings in relation to the relief likely to be obtained’ is linked also with the strength of the claim on the merits.⁴⁹ Accordingly, in the leading New Zealand case *Techflow NZ Ltd v Techflow Pty Ltd*⁵⁰ one of the reasons given by the court for its refusal of leave for a derivative action was that the costs of litigation seemed disproportionate to the amount realistically in issue.

In striking contrast, the Australian courts have declared in unambiguous terms that the criterion of the best interests of the company does not involve a ‘cost-benefit analysis of possible outcomes of prospective litigation’.⁵¹ It is significant that even in New Zealand law, the decision of the courts to grant or refuse leave does not turn solely on the cost-benefit analysis, which is merely one of the factors that the courts must have regard to, and not a precondition or sine qua non for leave for a derivative action.⁵² The New Zealand court in *Frykberg v Heaven*⁵³ has in fact acknowledged the important role of the statutory derivative action as a deterrent to wrongdoing.

⁴⁵ New Zealand Companies Act 1993, s 165(2)(d).

⁴⁶ *Tweedie v Packsys Ltd* (2005) 2 NZCCLR 584 (HC) at para 51.

⁴⁷ *Stichbury v One4All Ltd* (2005) 9 NZCLC 263,792 (HC) at para 37.

⁴⁸ *Vrij v Boyle* supra note 21; *Thorrington v McCann* (1997) 8 NZCLC 261,564.

⁴⁹ *Presley v Callplus Ltd* supra note 40 at para 47.

⁵⁰ Supra note 21.

⁵¹ *Metyor Inc (formerly Talisman Technologies Inc) v Queensland Electronic Switching (Pty) Ltd* QCA [2002] 269.

⁵² New Zealand Companies Act 1993, s 165(2)(b).

⁵³ (2002) 9 NZCLC 262,966.

4.3.2 *Availability of an Alternative Remedy*

A central factor in determining whether a proposed derivative action is in the best interests of the company is the availability of an alternative remedy, as stated above. If there are alternative measures to address the grievance of an applicant, which would produce substantially the same redress, the court should refuse to grant leave to the applicant to institute derivative proceedings on the company's behalf. In this way the court would avoid thrusting the company into litigation against its corporate will, bearing in mind that the board of directors (which represents the directing mind and will of the company) has refused to institute legal proceedings, hence the application to bring derivative proceedings for the company. A suitable alternative remedy could, for instance, be provided by an arbitration clause in the company's Memorandum of Incorporation regulating dispute resolution, or may consist of an action instituted in the name of the applicant himself, to which the company is not a party.

In applying this principle of an alternative remedy, it is vital that the proposed alternative remedy enables the applicant to obtain the redress he desires or provide substantially the same redress as a derivative action would have yielded. In other words, it must be a suitable alternative. Moreover, the alternative remedy must have a real prospect of success. If these conditions are satisfied, the judicial grant of leave for a derivative action is likely to be contrary to the best interests of the company.

In contrast, where a proposed alternative remedy would not produce the desired redress or substantially the same redress, it should pose no obstacle to the commencement of a derivative action and should be disregarded in the inquiry into the company's best interests. It must be stressed that in some circumstances a minority shareholder, who applies for leave to institute derivative proceedings, may also have a personal claim against the defendants.⁵⁴ But this of itself should not be fatal to his application for leave for

⁵⁴ In *Communicare & Others v Kahn* 2013 (4) SA 482 (SCA) the Supreme Court of Appeal recently held – citing with approval the views expressed by Maleka Femida Cassim 'Shareholder Remedies and Minority Protection' in Farouk HI Cassim, MF Cassim, R Cassim, R Jooste, J Shev & J Yeats

derivative litigation. To elaborate, there could in many instances be an overlap between a personal claim and a derivative claim. In other words, the same wrong may violate the rights of both the shareholder personally as well as those of the company, and may accordingly give rise to both a personal claim by the shareholder with the purpose of asserting his individual shareholder rights and obtaining personal redress for himself, as well as a derivative claim instituted by the shareholder on behalf of the company with the object of obtaining redress and recovery for the company itself and not the shareholder directly. It must be borne in mind that a personal action and a derivative action are not alternative remedies or alternative means of obtaining substantially the same redress—they are plainly designed to produce different results. Merely because an applicant has available to him—or has already commenced—a personal claim against the defendant, is manifestly an insufficient basis for concluding that a derivative action is contrary to the best interests of the company and withholding leave. It is respectfully submitted that the South African courts should be mindful of this.

Nonetheless in the field of breach of directors' fiduciary and statutory duties, these wrongs, in the majority of cases, would cause harm to the company itself as opposed to its shareholders. Directors' duties are generally not owed to the shareholders individually, as laid down in *Percival v Wright*.⁵⁵ But in certain circumstances, harm may be done by a director to a shareholder directly, in which case the shareholder would have personal redress against the director. For instance, it was accepted in *Coleman v Myers*⁵⁶ and *Peskin v Anderson*⁵⁷ that fiduciary duties may be owed by directors to individual shareholders where a 'special factual relationship' is established between them on the facts of the particular case.

A related issue, which must also be kept in mind, is the 'no reflective

Contemporary Company Law 2ed (2012) at 821 – that s 165 of the Act does not abolish the personal action, and that the personal action and the statutory derivative action thus co-exist (at para 20 read with footnote 8 of the judgment).

⁵⁵ [1902] 2 Ch 421 (ChD).

⁵⁶ [1977] 2 NZLR 225 CA (NZ).

⁵⁷ [2001] 1 BCLC 372 (CA).

loss' principle. The 'no reflective loss' principle applies when both the company and the shareholder have a claim against the directors or other defendants based on the same set of facts, and the shareholder's loss, insofar as this may be a diminution in the value of his shares or a loss of dividends, merely reflects the loss suffered by the company. In such cases the shareholder's claim is restricted by the principle that the shareholder cannot recover a loss that is simply reflective of the company's loss.⁵⁸ When the 'no reflective loss' principle applies, the only available remedy is an action brought by the company or on behalf of the company as a derivative action; there is no question of a personal shareholder action at all. An application of the 'no reflective loss' rule arose for example in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*,⁵⁹ where the court decided that the personal claim by the shareholders should fail as the only loss the shareholders had suffered (as a result of a misrepresentation by the directors in a misleading circular, in the course of seeking the shareholders' consent to a transaction) was a diminution in the value of their shares. This loss was simply an indirect loss or a reflection of the loss that the company itself had suffered as a result of the wrong done to the company (by the acquisition of certain assets at an overvalue). A similar situation arose in *Stein v Blake*,⁶⁰ where the loss sustained by a shareholder by a diminution in the value of his shares by reason of a misappropriation of the company's assets was held to be recoverable only by the company, and not by the shareholder who had suffered no loss distinct from that suffered by the company. The rationale for the 'no reflective loss' principle is that it prevents double recovery if the company were also to sue. It, furthermore, prevents the individual shareholder from recovering at the expense of the company and its creditors and other shareholders.⁶¹

However the 'no reflective loss' rule is no obstacle to a personal

⁵⁸ *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257; [1982] 1 Ch 204 (CA); *Johnson v Gore, Wood & Co* [2002] 2 AC 1 (HL) 62.

⁵⁹ Supra note 58.

⁶⁰ (No 2) [1998] 1 All ER 724 (CA).

⁶¹ Supra note 60.

shareholder claim where the loss suffered by the shareholder and that suffered by the company are distinguishable.⁶² In these instances it is possible to institute both a personal shareholder action as well as a company action, whether this is instituted by the company itself or by the shareholder as a derivative action on the company's behalf.

The principles submitted above are buttressed by authority in Australian and New Zealand law, but diverge significantly from the legal position in the United Kingdom.

In this regard, Australian courts have ruled that if an alternative means is available, and it has genuine prospects of recovery as well as the potential to yield a suitable remedy, it would be contrary to the best interests of the company to institute a derivative action.⁶³ This occurred, for instance, where an applicant could obtain the necessary redress by means of an order for specific performance of a contract in an action to which the company was not a party.⁶⁴ Regarding the critical question of the overlap between a personal action and a derivative action, there is both Australian⁶⁵ as well as New Zealand⁶⁶ judicial authority to the effect that if an applicant may pursue a personal claim against the proposed defendant, this does not necessarily mean that a derivative action is contrary to the best interests of the company. Indeed the Australian courts have stated that it may be advantageous to allow a derivative claim to be pursued in proceedings in which a personal claim is also pursued, particularly where there is a common substratum of fact underlying the two claims.⁶⁷

In stark opposition is the legal position in the United Kingdom. The United Kingdom legislation⁶⁸ provides that the court must consider whether the

⁶² See *Heron International Ltd v Lord Grade* [1983] BCLC 261.

⁶³ See eg *Hassall v Speedy Gantry Hire Pty Ltd* [2001] QSC 327; *Chapman ve E-Sports Club Worldwide Ltd* (2000) ACSR 462; see also *Swansson v Pratt* supra note 11.

⁶⁴ *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* supra note 2.

⁶⁵ See eg *Saltwater Studios Pty Ltd v Hathaway* [2004] QSC 435 at [10]; *Metyor Inc (formerly talisman Technologies Inc) v Queensland Electronic Switching Pty Ltd* supra note 51 at 405; *Ehsman v Nutectime International Pty Ltd* supra note 31.

⁶⁶ See eg *Bendall v Marshall* (2005) 9 NZCLC 263,772.

⁶⁷ *Ehsman v Nutectime International Pty Ltd* supra note 31.

⁶⁸ Companies Act, 2006, s 263(3)(f).

act or omission in respect of which a derivative claim is brought gives rise to an alternative cause of action which the shareholder could pursue *in his own right* rather than on behalf of the company. The existence of such an alternative remedy must be considered by the court, although it is not an absolute bar to the grant of permission for a derivative claim.⁶⁹ The relevant alternative remedy may be brought against the same defendants as the derivative action, but this is not necessarily required and the statutory provision extends also to an alternative remedy that is available against a different defendant. The only limitation is that the alternative claim must arise from the same act or omission that is the subject of the derivative claim.⁷⁰ The United Kingdom legislative provision is thus quite wide. It may include overlaps between a derivative claim and a personal action, including personal claims based on the unfairly prejudicial petition.⁷¹ Frequently, both a derivative action and an unfairly prejudicial petition may be founded on breaches of directors' duties. The United Kingdom legislation may thus limit and exclude the availability of the derivative action in these situations.

It is submitted that in South African law such a wide and dilated construction should be firmly eschewed. There are significant differences between the statutory schemes for the derivative action in the United Kingdom and South Africa. Unlike the United Kingdom legislation, the South African Act does not limit the availability of the derivative action to this extent. To do so in South African law would be consistent with neither the intention of the legislature nor the underlying nature and purposes of s 165 of the Act. It must also be borne in mind that, unlike the South African Act, the United Kingdom legislation expressly provides for a derivative action to be brought pursuant to a court order under the unfair prejudice remedy.⁷²

⁶⁹ *Iesini v Westrip Holdings Ltd* supra note 36.

⁷⁰ *Franbar Holdings v Patel* supra note 36.

⁷¹ In terms of the United Kingdom Companies Act, 2006, s 994, or a petition for a just and equitable winding up.

⁷² Section 260(2)(b) of the UK Companies Act, 2006 provides that a derivative claim may be brought in pursuance of a court order in proceedings under s 994 for the protection of shareholders against unfair prejudice. Section 996(2)(c) provides that when a shareholder succeeds in a petition under s 994, one of

4.3.3 *Is the Derivative Action Applicable to a Company in Liquidation?*

The concept of the 'best interests of the company', as discussed above, generally refers to the interests of the shareholders as a whole. But in the context of insolvency, the interests of the creditors of the company come to the fore. Common law authority in both the United Kingdom⁷³ and in Australia⁷⁴ requires directors, in discharging their duties to their company, to take into account the interests of creditors when the company is in financial difficulty, that is, when the company is insolvent or is near insolvency. A South African court is very likely to be persuaded to do the same. This principle on the duties of directors may be equally extended and applied to the statutory derivative action, with the effect that the precondition of the 'best interests of the company' could turn on the interests of the creditors of an insolvent or near insolvent company. The basis of this approach is that a successful derivative action would increase the assets of the insolvent or near-insolvent company, which would then be used to satisfy the claims of creditors. There is authority in the context of the Australian statutory derivative action that when a company is being wound up because of insolvency or is near insolvency due to financial difficulties, the company's best interests are reflected primarily by the interests of its creditors, or would at least require the directors to take creditors' interests into account.⁷⁵ This is because when a company is in insolvent circumstances, it is the creditors' assets that are at risk, rather than the proprietary interests of shareholders.

This, however, begs the question whether the statutory derivative action under s 165 of the Act would be available in the first place when companies are in liquidation. It is important to note that the derivative action at common law

the orders that may be made by the court is the authorisation of civil proceedings to be brought in the name of and on behalf of the company by such persons as the court may direct.

⁷³ See eg *Liquidator of West Mercia Safetywear v Dodd* [1988] BCLC 250 (CA); *Lonrho Ltd v Shell Petroleum Co Ltd* [1980] 1 WLR 627; *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd* [2003] 2 BCLC 153.

⁷⁴ See eg *Walker v Wimborne* (1976) 137 CLR 1; *Linton v Telnet Pty Ltd* (1999) 30 ACSR 465.

⁷⁵ See *Charlton v Baber* supra note 27; *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 2.

could not be brought when a company was in liquidation.⁷⁶ Since the statutory derivative action under s 165 of the Act does not explicitly exclude from its ambit companies in liquidation, it could give rise to uncertainty in South African law on this crucial issue.

It is submitted that, like the common law derivative action, the statutory derivative action under s 165 of the Act is not intended to apply to companies in liquidation. The mischief that the section aims to redress is to simplify and streamline the right of a minority shareholder to institute an action on behalf of a company that is a going concern; it arguably does not include companies in liquidation. The Act makes no reference to a liquidator and there are no indicators in s 165 to suggest that the legislature envisaged or intended the remedy to extend to companies in liquidation. While some of the criteria for leave, such as the 'best interests of the company', may be readily applied to companies in liquidation (in the manner discussed above), other criteria for leave do not lend themselves to adaptation for companies in liquidation, for instance, the criteria set out in s 165(5)(a) relating to the investigation of the demand and the response to the demand by the board of directors, or the rebuttable presumption in s 165(7) that the decision made by the directors not to involve the company in litigation against a third party is in its best interests. Moreover, when a company is in liquidation, there are other more suitable remedies available.

The Act should ideally be amended to clarify this vital issue. This could be easily achieved by way of a simple exclusion in s 165 of companies in liquidation. The current lacuna in the Act may create controversy and disputes in practice, and the need to ultimately seek judicial intervention to clarify the matter. Not only would this be time-consuming and costly, it could generate conflicting judicial decisions and give rise to a practical quandary.

This has been the experience in Australian law, where the issue has

⁷⁶ *Barrett v Duckett* [1995] 1 BCLC 243 (CA) 250, in the context of the English common law derivative action, on which South African law was historically based; *Fargro Ltd v Godfrey* [1986] 3 All ER 279; *Scarel Pty Ltd v City Loan and Credit Corporation Pty Ltd* (1988) 12 ACLR 730 (Fed C of A).

precipitated ongoing confusion and debate for over a decade. The Australian courts have expressed conflicting views on whether the statutory derivative action may be brought when a company is in liquidation.⁷⁷ A watershed judicial pronouncement seems to have finally been made on the matter by the New South Wales Court of Appeal in *Chahwan v Euphoric Pty Ltd*,⁷⁸ which declared that the statutory derivative action is not available where a company is in liquidation.⁷⁹

There is also some authority on this thorny issue in New Zealand, although it is not yet settled. *Hedley v Albany Power Centre Ltd (in liq)*⁸⁰ ruled that once a company is placed in liquidation ‘the Court no longer has—or at least ought not to exercise—its s 165 [ie statutory derivative action] jurisdiction’.

This vexed question must be decisively clarified in South African law by an amendment to the Act to obliterate the uncertainty in s 165. In the interim, it is submitted, based on its literal wording, the purpose and the intention of the legislature, and the lessons drawn from judicial experience in comparable jurisdictions, that s 165 of the Act should be interpreted to exclude companies in liquidation from its ambit and reach.

4.4 A RESIDUAL DISCRETION

The court may not grant leave to an applicant for derivative proceedings unless it is satisfied that all the three guiding criteria or gateways in terms of s 165(5)(b) are fulfilled. A final issue is whether the court has a residual discretion

⁷⁷ In New South Wales, *BL & GY International Co Ltd v Hypec Electronics Pty Ltd* [2001] NSWSC 705 stated as an obiter dictum that the statutory derivative action is not applicable to a company in liquidation; cf *Roach v Winnote Pty Ltd (in liq)* [2001] NSWSC 822 which held, conversely, that the statutory derivative action is applicable to a company in liquidation. The Supreme Court of Victoria found in *Fresh Start Australia Pty Ltd; Suteri v Lofthouse and Cauchi as liquidators of Fresh Start Australia Pty Ltd (in liq)* (2006) 59 ACSR 327 that the statutory derivative action does apply to a company in liquidation, while the Federal Court of Australia has had divided opinions—see eg *Mhanna v Sovereign Capital Ltd* [2004] FCA 1040, [2004] FCA 1252, [2004] FCA 1300; *Promaco Conventions Pty Ltd v Deadline Printing Pty Ltd* (2007) 159 FCR 486.

⁷⁸ [2008] NSWCA 52.

⁷⁹ This has been followed in later cases; see eg *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 2.

⁸⁰ [2005] 2 NZLR 196 (HC) at para [35].

to consider other criteria besides those listed in the section.

In view of the wording in s 165(5) that the court ‘may’—not ‘must’—grant leave only if the listed criteria are satisfied, it is submitted that there theoretically is room for the court to consider additional factors and to exercise a residual discretion to refuse leave despite the fulfilment of all the statutory criteria for leave.⁸¹

By contrast, in Australian law (where the statutory provision in s 237(2) of the Corporations Act, 2001, makes it plain by the use of the word ‘must’), the court is bound to grant leave if all the five criteria in the section have been satisfied. The Australian courts have ruled that if the prescribed criteria under the legislation are met, the court has no residual discretion and ‘must’ or is bound to grant leave.⁸² By the same token, the Australian courts are bound to refuse leave if unsatisfied that all the prerequisites have been fulfilled.⁸³ The relevant considerations in Australian law are thus limited to the five specified prerequisites.⁸⁴

The rationale for the different approach on this issue in terms of s 165 of the South African Act remains obscure. The South African courts may take into account all the relevant circumstances. In some circumstances, even where all the statutory prerequisites of s 165(5) have been satisfied, the court may still have the residual discretion to refuse leave. It is submitted that the courts should adopt a restrained and cautious approach in exercising their residual discretion to withhold leave. The approach of the courts as a general rule should be to grant leave once the criteria of s 165(5) are fulfilled, save in exceptional circumstances where there are other strong factors for swaying the courts’ discretion.

⁸¹ The five statutory criteria for leave under s 165 of the Act are discussed in Chapter 1, para 1.2.2.

⁸² *Maher v Honeysett & Maher Electrical Contractors Pty Ltd* supra note 14; *Magafas v Carantinos* [2006] NSWSC 1459; *Fiduciary Ltd v Morningstar Research Pty Ltd* supra note 26; *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 2.

⁸³ *Goozee v Graphic World Group Holdings Pty Ltd* supra note 14 at 541; *Charlton v Baber* supra note 27; *Jeans v Deangrove Pty Ltd* [2001] NSWSC 84; *Herbert v Redemption Investments Pty Limited* supra note 2; *Fiduciary Limited v Morningstar Research Pty Ltd* supra note 26.

⁸⁴ *Maher v Honeysett & Maher Electrical Contractors Pty Ltd* supra note 14.

The courts similarly have a residual discretion in Canadian law. If the complainant proves the three statutory prerequisites (namely, good faith, that the action appears to be in the interests of corporation, and that notice was given to the corporation) the court still retains a residual discretion to give or withhold permission.⁸⁵ It has been cogently stated⁸⁶ that leave ought to be granted once all the statutory prerequisites are satisfied, and that the courts must be mindful that all they are doing in exercising their discretion is permitting an otherwise suppressed grievance to be heard. This would encourage intra-corporate compromises instead of bullying.⁸⁷ This sensible contention applies equally to the role and the exercise of the residual judicial discretion in South African law.

4.5 CONCLUSION

The court thus plays a crucial role as the gatekeeper to statutory derivative actions and is guided in the exercise of its discretion by three vague, general and open-textured criteria, coupled with a residual discretion to refuse leave for a derivative action despite proof of all the statutory guiding criteria. The legislature has left it in the hands of the courts to flesh out the interpretation, application and the contours of the three guiding criteria and, depending on the favoured judicial approach, to effectively determine the ultimate fate and effectiveness of this remedy in South African law. One hopes that the courts will espouse a robust approach, along the lines of the guiding principles suggested above, that will breathe full life into this potentially valuable minority shareholder remedy rather than to stifle it.

⁸⁵ Canada Business Corporations Act, R.S.C. 1985 c. C-44, s 239(2).

⁸⁶ B Welling *Corporate Law in Canada: The Governing Principles* 3ed (2006) 518.

⁸⁷ Ibid.

CHAPTER 5: THE REBUTTABLE PRESUMPTION: DEFECTS AND CURES

5.1 INTRODUCTION

A critical prerequisite for the court to grant leave to institute derivative proceedings is that it must be satisfied that the grant of leave will be in the best interests of the company, as discussed in Chapter 4 above. The ‘best interests’ criterion is coupled with a far-reaching rebuttable presumption that the decision of the board not to litigate is, in certain circumstances, in the best interests of the company.¹ As a broad general concept, the presumption stems from underpinning policies that appear, on the surface, to be commendable. But on a closer examination, the flaws and defects of the presumption render it a major chink in the armour of the minority shareholder. For reasons set out below, the presumption requires urgent legislative amendment.

This chapter examines the rebuttable presumption, its flaws and defects, and the resulting practical predicaments when companies are betrayed by their own directors. Four proposals are submitted in paragraph 5.3 for its reform by legislative amendment.

Until such time as the amendments to the Act are effected (or failing amendment), the courts will have to engage more intimately with the business judgment rule, which is incorporated in the rebuttable presumption.² This rule presumptively protects the board decision not to bring legal proceedings against a miscreant director, despite the harm that he has inflicted on the company. Two aspects of the board decision must be considered by the courts, namely, its formal aspect and its substantive aspect, which are discussed in paragraphs 5.4 and 5.5 respectively. Paragraph 5.4 focuses on the *form* of the board’s decision-making process—this determines whether or not the protective presumption applies in the first place. Paragraph 5.5 addresses the *substance*

¹ In terms of s 165(7) read with (8) of the Act.

² In its third limb, ie s 165(7)(c) of the Act. See further below.

or the merits of the board decision—that is, the weight (or the ‘rebuttability’) of the presumption when it does in fact apply. The concept of directorial ‘independence’ in decision-making is also evaluated as a useful judicial tool to mitigate practical dilemmas.

5.2 FOUNDATIONAL POLICIES AND PRINCIPLES

5.2.1 Background

To properly understand the practical application of the rebuttable presumption and its flaws and shortcomings, it is essential by way of background to review certain selected foundational principles.

The need for a minority shareholder to bring a derivative action generally arises where the company itself improperly fails or refuses to institute legal action to redress a wrong done to it. The statutory derivative action is thus a crucial safeguard for minority shareholders. It enables a minority shareholder, who knows of harm inflicted on the company that has remained unremedied by management—often because they themselves are the wrongdoers—to institute proceedings on behalf of the company. The modernised statutory derivative action in terms of section 165 of the Act is, however, much wider than this. The availability of section 165 ranges beyond wrongs that are committed by the management or the controllers of the company, and extends also to wrongs committed by third parties or outsiders. This includes outsiders against whom the controllers of the company refuse to act, perhaps because they desire to shield the outsider, or are related to or associated with the outsider.

As a general principle, when harm is inflicted on a company, the ‘proper plaintiff’ to take legal action in respect of the wrong is the company itself and not individual shareholders,³ given that the company is a separate legal entity

³ *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189; *Burland v Earle* [1902] AC 83 (PC) at 93; *Prudential Assurance Co Ltd v Newman Industries Ltd* (No 2) [1982] Ch 204.

distinct from its shareholders.⁴ Closely linked with the proper plaintiff rule is the democratic principle of majority rule and the internal management principle, that the affairs of a company are decided by the rule of the majority and that the courts will not intervene in the internal affairs of the company at the instance of an individual shareholder so long as the majority acts lawfully.⁵ By becoming a shareholder in the company, a person undertakes to be bound by the lawful decisions of the prescribed majority of the company's shareholders, even where they adversely affect his own rights as a shareholder.⁶

Although the proper plaintiff rule is in theory a logical approach, it gives rise to practical difficulties and injustice. The potential for abuse arises where the wrongdoers who inflict harm on the company are the directors themselves, for instance where the directors engage in self-dealing or seize for themselves a corporate opportunity that belongs to the company. This is the classic scenario for a derivative action, since the wrongdoing directors are able to use their control to prevent the company from instituting legal proceedings against them to remedy the wrong. This hazard is particularly heightened when the wrongdoers have control of both the board of directors as well as the shareholders in general meeting.⁷

It is in these situations that the derivative action is most needed and it is imperative that the new statutory derivative action be readily available in these circumstances. Regrettably, this vital need may not have received proper recognition in the Act. Instead, the Act imposes additional barriers and obstacles to the availability of the derivative action in cases of directorial misconduct. This is where the Achilles heel of the new statutory derivative action lies. The weakness lies squarely in the rebuttable presumption as explained below.

⁴ As laid down in *Salomon v Salomon & Co* [1897] AC 22.

⁵ *Foss v Harbottle* supra note 3; see also *Edwards v Halliwell* [1950] 2 All ER 1064 at 1066.

⁶ *Sammel v President Brand Gold Mining Co Ltd* 1969 (3) SA 629 (A) at 678.

⁷ See eg *Wallersteiner v Moir (No 2)* [1975] All ER 849 (CA) at 857; see also *Cook v Deeks* [1916] 1 AC 554 (PC).

5.2.2 *The Rebuttable Presumption*

The court may not grant leave to a minority shareholder (or other qualified stakeholder) to institute a derivative action on the company's behalf unless the minority shareholder or applicant satisfies the court that this would, *inter alia*, be in the best interests of the company.⁸ In evaluating the best interests of the company, a statutory presumption arises that the grant of leave would, in certain circumstances, not be in the best interests of the company. This is a rebuttable presumption. When the presumption applies it is still possible for leave to be granted, but the minority shareholder (or other applicant) bears a heavier burden or standard of proof—in order to succeed, he must adduce sufficient evidence to rebut the presumption.

The rebuttable presumption that the grant of leave would *not* be in the best interests of the company (in terms of s 165(7) of the Act) arises if it is established that:

- (a) the proceedings are by the company against a 'third party', or by a 'third party' against the company. A person is a 'third party' for the purpose of the rebuttable presumption if the company and that person are not 'related' or 'inter-related'.⁹ This provision, which has a critical impact on the effectiveness of the statutory derivative action, is considered further in paragraph 5.3 below, and is referred to as '**the first limb**' of the presumption;
- (b) the company has decided not to bring the proceedings (or not to defend the proceedings, or has decided to discontinue, settle or compromise the proceedings, as the case may be).¹⁰ This constitutes the '**second limb**' of the presumption; *and*
- (c) in terms of s 165(7)(c), all of the directors who participated in that decision

⁸ In terms of s 165(5)(b)(iii) of the Act; see Chapter 4.

⁹Section 165(8)(a) of the Act.

¹⁰Proceedings by or against the company include any appeal from a decision made in proceedings by or against the company (s 165(8)(b) of the Act). For the purpose of clarity and simplicity, this chapter will refer only to the institution of legal proceedings on behalf of the company.

(referred to as 'the decision-making directors'):

- (i) acted in good faith for a proper purpose;
- (ii) did not have a personal financial interest in the decision, and were not 'related' to a person who had a personal financial interest in the decision. A 'personal financial interest' means a direct material interest of a financial, monetary or economic nature, or to which a monetary value may be attributed.¹¹ A person 'related' to a director could, for instance, be the spouse or a child of the director or a company 'controlled' directly or indirectly by him, by reason of his control of the majority of the voting rights or his control of the majority of the board;¹²
- (iii) informed themselves about the subject matter of the decision to the extent they reasonably believed to be appropriate; *and*
- (iv) reasonably believed that the decision was in the best interests of the company.

This provision is linked with the business judgment rule set out in s 76(4) of the Act, and is referred to as '**the third limb**' of the presumption.

The three limbs of the presumption are cumulative, so that all three limbs must be satisfied for the presumption to arise.

The courts, in considering whether the grant of leave for a derivative action would be in the best interests of the company, are thus enjoined to give substantial weight to the decision of the board of directors not to litigate. If the board has decided not to litigate, it is (rebuttably) presumed that a derivative action would *not* be in the best interests of the company.¹³

¹¹ Section 1 of the Act.

¹² See further s 2 of the Act; see Richard Jooste 'Groups of Companies and Related Persons' in FHI Cassim et al *Contemporary Company Law* 2ed (2012) 208 - 211.

¹³ Subject to s 165(7)(c).

5.2.3 *Policies Underpinning the Presumption*

The rebuttable presumption as a general concept is to be welcomed. It requires the court to have proper regard to the views of the board of directors relating to corporate litigation. The presumption is aligned with the fundamental policy principle in company law that the courts should not interfere with the internal affairs of companies, and must have regard to the honest and reasonable business decisions and the commercial judgment of the company's board of directors.

The decision to litigate may be regarded as a commercial decision. The decision involves not only the legal viability of the claim, but also its commercial viability, as litigation could undesirably interfere with the conduct of the company's business. In deciding whether to litigate, the board of directors would have to consider both legal issues as well as commercial and business factors, such as the likely costs of the litigation, the amount at stake or the potential benefit to the company, the defendant's financial position, the risk of corporate funds in costly litigation, the disruption of the company's operations including the diversion of managerial time and resources, and the potential harm to the company's image and its relationships with customers, suppliers, financiers and others.

In treating the directors' litigation decision as a commercial decision, s 165(7) is in line with the general judicial approach to the management of companies. It has been acknowledged in several leading cases that the directors of a company are better equipped than are judges to evaluate the best interests of the company, for directors have more knowledge, time and expertise at their disposal.¹⁴ A court consequently will not readily substitute its own commercial judgment on the merits of a decision for that of the directors, nor will it presume to act as a kind of supervisory board over directors' decisions that are honestly arrived at within the powers of their management.¹⁵

¹⁴ *Darvall v North Sydney Brick & Tile Co Ltd* (1989) 15 ACLR 230 (NSWSC).

¹⁵ *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821; *Hogg v Cramphorn Ltd* [1967] Ch 254 at 268; *Re Smith v Fawcett Ltd* [1942] Ch 304 at 306.

The established principle thus is that the courts are not business experts, and do not have the expertise to review the commercial merits of business decisions.¹⁶

This applies as a general principle also to decisions on corporate litigation. But an exception to the general principle must obviously arise where the impartiality and the objectivity of the board of directors is questionable, for instance if the claim concerns wrongdoing by a controller of the company or entails a breach of fiduciary duty by the directors themselves. More importantly, it must be acknowledged that the decision of the board of directors not to sue is distinct from normal commercial decisions, for in the sphere of litigation decisions it is judges—not directors—who have the superior ability to evaluate the merits of initiating litigation (as discussed further below). By creating a rebuttable presumption that the board's decision not to litigate is in the best interests of the company, s 165(7) prevents unwarranted interference and unwarranted overriding of the directors' authority to determine whether a company should pursue legal proceedings. Consequently, for a minority shareholder to bring a derivative action (contrary to the board's decision), he would have to show that litigation is in the best interests of the company.

5.2.4 Link with the Business Judgment Rule

The third limb of the presumption¹⁷ is effectively linked with and incorporates the business judgment rule as set out in s 76(4). The business judgment rule provides a safe harbour from liability for directors for their honest and reasonable business decisions. To the extent that the directors' reasonable decision that the company should not litigate against a third party¹⁸ is rebuttably presumed to be in the company's best interests, it is (presumptively) treated like any other business judgment or business decision that is normally left to the

¹⁶ *Howard Smith Ltd v Ampol Petroleum Ltd* supra note 15 at 832; see Farouk HI Cassim 'The Duties and the Liability of Directors' in FHI Cassim et al *Contemporary Company Law* 2ed (2012) at 524, 565.

¹⁷ As discussed above.

¹⁸ As opposed to a related or inter-related party.

directors to determine. This applies only if all the directors who had participated in the decision complied with the decision-making procedure prescribed in the third limb ie all were acting in good faith and were disinterested in the matter, were reasonably informed and reasonably believed the decision to be in the best interests of the company.¹⁹ The rebuttable presumption thus provides an important link between the statutory derivative action and the business judgment rule.

Insofar as both the business judgment rule and the third limb of the presumption require directors to be disinterested and not to be self-dealing, to make a reasonably informed decision, and to have a reasonable or rational belief that their decision is in the company's best interests, they mirror each other. However in two material respects the third limb of the presumption goes further than the business judgment rule as expounded in s 76(4)(a) of the Act. First, unlike the business judgment rule, the presumption imposes an additional requirement, in that the decision-making directors must also have acted in good faith for a proper purpose.²⁰ The duty to act in good faith and for a proper purpose is manifestly not a requirement of the business judgment rule under s 76(4)(a). Secondly, the business judgment rule is more lenient in its requisite standard of disinterestedness. The rebuttable presumption requires all decision-making directors to have no personal financial interest in the matter and to be unrelated to a person with a personal financial interest,²¹ while the business judgment rule is more lenient and may yet apply in such circumstances, as long as the director had made due and proper disclosure of the personal financial interest²² or had no reasonable basis to know of the personal financial interest of a related person.

The divergence between the rebuttable presumption and the business judgment rule is noteworthy and significant. It is unusual and rather mystifying that the business judgment rule does not require directors to act in good faith

¹⁹ As discussed above.

²⁰ Section 165(7)(c)(i) of the Act.

²¹ Section 165(7)(c)(ii) of the Act, as discussed above.

²² In compliance with s 75 of the Act.

for a proper purpose. Good faith is an essential and vital element of the business judgment rule both in US law,²³ which is the birthplace of the business judgment rule, and in Australian law.²⁴

The rebuttable presumption in s 165(7) of the South African Act is evidently modelled on the Australian equivalent,²⁵ and the two statutory provisions are substantially similar. The one minor difference is that the Australian version of the rebuttable presumption provides that the directors must have '*rationaly*' believed the decision to be in the best interests of the company, and not '*reasonably*' believed, as per the South African Act.²⁶ However the Australian legislation continues to state further that the director's belief is a rational one unless the belief is one that no *reasonable* person in their position would hold. Unlike the discrepancy under the South African Act, in the Australian legislation both the rebuttable presumption and the business judgment rule²⁷ eminently require directors to act in good faith for a proper purpose. Perhaps the cause of the aberration in the South African Act is simply the result of directly lifting or borrowing selected provisions from Australian legislation without a comprehensive and thorough study of their consequences and implications. In any event, insofar as the statutory derivative action is concerned, it is submitted that the inclusion of good faith as a precondition for the rebuttable presumption is the correct approach. The requirement of good faith may play a potentially important role in solving the dilemmas that arise in relation to directorial misconduct.²⁸

5.3 DEFECTS OF THE PRESUMPTION

The rebuttable presumption that a derivative action is *contrary* to the company's

²³ See eg *Aronson v Lewis*, 472 A.2d 805 at 812-16 (Del. 1984); Model Business Corporation Act, s 8.31; American Law Institute's Corporate Governance Principles (1994), s 4.01(c).

²⁴ Australian Corporations Act, 2001, s 180(2)(a); see also Farouk HI Cassim op cit note 16 at 564.

²⁵ Section 237(3) of the Australian Corporations Act.

²⁶ See s 165(5)(c)(iv).

²⁷ Section 180(1) and (2) of the Australian Corporations Act.

²⁸ See further para 5.4 below, particularly the discussion of directorial 'independence' in para 5.4.2.

best interests operates only where an applicant seeks leave to institute derivative proceedings against a wrongdoing third party, whom the company itself has decided not to sue. For instance, this could entail a contractual or delictual dispute between the company and an outsider, such as a customer or a supplier. Conversely, when leave is sought to bring a derivative action against a related or inter-related person, the presumption is wholly inapplicable.²⁹

It is a sensible policy decision for the presumption to operate against the applicant where the proceedings involve an outsider. Derivative actions are not so commonly needed against errant outsiders who have no connection with the company's directors or shareholders, but rather against insiders who have the power to abuse their control of the company and particularly its litigation decision. As so aptly stated by Lord Denning in *Wallersteiner v Moir (No 2)*,³⁰ '[t]he [proper plaintiff] rule is easy enough to apply when the company is defrauded by outsiders. The company itself is the only person who can sue.' In certain circumstances, however, derivative actions against outsiders are necessary, especially where the company itself improperly fails or refuses to sue. A useful illustration arose in Canadian law in *Commalert Monitors Inc v Maple Ridge Business Centre Ltd*,³¹ where the president of a company, who had been unable to obtain a board resolution approving of the institution of a legal action in the company's name against the company's landlord, was granted leave to pursue a derivative action on the company's behalf in respect of a rent dispute.

Derivative claims against outsiders could also arise in circumstances where an outsider has assisted an insider of the company, such as the majority shareholder or the company's controllers, in the commission of the wrong perpetrated on the company. The need for a minority shareholder to bring a derivative action to protect the company's legal interests would arise more frequently in these scenarios, than against 'pure' outsiders who are neither

²⁹ Section 165(7) read with s 165(8).

³⁰ *Supra* note 7 at 857.

³¹ (1995) 56 ACWS 3d 1290, [1995] BCWLD 2239 (SC), a British Columbia case.

related to nor associated with the controllers of the company and whom the controllers of the company have no particular wish to shield.³²

In essence, when a third party harms the company, and the directors—who comply fully with the formal decision-making procedure prescribed in the third limb³³—decide not to institute legal action, it generally is (rebuttably) presumed that the grant of leave for a derivative action is *contrary* to the company's best interests. Although leave may yet be granted, the applicant now bears a heavier burden—in order to succeed he must rebut the presumption. On the other hand, when harm is inflicted on the company by a person who is related or inter-related to it, the presumption is inapplicable, and the court would more readily grant leave for the derivative action. Although the dichotomy between third parties and related parties appears at first blush to be a rational approach, it is plagued by a serious shortfall. This flows from the statutory definitions of a 'third party' and a 'related party', and is discussed in detail below.

5.3.1 *Wrongdoing by Majority Shareholders and Related Parties*

Persons 'related' to the wronged company include its holding company and its subsidiary companies.³⁴ As for individuals, an individual is 'related' to the wronged company if he or she 'controls' the company. The term 'control' broadly means the ability to control the exercise of a majority of the voting rights of the company, or the ability to control the majority of the directors by virtue of the right of appointment or election.³⁵ When any of these related persons (or

³² The operation of the rebuttable presumption may (or may not) be excluded in these cases by its third limb, on the basis that the decision-making directors failed to comply with the prescribed decision-making procedure. This depends on the particular facts and circumstances of each case and is explored further in the discussion of 'independence' in para 5.4 below.

³³ Discussed above.

³⁴ Also included is any juristic person that directly or indirectly 'controls' the wronged company (or its business), or that is controlled by it. Juristic persons are, moreover, related where another person directly or indirectly 'controls' each of them or the business of each of them. See further s 2(1)(b) and (c) of the Act; Richard Jooste op cit note 12 at 208 - 211 .

³⁵ The concept of 'control' for these purposes is dealt with in s 2(2) of the Act.

inter-related persons)³⁶ inflict harm on the company, a refusal by the company's board to litigate against the wrongdoer will not be protected by the presumption—the operation of which is excluded by virtue of its first limb—and the derivative action that a minority shareholder seeks to institute will *not* be presumed to be contrary to the best interests of the company. This smoothes the applicant's path when the wrongdoer, for instance, is the majority shareholder of the company, or is a person who pursuant to a shareholder agreement is able to control the majority of the company's voting rights, or is a person who controls the composition of the majority of the board.

By depriving such wrongdoers of the benefit of the presumption, the Act sensibly recognises the need for a safety measure where the company is harmed by its own majority shareholders, who have the power to abuse their influence over the board of directors and thereby to prevent the company from proceeding against them. The board of directors may be swayed to vote down any demand by a minority shareholder or other stakeholder that legal proceedings be brought against the transgressors, given that the majority shareholders wield the power to appoint and remove them from office as directors. In light of the potential for abuse, the exclusion of related parties from the ambit of the presumption is plainly a logical one.

The exclusion of 'related' and inter-related parties' also provides a safeguard against 'tunnelling'. Tunnelling is an abuse specific to public companies with a dominant shareholder, particularly where the dominant shareholder controls several companies by way of intricate cross-shareholding schemes and co-ordinates their businesses. The dominant shareholder may be a wealthy individual or family, or even a coalition or syndicate of investors which jointly dominate the firm. This creates the risk of self-dealing by the dominant shareholder, whether by directly entering into contracts with the company or, more commonly, by doing so through other entities that he controls (that is, related party transactions and intra-group transactions). These intra-group

³⁶ See s 1 of the Act; Richard Jooste op cit note 12 at 211.

transactions may be used to expropriate the minority shareholders of the company, by transferring or siphoning off or ‘tunnelling’ resources out of the company to the controlling shareholder. Tunnelling could even entail the payment of grossly inflated salaries and compensation to the majority shareholders. Dominant shareholders may thus opportunistically divert corporate value or wealth to themselves.

This sort of self-dealing by majority shareholders would more frequently form the basis of a derivative action in closely-held public companies with a dominant shareholder (that is, the continental European type of public company which is often family-controlled³⁷ or the Chinese type of public company which is usually a transformed state-owned enterprise in which the state holds more than 60% of the shareholding³⁸), as opposed to widely-held public companies with diffuse share ownership (such as the US and UK type of public companies which generally have widely dispersed shareholders,) in which the basis of derivative actions frequently is self-dealing by directors and managers. The derivative action is intended to be an instrument to protect minority shareholders and other stakeholders from opportunism by insiders (ie majority shareholders and directors). Insofar as the rebuttable presumption in s 165(7) of the Act deprives both related and inter-related parties of the benefit of its protection, it laudably caters for self-dealing and sweetheart deals by *dominant shareholders*. Regrettably, however, the Act fails to adequately cater for self-dealing and abuse by the *directors* of a company.

5.3.2 *Wrongdoing by Directors*

It is disquieting to note that when harm is inflicted on a company by its own directors, the rebuttable presumption still applies. This means that when a minority shareholder seeks leave to bring proceedings to redress

³⁷ Pierre-Henri Conac, Luca Enriques & Martin Gelter ‘Constraining Dominant Shareholders’ Self Dealing: The Legal Framework in France, Germany and Italy’ (2007) 4 *European Company and Financial Law Review* 491 at 495.

³⁸ Hui Huang ‘Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis’ (2012) 27 *Banking and Finance Law Review* 619 at 625.

mismanagement or misconduct by the company's directors, the derivative proceedings are rebuttably presumed to be *contrary* to the company's best interests. The refusal by the board of directors to proceed against their fellow director/s would presumptively be protected³⁹ (provided, of course, that the board decision complies with the decision-making process prescribed in the third limb of the presumption).⁴⁰ While the presumption is excluded in the event of wrongdoing by *majority shareholders*,⁴¹ the Act illogically fails to provide for a similar exclusion in respect of *directorial* wrongdoing. It is odd that the directors are regarded as 'third parties' in relation to the company⁴² for the purposes of s 165. The result is that miscreant directors are undeservedly protected by the presumption.

This is most disturbing, as it overlooks the cardinal point that derivative actions in the vast majority of cases are brought to protect the company against its own errant directors. Under the Companies Act 61 of 1973, the statutory derivative action⁴³ was devoted solely to misconduct by directors and officers. The derivative action is a vital weapon that is purposed at empowering minority shareholders to monitor and police the board of directors, and to play an effective role in holding corporate management accountable for misconduct. In the key situation where directors have inflicted harm on the very company that they are bound to serve, the statutory derivative action should be more (and not less) flexibly and readily available, because this is when the risk of conflicted or biased decision-making by the board is most acute. This risk cannot be overemphasised. Innocent directors who had no involvement in the wrongdoing may act inconsistently with corporate interests in deciding not to sue the wrongdoing directors, as a result of their professional, personal or social bonds with them. This widely recognised danger is labelled in US law as a 'structural

³⁹ Maleka Femida Cassim 'Shareholder Remedies and Minority Protection' in FHI Cassim et al *Contemporary Company Law* 2ed (2012) at 789.

⁴⁰ As discussed above.

⁴¹ And related persons.

⁴² Section 165(8)(a) read with the definition of 'related person' in s 2 of the Act.

⁴³ Section 266 of the Companies Act 61 of 1973.

bias'.⁴⁴ The failure of s 165 to properly cater for wrongdoing by the directors themselves regrettably creates a major predicament which has the potential to strangle the use and effectiveness of the derivative action where it is most needed.

The only circumstance where directors would be denied the benefit of the presumption is where they fall within the definition of 'related' persons, that is, where the miscreant directors happen to 'control' the company as well in the sense of having (direct or indirect) control of the majority of the company's voting rights or control over the constitution of the majority of the board. To this extent, the Act caters for the worst case scenario when the company is defrauded by directors who are also the majority shareholders, in other words, situations where the wrongdoers control both organs of the company. The Act thus provides a solution to the vexed problem raised by Lord Denning in *Wallersteiner v Moir (No 2)*,⁴⁵ that if the company 'is defrauded by insiders who control its affairs—by directors who hold a majority of shares—who then can sue for damages?' Directors who are concurrently related persons are more likely to be found in smaller private owner-managed companies, where there is no split between ownership and control, and all of the shareholders of the company are generally also directors of the company. But in larger public companies, directors are far less likely to also have 'control' of the company, as 'related' persons.

One wonders whether the classification of directors as 'third parties'—and not as 'related persons'—is an unintended consequence without an appreciation of its full effects, instead of a carefully considered policy decision. In this regard, the presumption in s 165(7) of the Act is apparently derived directly from the Australian rebuttable presumption.⁴⁶ Likewise, the definition of a third party in s 165(8) of the South African Act appears at first glance to be

⁴⁴ See eg *Zapata Corp v Maldonado* 430 A 2d 779 (Del Sup Ct 1981); *Joy v North* 692 F 2d 880 1982. See further paras 5.4 and 5.5.2 below.

⁴⁵ *Supra* note 7 at 857.

⁴⁶ Section 273(3) of the Australian Corporations Act.

very similar to the equivalent Australian version.⁴⁷ But what is overlooked, or is conspicuous by its absence, in the South African Act is a wider definition of a ‘related party’ to include the directors of a company.⁴⁸ In marked contrast, the Australian legislation—in a separate and easily overlooked Part of that statute⁴⁹—contains a far wider definition of a ‘related party’ that includes serving directors and their relatives. This comprehensive definition has a far-reaching impact on the efficacy of the Australian statutory derivative action and renders it much more effective than the South African version.

5.3.3 *Suggested Reform of the Act*

This glaring defect in s 165 constitutes the Achilles heel of the new statutory derivative action. It must be amended by the legislature by way of an Amendment Act. There are four aspects of the presumption that require urgent amendment.

First, a simple and straightforward—yet crucial—amendment must be made to s 165(8)(a) to expressly provide that a person is a ‘third party’ if the company and that person are not related or inter-related, *or if that person is not a director of the company*. This amendment would carve out the directors of the company from the ambit and the benefit of the presumption.

Secondly, s 165(8)(a) should also explicitly exclude from its definition of a third party any person who is related to a director of the company—with the effect that the presumption would not apply to such defendants. When an applicant seeks leave to bring a derivative action against a relative of a director (such as his father or his son) or against a company or other entity that is related to a director, the risk of a structural bias or biased decision-making by the board would clearly arise. The board of directors may be reluctant to authorise the institution of legal proceedings against a person or an individual

⁴⁷ In s 273(4) of the Australian Corporations Act, 2001.

⁴⁸ At least for the purpose of the statutory derivative action.

⁴⁹ Section 228 of the Australian Corporations Act.

who is related to one of their fellow directors.

Thirdly, the presumption should not operate where the defendant is a former director of the company. Directors' fiduciary duties extend equally to resigning directors who, for instance, have deliberately resigned with the intention of exploiting a corporate opportunity that arose while they were directors of the company.⁵⁰ A minority shareholder or applicant should not be faced with the practical hurdle of having to rebut the presumption that the grant of leave is contrary to the company's best interests merely because the miscreant directors have resigned from office as directors prior to the commencement of the legal proceedings. For these reasons, it is submitted that the suggested amendment to s 165 must also close the existing loophole for former directors of the company.

Fourth, it is noteworthy that former directors are regarded as 'related' parties under the Australian Corporations Act⁵¹ only if they were directors in the previous six months prior to commencement of the proceedings. But in the South African context a six month window period for former directors would not be adequate. This is both in view of the time delays for the commencement of litigation in the South African environment, as well as the statutory provision that an applicant may not apply for leave for a derivative action unless he has first given the company a period of some 60 business days, ie twelve weeks, to respond to his demand that the company institute legal action itself.⁵² It is accordingly submitted that for the purposes of the proposed amendment to the South African Act, a former director ought to be regarded as a related party for at least a period of 24 months after his resignation or vacation of office as a director. The adoption of a 24 month window period for former directors would also harmonise with s 162(2)(a) of the Act, which permits applications for an order declaring a former director delinquent or under probation to be brought for

⁵⁰ See eg *Canadian Aero Service v O'Malley* (1973) 40 DLR 3d 371 (SCC); *Industrial Development Consultants v Cooley* [1972] 2 All ER 162; *Da Silva v CH Chemical (Pty) Ltd* 2008 (6) SA 620 (SCA); see eg Maleka Femida Cassim 'Da Silva v CH Chemical (Pty) Ltd: Fiduciary Duties of Resigning Directors' (2009) 126 *SALJ* 61.

⁵¹ Section 228(5).

⁵² Section 165(4) read with (5) of the Act; see also s 165(6).

a period of up to 24 months after he has ceased to be a director of the company.

One may perhaps contend that in order to exclude directors from the ambit of the presumption, the courts could adopt a purposive interpretation of s 165(8)(a) rather than a strict literal reading of the provision. On a purposive approach,⁵³ s 165(8)(a) would be read, not as providing for an exclusive or exhaustive definition of a 'third party', but rather as a non-exhaustive definition of a third party. But it is doubtful whether a court could adopt a purposive interpretation, in light of the consideration that the definition of a third party in s 165(8)(a) appears on a literal reading to be close-ended and exhaustive.⁵⁴ The optimal solution remains an expeditious amendment of the Act to cure the defects, rather than expecting the judiciary to do so.

⁵³ Significantly, the court is enjoined by s 158(b)(i), when determining a matter or making an order in terms of the Act, to promote the spirit, purpose and objects of the Act. A robust purposive interpretation of s 165(7) read with (8)(a), so as to facilitate the institution of derivative actions against the miscreant directors of a company, is buttressed by the stated purposes of the Act. Among the relevant purposes of the Act are the encouragement of high standards of corporate governance, the encouragement of the efficient and responsible management of companies, and balancing the rights and obligations of shareholders and directors within companies (s 7(b)(iii), (j) and (i) of the Act, respectively). The promotion of these statutory purposes by an efficient and effective derivative action may, in turn, strengthen investor confidence and promote investment in the South African markets, which is yet another object of the Act, and may also promote an effective environment for the efficient regulation of companies (s 7(c) and (l) of the Act, respectively).

It must be borne in mind that the derivative action is increasingly viewed as a valuable instrument for shareholder control of corporate misconduct. It has twin purposes: first, it enables a minority shareholder or other stakeholder to seek compensation for the company from miscreant directors and others who have harmed it; and secondly, and perhaps more importantly, it ensures some degree of accountability by directors and is a deterrent to future directorial misconduct.

Furthermore, s 158(b)(ii) of the Act declares that if any provision of the Act, read in its context, can reasonably be construed to have more than one meaning, the court must prefer the meaning that best promotes the spirit and purpose of the Act, and that will best improve the realisation and the enjoyment of rights. It is perhaps arguable that s 165(8)(a) could be reasonably construed to have more than one meaning, viz it may be construed as either an exhaustive definition or a non-exhaustive definition of a third party. If the latter construction is found by the courts to be a reasonable one, it would prevail as the preferred meaning that best promotes the spirit and purpose of the Act.

⁵⁴ See eg *Union Government (Minister of Finance) v Mack* 1917 AD 731 at 739 which laid down that 'the language of the Legislature should be read in its ordinary sense'; see also *Norden v Bhanki* 1974 (4) SA 647 (A) 655A which held that the 'plain meaning' of statutory language is paramount in statutory interpretation. Also relevant here is the legal principle 'expressio unius est exclusio alterius' (the express inclusion of one situation results in the exclusion of that which is not mentioned). This legal principle is a prima facie indicator of meaning (see for instance *Chotabhai v Union Government (Minister of Justice)* and *Registrar of Asiatics* 1911 AD 13 at 28; *Makholiso v Makholiso* 1997 4 SA 509 (Tk) 517).

5.4 THE FORM OF THE BOARD DECISION: THE DECISION-MAKING PROCESS

Until such time as the amendments to the Act are effected (or failing amendment), the courts will have to engage more intimately with the business judgment rule. As explained above, the business judgment rule is incorporated, in modified form,⁵⁵ in the derivative action through the third limb of the rebuttable presumption. Paragraphs 5.4 and 5.5 focus on the application of the business judgment rule / rebuttable presumption in the context of derivative actions.

The rebuttable presumption operates to protect the litigation decision of the board of directors only if the decision-making directors comply with the decision-making process prescribed in the third limb. The third limb—which embraces the business judgment rule—regulates the decision-making process or the *form* of the board decision (as opposed to the *substance* of the decision). If the *form* of the board’s litigation decision fails to meet all the four requirements of the third limb, then the presumption does *not apply*, and the board decision not to litigate against the wrongdoer will receive no presumptive protection at all. If on the other hand, the form of the board decision satisfies all the requirements of the third limb, then the board decision not to sue the wrongdoing director—that is, the *substance* or the merits of the decision itself—is protected by the presumption, although this, significantly, may be rebutted.

To express it more simply, a two-step inquiry is involved in the judicial scrutiny of the board decision not to sue a miscreant director or third party wrongdoer:⁵⁶

- (i) The first step concerns the decision-making process or the *form* of the board’s litigation decision. This determines whether the protective presumption operates or not. If the presumption does not operate that is

⁵⁵ See para 5.2 above; see further para 5.5 below.

⁵⁶ The formulation of this two-step inquiry is based both on s 165(7) and on the US approach as expressed in the leading case *Zapata Corp v Maldonado* supra note 44; see also Franklin A Gevurtz *Corporation Law* (2010) 294 – 5, 437 for a discussion of the distinction in US law between the decision-making process and the substance of the decision itself. The relevance of US law is discussed in para 5.5.2 below.

clearly the end of the inquiry and the board's decision is disregarded. If on the other hand the presumption does apply, one must proceed to the second step of the inquiry.

- (ii) The second step concerns the merits of the board's litigation decision or the *substance* of the decision itself. It relates to the weight of the protective presumption (or its 'rebuttability'), in other words, the degree of judicial deference that should be given to the board's decision not to sue the wrongdoer.

Paragraph 5.5 discusses the second step of the inquiry, while paragraph 5.4 focuses on the first step. In particular, the concept of the 'independence' of decision-making directors is explored. This is a valuable tool that the courts may rely on to mitigate the practical dilemmas arising in relation to directorial wrongdoing and mismanagement of companies.

5.4.1 Further Problems Failing Amendment

Until such time as the suggested amendments to the Act are effected (or in the absence of an amendment) to carve out wrongdoing directors from the benefit of the rebuttable presumption, further problems and dilemmas may be expected to arise in relation to directorial misconduct.

It must be stressed at the outset that there are two important circumstances in which the protective presumption will *not* apply to directorial misconduct. First, where the company has been wronged by one or more of its directors and the errant director votes on, or even merely participates in taking, the litigation decision. In these circumstances the presumption cannot operate, for it would be impossible to satisfy its third limb. The wording of the third limb makes it clear that for the presumption to operate, 'all' the directors who participate in the litigation decision must be disinterested, in the sense of having no 'personal financial interest'⁵⁷ in the decision. As a matter of principle, if the

⁵⁷ Section 165(7)(c)(ii) of the Act.

defendant or miscreant director is permitted to vote, or is allowed to participate in the deliberations at the board meeting, this would taint any decision not to proceed against him and the presumption would not apply. Secondly, in the unusual situation where the entire board has committed the alleged wrong against the company, the presumption can never apply, since none of the directors would be disinterested nor would they be acting in good faith for a proper purpose in deciding not to litigate against themselves.

But problems arise in many other situations, most notably, where the company has been harmed by its own directors who constitute a majority of the board. In these cases the presumption may still apply.⁵⁸ The consequence is that the commencement of derivative litigation against the errant majority may be rebuttably presumed to *oppose* the best interests of the company. If only those minority directors, who were uninvolved in the wrongdoing, participate in the litigation decision in which they resolve that the company will not litigate against their fellow directors, the presumption may yet apply—assuming of course that the decision-making directors fulfil the four formal and procedural requirements set out in the third limb. The practical question arises whether it is possible in the first place for the minority directors to validly pass a board resolution, bearing in mind that the majority of the board (ie the wrongdoers) is disabled from voting on the litigation decision. In view of the statutory provisions relating to board meetings and board resolutions, this evidently is achievable.⁵⁹

⁵⁸ Provided that the errant directors do not participate in the litigation decision of the board.

⁵⁹ See s 75(5)(b) – (f). In this regard, a board resolution (unless otherwise stated in the company's Memorandum of Incorporation) requires the approval of a majority of the votes actually cast, as opposed to approval by a majority of all the company's directors (s 73(5)(d) of the Act). As long as the directors are able to constitute a board meeting, the disinterested minority directors may validly resolve that the company should not sue the miscreant majority directors.

To constitute a board meeting, the Act requires the presence of a majority at the meeting before a vote may be called (s 73(5)(b)). The implication is that at least some of the wrongdoing directors would have to be present at the meeting to validly constitute it (given that a majority of the directors were the wrongdoers). If none of the wrongdoing majority directors attend, the board meeting cannot be constituted and a vote cannot be taken, with the result that the presumption will be inapplicable ie the derivative litigation would *not* be presumed to be contrary to the best interests of the company.

If on the other hand a board meeting is duly constituted through the attendance of at least some of the wrongdoers, the miscreant directors would not be permitted to participate in or vote on the litigation decision. Their absence from the meeting during this time would not affect the quorum for the meeting, for they are deemed to be present 'for the purpose of determining whether sufficient directors

However, one wonders whether minority directors, in making their litigation decision in these circumstances, would really be acting free from any latent pressure or bias in favour of the defendants, who are their fellow directors and the majority of their board.

A thorny situation similarly occurs in the event of wrongdoing by a dominant or an influential director. Where the miscreant director who commits a wrong against the company does not necessarily hold the majority of the votes at board meetings, but dominates or is able to influence the board, the danger arises that the dominant director would be in a position to abuse his power to prevent the company from seeking redress against him. His dominance or influence over the board could arise, for instance, from close or long-standing personal friendships with his co-directors, or the ability to materially influence the career paths or the financial interests of his co-directors. If his fellow board members resolve not to sue the dominant director for his wrongdoing, the rebuttable presumption may inappropriately protect their decision not to litigate against him. Although his fellow board members are neither unbiased nor 'independent', they are nevertheless 'disinterested' for the purpose of s 165(7)(c)(i), in the sense of not having a personal financial interest in the decision. While the third limb of the presumption takes into account self-dealing or a 'personal financial interest' (ie 'disinterestedness'), it disturbingly gives far less emphasis to a lack of independence. The rebuttable presumption may thus apply in favour of the dominant wrongdoer in these instances, unless it is shown to the satisfaction of the court that the third limb of the presumption is not fulfilled, in that one or more of the directors failed to make the litigation decision in good faith for a proper purpose, or had a personal financial interest in the matter, or was not reasonably informed, and/or did not reasonably believe the

are present to constitute the meeting' (s 75(5)(f)(i)). Conversely, the miscreant directors are regarded as being absent from the meeting for voting purposes and for determining whether the resolution has sufficient support to be adopted (s 75(5)(f)(ii)). In other words, a majority of the minority directors (who were uninvolved in the wrong done to the company) may validly adopt a resolution refusing to sue the miscreant majority of the board. In this event it may be rebuttably presumed that the institution of derivative litigation against the miscreant majority directors who had harmed the company would be contrary to the company's best interests.

decision to be in the company's best interests.

This, in practice, may prove to be a difficult feat. The directors are unlikely to act without at least appearing to make a reasonable inquiry and appearing to be reasonably informed. Moreover, a decision would seldom be so absurd that one could confidently conclude that the directors were unreasonable, particularly bearing in mind the numerous commercial and business factors which come into play when making the litigation decision for a company, such as the likely legal costs, the potential damage to the company's image and reputation, and the disruption of the company's business operations. As for the bias or the lack of 'independence' of the decision-making directors, although the concept of independence is an aspect of the directors' fiduciary duty of good faith,⁶⁰ it may in practice be a Herculean task for an applicant to prove that the decision-making directors by reason of their lack of independence were in bad faith.⁶¹ If 'independence' were, instead, a specific and explicit requirement of the third limb, it would be much easier to exclude the application of the presumption in cases where the board decides to absolve a dominant or influential director from his corporate misconduct.

The issue of who bears the onus of proof is an important, but unanswered, question in South African law. In Australian law the *Explanatory Memorandum to the Corporate Law Economic Reform Program Bill*⁶² states that the statutory formulation creates a *presumption* in favour of the directors. In other words, there is a presumption that the directors have complied with the prescribed decision-making process, and the onus is on the applicant to overturn this presumption and to establish that the directors have violated at least one of the four criteria. This is despite the literal wording and the

⁶⁰ Farouk HI Cassim op cit note 16 at 524, 529; see also LCB Gower *The Principles of Modern Company Law* 2ed (1957) 474 and 5ed (1992) 553 in respect of long-standing common law principles on the duty to act in good faith; see also S Mortimore QC *Company Directors: Duties, Liabilities and Remedies* (2009) 257.

⁶¹ And thus in breach of s 165(c)(i). See further para 5.4.2 below.

⁶² *Explanatory Memorandum to the Corporate Law Economic Reform Program Bill*, 1998 at para 6.4; see eg RP Austin & IM Ramsay *Ford's Principles of Corporations Law* 14ed (2010) 438, in respect of the business judgment rule, which is incorporated in modified form in the rebuttable presumption in the statutory derivative action.

formulation of the statutory rule (in terms of s 180(2) and s 237(3)) which states that the protection applies only 'if' the directors meet the four stated criteria. The Australian courts, however, have not yet decisively ruled on the matter. In US law, which is the original source of these concepts, the principle operates also as a procedural rule of evidence, whereby the burden of proof usually rests upon the applicant (or plaintiff) to establish that the directors in making their decision have failed to comply with their duty to act in good faith, in the corporation's best interest and on an informed basis.⁶³ In other words, the presumption applies unless the applicant adduces sufficient evidence to rebut it, eg bad faith or self-dealing. The logic and reasoning is that it is in accordance with the ordinary rules of civil procedure that the plaintiff or applicant must prove his case—accordingly, a person who challenges the decision of the board of directors not to litigate against a wrongdoer, must bear the burden of proving his case. Perhaps the South African courts would adopt a similar approach to the onus of proof of the four requirements (of directorial decision-making) under the third limb of the presumption in s 165(7)(c).

Even in situations where a miscreant director is neither dominant over his fellow directors nor holds the majority of the votes at board meetings, the presumption would still apply to his benefit (as long he does not participate in the litigation decision and the decision-making directors all comply with the procedural requirements of the third limb). This is problematic, for even directors who sincerely wish to make an honest and good faith decision on whether or not to sue a fellow director, may be swayed by empathy or even by subconscious bias in favour of their fellow directors. As so aptly proclaimed in the leading Delaware case, *Zapata Corp v Maldonado*:⁶⁴

⁶³ *Aronson v Lewis*, supra note 23 at 812-16; *Grobow v Perot* 539 A.2d 180 (Del. Ch. 1988); *Citron v Fairchild Camera and Instrument Corp.* 569 A.2d 53 (Del.1989). Some cases, however, have placed the burden of proof on the plaintiff, eg *Zapata v Maldonado* supra note 44, cf *Auerbach v Bennett* 393 NE 2d 994 (NYCA 1979). It is noteworthy that the structure and formulation of the rule under the US Model Business Corporation Act (s 7.44) and the American Law Institute *Principles of Corporate Governance* (1994) (ss 4.01(c) and 7.07 - 7.10) is substantially parallel to the statutory formulation of the rule in the South African and Australian legislation.

⁶⁴ Supra note 44.

‘[w]e must be mindful that directors are passing judgment on fellow directors... The question naturally arises whether a ‘there but for the grace of God go I’ empathy might not play a role. And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse’.

When a director is the wrongdoer, there should emphatically be no presumption that derivative litigation against him is contrary to the best interests of the company. To allow this, is to unfairly burden the minority shareholder or applicant with the practical obstacle and deterrent of a heavier and more difficult standard of proof.

5.4.2 The Solution : The Concept of Directorial ‘Independence’

Failing an amendment of s 165, the concept of ‘independence’ would go a long way towards mitigating the above problems associated with statutory derivative actions against miscreant directors. The concept of independence is distinct from the concept of disinterestedness. While the third limb of the presumption requires disinterestedness on the part of decision-making directors—in the sense of not having a personal financial interest in the decision or transaction being challenged⁶⁵—it overlooks independence.

Disinterestedness is narrower than independence. While the concept of ‘independence’ includes ‘disinterestedness’, the converse does not apply. Disinterestedness entails not having a personal interest in the challenged or impugned transaction,⁶⁶ whereas ‘independence’ means not being influenced in favour of the defendants by reason of personal or other relationships.⁶⁷ An independent director is in a position to base his decision on the objective merits

⁶⁵ Section 165(7)(c)(ii).

⁶⁶ American Bar Association, Section of Business Law *Model Business Corporation Act: Official Text with Official Comment and Statutory Cross-References Revised through 2002* (2002), Official Comment to s 7.44 at 7-91 – 7-94.

⁶⁷ See eg *Aronson v Lewis*, supra note 23 at 812 - 816.

of the issue rather than being governed by extraneous or subjective considerations or influences.⁶⁸ The question of independence has been said to turn on ‘whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind’.⁶⁹ This takes into account both past relationships and existing influence.⁷⁰ A useful case in point is *re Oracle Corp Derivative Litigation*,⁷¹ in which the US (Delaware) court found that the committee of directors in making the litigation decision for the company had lacked independence, even though its members had not been named as defendants in the derivative suit and even though they had sought the legal advice of a reputable law firm. The basis of the court’s finding was that the directors on the committee had long-standing professional or academic relationships with the defendants through Stanford University. An independent director need not necessarily be an outside director or a non-executive director—depending on the circumstances an officer or executive director may be independent.

The presumption in s 165 of the Act takes cognisance of ‘independence’ to a limited extent only, ie only insofar as a decision-making director is related to the wrongdoer⁷² or the litigation concerns a person who has control over the majority of the board.⁷³ But this does not go far enough. The adoption of a wider and more comprehensive concept of independence would serve as a safeguard against several of the abuses identified above in paragraph 5.4.1, such as wrongdoing by a director who is dominant or who has close or long-standing personal relationships with his fellow board members. The latter situation must, however, be distinguished from mere casual acquaintance or collegiality, which would not unduly influence a decision-making director. The question of independence would frequently depend on the particular facts and circumstances of each case.

⁶⁸ *Kaplan v Wyatt* 499 A.2d 1184 (Del SC 1985); see also *Einhorn v Culea*, 612 N.W.2d 78 (Wis. 2000).

⁶⁹ *Parfi Holding AB v Mirror Image Internet Inc* 794 A.2d 1211 (Del. Ch. 2001).

⁷⁰ See eg *Beam ex rel. Martha Stewart Onmimedia, Inc v Stewart* 845 A.2d 1040 (Del SC 2004) 1051.

⁷¹ 824 A.2d 917 (Del. Ch. 2003). The relevance of US law is discussed further below.

⁷² Or to a person with a personal financial interest in the matter (see s 165(5)(c)(i) of the Act).

⁷³ In which event the first limb of the presumption will not be met.

It is submitted that the South African courts must endow the concept of independence with an elevated status as a key element of the presumption, and that it ought to be a pivotal inquiry whether the decision-making directors who had made the litigation decision were truly independent. Should the directors fail to meet this threshold, the courts must exclude the presumption from applying. The notion of independence may thus function as a valuable tool by which to circumvent the decision of a biased board that refuses to sue a miscreant director. It is furthermore submitted that the South African courts may emphasise the concept of independence by relying on the requirement of good faith under the third limb of the presumption. The duty to exercise an independent judgment is, at common law, part of the overarching fiduciary duty to act in good faith.⁷⁴ Accordingly, the proposed judicial inquiry into independence could and should logically form part of the third limb of the presumption. More specifically, it would fall under the requirement in terms of s 165(7)(c)(i) that the directors who participate in the litigation decision must *act in good faith* for a proper purpose. Section 165(7)(c)(i) thus offers a ready platform by which the courts may give greater prominence and weight to the concept of independence.

By adopting this approach the courts would, first, be able to ameliorate the harsh impact of the lacuna in s 165 of the Act, which incorrectly regards directors as ‘third parties’ to the company in whose favour the presumption may apply. Secondly, the notion of independence would also come to the rescue where a company is harmed by an outsider (such as a customer, supplier or service provider), particularly where the outsider or third party has assisted the company’s controllers in the commission of the wrong inflicted on the company, or where the outsider is associated with the company’s controllers. The need for a minority shareholder to bring a derivative action against an outsider would arise more frequently in these circumstances than against ‘pure’ outsiders. While the application of the presumption may be clearly debarred in some of

⁷⁴ Farouk HI Cassim op cit note 16 at 524, 529. See also LCB Gower *The Principles of Modern Company Law* 2ed (1957) 474 and 5ed (1992) 553 in respect of long-standing common law principles on the duty to act in good faith; see also Mortimore op cit note 60 at 257.

these cases by its third limb (for instance, if the board had been involved with the outsider in the commission of the wrong), in many other circumstances it may be more difficult to prove in practice that the decision-making directors had violated the third limb of the presumption (for instance, if the board wishes to shield an outsider who had assisted the majority shareholders (or even a fellow director) in the commission of the wrong). In these scenarios it is submitted that the concept of ‘independence’ would be of considerable assistance to the court as a basis for excluding the inappropriate application of the presumption.

5.5 THE SUBSTANCE OF THE BOARD DECISION: THE WEIGHT OF THE PRESUMPTION

Paragraph 5.4 focused on the requirements for the board’s decision-making process or the *form* of the decision, which determines whether or not the rebuttable presumption applies. It is apt to now turn to a discussion of the *substance* or the merits of the board decision. This constitutes the second step of the two-step inquiry.⁷⁵ When all the *formal* requirements of the presumption are satisfied and the presumption thus applies, the court (rebuttably) presumes that the board decision not to litigate against a miscreant director or third party wrongdoer is in the company’s best interests. How much weight should the court give to this presumption, bearing in mind that it is *rebuttable*?

5.5.1 *Position in South African Law*

To succeed in an application for leave to institute derivative litigation against the wrongdoer, the applicant must satisfy the court, on a balance of probabilities, that the derivative action is in the company’s best interests.⁷⁶ When the rebuttable presumption operates—and it is thus presumed that the board decision *not* to litigate is in the company’s best interests—it is more difficult for an applicant to succeed in his leave application. To satisfy his onus of proof, the

⁷⁵ As discussed in para 5.4 above.

⁷⁶ In terms of s 165(5)(b)(iii) of the Act.

applicant would have to adduce sufficient evidence to overturn or rebut the presumption. Consequently, when the rebuttable presumption operates, the applicant is clearly burdened with a heavier standard of proof.⁷⁷ The question of the weight that the courts should give to the presumption is essentially linked with the degree of judicial deference the courts should give to the judgment or decision of the company's board of directors not to litigate against the wrongdoer.

By incorporating the (rebuttable) presumption in the statutory derivative action, the Act gives recognition to the policy principle that a decision to litigate is not only a legal but also a commercial decision which falls within the function and expertise of the directors of the company, rather than the court. The court would not unduly interfere in the merits of the directors' decision, once it is established that the protective presumption in s 165(7) applies.

It is submitted that in the particular field of the statutory derivative action, the court should avoid giving too much deference or too much weight to the judgment of the directors on whether or not to litigate. The court should instead apply its own independent judgment or its discretion on whether the commencement of derivative litigation would be in the best interests of the company. The court should thus balance the board's views on the company's best interests and the valid claims of the company as represented by the applicant. Litigation decisions of the board may be contrasted with normal commercial or business decisions made by directors. In the sphere of ordinary commercial decisions, the *merits* and the wisdom of the directors' decision fall outside the scope of judicial review when the *formal* requirements of the business judgment rule contained in s 76(4) of the Act are complied with. The business judgment rule, which protects directors from liability for their business decisions and from the risk of hindsight bias, is justifiable on the basis that it

⁷⁷ This discussion of the onus of proof relates to the onus of rebutting the presumption. It should not be confused with the discussion of the onus of proof in para 5.4 above, which relates to the onus of establishing whether or not the presumption applies in the first place. In essence, the presumption may be avoided in one of two ways: either by showing that it does not apply (ie on *formal* grounds) or by rebutting it (ie on *substantive* grounds).

encourages entrepreneurship, innovation and legitimate risk-taking by directors. In stark contrast with ordinary business decisions, directors' decisions not to litigate expose them to little risk of personal liability, even if the court reverses their decision and grants leave for a derivative action.⁷⁸ Consequently, the merits of the board decision whether or not to sue should not be insulated from judicial scrutiny. The Act specifically gives recognition to this distinction between ordinary commercial decisions and litigation decisions. It does so by providing in s 165(7) that the presumption—which protects the *merits* or the wisdom of the board's decision not to litigate—is *rebuttable*. This is distinct from ordinary commercial decisions which fall under the protection of the business judgment rule in s 76(4), and which are insulated by s 76(4) from a judicial assessment of the merits.

The court should thus evaluate not only the directors' decision-making process but also its decision not to litigate. The court may assess the *form* as well as the *substance* of the directors' litigation decision. If the form of the decision-making process was defective (eg if the decision-making directors made a fraudulent or dishonest decision), the rebuttable presumption cannot operate at all. This is because of lack of compliance with the third limb of the presumption.⁷⁹ If on the other hand, the substance or the merits of the directors' litigation decision (but not the form) is defective, the rebuttable presumption does operate, but it may be successfully rebutted on a robust judicial scrutiny of the merits of the decision.

As a matter of policy, excessive deference by the courts to the litigation decisions of directors would defeat the purpose of the statutory derivative action, bearing in mind that its chief function is to monitor the conduct of the board to ensure directorial accountability and to deter wrongdoing by directors themselves. If the courts routinely or extensively defer to directors' litigation decisions and rarely question their merits or wisdom, the practical result would

⁷⁸ JC Coffee & DE Schwartz 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform' (1981) 81 *Columbia Law Review* 261 at 302 – 305.

⁷⁹ Which requires disinterestedness by decision-making directors, good faith for a proper purpose, reasonable inquiry and a reasonable belief.

effectively be to reduce the derivative action to redundancy insofar as directorial wrongdoing and third party wrongdoing are concerned, as leave would seldom be granted in these cases. Such an approach would practically sound the death knell for the derivative action as an effective instrument for shareholder control of managerial misconduct.

Consequently, when a derivative action relates to wrongdoing by a director of the company, the courts must exercise an independent judgment, and should give little weight to the presumption. Conversely, in straightforward cases involving a derivative action against a pure outsider, who has no association with either the directors or the shareholders of the company, the views of the directors on litigation may more reliably be given greater weight by the court—so long as the court is not overly deferential to the judgment of the directors.

The rebuttable presumption may thus be used robustly as an instrument by which the courts may weigh up the views of the directors and the claims of the minority shareholder (or applicant), by applying their own independent and objective judgment. Three further advantages flow from this approach. First, it is worth emphasising that by an objective scrutiny of the *substance* or merits of the board's litigation decision, the court is merely permitting a shareholder grievance to be heard. This would thwart the potential for abuse by the board, which would otherwise have the power to prematurely terminate worthy grievances.⁸⁰ A second benefit of judicial assessment of the merits of the board decision is the attendant awareness by directors that they are accountable for and must justify their litigation decision to the court. This would deter complacency, and would serve to enhance the quality and the integrity of the board's decision. Thirdly, one may question the contention that courts are not qualified to make litigation decisions for companies, on the ground that the courts have a special aptitude for examining or evaluating the merits of initiating lawsuits. While directors may be better equipped than judges to make normal

⁸⁰ As cogently pointed out in *Zapata Corp v Maldonado* supra note 44 at 788 - 789.

business decisions, the decision not to sue is quite a different and distinct one. In this arena the courts' expertise and ability to appraise the proposed litigation must surely surpass that of the board.⁸¹

5.5.2 *Lessons from the USA*

The derivative action in US law is a long-standing shareholder remedy that originated from common law principles established in 1882,⁸² which are now found in statutory form.⁸³ The rich and well-developed US jurisprudence as well as the judicial approach to business judgments of the company's directors contain instructive lessons for South African law. They yield valuable guiding principles, particularly on the weight that the South African courts should give to the rebuttable presumption in s 165(7). Unlike the Commonwealth models of the derivative action, which centre on judicial supervision and the need to obtain the leave of the court, the US derivative action is supervised by a committee of independent directors of the company and not by the court. The Commonwealth model of the derivative action was first enacted in Canada, and later adopted (with some modifications) in New Zealand, Australia, Singapore, Hong Kong, the United Kingdom and, significantly, also in South Africa. But the South African provisions are unique, for the Act contains a dual screening mechanism for a derivative action: first, an investigation must be conducted by an independent investigator or investigative committee appointed by the board of directors of the company; and secondly, the leave of the court must be obtained. While the latter requirement is derived from the Commonwealth models, the former requirement is inspired by US law.

In the USA, the business judgment rule plays a prominent role in the

⁸¹ See the US federal court opinion in *Joy v North* supra note 44, in which the court emphasised this point; see also *Zapata's* case supra note 44..

⁸² In *Hawes v City of Oakland* 104 US 450 1882 (US Supreme Court). The derivative action was first recognised in the USA in 1855 in *Dodge v Woolsey* 59 US 18 How 331 1855 (US Supreme Court).

⁸³ See eg Model Business Corporation Act; American Law Institute's Corporate Governance Principles Pt VII, Ch 1 (1994); rule 23.1 of the Federal Rules of Civil Procedure, 1966.

statutory derivative action.⁸⁴ The litigation decision made by the US 'special litigation committee' of independent directors,⁸⁵ which is responsible for screening derivative actions, is protected by the business judgment rule. It must be borne in mind that in the USA, the committee of independent directors is ultimately responsible for both the investigation of the shareholder demand and for making the litigation decision.⁸⁶ In contrast under the South African Act, these functions are split: the independent investigator or committee investigates the shareholder demand and reports to the board, while the disinterested board of directors is responsible for ultimately making the litigation decision. Parallels may thus be drawn between the litigation decision made by the disinterested directors of the company in South African law (whose decision is protected by the modified business judgment rule, as contained in the rebuttable presumption) and the litigation decision made by the US special litigation committee of independent directors (whose decision is similarly protected by the business judgment rule). An exploration of the extent to which the US courts scrutinise the litigation decisions of independent directorial committees under the US business judgment rule is consequently instructive in South African law to the judicial scrutiny of directors' litigation decisions. In South African law the courts are similarly required to apply the business judgment rule, as set out in the third limb of the rebuttable presumption.⁸⁷

For two reasons, it would be misguided and incorrect to apply the US jurisprudence on judicial scrutiny of the decisions of special litigation committees under the business judgment doctrine, to the South African provisions on the independent investigator or committee under s 165(4)(a) and (5) of the Act. First, the US jurisprudence applies specifically to *litigation decisions* made by the special litigation committee of independent *directors*. In South African law, the litigation decision is made by the board of directors. The investigator or committee merely reports and makes a recommendation to the

⁸⁴ See further below.

⁸⁵ Or by the independent board of directors, as the case may be.

⁸⁶ It may, but need not, be assisted in its investigation by independent legal advisors and experts.

⁸⁷ See s 165(7)(c); see further para 5.4 above.

board (to facilitate the board's decision-making process). Secondly, the basis of these US decisions is the business judgment rule, which by definition can apply only to decisions made by *directors* on behalf of the company. The business judgment rule does not apply to the independent investigator or committee under the Act, which neither makes a decision for the company, nor is necessarily comprised of directors. Accordingly, insofar as the discussion in this chapter relates to the board's litigation decision, it is apt to compare it with the US law on decisions of special litigation committees.

Apart from the USA, little guidance is derived from other jurisdictions. While both the South African and the Australian legislation take account of the views of the company's directors by means of the rebuttable presumption, Australian law yields little assistance as its legislation sensibly carves out miscreant directors from the benefit of the presumption. In contrast the Canadian, New Zealand and the United Kingdom legislation contain no such presumption. But, despite the absence of an explicit presumption, the courts in these jurisdictions, when deciding whether a derivative claim is in the interests of the company, similarly have regard to the views of the company's directors on commercial matters⁸⁸—which is, of course, the essence of the South African rebuttable presumption.

Turning to US law,⁸⁹ when shareholders attempt to bring derivative suits,

⁸⁸ See for instance *Schafer v International Capital Corp* 1996 SJ No 770, 153 Sask. R. 241 (QB) in respect of the legal position in Canadian law. The court is explicitly required in terms of the United Kingdom Companies Act, 2006, s 263(2)(a) and (3)(b), to consider whether a director, or a person acting in accordance with the duty to promote the success of the company, would seek to continue the claim and the importance they would attach to continuing it.

⁸⁹ Briefly, by way of background, almost all US jurisdictions require a shareholder to first make a demand on the corporation's board of directors before instituting a derivative suit unless a demand is excused, usually on the basis that it would be futile, eg because a majority of the board has an interest in the matter and is thus tainted (see the test in the Delaware case *Aronson v Lewis* supra note 23; see also *Marx v Akers* 666 N.E. 2d 1034 (NY 1996), a New York Court of Appeals case). Under the Model Business Corporation Act (s 7.42), the futility rule has been abolished in favour of a universal demand rule, which requires a demand in all cases. A universal demand rule is also adopted by the American Law Institute's Principles of Corporate Governance (s 7.03). In the event of demand refusal, that is, if the directors refuse to take action, the shareholder may not generally proceed with a derivative action. The directors' decision is protected by the business judgment rule in simple cases involving a claim against a third party, and presumptively protected by the business judgment rule in instances of directors' violations of their duties (*Allison v General Motors Corp* 604 F. Supp. 1106, 1122 (D.Del 1985)), which unsurprisingly comprise the majority of claims. The effect is that the shareholder may institute a derivative action only if he is able

a common defensive tactic is that the board of directors sets up a committee comprised of independent directors, referred to as the special litigation committee, to which it delegates its power to decide whether it would be in the best interests of the corporation for it to pursue the lawsuit. In some US jurisdictions the special litigation committee is provided for in legislation⁹⁰ or rules of court,⁹¹ while in others it has evolved in case law. In the majority of cases these committees of independent directors recommend dismissal of the claim, on the basis that the claim is not in the best interests of the corporation, pursuant to which the corporation brings a motion to dismiss the suit. The approach of the US courts to the recommendation of the special litigation committee varies in different states, but there are generally two main approaches.⁹² These approaches are most useful in providing guidelines for the South African courts, and to determine the appropriate weight that the South African courts should give to the *merits* of the board's litigation decision (ie the 'rebuttability' of the presumption in s 165(7)).

The traditional approach, as expressed by the New York Court of Appeals in *Auerbach v Bennett*,⁹³ generally gives complete judicial deference to the recommendation of the committee of independent directors, under the business judgment doctrine, and allows for only minimal judicial review. The court's approach as expressed in *Auerbach v Bennett* is that the 'substantive decision falls squarely within the embrace of the business judgment doctrine [and] is outside the scope of our review', but '[a]s to the methodologies and procedures best suited to the conduct of an investigation of facts and the determination of legal liability, the courts are better qualified in this regard than are corporate directors in general'. In other words, this approach permits the

to prove a conflict of interest, a lack of good faith or an absence of due care by the directors in deciding not to sue, eg if a majority of the directors had participated in the wrongdoing or were dominated or controlled by the wrongdoers.

⁹⁰ Eg in California Corp. Code s 88(b)(2).

⁹¹ Eg Del. Ch. Ct. R. 23.1.

⁹² Where a derivative suit is against a third party, such as a supplier for a breach of contract, the courts are generally deferential to the special litigation committee, unless the decision fails to satisfy the business judgment rule. The two approaches discussed below apply mainly in respect of derivative cases against directors or officers of the company.

⁹³ Supra note 63; see also *Gall v Exxon Corp*, 418 F Supp 508 (SDNY 1976).

court to evaluate the procedure or *form* of the decision-making process, but the *substance* or merits of the directors' (or committee's) decision will not be scrutinised or questioned by the court. This was followed in the well-known case *Lewis v Anderson*,⁹⁴ among others. Accordingly, to succeed, the plaintiff or shareholder must establish that the directors on the committee were not truly independent or disinterested, or did not act in good faith, or were not sufficiently diligent in their investigations and deliberations—all of which concerns the *form* of the decision.⁹⁵

This approach would arguably be unsustainable in the South African context, for s 165(7) clearly states that the presumption, which protects the disinterested directors' litigation decision, is *rebuttable*. Accordingly at least some judicial scrutiny of the merits or *substance* of the board's litigation decision must be undertaken by the South African courts.

The contrasting approach in US law—and the preferable approach in the South African context and environment—allows for greater judicial scrutiny of the *substance* or *merits* of the decision of the special litigation committee of independent directors. This approach originated in Delaware⁹⁶ and was lucidly expressed by the Supreme Court of Delaware in the famous case *Zapata Corporation v Maldonado*⁹⁷ to be a two-step process, as follows:

- (i) The first step is for the court to inquire into the good faith of the directors on the committee, their independence from the defendant, the

⁹⁴ 615 F 2d 778 (9th Cir. 1979).

⁹⁵ This traditional approach is adopted also in the Model Business Corporation Act, which provides in § 7.44(a) that if a special committee of independent directors, in good faith and after conducting a reasonable inquiry, finds that the maintenance of the derivative action is not in the best interests of the corporation, the court *shall* dismiss the derivative proceedings on motion by the corporation. This provision clearly incorporates the business judgment rule. It requires independence, good faith and a reasonable inquiry. But it does not permit the court to review the reasonableness of the determination, that is, it cannot apply its own independent judgment but must focus wholly on the *procedural* aspects. If these are satisfied the court has no discretion and *shall* dismiss the suit. (This provision of the Model Business Corporation Act applies equally to demand-required situations, for the Model Business Corporation Act makes no distinction between demand required and demand excused cases. It adopts a universal demand requirement.)

⁹⁶ Although this approach in Delaware applies only to a demand-excused situation, in a number of other US states it applies in both demand-required and demand-excused cases, for instance, in North Carolina.

⁹⁷ Supra note 44.

reasonableness of their investigation and the reasonable bases for their findings and recommendations, ie the first step concerns the *form* or procedure of the decision. (These requirements of the US business judgment rule are similar to the South African requirements for the decision-making procedure as contained in the third limb of the presumption.)⁹⁸ If the court is not satisfied on any of these procedural grounds, it must permit the derivative litigation to proceed. Notably, the concept of ‘independence’ is of central significance in the first step of the inquiry, and special litigation committees have been recognised by several US courts to have a structural bias in that the directors who are on the committee may feel silent pressure, or may be influenced in favour of the miscreant directors,⁹⁹ which occurred in the case *re Oracle Corp Derivative Litigation*¹⁰⁰ (discussed above).

- (ii) If the court is satisfied with the procedural grounds in the first step of the inquiry, it may proceed to the second step of the inquiry. In the second step the court, in its discretion, may apply its own independent judgment to the special litigation committee’s decision to dismiss the suit. In other words, the court may evaluate the *merits* or *substance* of the independent directors’ decision. The consequence is that the court may permit the derivative suit to proceed, despite the committee’s decision to dismiss it.¹⁰¹

It was proclaimed in *Zapata Corp v Maldonado* that: ‘[t]he second step is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation’s interest’.¹⁰² Notably, the *Zapata*

⁹⁸ See para 5.4 above.

⁹⁹ See *Hasan v Cleve Trust Realty Investors* 729 F. 2d 372 at 376 - 377 (6th Cir. 1984); *Zapata Corp v Maldonado* supra note 44 at 788 - 789; *Joy v North* supra note 44.

¹⁰⁰ Supra note 71.

¹⁰¹ The second stage focuses on matters such as the strength of the claim, the likelihood of recovery, and matters of law and policy.

¹⁰² Supra note 44 at 788 - 789.

approach was followed in a federal court opinion, *Joy v North*.¹⁰³

This approach gives the US court the power to disregard the *substance* of the litigation decision of the independent directors (or committee). Despite the directors' decision not to litigate, the court may permit a shareholder to proceed with a derivative suit anyway. In this way, excessive deference to the litigation decision of the directorial committee is avoided.

The *Zapata* approach clearly supports the proposal submitted in paragraph 5.5.1 above that the South African courts should avoid giving excessive weight or excessive deference to the rebuttable presumption that protects the litigation decision of the company's directors. It must be borne in mind that the presumption in s 165(7) is rebuttable. A South African court, accordingly, ought to be inclined to apply its own independent and objective judgment on the *substance* or *merits* of the litigation decision whenever the derivative action concerns a miscreant director. However, when the defendant in the derivative action is a third party who is associated with neither the shareholders nor the directors of the company, more weight may properly be given to the board's decision not to litigate.

5.6 CONCLUSION

The genesis of the derivative action is where the wrongdoers who perpetrate harm on the company are the directors or controllers of the company, who have the power to subsequently abuse their control to prevent the company from instituting legal proceedings against them. The new statutory derivative action under s 165 of the Act has sadly failed to give due and proper recognition to this cardinal principle, and instead imposes additional barriers and obstacles to the availability of the derivative action specifically in cases of directorial misconduct. This is the fatal flaw of the new statutory derivative action, which has the potential to choke-off the use of the remedy where it is most greatly needed.

¹⁰³ Supra note 44.

The defect lies squarely in the rebuttable presumption in terms of s 165(7) read with (8). The presumption is plagued by a serious shortfall, in that it regards directors to be ‘third parties’ to the company, and thus beneficiaries¹⁰⁴ of the presumption that the grant of leave for derivative proceedings against them would be contrary to the best interests of the company.

It is respectfully submitted that this glaring and egregious defect in the Act must be amended by the legislature. It would require a simple and straightforward amendment to carve out directors from the benefit of the rebuttable presumption, the details of which have been discussed above. It is further submitted that former directors should similarly be excluded, for a period of 24 months, from the benefit of the presumption, as should persons who are related to directors of the company.

Until such time as the suggested amendment to the Act is effected (or in the absence of an amendment), the judiciary may have to take prophylactic measures to circumvent the presumption. The courts will have to engage more intimately with the business judgment rule, which is contained in modified form in the third limb of the rebuttable presumption.¹⁰⁵ The judicial scrutiny of the board decision not to litigate against a miscreant director or third party wrongdoer involves a two-step inquiry.

The first step concerns the *form* of the directors’ decision making process. If any of its four requirements are not met (ie good faith, disinterestedness, reasonable inquiry and reasonable belief), the protective presumption will *not apply*. The concept of ‘independence’—as distinct from ‘disinterestedness’—would go a long way towards mitigating the problems associated with statutory derivative actions against miscreant directors. A ready platform from which the courts may emphasise independence is provided by the requirement of good faith under the third limb of the presumption. The notion of independence would also be of assistance where the company has been

¹⁰⁴ In certain circumstances,

¹⁰⁵ Section s 165(7)(c) of the Act.

harmed by an outsider who has some association with the company's controllers or directors.

The second step of the two-step inquiry concerns the *substance* or the merits of the board's litigation decision. When the first step is satisfied and the rebuttable presumption does apply, the courts should avoid giving too much weight to the presumption or too much deference to the judgment of the board not to litigate against the wrongdoer. The court should instead apply its own discretion and its own independent judgment on the *merits* or *substance* of the board's litigation decision. Excessive deference by the courts to the views of the directors would defeat the very purpose of the statutory derivative action. This is because in the typical situation directors are not devoid of bias, even if this is a subconscious bias. Lessons may be drawn in this regard from USA law, and particularly from the approach laid down in the leading Delaware case *Zapata Corporation v Maldonado*.¹⁰⁶ *Litigation* decisions of the board are protected by the presumption in s 165(7) on a *rebuttable* basis—they are thus distinct from ordinary commercial decisions of the board, which fall under the protection of the business judgment rule in s 76(4) of the Act, and which are insulated by s 76(4) from judicial scrutiny of the merits.

¹⁰⁶ Supra note 44.

CHAPTER 6: SHAREHOLDER RATIFICATION

6.1 INTRODUCTION

While the rebuttable presumption centres on the views of the company's board of directors on the proposed derivative action, one must also have regard to the views of the other main organ of the company, namely the shareholders in general meeting. The crucial question thus arises whether ratification, approval or condonation by shareholders of a wrong done to the company would prevent the institution of a derivative action to redress that wrong.

At common law, shareholder ratification or approval of a wrong done to the company, or even the mere ratifiability of the wrong, was a paramount consideration which constituted a complete barrier to a derivative action.¹ But under the new statutory derivative action the role of shareholder ratification has been drastically, and laudably, pruned down. Yet the role and the relevance of shareholder ratification remains a significant issue, which is discussed in this chapter.

6.2 LEGAL POSITION IN SOUTH AFRICAN LAW

The ratification or the ratifiability by shareholders of any particular wrong done to the company is not necessarily fatal to a derivative action. The Act provides that shareholder ratification or approval will neither prevent, nor prejudice the outcome of, a derivative action or an application for leave to bring a derivative action. The court, however, may take the ratification or approval into account in making any judgment or order.²

The neutralisation by the Act of shareholder ratification or approval gives

¹ The common law derivative action is now abolished by s 165(1) of the Act. Ratification was not an obstacle to a statutory derivative action under s 266 of the Companies Act 61 of 1973.

² Section 165(14) of the Act.

the court the appropriate flexibility to decide each case on its particular facts and merits. This is the correct, modern, approach and is to be welcomed. It frees the court from the fetters of the principle of majority rule, and replaces this with a judicial discretion to take into consideration the majority view. This approach concurrently overcomes the problems and uncertainties that prevailed at common law on the issue of shareholder ratification of wrongs done to the company. In this regard, at common law and under the rule in *Foss v Harbottle*,³ the derivative action was excluded as a mechanism to enforce wrongs that were actually ratified or were merely 'ratifiable' (ie where there was a mere possibility of ratification of the wrong). However the major quandary was to draw a distinction between ratifiable and non-ratifiable conduct. Now, under s 165 of the Act, where the ratification or approval (or condonation) of the wrong does not arrest or offset the derivative action, there is no longer any need to rely on obscure distinctions between ratifiable and non-ratifiable actions or on elusive concepts such as 'fraud on the minority'.

In the exercise of its discretion to take into account shareholder ratification or approval, there are a number of factors that the court may consider:⁴

- (i) First, more weight ought to be given to a vote by independent and disinterested shareholders who have no personal interest in the matter. Conversely, ratification by the wrongdoers of their own wrongdoing should manifestly be disregarded. The courts should be more inclined to discount shareholder ratification if a wrongdoing party or a biased party voted in his capacity as a shareholder, for instance, where the wrongdoers were the majority shareholders, who ratified or approved their own wrongdoing; or where the wrongdoers dominated or had substantial influence over the majority shareholders.
- (ii) Secondly, the court ought to have regard to how well-informed the

³ (1843) 2 Hare 461, 67 ER 189.

⁴ See Maleka Femida Cassim 'Shareholder Remedies and Minority Protection' in FHI Cassim et al *Contemporary Company Law* 2ed (2012) 795.

shareholders were at the time they had ratified or approved the wrongdoing. A valid approval requires full disclosure of the facts in order to make an informed decision. If the shareholders were given inadequate information, or if new information subsequently came to light, the court should give little weight to the shareholder ratification.

- (iii) A third factor that the courts may conceivably take into account is whether the character of the act renders it ratifiable or non-ratifiable. This could reintroduce certain aspects of the common law derivative action, for instance an illegal act or a 'fraud on the minority' is never ratifiable.
- (iv) A fourth factor is that ratification or approval should perhaps be given less significance in companies with large numbers of widely dispersed shareholders, including listed public companies, in which there is a divorce between ownership and control. This is because of shareholder apathy. Most shareholders do not attend the shareholders' meeting or participate in the ratification vote. Those who do, are not always sufficiently cognisant of the wrongdoing that they are asked to ratify. It must also be borne in mind that many shareholders in such companies often hold their shares as passive investors without any intention of being active in corporate affairs.

It is noteworthy that the predecessor to s 165 of the Act (ie s 266 of the Companies Act 61 of 1973) had similarly abolished the ratifiability principle. Section 266 of the 1973 Act applied regardless of any ratification or condonation by the company of the cause of action or the related conduct. However, while s 266(4) of the 1973 Act empowered the court to order that any resolution ratifying or condoning the wrong was of no force or effect, the approach adopted under s 165 of the new Act is somewhat different. It appears that under s 165 the court will simply sidestep the ratification decision of the majority shareholders (by making the derivative action available), rather than striking down the decision of the majority shareholders as done under the 1973 Act.

6.3 PROPOSED REFORM OF THE ACT

Although it is the clear intention of the legislature in terms of s 165(14) of the Act that a derivative action is not arrested or prevented by shareholder ratification or approval of the wrong inflicted on the company, the wording of s 165(14) is strange. It incorrectly refers to shareholder ratification or approval of ‘any particular conduct *of the company*’ [emphasis added], when it should in fact relate to shareholder ratification or approval of the conduct of the *wrongdoer*. In the arena of the statutory derivative action, an applicant litigates on behalf of the company to redress a wrong done to the company. The company in a derivative action is the injured party. Accordingly, any ratification or approval by shareholders must of course relate to approval of the wrongdoer’s conduct—and not approval of the company’s conduct.

Section 165(14) ought to be amended to correct this bizarre wording. Failing an amendment, a court is free to interpret the provision literally,⁵ and consequently judge it to be nonsensical.

As for the drafting or wording of the suggested amendment, it is submitted that the words ‘of the company’ should simply be deleted from the phrase ‘ratified or approved any particular conduct *of the company*’ [emphasis added] in s 165(14). Alternatively, if a more comprehensive statutory provision is preferred, the latter phrase may be replaced with the following (or similar) wording: ‘ratified or approved any alleged breach of a right or duty owed to the company’.

6.4 LEGAL POSITION IN OTHER COMPARABLE JURISDICTIONS

The South African approach to shareholder ratification is in harmony with the approach adopted in Canadian and Australian law. Ratification in the Canadian legislation is similarly a factor which the court may take into account, but it is not

⁵ See eg *Union Government (Minister of Finance) v Mack* 1917 AD 731 at 739 which is authority for the widely-recognised rule that ‘the language of the Legislature should be read in its ordinary sense’; see also *Norden v Bhanki* 1974 (4) SA 647 (A) 655A which confirms that the ‘plain meaning’ of statutory language is paramount in statutory interpretation.

decisive and does not automatically result in a stay or dismissal of the action.⁶ Likewise, under the Australian legislation,⁷ ratification or approval is not an obstacle to derivative proceedings, but may be taken into account by the court in its order or judgment. The court is required to have regard to two matters: first, how well-informed the shareholders were when deciding to ratify or approve the conduct, and secondly, whether the shareholders who had ratified or approved the conduct were acting for proper purposes.

In contrast, under the New Zealand Companies Act, 1993, the effect of ratification is debatable and uncertain. A unique and unusual statutory provision⁸ preserves the common law rules relating to shareholder ratification of breaches of directors' duties. Consequently, the effect in New Zealand is that shareholder ratification of directorial misconduct could perhaps preclude a statutory derivative action. But the courts have not yet ruled on the matter, and the issue is still unsettled.⁹ Conversely, a derivative action is not barred in New Zealand law by the mere ratifiability (ie the possibility of ratification) of a wrong suffered by the company, although the court may take it into account in the exercise of its discretion.¹⁰

In the United Kingdom, too, the ratifiability principle has not been entirely neutralised. The Companies Act, 2006,¹¹ provides that permission for a derivative action *must* be refused if the court is satisfied that the cause of action arises from an act or omission that was authorised by the company before it occurred, or has been ratified by the company since it occurred. Even if no authorisation or ratification has taken place, the court in considering whether to

⁶ Canada Business Corporations Act, R.S.C. 1985 c. C-44, s 242(1); Ontario Business Corporations Act R.S.O. 1990, c. B.16, s 249(1).

⁷ Australian Corporation Act, s 239(1) and (2).

⁸ Section 177(4) of the New Zealand Companies Act, 1993, which states that: '[n]othing in this section limits or affects any rule of law relating to the ratification or approval by the shareholders or any other person of any act or omission of a director or the board of a company'.

⁹ The confusion is exacerbated by s 177(3) of the New Zealand Companies Act, which states: '[t]he ratification or approval under this section of the purported exercised of a power by a director or the board does not prevent the court from exercising a power which might, apart from the ratification or approval, be exercised in relation to the action of the director or the board'.

¹⁰ In terms of s 165 of the New Zealand Companies Act.

¹¹ Section 236(2)(c).

give permission for a derivative action must take into account whether the relevant act or omission could be, and in the circumstances is likely to be, ratified by the company. In other words, authorisation or ratification cures the breach and quite mechanically prevents a derivative action in the United Kingdom.¹² This approach is problematic, as it evidently still leaves the courts to grapple with the confusion and the predicament that existed at common law in determining which wrongs are ratifiable and which are unratifiable, as confirmed in *Franbar Holdings Ltd v Patel*.¹³ The United Kingdom legislation¹⁴ explicitly retains the common law rules as to acts that are incapable of being ratified by the company, such as illegal acts or fraud on the minority, which previously were commonly known as the exceptions to the rule in *Foss v Harbottle*.¹⁵ It is also significant that the wrongdoers and connected shareholders are now disqualified from voting on the ratification of the wrong even if it is ratifiable.¹⁶ The issue of ratification may thus elicit major difficulties in United Kingdom law, and the quandary of the ratifiability principle that began at common law is likely to continue to create jurisprudential and practical challenges. South African law, with respect, has adopted a wiser and more modernised approach than the United Kingdom and New Zealand, by the clear abrogation in the Act of the ratifiability principle.

6.5 CONCLUSION

It is a commendable approach that neither shareholder ratification of the wrong done to the company, nor the ratifiability of the wrong, is necessarily fatal to a derivative action under s 165 of the Act. While this, however, is the clear intention of the legislature, the wording of the provision in s 165(14) is strange

¹² See also s 239 of the United Kingdom Companies Act, which imposes restrictions on the power to ratify.

¹³ [2008] BCC 855 at 897.

¹⁴ United Kingdom Companies Act, 2006, s 239(7).

¹⁵ *Supra* note 3.

¹⁶ United Kingdom Companies Act, 2006, s 239.

and it could very likely be condemned by a court to be nonsensical. Suggestions for its amendment are proposed above in this chapter.

CHAPTER 7: ORDERS OF COSTS, AND OTHER HURDLES AND OBSTACLES

7.1 INTRODUCTION

Despite the modernisation of the statutory derivative action under the Companies Act of 2008, the greatest impediment to a derivative action by minority shareholders (or other suitable applicants with locus standi) arises from the practical barriers to the commencement of derivative proceedings. The chief barriers or hurdles are first, the risk of the minority shareholder being burdened with liability for the costs of the derivative proceedings and secondly, the minority shareholder's lack of access to corporate information. This chapter focuses on these important practical hurdles and obstacles to the derivative action and other related matters.

As long ago as 1970 the Van Wyk De Vries Commission of Enquiry into the Companies Act¹ declared that one of the worst anomalies of the derivative action is the risk of the plaintiff shareholder having to bear the costs of an action in which he is 'in effect not the real plaintiff'. In light of this progressive and enlightened finding, it is disappointing that the legislature has failed to adopt a more resolute approach under the Companies Act 71 of 2008 to the vexed issue of costs. If the new liberalised derivative action is to be a success, the courts must face this obstacle head on. It is vital that the remedy is not unwittingly suffocated by the courts, through the imposition of adverse costs orders on shareholder litigants.

A functional derivative action is essential to a sound system of corporate law. Paragraph 7.2 discusses certain foundational principles and policies that underscore the derivative action and that are particularly relevant to a full and proper understanding of the issue of orders of costs. These foundational

¹ *Main Report* (RP 45 of 1970) at para 42.12; see also 'Company Law for the 21st Century' *Government Gazette* 26493 of 23 June 2004 at para 2.2.2.

policies include the rationale of the derivative action, which is explained and elaborated on in paragraph 7.2; the safeguards against abuse of the derivative action by predatory shareholders; and the fears that the new statutory derivative action would open the floodgates to shareholder litigation, thereby causing directors to flee the board. These underlying policies are an important part of this chapter—they are not only vital for a proper grasp of the issues surrounding orders of costs, but are also taken directly into account in devising the framework and the guidelines for the exercise of the judicial discretion to make costs orders and indemnity orders (and particularly orders of security for costs). A cardinal theme of this framework for costs orders is that, since a comprehensive array of efficient and effective safeguards against shareholder abuse is now integrated into the new statutory derivative action, the courts must cease to use (or misuse) adverse costs orders as a safeguard against abuse as they have traditionally done in the past (as explained further in paragraph 7.2 below). In order to justify this line of reasoning, the new and innovative safeguards against shareholder abuse are discussed in this chapter.

In light of these underlying principles and policies canvassed in paragraph 7.2, paragraph 7.3 discusses costs orders and proposes a framework for the exercise of the judicial discretion to make orders of costs. It is notable that this framework for costs orders takes into account the rationale of the derivative action and the comprehensive safeguards against abuse of the remedy. The framework for costs orders also suggests guidelines from other jurisdictions, as well as traps and pitfalls that our courts must be wary of in making costs orders. Reference is made to the legal position in other common law jurisdictions, specifically Australia, Canada, New Zealand and the United Kingdom, and the approach in the USA.

Besides the hurdle of costs orders, this chapter also considers other important hurdles and obstacles to the derivative action, and other related matters that form part of the broader context of the research issue on orders of costs, so as to provide a complete picture. In this regard, paragraph 7.5 addresses the legal costs of defendant directors in derivative actions. While the

plaintiff in a derivative action has to overcome a costs hurdle, the *defendant* director in a derivative action is conversely in a much more favourable position, for he is usually insulated against legal costs by means of indemnification or directors' and officers' insurance. The indemnification and insurance of defendant directors in derivative actions is the focus of paragraph 7.5. Paragraph 7.6 deals with the minority shareholder's hurdle of obtaining access to inside corporate information, which usually lies in the hands of the wrongdoers. Lack of access to vital corporate information has long been recognised as a major barrier to the derivative action. This paragraph evaluates whether the new Companies Act has improved the position of the plaintiff or applicant insofar as access to information is concerned. It is notable that paragraph 7.6 thus builds on the earlier discussion in Chapter 3 (at paragraph 3.3) of the impact that the hurdle of access to information has on the leave application, and particularly on the second guiding criterion for leave. Finally, to round off the discussion of orders of costs and other hurdles and obstacles to the derivative action, paragraph 7.7 evaluates the role of public enforcement, as a useful new avenue provided by the Companies Act to overcome the two worst hurdles faced by the derivative litigant, namely the risk of liability for costs and the lack of access to information. Regarding the link between public enforcement and the exercise of judicial discretion, it is submitted below in paragraph 7.7 that in view of the current dearth of *public* enforcement of company law in South Africa, it is vital and in the public interest to encourage and promote the *private* enforcement of company law rules through the use of remedies such as the statutory derivative action. This need to promote private enforcement is a key factor that the courts must be cognisant of both in exercising their judicial discretion to grant leave for statutory derivative actions, and in exercising their judicial discretion to make costs orders and indemnity orders in favour of those minority shareholders (and other stakeholders) who take the initiative of instituting derivative actions despite the strong hurdles and obstacles that they encounter (see further below).

7.2 FOUNDATIONAL POLICIES AND PRINCIPLES

7.2.1 *Rationale of the Derivative Action*

The rationale of the derivative action is of fundamental importance to a proper understanding of the issues surrounding orders of costs. The derivative action is designed (as previously stated), first, as a remedial device by which shareholders² may enforce rights or recover compensation for the company when the board of directors refuses to do so and, secondly, as a deterrent device to prevent management abuse and to ensure control over the board by allowing shareholders and others to litigate against directors who have breached their fiduciary duties to the company.³ The dual objectives of the statutory derivative action have been widely recognised. In the United States, *Diamond v Oreamuno*⁴ proclaimed that the purpose of the derivative suit is not merely to compensate the company, but also to deter. The derivative action is generally considered in the United States to be the ‘chief regulator of corporate management’,⁵ for it promotes accountability by directors and managers. Recognition was also given to this deterrent objective of the derivative action by the Ontario Court of Appeal in *Richardson Greenshields of Canada Ltd v Kalmacoff*,⁶ while in New Zealand law it was stated in *Frykberg v Heaven*⁷ that ‘[c]laims against employees or directors of companies who have misused information gained in confidence or who have breached fiduciary obligations are often brought not only to recover damages or seek an injunction but also to act

² And other applicants with standing under s 165(2) of the Act. For the purpose of convenience this chapter refers mainly to shareholder applicant. However most of the submissions made in this chapter apply equally to other applicants with locus standi under s 165.

³ *Richardson Greenshields of Canada Ltd v Kalmacoff* [1995] BLR (2d) 197 (CA) at 205. The Canadian legislation relating to the statutory derivative action inspired the approach in Australian, New Zealand and Singapore law, among others. These Commonwealth models have exercised a strong influence on the South African statutory derivative action. The statutory derivative action in the South African Act has also been influenced by US law. The jurisprudence of these jurisdictions is accordingly relevant in the South African context. See also s 5(2) of the Act.

⁴ 24 NY 2d 494, 248 NE 2d 910, 301 NYS 2d 78 (1969).

⁵ *Cohen v Beneficial Industrial Loan Corp* 337 US 541 (1949).

⁶ *Supra* note 3.

⁷ (2002) 9 NZCLC 262,966 at 262,974.

as a deterrent to others’.

The derivative action is increasingly seen as a valuable corporate governance tool. The role of the derivative action in corporate governance was lucidly expressed in *Seinfeld v Coker*⁸ as follows:

‘It is important for shareholders to bring derivative suits because these suits, filed after the alleged wrongdoing, operate as an *ex post* check on corporate behaviour.... When shareholder plaintiffs bring meritorious lawsuits, they deter improper behaviour by similarly situated directors and managers, who want to avoid the expense of being sued and the sometimes larger reputational expense of losing in court.’

In the same vein, the first reported case on the new derivative action in Singapore⁹ declared that derivative actions ‘are intended to improve the standards of private corporate governance since directors who breach their duties to the company could be made accountable’. Provided that the new statutory derivative action is properly cultivated by the South African courts to flourish as an effective remedy, it would have the added benefit of not only deterring future misconduct by directors to the advantage of shareholders, but also of preventing mismanagement by directors of other companies. The genuine prospect of liability, with attendant financial loss, reputational loss and loss of social status,¹⁰ serves as a strong deterrent to corporate wrongdoing and to violations of the duties owed by directors to their companies, and thus advances managerial accountability.

To analyse it from an economic perspective, the derivative action may perform an important function in corporate governance by serving to align the conflicting interests of managers and shareholders. It thus allays the ‘agency problem’ which results from the ‘principal-agent’ relationship between the shareholders as a whole (the ‘principal’) and the board of directors and

⁸ 847 A.2d 330 (Del. Ch. 2000) at para 7.

⁹ *Teo Gek Luang v Ng Ai Tiong and Ors* [1999] 1 SLR 434 at 438.

¹⁰ JC Coffee ‘New Myths and Old Realities: The American Law Institute Faces the Derivative Action’ (1992 – 1993) 48 *The Business Lawyer* 1407 at 1428 – 9.

managers of the company (the 'agent'). In so doing, the derivative action fundamentally reduces 'agency costs', that is, the monitoring costs that shareholders incur in ensuring that directors act in the interests of shareholders as a whole rather than in their own personal interests, when their respective interests diverge.¹¹

Although the deterrent objective of the derivative action is widely accepted, there are differing views. Some academics have questioned the role of shareholder litigation in corporate governance,¹² while some judicial decisions have (with respect incorrectly) regarded the purpose of the derivative action to be purely compensatory.¹³ In many instances, the dual purposes of compensation and deterrence may be regarded as complementary. To elaborate, by empowering shareholders and other stakeholders to enforce corporate rights, a real prospect of personal liability is created which functions to deter directorial wrongdoing and improve managerial accountability. An award of damages to the company serves to compensate the company (and indirectly all its shareholders) while concurrently affirming the principle that other directors who engage in misconduct will be sanctioned.

To view the twin purposes of the derivative action as invariably complementary is, however, to gloss over the difficulties. In certain situations the compensatory and the deterrence rationales may conflict, particularly in the public company setting where empirical studies have shown that a successful derivative action is unlikely to boost a public company's share value or the firm's market price.¹⁴ It is in these cases that the objective of deterrence may

¹¹ J Amour, H Hansmann & R Kraakman 'Agency Problems and Legal Strategies' in R Kraakman et al *The Anatomy of Corporate Law: A Comparative and Functional Approach* 2ed (2009) 35 – 37.

¹² See eg the analysis of MJ Whincop 'The Role of the Shareholder in Corporate Governance: A Theoretical Approach' (2001) 25 *Melbourne University Law Review* 418, which combines social choice theory with other economic considerations; see also R Romano 'The Shareholder Suit: Litigation Without Foundation?' (1991) 7(1) *Journal of Law, Economics and Organization* 55 at 84 - 85.

¹³ That is, to provide compensation for the company as a whole with a consequential indirect benefit to all current shareholders. See eg *Bangor Punta Operations Inc v Bangor & Aroostook RR*, 417 US 703 (1974); *Home Fire Ins. Co v Barber*, 67 Neb. 644, 673, 93 NW 1024 (1903); *Westgold Resources NL v Precious Metals Australia Ltd* [2002] WASC 221 at para 21.

¹⁴ Romano op cit note 12. This, however, is controversial.

trump that of compensation.¹⁵ Three compelling objections may be raised against the contention that compensation is the only rationale, or even the primary rationale, of the derivative action.¹⁶ First, the likelihood of share transfers between the time of the wrong and the time of the recovery means that new shareholders receive a (indirect) windfall gain, while existing shareholders who sell their shares during this period do not benefit from the corporate recovery. Secondly, the injury and the gains of the company are not congruent with the injury and the gains of its shareholders. Thirdly, the recovery of shareholders on a pro-rated basis is typically a mere trivial amount (particularly in public companies where minority shareholders are more widely dispersed and have a lower individual stake). Accordingly the rationale of the derivative action is not, and cannot, be purely remedial or compensatory.

The American Law Institute's *Principles of Corporate Governance*, in seeking to balance the rationale of compensation against the deterrent rationale, makes explicit the prophylactic function of the derivative action.¹⁷ Section 7.10(b) of the *Principles* provides that even if a derivative action will *not* produce a net financial recovery for the company, it cannot be dismissed if dismissal would permit a defendant to retain a 'significant improper benefit'.¹⁸ This patently takes into account the public interest and the deterrent value of the derivative action.

A fundamentally important practical question is whether leave applications for derivative proceedings should entail a cost-benefit analysis.¹⁹ Based on the discussion above, it is submitted that the South African courts, in assessing from a cost-benefit perspective whether the grant of leave under s 165 would be in the best interests of the company,²⁰ must take into account not

¹⁵ JC Coffee & DE Schwartz 'The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform' (1981) 81 *Columbia Law Review* 261 at 305; American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* (1994) at 596 – 599, 601 and s 7.10(b).

¹⁶ Coffee & Schwartz op cit note 15 at 302 – 305.

¹⁷ American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* (1994) at 596 – 599 and s 7.10(b).

¹⁸ And provided certain other conditions are met.

¹⁹ See further Chapter 4 at para 4.3.1.

²⁰ See s 165(5)(b)(iii) of the Act.

only the likely net financial recovery to the company but, more importantly, the benefit and gains to shareholders that are likely to result from the deterrence of future misconduct by directors and managers of the company. Moreover for most investors, who hold a diversified portfolio of shares, there is a 'generic benefit' or value to a derivative action by its deterrence of directors of *other* companies, even if the action results in a net loss to the particular company that is involved in the action.²¹ The derivative action thus yields not only private benefits but also public benefits, by its long term deterrent value and by the social and economic value of enhanced investor confidence in the integrity of the corporate system.

In light of these essential purposes of the derivative action, the courts must cease to impose artificial confines on its availability and to stultify its use by means of adverse costs orders.²² The derivative action could undoubtedly be very useful in promoting good corporate governance practices²³ in South African law, provided that the courts breathe full life into it. A whole host of safeguards are already built into s 165 of the Act to snuff out the abuse of the remedy by shareholders and others.

7.2.2 Safeguards Against Abuse of the Derivative Action

The abuse of the derivative action by predatory shareholders was described in the US case *Cohen v Beneficial Industrial Loans Corporation*²⁴ as follows:

'[derivative suits] sometimes were brought not to redress real wrongs, but to realize upon their nuisance value. They were bought off by secret

²¹ American Law Institute *Principles of Corporate Governance: Analysis and Recommendations* (1994) at 597, 601 and s 7.10(b).

²² See also 'Company Law for the 21st Century' supra note 1 at para 2.2.3, para 4.4.1; *Memorandum on the Objects of the Companies Bill, 2008*, Companies Bill [B 61D--2008] at para 1.2.4; s 7 of the Act.

²³ Litigation is not the primary or initial mechanism for corporate governance, nor is it the only means for holding directors accountable. It tends to be more in the nature of a last resort mechanism. Other means for directorial accountability include social and market forces, the market for takeovers or market for corporate control, and shareholder voting. Significantly, all of these mechanisms have their own shortcomings and defects. An effective derivative action thus has a valuable role to play.

²⁴ Supra note 5 at 548.

settlements in which any wrongs to the general body of share owners were compounded by the suing stockholder, who was mollified by payments from corporate assets. These litigations were aptly characterized in professional slang as “strike suits”.’

It is a practical hazard that minority shareholders and other stakeholders²⁵ may institute nuisance actions, which are frivolous, vexatious or unmeritorious, directed at harassing the management of the company. A particular form of abuse is the exploitation by opportunistic shareholders of this remedy by using it for ‘gold digging’ claims²⁶ or ‘greenmail’, whereby shareholders bring (often meritless) derivative actions, not to obtain benefits for the company, but with the aim of extracting personal benefits for themselves.

Such ‘strike suits’ must be distinguished from collusive settlements or secret settlements, in which the company’s directors (who are usually the true defendants) ‘buy off’ the claim from the shareholder by using company assets, for instance, by a bribe or a costly payment to the shareholder, or even by a settlement disguised as a repurchase or buy-back of his shares at above market price. In *Manufacturers’ Mutual Fire Insurance Company of Rhode Island v Hopson*,²⁷ for instance, a derivative action was discontinued by a minority shareholder when his stock was repurchased by the company at seven times its market value. While meritless ‘strike suits’ may ultimately result in collusive settlements, the risk of collusive settlements is greater when the shareholder’s claim is a meritorious one (as the defendant directors would then have a greater incentive to settle with the shareholder on an individual or personal basis, for an amount that is less than the damages likely to be awarded against them in a derivative action). Private or collusive settlements are clearly contrary to the interests of the company. Not only does the company first suffer the original damage at the hands of the wrongdoers, but additionally the subsequent settlement occurs at the expense of the company whose assets

²⁵ With standing under s 165(2) of the Act.

²⁶ See Maleka Femida Cassim ‘Shareholder Remedies and Minority Protection’ in Farouk HI Cassim, MF Cassim, R Cassim, R Jooste, J Shev & J Yeats *Contemporary Company Law* 2ed (2012) at 795.

²⁷ 25 NYS 2d 502 (1940).

are used for the settlement, and the company is deprived of a judgment in its favour. Secret settlements also occur at the expense of the other shareholders, who are deprived of the (indirect) benefit of recovery by the company.

A number of safeguards are embodied in the Act to curb such abuses of the derivative action. The first protective device is the requirement of a demand on the board of directors,²⁸ which ensures that the minority shareholder seeking a derivative action makes reasonable efforts to cause the company to seek relief on its own behalf. Secondly, the company has the statutory right to apply to court within 15 business days to set aside a demand that is frivolous, vexatious or meritless,²⁹ without any need to investigate such nuisance demands. Thirdly, the claim of the minority shareholder (if not set aside by the court) must pass the scrutiny of an investigation conducted by an impartial person or committee that is appointed by the board of directors to screen the claim.³⁰

Fourthly, the chief safeguard against the exploitation of s 165 is the judicial control of the leave procedure. The discretion of the court to grant or withhold permission for minority shareholders to litigate a corporate cause of action—which is guided by the three gateways or threshold tests of good faith, a serious question to be tried and the best interests of the company—is clearly designed to filter out strike suits and other nuisance claims.³¹ The fifth buffer is the court's authority to replace the person with control of the derivative action,³² for instance, if the original applicant is not in good faith but the claim is nonetheless a valid one. This power is valuable also where the derivative action is misused by delinquent directors who, as a ploy to stifle successful litigation against themselves, persuade a friendly shareholder to nominally institute derivative litigation against them without any genuine intention of properly pursuing it. The statutory solution to directorial abuse of s 165 is supplemented

²⁸ Section 165(2) (read with (5)).

²⁹ Section 165(3).

³⁰ Section 165(4); see further para 7.6 below.

³¹ Section 165(5)(b)(i) – (iii). See Chapter 1; see also Chapters 2 – 4.

³² Section 165(12).

by the shareholder's power to intervene in an action by the *company*, which is being unsatisfactorily pursued by its board of directors, and to *continue* it as a *derivative* action³³ thus divesting the board of control of the litigation.

The sixth protective measure against abuse is the judicial control of settlements. This is an essential safeguard. A derivative action brought or intervened in with leave under s 165 may not be discontinued, compromised or settled without the leave of the court.³⁴ This mechanism is conceived specifically to prevent collusive settlements. Since the court would presumably consider the interests of the company and the fairness of the settlement, it has the power to restrain the major problem of unjust or secret settlements. Applicants in most comparable jurisdictions, including the USA, New Zealand, Canada, Australia and Ghana,³⁵ must likewise refer any offer of settlement back to the court for approval.

Over and above this sturdy array of checks and balances, the Act contains two further ostensible or purported safeguards: first the possibility of the minority shareholder being burdened with a costs order, and secondly the discretion of the court to order minority shareholders to furnish security for costs. Although these two provisions are intended to further curb shareholder abuse, their true effect is to derail the legitimate use of the derivative action and bring to an abrupt halt any hopes for the realisation of its worthy objectives. Simply put, these provisions are an overkill. A framework for costs orders is suggested below,³⁶ which takes into account the comprehensive system of safeguards against abuse of the derivative action.

³³ See s 165(2). See also s 165(10) and (15) which contemplate that leave under s 165 may be given either to *bring* or to *intervene in* legal proceedings.

³⁴ Section 165(15).

³⁵ Respectively, US Federal Rules of Civil Procedure r 23.1; New Zealand Companies Act 105 of 1993, s 168; Canada Business Corporations Act, R.S.C. 1985 c. C-44, s 242(2); Ontario Business Corporations Act R.S.O. 1990, c. B.16, s 249(2); Australian Corporations Act 2001, s 240; Ghana Companies Code, 1963, s 210(9).

³⁶ See para 7.3 below.

7.2.3 *An Opening of the Floodgates? Evidence in Comparable Jurisdictions*

Concerns (which are perhaps misguided) have been raised that the new liberalised statutory derivative action, coupled with the partial codification of directors' duties in the Act, would open the floodgates of shareholder litigation, and that their increased exposure to personal liability could make directors averse to legitimate risk-taking or even cause them to flee the board.³⁷ However the experience and evidence in comparable common law jurisdictions has shown that despite the adoption of a more shareholder-friendly approach to the statutory derivative action, none of these fears has materialised.

The modernised and flexible approach taken by the Australian courts in granting leave for the statutory derivative action has not resulted in an increase in the number of judgments. In its first five years in operation, the number of judgments on the new statutory derivative action (31 in total) was comparable to the number of judgments on its predecessor, the common law derivative action, in the preceding five year period (30 in total).³⁸ Out of these applications, leave was granted in an encouraging 61.3% of cases (19 cases in total) and refused in 38.7% of cases (12 cases). Similarly in Canada, the derivative action has not made a dramatic impact on minority shareholder litigation. Canadian shareholders are still more likely to rely on the oppression remedy rather than the derivative action.³⁹ The oppression remedy has several procedural advantages over the derivative action. First, there is no need to apply to the court for leave; secondly it may be easier to prove unfair prejudice under the oppression remedy than to prove a violation of corporate rights under the derivative action; thirdly the shareholder or applicant benefits directly from the oppression remedy, unlike the derivative action where the recovery accrues to the company as a whole and only indirectly to the shareholder as reflected by

³⁷ See eg Dickerson, Howard & Getz *Proposals for a New Business Corporations Laws in Canada* (1971); English Law Commission *Shareholder Remedies* (Law Com: No 246 Cm 3769) Guiding Principles para 1.9.

³⁸ IM Ramsay & BJ Saunders 'Litigation by Shareholders and Directors: An Empirical study of the Australian Statutory Derivative Action' (2006) 6(2) *Journal of Corporate Law Studies* 397 at 445.

³⁹ BR Cheffins & JM Dine 'Shareholder Remedies: Lessons from Canada' (1992) 13(5) *The Company Lawyer* 89 at 94.

an increase in the value of his shares; and fourthly, a wider range of relief is available under the oppression remedy.⁴⁰

In contrast with the trends in Australia and Canada, the New Zealand statutory derivative action appears to have had a stronger impact. This remedy has proven to be almost as popular as the unfair prejudice remedy in New Zealand, and it has been suggested that the success of the former is at the expense of the popularity of the latter.⁴¹ Applications for leave to bring derivative proceedings were shown to be reasonably prevalent in New Zealand,⁴² but this has by no means opened the floodgates of shareholder litigation.

It is also noteworthy that the impact of the derivative action in common law jurisdictions is distinctly within the private company scenario⁴³ as opposed to the public company scenario. (Interestingly a similar trend has been observed in China, a civil law jurisdiction which introduced the derivative action in 2005,⁴⁴ where it was found that the remedy was used exclusively in private companies and not even a single case over the five-year period of an empirical study had concerned a public company.⁴⁵) The above data strongly suggests that the fears and concerns about the availability of the new statutory derivative action are largely unfounded.

In the USA, which is known for its litigious culture, empirical studies have concluded that shareholder litigation is an infrequent experience. A study of shareholder suits in public companies from the late 1960s to 1987, found that a modest 19% of the sample of 535 public companies had experienced a

⁴⁰ See s 163 of the Companies Act 71 of 2008.

⁴¹ L Taylor 'The Derivative Action in the Companies Act 1993: An Empirical Study' (2006) 22 *New Zealand Universities Law Review* 333 at 334, 362 - 363.

⁴² *Ibid.*

⁴³ Ramsay & Saunders op cit note 37 found that 87.1% of cases (27 cases) involved private companies and only 12.9% (4 cases) involved public companies, while Taylor op cit note 40 concluded that closely held companies with five or fewer shareholders were involved in the overwhelming majority of New Zealand cases.

⁴⁴ Company Law of the People's Republic of China promulgated on 29 December 1993 and amended in 2005 with effect from 1 January 2006.

⁴⁵ H Huang 'Shareholder Derivative Litigation in China: Empirical Findings and Comparative Analysis' (2012) 27 *Banking & Finance Law Review* 619 at 631.

shareholder suit.⁴⁶ This is so, despite the flexible US rules on legal fees (including the rejection of the ‘loser pays’ principle, the use of contingency fees, the common fund doctrine and generous attorneys’ fees),⁴⁷ which are far more shareholder friendly than South Africa and other jurisdictions.

The modest impact (in terms of the number of judgments) of the statutory derivative action in the USA and in other jurisdictions must not be interpreted to mean that the remedy is ineffective or that it holds no benefits for shareholders and stakeholders. Although a derivative action may not always generate a financial or compensatory benefit, its primary value lies in its deterrent capacity to chill future corporate wrongdoing—and this effect cannot be measured by empirical studies.⁴⁸ Its importance, however, must not be underestimated.

As contrasted with its more restricted use and efficacy in the Commonwealth jurisdictions, the derivative action is utilised much more successfully in the USA. This primarily is due to the generous US rules on costs. The rarity of derivative litigation in civil law jurisdictions such as Japan, France, Italy and Germany,⁴⁹ has been attributed directly to aspects of procedural law, particularly the burdensome rules on legal fees and costs. In consequence, the private enforcement of directors’ breaches of fiduciary duties in these jurisdictions is weak.⁵⁰ The impact of alleviating the costs barrier is reflected in the Japanese experience. Throughout the first few decades of its existence the Japanese statutory derivative action⁵¹ was rarely used, until dramatic changes were implemented in 1993 to the costs rules, making it more affordable for shareholders to pursue derivative actions. The result was a

⁴⁶ Romano op cit note 12 at 59.

⁴⁷ See further para 7.4 below.

⁴⁸ JC Coffee op cit note 10 at 1428, 1436 – 7.

⁴⁹ PE Conac, L Enriques & M Gelter ‘Constraining Dominant Shareholders’ Self-Dealing: The Legal Framework in France, Germany and Italy’ (2007) 4 *European Company and Financial Law Review* 491 at 497, 507 – 509.

⁵⁰ In France this is countered to some extent by stronger public enforcement. Self-dealing French directors commonly face criminal prosecution for *abus de biens sociaux* (abuse of corporate assets), usually on demand by minority shareholders acting derivatively in the name of the company, for which the sanction is imprisonment for up to five years or a fine up to 375,000 euros. (Art. L. 241-3 and Art. L. 242-6 Code de Commerce.)

⁵¹ Articles 267 – 268-3 Commercial Code.

positive spurt in derivative suits.⁵² In order for the South African derivative action to have any hope of surviving and thriving, the courts must exercise their discretion wisely and circumspectly, to whitewash the barrier of costs that has long plagued minority shareholders in derivative litigation.

7.3 A FRAMEWORK FOR COSTS ORDERS

7.3.1 *The Hurdle of Costs*

A minority shareholder who brings a derivative action acts for the company and not for himself. The benefit of a successful action, likewise, accrues not directly to the minority shareholder but to the company. That is to say, all the shareholders in the company share indirectly in the gains, pro rata, to the extent that there may be a rise in the value of their shares.

Since the individual shareholder brings the derivative action on behalf of a group of persons, who all share in the benefit obtained by his efforts, a 'collective action' problem exists.⁵³ The legal costs and expenses to the individual shareholder of bringing the action typically outweigh his small pro rata benefit, so that there is no true recovery for him. Even if the litigation is a success, the plaintiff shareholder may still be out of pocket, as he would recover only some—but not all—his legal costs from the true defendant (who has harmed the company), under the 'loser pays' principle that costs follow the event in South African civil procedure. For him, it is a hollow victory. Additionally, the risk of being saddled with the liability for his opponents' legal costs should the derivative action fail, is indisputably the worst repellant to derivative litigation. Although it is intended as a safeguard to deter baseless actions, in reality it would frustrate and deter even bona fide applicants with

⁵² Specifically, a change was made to the filing fee for derivative law suits, from a percentage of the claim for compensation to a uniform filing fee; see generally Kraakman et al op cit note 11 at 174 – 5.

⁵³ Whincop op cit note 12 at 422 – 424.

meritorious grievances from instituting a derivative action. On a cost-benefit analysis, given the strong prospect of a net loss—no matter the outcome of the litigation—few shareholders would ever have any incentive to bring a derivative action for the company's benefit even when it would be clearly justified.

The result is shareholder apathy. This is particularly intensified when shareholders have a small stake in the company, for instance in widely-held or public companies with large groups of dispersed shareholders. Shareholder apathy in the field of the derivative action is compounded by the free-rider effect. There is the obvious temptation to be a free-rider, who leaves it to a fellow shareholder to invest the time, effort and costs of bringing a derivative action, while the free rider rides on his efforts by reaping a share in the benefits of the derivative litigation despite his passivity.⁵⁴

It must also be borne in mind that individual shareholders often do not have the financial and other resources necessary for litigation, while institutional shareholders who do, must weigh up their obligations to their beneficiaries. If the shares of the company are liquid and there is a ready market for them, a rational shareholder would be more inclined to simply exit the company by selling his shares rather than to litigate against the miscreant directors of the company.

The result of all these factors is that corporate delinquents frequently escape accountability for their misconduct, at the expense of the interests of the company itself, and the wider public interest in the proper management of companies and the integrity of the corporate system.

7.3.2 The Statutory Provision Under the Act

Section 165(10) of the Act confers on the court a wide discretion to make, at any time, any order it considers appropriate about the costs of derivative proceedings. In failing to shift the burden of the costs back to the company,

⁵⁴ See Maleka Femida Cassim op cit note 26 at 777.

which is the real plaintiff, this provision dismally fails to overcome the shareholder's disinclination to litigate stemming from the normal 'loser pays' rule. It is an overly conservative provision that leaves the minority shareholder without the assurance that he will recover his legal fees and costs from the company. This will always be subject to the uncertainty that is inherent in a discretion conferred on the court. The minority shareholder is at the mercy of the court.

In striking contrast, New Zealand law features a more encouraging and modern approach. It effectively codifies the indemnity order, by means of a statutory presumption in favour of company funding. The New Zealand Companies Act⁵⁵ directs the court, on application by a shareholder or other applicant to whom leave for a derivative action has been granted, to order that the whole or part of the reasonable costs of bringing the derivative proceedings must be paid by the company, unless it would be unjust or inequitable for the company to bear those costs. The clear intention is that once leave is granted for a derivative action, it is the company that should fund the action, even if the legal action ultimately fails.

The bland South African provision, which is sourced directly from the Australian costs provisions,⁵⁶ has two apparent objectives: first to enable the court to protect the bona fide shareholder against liability for costs by indemnifying him out of company funds, and secondly to provide a further safeguard against dubious or unmeritorious actions.⁵⁷ It is submitted that the first of these objectives is a worthy one which ought to be given primacy. This is buttressed by the recent case *Wood v Links Golf Tasmania Pty Ltd*⁵⁸ in which the Federal Court of Australia found that the intention of Parliament is that the costs of derivative actions should generally be met by the *company*. On the other hand, the second objective should be largely discounted, for a full

⁵⁵ New Zealand Companies Act, 1993, s 166.

⁵⁶ Section 242 of the Australian Corporations Act, 2001, save that the latter explicitly provides for orders for indemnification for costs, which the South African Act fails to adopt.

⁵⁷ According to the Australian Explanatory Memorandum to the Corporate Law Economic Reform Program Bill, 1998, at para 6.19; see also Van Wyk De Vries Commission of Enquiry into the Companies Act *Main Report* (RP 45 of 1970) at para 42.17.

⁵⁸ [2010] FCA 570.

spectrum of protective measures against shareholder abuse is already built into s 165 of the Act, as detailed above. Where costs orders and indemnity orders are made in favour of derivative applicants, this of itself does not provide any positive incentive to sue, because the applicant will not directly receive any compensation, regardless of the outcome of the action. For the courts to use costs orders as a deterrent to doubtful or unmeritorious actions would paradoxically serve to disincentivise the pursuit of worthy and meritorious claims as well.

In view of the anaemic approach taken by the South African legislature to costs orders, the role of the courts is of fundamental importance. To ward off the possibility of corporate harm without legal remedy, the judiciary must confront the vexed issue of costs by means of a fresh, shareholder-friendly approach. Unless the judicial discretion with regard to costs is exercised in a balanced and flexible manner, it could cause the early demise of the new statutory derivative action and effectively reduce s 165 to a dead letter in our law.

A framework is proposed below for the exercise of the discretion of the court to make costs orders. Guiding principles based on the experience in other jurisdictions are canvassed, together with a list of pitfalls which the courts should avoid.

Under s 165(10) the courts have wide powers to make costs orders. The order may concern the costs of the application for leave (or permission) to bring a derivative action or the actual derivative action itself. It may relate to the costs of the company, the applicant (who applied for or was granted leave), or any other party (such as the true defendants eg the directors whose conduct is the subject of the complaint).⁵⁹ Since the court may make ‘*any*’ costs order ‘*at any time*’ [emphasis added] under s 165(10), it has the power to order indemnification for the minority shareholder out of corporate funds, or to award

⁵⁹ Derivative actions under s 165 are not restricted to directorial misconduct, but may also concern wrongdoing by third parties or outsiders. For the purpose of convenience, this chapter refers mainly to wrongdoing directors.

interim costs to the minority shareholder to finance the derivative action on an ongoing basis until its conclusion. The courts in their discretion may also use this provision to support minority shareholders in recovering their full legal costs and expenses from the company, regardless of the ultimate success or failure of the derivative action. Notably, s 165 of the Act does not exclude the general discretion of the courts to determine costs orders without being confined to the statutory provisions,⁶⁰ and it thus appears to preserve the general judicial discretion with regard to costs orders.

7.3.3 *A Right of Indemnification*

Based on common law and the experience in other jurisdictions, it is respectfully submitted that the South African courts ought to implement, as a general rule, the following guiding principle on costs: once the court grants leave or permission under s 165 to a minority shareholder (or other applicant) to bring a derivative action, he is entitled to be indemnified by the company for his reasonable costs and expenses, save where the interests of justice or equity dictate otherwise. In other words, the successful applicant who has obtained leave under 165 automatically acquires a right to an indemnity from the company.

At this stage of the proceedings, the minority shareholder will have satisfied the three threshold tests for leave in terms of s 165(5)(b). In other words, the court at this point would be satisfied that the applicant is acting in good faith, that there is a serious question to be tried, and that the pursuit of the substantive derivative action is in the best interests of the *company* itself. It consequently is just and proper that, from this stage onwards, the company itself should bear the financial risk and the reasonable costs of the derivative proceedings—regardless of whether the substantive action ultimately fails or succeeds—since the company is the true plaintiff whose rights are being

⁶⁰ *Foyster v Foyster Holdings Pty Ltd (prov liq apptd)* (2003) 44 ACSR 705 at 708, and *Charlton v Baber* (2003) 47 ACSR 31 are Australian authority for the preservation of the general judicial discretion with regard to costs orders.

vindicated and to whom any recovery will flow.

It is only in exceptional circumstances that the company should be relieved from paying the costs, that is, where it would be unjust or inequitable to require the company to do so. This could arise, for instance, if the company is financially unable to bear the costs. Conversely, neither the financial need of the minority shareholder nor his wealth should disqualify him from indemnification, as the minority shareholder seeks the remedy not for himself personally but for the company. His personal financial status should be irrelevant to the issue of costs.

Authority for this approach may be derived both from South African common law as well as other comparable jurisdictions (which are discussed in paragraph 7.4.1 below). The rationale at common law for an indemnity was most cogently explained by Lord Denning in the renowned case *Wallersteiner v Moir (No 2)*⁶¹ as follows:⁶²

‘[T]he minority shareholder, being an agent acting on behalf of the company, is entitled to be indemnified by the company against all costs and expenses reasonably incurred by him in the course of the agency. This...arises on the plainest principles of equity.... Seeing that, if the action succeeds, the whole benefit will go to the company, it is only just that the minority shareholder should be indemnified against the costs he incurs on its behalf.’

Although *Wallersteiner’s* case concerned the common law derivative action (which is now abolished in South Africa),⁶³ the broad principles laid down by the English Court of Appeal continue to be relevant to the statutory derivative action. The conditions for an indemnity, as laid down in *Wallersteiner’s* case, are instructive. Lord Buckley stated that the company should normally be liable for the shareholder’s costs provided that the shareholder brings the derivative

⁶¹ [1975] QB 373 (CA). South African company law was historically based on English company law under the previous regime.

⁶² Ibid at 391 – 392.

⁶³ Section 165(1) of the Act.

action in *good faith* and on *reasonable grounds*.⁶⁴ Lord Denning added that the initiation of the action must be a reasonable and prudent course to take in the *interests of the company*.⁶⁵

It is of manifest significance that these common-law conditions for an indemnity or *Wallersteiner* order are the precise statutory prerequisites that a minority shareholder must now satisfy under s 165(5)(b) of the Act in order to obtain leave for a derivative action. Accordingly, a successful applicant who is granted leave under s 165 will already have fulfilled all the conditions for a '*Wallersteiner* order'. He thus deserves to be indemnified by the company, from that stage onwards.

The practical consequences stemming from an indemnity—in the event of the ultimate success of the actual derivative action or its eventual failure—are as follows:⁶⁶

'If the action succeeds, the wrongdoing director will be ordered to pay the costs: but if they are not recovered from him, they should be paid by the company. And all the additional costs (over and above party and party costs) should be taxed on a common fund basis and paid by the company.

... *But what if the action fails?* ...[T]he minority shareholder...should not himself be liable to pay the costs of the other side, but the company itself should be liable, because he was acting for it and not himself. In addition, he should himself be indemnified by the company, in respect of his own costs *even if the action fails*' [emphasis added].

These are, with respect, useful guidelines for the South African courts to follow in their application of s 165(10) of the Act.

The drawback or danger, however, is that the common law approach to indemnification was not fully cemented. In contrast with *Wallersteiner's* case,

⁶⁴ Supra note 61 at 403 – 404.

⁶⁵ Supra note 61 at 392.

⁶⁶ *Wallersteiner v Moir* supra note 61 at 391 - 392.

*Smith v Croft (No 1)*⁶⁷ took a more restrictive approach, and held that interim funding orders for the imposition of costs on the company should be made only if the plaintiff could show a genuine financial need. On the *Smith v Croft* approach, the plaintiff's financial status is taken into account, with the result that wealthy minority shareholders would be barred from obtaining indemnification. The financial needs test is glaringly inappropriate, for it is at odds with the essential nature of the derivative action. The plaintiff shareholder litigates not for himself, but on behalf of the company and for the direct benefit of the company. Not even affluent shareholders would be prepared to risk their own wealth to litigate on behalf of another. The financial needs test, significantly, was rejected in a later English case,⁶⁸ in which an indemnity order was granted to a wealthy plaintiff.

It is respectfully submitted that the South African courts must decisively reject the financial needs test of *Smith v Croft* if the new statutory derivative action is to take root in our law. As Lord Denning⁶⁹ so incisively put it, '[i]t is a well-known maxim of law that he who would take the benefit of a venture if it succeeds ought also to bear the burden if it fails.'

7.3.4 *Timing of the Order*

The order of indemnification or costs order ought to be made at the stage at which leave is granted to pursue a derivative action, on the basis explained above. To delay the order until the final conclusion of the substantive action would be to create uncertainty and much inconvenience over the litigation costs. It is regrettable that the first South African case on the new statutory derivative action, *Mouritzen v Greystone Enterprises (Pty) Ltd*,⁷⁰ took such a tentative approach. Although the court granted leave for the derivative action, it reserved the issue of costs for determination by the court hearing the

⁶⁷ [1986] 2 All ER 551.

⁶⁸ *Jaybird v Greenwood Ltd* [1986] BCLC 318.

⁶⁹ *Wallersteiner v Moir (No 2)* supra note 61 at 392.

⁷⁰ 2012 (5) SA 74 (KZD).

substantive action.⁷¹ Such reservations of costs impose a daunting financial disincentive for prospective applicants, which would undermine the proper use of the remedy by minority shareholders and others, to the ultimate detriment of the companies on whose behalf they sue. It is advisable for future courts to espouse a more balanced and robust approach to orders for costs and indemnification, that would give confidence and assurance to litigants suing derivatively.

A distinction must be drawn between the costs of the substantive derivative action itself and the costs of the prior application to court in terms of s 165 for leave to bring the derivative action. The former is discussed above. Regarding the latter, the applicant would (and should) usually be held liable for the costs of a failed application. On the other hand, a successful applicant should, as a general rule, be entitled to the immediate payment or reimbursement by the company of the costs that he has incurred in bringing the application for leave. The court is clearly empowered to make such an order in terms of s 165(10) of the Act. It is disappointing that *Mouritzen's* case declined to do so, and instead reserved the costs of the leave application also for determination by the court hearing the actual derivative action.⁷² This narrow and retrograde approach unreasonably burdens shareholder litigants. One hopes that it does not set a trend in South African law.

7.3.5 *Interim Costs*

In appropriate circumstances a shareholder who has obtained leave to bring a well-founded derivative action should be given access to corporate funds, on an ongoing basis, to finance the litigation, provided that the company is financially prosperous or financially able to fund the derivative proceedings. An interim costs order in favour of the shareholder will alleviate the burden on him and ensure that he is not discouraged by a lack of funds to maintain the substantive

⁷¹ At para 67.

⁷² Supra note 70 at para 68.

proceedings or by financial inability to meet the interim costs and expenses until the finalisation of the action. Furthermore, an indemnification in itself does not necessarily give the shareholder priority over the unsecured creditors, as pointed out in the UK case *Qayoumi v Oakhouse Property Holdings Plc*.⁷³

The prospect for an award of interim costs is implicit under s 165(10) of the Act, but a preferable approach would have been an explicit statutory provision for interim costs, along the lines of the Canadian legislation. Insofar as the Canadian legislation specifically permits complainants to apply to the court for the interim payment of costs by the company, including legal fees and disbursements,⁷⁴ it sends a clear signal to shareholder litigants to seek relief.

7.3.6 Security for Costs

The court, in its discretion, may require the minority shareholder in derivative proceedings to provide security for costs.⁷⁵ For a number of reasons this provision is open to criticism. First, the costs and the attendant amount of security required to cover them may be formidable, in view of the number of parties to a derivative action and the company's ability to indemnify⁷⁶ its defendant directors for the costs of a successful defence. It is the nature of derivative litigation for cases to be lengthy and complex and, while the true defendants have substantial financial resources at their disposal, the individual shareholder usually does not. Secondly, the minority shareholder, who must furnish security early in the legal proceedings, faces up-front costs in pursuing the action even if he is ultimately victorious.

Thirdly and most importantly, there is no true rationale for a security for costs provision. It is ostensibly designed to curb strike suits and secret

⁷³ [2000] 1 BCLC 352.

⁷⁴ Although the applicant may be held accountable to repay the interim costs on final disposition of the application or the action; see the Canada Business Corporations Act 1985, s 242(4); Ontario Business Corporations Act, 1990, s 249(4).

⁷⁵ Section 165(11).

⁷⁶ See further para 7.5 below.

settlements.⁷⁷ But as incisively contended in US law, in which this mechanism is rooted, a demand for security for costs is no true antidote to strike suits. Where predatory shareholders bring actions directed at extorting a settlement in which the company (rather than the true defendants) pays the shareholder, the more correct and more obvious solution is to bar collusive settlements.⁷⁸ This is precisely what s 165(15) of the Act already does.

An alternative rationale is that an order for security for costs could be motivated by a desire to protect the financial resources of the company and the defendant directors,⁷⁹ particularly if there is a chance that the minority shareholder will be unable to meet their legal costs should the derivative action fail. But as a matter of principle minority shareholders should not be disqualified from protecting corporate rights by reason of their lack of personal wealth. In any event, there are other mechanisms for shielding the financial interests of both the company and the defendant directors (ie the company is protected by the leave procedure which is conceived specifically to filter out corrupt and frivolous actions, while the defendant directors are usually protected by indemnification and insurance in terms of s 78).

It is significant that in the USA the use of security for costs statutes has now, for strategic reasons, effectively fallen by the wayside. Prior to the 1970s, US shareholders were required to post a deposit for the company's legal expenses,⁸⁰ and this trend was followed in several US states by the enactment of security for expenses statutes.⁸¹ But these statutes were subject to increasing criticism, for their true effect was to pose a serious obstacle to

⁷⁷ See eg *Cohen v Beneficial Industrial Loan Corp* supra note 5.

⁷⁸ Hornstein 'New Aspects of Stockholders' Derivative Suits' (1947) 47 *Columbia Law Review* 1 at 1, 3 and 5.

⁷⁹ The Australian Corporations Act, 2001, does not expressly provide for orders for security for costs. However, according to *Fiduciary Ltd v Morningstar Research Pty Ltd* (2005) 53 ACSR 732 at 744 and *Charlton v Baber* supra note 60, the legislation would permit an order for security for costs to protect the interests of the company.

⁸⁰ *Cohen v Beneficial Industrial Loan Corp* supra note 5.

⁸¹ Eg New York (NY Bus Corp Law s 627) and the previous Model Business Corporation Act (1969) before 1982 (s 249). Notably, Delaware did not enact a security for expenses statute.

shareholders and to discourage even meritorious derivative actions.⁸² Such ill effects are likely to be felt even more strongly in the South African environment bearing in mind that, unlike the USA, South Africa does not have a litigious culture, and litigiousness is further disciplined by the 'loser pays' rule of costs.

Once again, like the previous South African Companies Act 61 of 1973, which empowered the court to order applicants to furnish security (for the costs of the application as well as the often substantial costs of the provisional curator ad litem),⁸³ a costs barrier is erected against the applicant which could reduce the effectiveness of the remedy. Canadian legislation, perhaps relying on the experience of the USA, specifically forbids an order of security for costs as a precondition to a derivative suit.⁸⁴ It is submitted that s 165(11) of the Act ought to be amended to prohibit or disempower the courts from ordering minority shareholders and other derivative litigants to furnish security for costs, whether in connection with an application for leave or in connection with the action brought or intervened in pursuant to the grant of leave. Pending an amendment, the courts ought staunchly to refuse to burden derivative litigants with the additional hindrance of an order of security for costs.

7.3.7 *Remuneration and Expenses*

According to s 165(9)(a), if the court grants leave to an applicant under s 165 for a derivative action, the court must also make an order stating who is liable for the remuneration and expenses of 'the person appointed'. This provision is ambiguous and it is uncertain to whom 'the person appointed' refers. It may be intended to refer to the person who was appointed by the company⁸⁵ to investigate the demand or it could perhaps be intended to mean the person who is granted leave by the court to conduct the derivative action. Neither interpretation is problem-free. This provision is a gremlin in the Act that requires

⁸² See eg *McClure v Borne Chemical Co.* 292F 2d 824 (3rd Cir 1961) 829.

⁸³ Section 268 of the Companies Act 61 of 1973.

⁸⁴ Canada Business Corporations Act, 1985, s 242(3); Ontario Business Corporations Act, 1990, s 249(3).

⁸⁵ Under s 165(4).

clarification by way of a legislative amendment.

7.3.8 *Personal Recovery by Shareholders*

While the South African Act does not allow for individual or personal recovery by shareholders in derivative actions, this is permitted in several jurisdictions including Canada, New Zealand and Ghana.⁸⁶ The US courts have also departed in some cases⁸⁷ from the general principle of giving relief only to the company and have, in the interests of justice, allowed payment to be made directly to shareholders of the harmed company.

The inclusion in the South African Act of a judicial power to award individual recovery to former or current shareholders would be useful in preventing inequitable results in certain exceptional circumstances. If, for instance, the shareholders at the time of the corporate injury are not shareholders at the time of the legal action, an order for pro rata relief in favour of *former* shareholders, who had sold their shares at an undervalue, would avoid the unjustified enrichment of new shareholders who had bought their shares after the wrongdoing. It would thus prevent similar situations as in *Regal Hastings Ltd v Gulliver*,⁸⁸ where the inability to make such an order resulted in the new controllers of the company effectively recovering an undeserved portion of their purchase price which they had willingly undertaken to pay. As for an order for pro rata relief directly to *current* shareholders, this may avert abuse where the true defendants in a derivative action are the majority shareholders or controllers of the company, who are able to repeat the wrongdoing or to use the proceeds of the derivative action for other purposes, thereby denying individual shareholders of the company any (direct or indirect) benefit of the recovery.⁸⁹ In certain cases an order of pro rata relief to individual shareholders

⁸⁶ Respectively, Canada Business Corporations Act, 1985, s 240(c); Ontario Business Corporations Act, 1990, s 247(c); New Zealand Companies Act, 1993, s 167(d); Ghana Companies Code 1963, s 210(8).

⁸⁷ See eg *May v Midwest Refining Co*, 121 F 2d 431 CCA 1st (1941); *De Tomasso v Loverro* 250 App Div 206, 293 NYS 912 (1937).

⁸⁸ [1942] 1 All ER 378.

⁸⁹ AJ Boyle *Minority Shareholders' Remedies* (2002) 85.

excluding the wrongdoers, may be useful in debarring the wrongdoers or their supporters from perversely sharing (directly or indirectly) in the recovery. Furthermore, the possibility of payment of compensation directly to shareholders is a positive incentive for minority shareholders to take the initiative and the risks of instituting a derivative action. Personal recovery by shareholders is a way of solving the problem of costs faced by minority shareholders and other derivative litigants. It is a solution to the free-rider problem that is discussed (in paragraph 7.3.1) above.

If, however, the discretion to order pro rata relief to shareholders is made available in South African law, it must be exercised sparingly and reserved for exceptional situations only. The general rule must remain that the essence of the derivative action is to seek relief directly for the benefit of the company. To use this power too readily would be to blur the line between personal remedies for shareholders and the derivative action for corporate redress. It could also encourage strike suits aimed primarily at personal benefit for applicants.

7.4 LESSONS FROM COMPARABLE JURISDICTIONS

7.4.1 *Support for a Right of Indemnification*

The submission is made above that the South African courts should extend the principled approach to costs orders propounded in *Wallersteiner v Moir*⁹⁰ to costs orders under s 165 of the Act, so as to grant to shareholders, who have already obtained leave for a derivative action, a mandatory right to an indemnity from the company (save in exceptional circumstances). This proposal is bolstered by substantial authority in comparable jurisdictions. Other Commonwealth jurisdictions have also espoused the *Wallersteiner* approach to costs orders, whether directly in legislation or through decisions of the courts.

New Zealand law has effectively codified the indemnity order in the

⁹⁰ Supra note 61; see para 7.3.3 above.

Companies Act⁹¹ itself. In contrast in Canadian law it has been implemented by the courts. The well-known case *Turner v Mailhot*⁹² relied on the conditions laid down in *Wallersteiner v Moir* to rule that an applicant who obtains leave for a statutory derivative action establishes a prima facie right to an indemnity or order of costs from the company.

In the United Kingdom, the discretionary power of the court to award pre-emptive costs orders or indemnity orders in favour of derivative claimants is now codified in r. 19.9.E of the Civil Procedure Rules 2000.⁹³ It was found in *Wishart v Castlecroft Securities Ltd*⁹⁴ that courts have the power to make declaratory conditional orders in leave proceedings as to the costs of the main derivative litigation. The approach in *Wallersteiner* was applied in *Stainer v Lee*⁹⁵ in the context of the new statutory derivative action, pursuant to which the court decided that the claimant was entitled to be indemnified for his reasonable costs.

Likewise, the Federal Court of Australia in *Wood v Links Golf Tasmania Pty Ltd*⁹⁶ referred with approval to *Wallersteiner v Moir (No 2)* and proceeded to adopt the common law principle that if the shareholder's action 'is bona fide to protect the [company] and the [company] will receive the benefit of success, there is no good reason why the expenses should be met out of the private resources of [the] shareholder'.⁹⁷ The court qualified this dictum by stating that costs orders may be refused in certain countervailing circumstances. *Wood's* case⁹⁸ plainly declared that:

'The purpose of permitting a person to bring an action in the name of the company is to prevent conduct which involves some element of harm. In

⁹¹ New Zealand Companies Act, 1993, s 166; see para 7.3.2 above.

⁹² [1985] OJ No 251, 50 OR (2d) 561, 28 BLR 222 (HCJ).

⁹³ Previously rule 19.9(7) of the 1998 Rules.

⁹⁴ [2009] CSIH 65.

⁹⁵ [2010] EWHC 1539 (Ch). This was subject to a limit of £40,000 since the amount of likely recovery was uncertain.

⁹⁶ Supra note 58 at para 9.

⁹⁷ *Farrow v Registrar of Building Societies* [1991] 2 VR 589 at 595 in *Wood v Links Golf Tasmania Pty Ltd* supra note 58 at para 9.

⁹⁸ Supra note 58 at para 9.

most cases the wrongdoer will be in control of the company. That will be the reason the company itself is not bringing the action. The purpose of [the derivative action] is to increase the likelihood that someone brings a claim which the company ought to have commenced. In those circumstances, I can think of no good reasons why the company should not bear the costs.'

It was consequently ordered in *Wood's* case that the company must meet the fair and reasonable costs of the action.⁹⁹

There thus is ample (though not consistent or unwavering)¹⁰⁰ support for the proposal that the South African courts, when granting permission to an applicant to pursue a derivative action, should effectively implement a presumption in favour of company funding. This may be done by means of a judicially recognised right to an indemnity from the company, except where it would be unjust or inequitable in the circumstances.

While the approach of most Commonwealth jurisdictions to the obstacle of costs is to allow the court a discretion to indemnify the plaintiff shareholder for costs incurred or to be incurred, a closer analysis reveals that there are serious flaws in the practical operation of indemnity and costs orders.¹⁰¹ The USA, by contrast, follows a different approach that resolves the issue of costs more successfully. The upshot is that the derivative suit in the USA is a much more successful tool for the control of the conduct of directors, as evidenced by the empirical studies discussed above.

Two features in particular make the derivative action more feasible in the USA. First, unlike the Commonwealth jurisdictions in which the indemnity orders are merely discretionary rather than mandatory, the US rule is that the corporation *must* pay the attorney's fees of the successful plaintiff.¹⁰² This is

⁹⁹ The court also noted that the order could be recalled at a later stage if the claim subsequently turned out to be unmeritorious; in this regard, see para 7.4.3 below.

¹⁰⁰ See further para 7.4.2 below.

¹⁰¹ See para 7.4.2 and 7.4.3 below.

¹⁰² See eg *Sprague v Ticonic National Bank*, 307 US 161, 59 S.Ct. 777 (1939). This rule originated in *Trustees of Greenough*, 105 US 527 (1881) and *Central RR & Banking Co v Pettus*, 113 US 116 (1885).

referred to as the 'common fund' doctrine. Secondly a plaintiff suing derivatively in the US has recourse to the contingency fee system, whereby fees are charged only if the lawsuit is successful or is settled out of court, usually at a rate of 20 – 30 percent of the award to the company. The rejection of the 'loser pays' rule or fee-shifting in the USA means that each party pays his own attorney whether he wins or loses the case. These favourable fees rules have resulted in the creation of a specialised plaintiffs' bar.¹⁰³

While a vigorous contingency fee system may not be practicable in South African law at this juncture, the former feature of US law (ie the 'common fund' doctrine) is instructive. The basis of the 'common fund' doctrine is that if the litigation instituted by the plaintiff produces a common fund or recovery that benefits a class of persons (or an entity in which a class of persons has an interest), the reasonable legal expenses of the plaintiff may be deducted from the recovery. Since a whole class of persons benefits from the action, fairness dictates that they should contribute equally to the litigation expenses, for to do otherwise would be to unjustly enrich the corporation at the expense of the plaintiff.¹⁰⁴ This highly sensible doctrine may be contrasted with the much weaker position of the shareholder in South Africa and Commonwealth jurisdictions, where even successful derivative litigants run the risk of suffering a personal net loss in pursuit of the company's success.¹⁰⁵ The possibility of the unjustified enrichment of the company ought to be borne in mind by the South African courts when formulating costs orders in favour of shareholder litigants. To avoid unjustified enrichment, where the costs of the successful shareholder are not recovered from the wrongdoing directors (or other defendant), they should be paid by the company, as should all additional costs over and above party and party costs.

The US courts use two methods to calculate attorneys' fees in derivative

¹⁰³ MJ Loewenstein 'Shareholder Derivative Litigation and Corporate Governance' (1999) 24 *Delaware Journal of Corporate Law* 1 at 1 - 2.

¹⁰⁴ *Mills v Electric Auto-Lite Co* (1970) 396 US 375 at 396.

¹⁰⁵ Ie, to the extent that their costs and expenses are either not recovered or not recoverable from the wrongdoing defendants.

litigation. If the case generates a common (monetary) fund the percent method applies, pursuant to which the attorney's compensation consists of a percentage, usually 20 – 30 percent,¹⁰⁶ of the amount awarded to the company in the derivative action. If, on the other hand, the derivative action does not produce a monetary recovery for the corporation but produces a substantial non-monetary benefit (whether by judgment or settlement), the substantial benefit test is used.¹⁰⁷ An example of a substantial non-monetary benefit (or intangible relief) is where a derivative action brings about major changes to the management or power structure of the corporation designed to prevent future misconduct.¹⁰⁸ Despite the absence of a financial recovery, the corporation is nonetheless ordered in these cases to pay the fees of the plaintiff's attorney,¹⁰⁹ who is remunerated by the 'lodestar' method for the number of hours reasonably spent at the applicable market hourly rate.¹¹⁰ The substantial benefit test is a clear recognition that the benefits of a derivative action extend beyond mere monetary compensation for harmed companies, and that the remedy may validly generate intangible, yet valuable, relief for companies. The South African courts, in making indemnification and costs orders, should consequently avoid the temptation to limit or cap these orders to the amount of the company's likely or actual financial recovery (as done for instance in the UK case *Stainer v Lee*).¹¹¹ The derivative action is not merely a remedial device to obtain patrimonial compensation for corporate wrongs, but is equally a deterrent mechanism to prevent future management abuses (as previously discussed).

¹⁰⁶ See eg *In re Oracle Sec Litig*, 852 F Supp at 1437 (1994); *Thomas v Kempner* 498 A 2d 320 (Del Ch 1979).

¹⁰⁷ This is an extension (sometimes referred to as an exception) of the 'common fund' doctrine.

¹⁰⁸ *Fletcher v AJ Indus*, 266 Cal.App.2d 313, 72 Cal.Rptr. 146 (1968).

¹⁰⁹ See eg *Bosch v Meeker Coop. Light & Power Association*, 257 Minn, 362, 101 NW2d 423 (1960).

¹¹⁰ See eg *Schlensky v Dorsey*, 574 F.2d 131(3rd Cir. 1978). The lodestar method may also be used where a common fund is generated, but the courts prefer to use the percent method in these cases. See also *Southerland v International Longshoremen's Union*, 845 F 2d 796 (9th Cir 1987); *Cohan v Loucks*, No 12,323, 1993 Del. Ch. LEXIS 99 (Del Ch June 11, 1993); *Good v Texaco, Inc*, No 7501, 1985 WL 11536 (Del Ch Feb 19, 1985). The lodestar figure may be adjusted upward or downward by the court depending on a number of other factors (*Hensley v Eckhart*, 461 US 424, 433 (1983)).

¹¹¹ Supra note 95.

7.4.2 *Flaws in Indemnity and Costs Orders: Inconsistencies in Approach*

A closer examination of the judicial trends and approaches in common law jurisdictions reveals serious flaws and stumbling blocks that must be avoided by the South African courts. Despite the high level of support for the *Wallersteiner* approach, the judicial stance on indemnity and costs orders in these jurisdictions has not always been uniform or consistent.

In Australian law, some progressive dicta initially were made that a person with judicial permission or leave to pursue a claim on behalf of a company 'should be protected, as to costs, by the company itself' on the grounds that he is 'the surrogate of the normal corporate decision makers whose decision has not been forthcoming'.¹¹² Nonetheless, it effectively became the common practice for Australian courts to require the shareholder in the first instance to bear the burden of costs.¹¹³ Even if the company was prosperous, the Australian courts were strangely reluctant to grant costs orders against it.¹¹⁴ An empirical analysis of all decisions on the new Australian statutory derivative action in the first five years of its operation¹¹⁵ revealed that the company was ordered to pay the applicant's costs for the leave application in only 21% of successful applications, and the costs of the actual derivative action in none of the cases surveyed. The courts have even contrarily or perversely ordered the shareholder in some cases to bear all or part of the *company's* costs in relation to the derivative proceedings, with the misguided intention of protecting the company's financial resources.¹¹⁶ This erroneous reasoning overlooks the fundamental nature and purpose of the derivative action.

¹¹² *Foyster v Foyster Holdings Pty Ltd* supra note 60 at para 13.

¹¹³ As acknowledged in *Sub Rosa Holdings Pty Ltd v Salsa Sudada Production Pty Ltd* [2006] NSWSC 916 at para 49; see also *Wood v Links Golf Tasmania Pty Ltd* supra note 58 at para 9.

¹¹⁴ See eg *Ehsmann v Nutectime International Pty Ltd* (2006) 58 ACSR 7051.

¹¹⁵ Ramsay & Saunders op cit note 38 at 428.

¹¹⁶ *Roach v Winnote Pty Ltd* (2006) 57 ACSR 138 at 145; see also *Fiduciary Limited v Morningstar Research Pty Limited* [2005] NSWSC 442. An order for indemnification for the company's costs and expenses was made in *Carpenter v Pioneer Park Pty Limited (in liq)* [2004] NSWSC 1007 with the rider that if the derivative action was successful and the company was compensated, the applicant could apply to court for reimbursement of these expenses.

It is encouraging, however, that these regressive trends appear to be waning. The Federal Court of Australia, in an enlightened and lucid judgment in *Wood v Links Golf Tasmania Pty Ltd*¹¹⁷ was sharply critical of these common practices of the Australian judiciary regarding costs orders. The court, espousing the reasoning in *Wallersteiner v Moir*, decisively declared that the company itself must generally bear the costs of derivative litigation.

The Canadian legislation¹¹⁸ is more reassuring to prospective applicants than its South African and Australian counterparts. First, it explicitly refers to the imposition of costs orders on the *company* to bear the reasonable legal fees of the complainant, without any concomitant reference to costs orders for complainants to pay the company's costs (though the latter is not prohibited). Secondly, the legislation incorporates an express permission to seek interim costs. While on the face of it the Canadian provisions support corporate funding for shareholders, they have in practice been interpreted inconsistently and sometimes narrowly by the courts. Two main approaches emerge. The earlier and more liberal line of reasoning was laid down in *Turner v Mailhot*¹¹⁹ in which the Ontario High Court, relying on the *Wallersteiner* conditions, concluded that shareholders who are granted leave for a statutory derivative action have a *prima facie* right to an indemnity or order of costs from the company.¹²⁰ While the financial inability of an applicant to fund an action would weigh heavily in favour of an indemnity, it is not a precondition for an indemnity.¹²¹ In other words, a shareholder's wealth, commendably, does not deprive him of an indemnity from the company.

A divergent line of Canadian cases, in contrast, established financial

¹¹⁷ Supra note 58; see para 7.4.1 above.

¹¹⁸ See Canada Business Corporations Act, 1985, s 240(d); Ontario Business Corporations Act, 1990, s 247(d).

¹¹⁹ Supra note 92.

¹²⁰ It was stated further that the court has the discretion to set the amount on fair terms. *Turner*, in the circumstances, was given a partial indemnification; in this regard, see further para 7.4.3 below.

¹²¹ *Turner v Mailhot* supra note 92 at 567.

need as a general prerequisite for an award of interim costs.¹²² Although a complainant will not necessarily be required to dispose of personal assets such as a home, his personal financial resources and borrowing capacity would be looked to first as a source to fund the litigation.¹²³ This rigid approach is based on the test in *Smith v Croft*.¹²⁴ Its rationale is that the denial of interim costs will better discipline the shareholder in the conduct of the action, as he will make litigation decisions knowing that he will not necessarily be reimbursed for the legal costs.¹²⁵ This, however, is to overshoot the mark. It is more likely to deter, rather than to temper, shareholder litigants. It is a trend that must be firmly eschewed by the South African courts, in preference for the *Turner v Mailhot* line of reasoning, discussed above.

Turning to New Zealand law, the statutory presumption in favour of company funding¹²⁶ boldly provides the greatest support for the proper funding of derivative litigation from the corporate treasury. But the New Zealand courts have surprisingly ignored the literal wording of the legislation. In the first judgment, *Vrij v Boyle*,¹²⁷ the court set the trend by refusing the shareholder's application for an indemnity for costs at the time of the grant of leave; the court instead reserved all questions of costs and indemnification pending the outcome of the full hearing, on the basis that costs follow the event. This approach is clearly at odds with the literal meaning and the intention of the legislation on awards of costs,¹²⁸ which shifts the costs of the proceedings back

¹²² *Intercontinental Precious Metals v Cooke* (1994) 10 BLR (2d) 203 (BCSC) at 224; *Johnson v Meyer* [1987] SJ No 668, 62 Sask R 34 at 40 (QB), which stated that interim costs may be awarded in a derivative action where it is financially necessary to ensure that the action proceeds.

¹²³ *McKay v Munro* (1992), 119 NSR (2d) 195 (NSSCTD).

¹²⁴ *Supra* note 67; see para 7.3.2 above.

¹²⁵ *Intercontinental Precious Metals v Cooke* *supra* note 121; *Primex Investments Ltd v Northwest Sports Enterprises Ltd* [1995] 13 BCLR (3d) 300 (SC).

¹²⁶ See para 7.3.2 above.

¹²⁷ [1995] 3 NZLR 763.

¹²⁸ Section 166 of the New Zealand Companies Act 105 of 1993 states that the court shall, on the application of the shareholder or director to whom leave was granted to bring or intervene in the proceedings, order that the whole or part of the reasonable costs of the proceedings must be met by the company unless the court considers that it would be unjust or inequitable for the company to bear those costs.

to the company, first, from the time of the leave application¹²⁹ and, secondly, *irrespective* of the outcome of the substantive action. It is noteworthy that a New Zealand court¹³⁰ has pronounced, similarly to the ill-advised line of Canadian decisions above, that '[t]he discipline which costs provide in the conduct of litigation cannot be overstated'.

Subsequent to *Vri v Boyle*, orders were made in some cases that the company itself meet the costs of the derivative proceedings.¹³¹ But in the majority of cases, as shown by empirical data, the courts have not ordered the company to bear the costs, often because the applicant does not apply for a costs order¹³² or even undertakes to bear the costs himself.¹³³ A strong motivation is that many applicants use the successful leave application as a tactic to facilitate a settlement of the dispute with the company and its directors, without actually commencing a substantive derivative action.¹³⁴

The decisions within the various Commonwealth jurisdictions have thus been discordant on the thorny issue of awards of costs. The South African courts would do well to avoid such uncertainty and unpredictability. This may be attained by building up a carefully reasoned framework for costs orders, resting on firm and principled foundations.

7.4.3 *Pitfalls and Traps to be Avoided*

Equity demands that the South African courts should effectively implement a general principle, as proposed above, that successful applicants, who have obtained leave to bring a derivative action under s 165, have an automatic right of indemnification by the company regardless of the outcome of the substantive derivative action, unless the strict interests of justice or equity dictate otherwise.

¹²⁹ The application under s 166 of the New Zealand Act would usually be made at the time of leave application under s 165 of that Act.

¹³⁰ *Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* (No 2) [1993] 2 NZLR 617 at 682, which concerned a derivative action brought under the Securities Amendment Act 1988 (NZ).

¹³¹ Eg *MacFarlane v Barlow* (1997) 8 NZCLC 261,470.

¹³² Eg *Thorrington v McCann* (1997) 8 NZCLC 261,564.

¹³³ Taylor op cit note 41 at 355, 362.

¹³⁴ Ibid.

For instance, an indemnity would be unjust or inequitable if the company is financially unable to bear the costs,¹³⁵ or if the company's claim is only aspect of a much wider dispute between the parties.¹³⁶

However, a number of traps and pitfalls come to light, drawing on the experience in comparable jurisdictions, which should be pre-empted in South African law. Foremost among these snares is the test of financial hardship or the financial inability of the minority shareholder (or other applicant) to bear the costs. This test is unsound in principle, on the basis explained above,¹³⁷ and should be discarded as a prerequisite for an indemnity from the company. Other stumbling blocks to be avoided include the following:

- (i) *The strength of the claim or its merits:*¹³⁸ Bearing in mind that a shareholder, who has obtained leave to bring a derivative action under s 165 of the Act, would already have established that the claim has sufficient merit for leave to be granted,¹³⁹ it would be odd and peculiar for the courts to revisit the merits of the action and its prospects of success when considering the shareholder's entitlement to an indemnity from the company.¹⁴⁰ It would also result in time-consuming and expensive mini-trials or interim trials on the merits,¹⁴¹ thereby undermining the objectives of the new leave procedure.
- (ii) *The true defendant's stake in the company:* Where the true or real

¹³⁵ In Australian law, see *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313 at para 75; *Carpenter v Pioneer Park Pty Limited (in liq)* supra note 116 at para 20; *Wood v Links Golf Tasmania Pty Ltd* supra note 58 at para 12. In New Zealand law, see *Re Kambrook Manufacturing (NZ) Ltd* HC Wellington M505/95, 23 May 1996.

¹³⁶ *Fiduciary Limited v Morningstar Research Pty Limited* supra note 116, approved in *Wood v Links Golf Tasmania Pty Ltd* supra note 58 at para 11.

¹³⁷ See further paras 7.3.3 and 7.4.2 above.

¹³⁸ Some restrictive foreign decisions have considered indemnities and interim costs orders as an exceptional remedy to be withheld when there are doubts about the merits of the proceedings. In this regard, in Canadian law, see *Intercontinental Precious Metals v Cooke* supra note 122; *Primex Investments Ltd v Northwest Sports Enterprises Ltd* supra note 125. In New Zealand law, see *Needham v EBT Worldwide Ltd* (2006) 3 NZCCLR 57 (HC).

¹³⁹ Section s 165(5)(b)(ii) of the Act provides that the court, in order to grant leave, must be satisfied that there is a serious question to be tried.

¹⁴⁰ See eg W Kaplan and B Elwood 'The Derivative Action: A Shareholder's "Bleak House"?' 2003 (36) *University of British Columbia Law Review* 459 at 465.

¹⁴¹ See Chapter 3, para 3.2.

defendant has a substantial stake in the company, it has been contended that an indemnification by the company effectively obliges him to fund legal proceedings against himself,¹⁴² particularly in small quasi-partnership companies or owner-managed companies. This reasoning is faulty, for it flouts the cardinal principle that the company is a separate legal entity distinct from its shareholders regardless of its size; it is the indemnifying company that would fund the derivative action, not its shareholders. Moreover, the true defendant (who frequently is a wrongdoing director) is often indemnified by the company or is insured at the company's expense—with the result that the harmed company effectively funds the defence of the alleged wrongdoer who has harmed it.¹⁴³

- (iii) *Whether the benefit is sought more for the company or more for the plaintiff:*¹⁴⁴ This controversial issue arises from the overlap and a blurring of the lines between personal actions which are brought for personal redress by shareholders, and derivative actions which are brought by shareholders seeking redress on behalf of the company.
- (iv) *The likely amount of the recovery:*¹⁴⁵ To cap an indemnity or to limit it to the likely amount of the company's financial recovery, is to ignore the primary rationale of the derivative action, which is not only purposed at obtaining monetary benefits or compensation for the company, but also at chilling future directorial misconduct and promoting accountability. Once an indemnity is justified in principle, the applicant ought to be

¹⁴² In New Zealand law, see *Frykberg v Heaven* supra note 7; fortunately *Presley v Callplus Ltd* [2008] NZCCLR 37 (HC) reduced the significance of this factor in New Zealand law. In Australian law, see *Ehsmann v Nutectime International Pty Ltd* supra note 114; *Fiduciary Limited v Morningstar Research Pty Limited* supra note 116. (See also the English cases *Halle v Trax BW Ltd* [2000] BCC 1020 and *Mumbray v Lapper* [2005] EWHC 1152 (Ch)).

¹⁴³ See further para 7.5 below.

¹⁴⁴ In Canadian law, see *Turner v Mailhot* supra note 92, where the court found that the action involved a struggle between Turner and Mailhot, rather than one for the advantage of the company (para 6). As a result the plaintiff's indemnity was restricted to 50% of his total costs.

¹⁴⁵ The UK case *Stainer v Lee* supra note 95 found that the claimant was entitled to be indemnified for his reasonable costs, but since the likely amount of the recovery in the derivative action was uncertain, the court capped the indemnification at a limit of £40,000 (with liberty to later extend its scope).

indemnified in full, for all his reasonable costs and expenses.¹⁴⁶

- (v) *Conflation with the leave application:* Some foreign decisions have held, in the context of the application for leave to bring a derivative action, that it substantiates an applicant's claim that he is acting in good faith and/or in the interests of the company where he is willing and able to fund the derivative action himself.¹⁴⁷ This test would conflate the leave application (under s 165(5) of the South African Act)¹⁴⁸ with the separate issue of costs and indemnification (under s 165(10) of the Act). These clearly are two separate and distinct inquiries in the South African context, and must remain so. A second defect is that this test may result in the unseemly refusal of leave to less wealthy applicants, such as individual minority shareholders, which would subvert their role as corporate watchdogs.
- (vi) *Connection between the wrongdoing and the applicant's financial inability:* The Canadian case *Barry Estate v Barry Estate*¹⁴⁹ advocated a strict three-part test comprised of the strength of the applicant's case; genuine financial need on the part of the applicant which, but for the interim costs order or indemnification, would prevent the pursuit of the claim; and some connection between the conduct complained of and the applicant's financial inability. While the first two branches of this test are discussed above, the third branch is equally objectionable, since the only actionable harm in a derivative action is harm done directly to the company, not to the shareholder or applicant.¹⁵⁰ This test may be appropriate for a personal shareholder action, such as the oppression

¹⁴⁶ See the discussion of the 'substantial benefit' test in para 7.4.1 above.

¹⁴⁷ In Canadian law, see *Intercontinental Precious Metals v Cooke* supra note 122. In Australian law, see *Metyor Inc (formerly Talisman Technologies Inc) v Queensland Electronic Switching (Pty) Ltd* QCA [2002] 269; *Fiduciary Limited v Morningstar Research Pty Limited* supra note 115. In New Zealand law, see *Needham v EBT Worldwide Ltd* supra note 138 at paras 20 and 46; see also *Re Wilson Neill Ltd* (1993) 6 NZCLC 68,336, 68,362.

¹⁴⁸ This requires an applicant to establish his good faith and that the litigation is in the best interests of the company (s 165(5)(b)(i) and (iii)).

¹⁴⁹ [2001] OJ No 2991 (QL) (Sup Ct J).

¹⁵⁰ Kaplan & Elwood op cit note 140 at 465.

remedy—which appears to have originally been its origin.¹⁵¹ It clearly does not befit the derivative action.

7.5 DIRECTORS' INDEMNITY AND INSURANCE

Derivative actions are usually brought to remedy corporate harm inflicted by a miscreant director whom the board of directors improperly fails to sue. While a costs hurdle confronts the minority shareholder, or other stakeholder who seeks to vindicate the company's rights in a derivative action, the defendant director is conversely in a more favourable position. The defendant director has access to substantial corporate funds for his defence, as directors are invariably protected against legal costs and expenses by means of indemnification or insurance.

7.5.1 Indemnification of Directors

A company is permitted, but not obliged, to provide funds to a defendant director to meet any expenses incurred or to be incurred in defending derivative proceedings. Section 78 of the Act states that a company may advance expenses to a director to defend litigation (including derivative litigation), or may indemnify the director, whether directly or indirectly.

However if judgment is ultimately given against the director, on the basis of his *wilful* misconduct or wilful breach of trust,¹⁵² these costs must be refunded or repaid to the company.¹⁵³ In contrast, if a director is held liable to the company for *negligence*, not only his legal costs but also his liability remain indemnifiable by the company.¹⁵⁴

This is a peculiar provision. Its practical effect is that directors who have *negligently* harmed the company stand to lose nothing. They are free of any

¹⁵¹ See *Allers v Maurice* (1992) 5 BLR (2d) 146 (Ont Gen Div); *Wilson v Conley* (199) 1 BLR (2d) 220 (Ont Gen Div); *Perrett v Telecaribe Inc* [1999] OJ No 4487.

¹⁵² Or if the director's liability arises from reckless trading, or in terms of s 77(3)(a) – (c), or consists of a fine in terms of s 78(3).

¹⁵³ Section 78(4) – (6) read with s 78(8).

¹⁵⁴ Section 78(4) – (6).

personal responsibility to the company, both for the payment of the award of damages to the company and for the payment of the legal costs of their defence. To permit the company to indemnify a negligent director who has harmed it, is tantamount to an exemption from liability. A distinction must be drawn between directors' liability for negligence to third parties and liability for negligence to the company itself. Several US states logically prohibit indemnification against the latter.¹⁵⁵ The United Kingdom legislation similarly permits the indemnification of directors against liability for negligence to third parties by means of qualifying third party indemnity provisions,¹⁵⁶ while sensibly proscribing indemnification against liability for negligence to the company itself¹⁵⁷ (though this may be insured by means of directors' and officers' liability insurance).¹⁵⁸

It is submitted that the flaw in s 78 of the South African Act, in respect of indemnification, ought to be corrected by the adoption of a similar distinction. On the one hand, directors' liability for negligence to *third parties* should remain indemnifiable by the company while, on the other hand, directors' liability for negligence to the *company itself* should logically be prohibited from indemnification.

Bearing in mind that indemnification under s 78 of the South African Act is not an obligation of the company but merely an election, if the board of directors decides to indemnify a co-director who has been held liable to the company in a derivative action for negligence, the board decision may be open to challenge. The basis of the challenge is that the indemnification decision of the board is in breach of their fiduciary duty to act in good faith and in the best interests of the company. Where the negligent director's right to an indemnity is entrenched in his contract of service, questions may arise as to its enforceability.

¹⁵⁵ Eg New York (NY s 722), California (Cal s 317) and Delaware (s 145).

¹⁵⁶ Section 234 of the United Kingdom Companies Act, 2006.

¹⁵⁷ Section 232(2) of the United Kingdom Companies Act, 2006.

¹⁵⁸ Section 233 of the United Kingdom Companies Act, 2006.

7.5.2 Insurance

Directors are often protected by directors' and officers' liability insurance ('D & O insurance') especially in larger companies. A company may purchase insurance: (i) to protect its *directors* against any indemnifiable liability or expenses; or (ii) to protect the *company* against any contingency including any indemnifiable liability, indemnifiable expenses or advanced expenses.

Consequently, a director who is sued for fraudulent or *wilful* misconduct may rely on his insurance only if the claim is abandoned or if he is exculpated, but not if the claim against him is successful.¹⁵⁹ The fraudulent or self-dealing director thus bites the bullet of personal liability, which serves as compensation for the company and as a deterrent to others. On the other hand, if a director is held liable for *negligence*, his insurance may cover both the claim itself (ie his liability for damages) and the legal costs of his defence. Insurance is particularly useful where the company is unable to indemnify a director due to financial difficulties, or where the company is unwilling to indemnify him. Unlike an indemnity, which the company has the power but not a duty to provide, an insurance policy contractually binds the insurer.

It is significant that the company often pays the D & O insurance premiums while the negligent director benefits from it. The question thus arises whether D & O insurance is effectively a shifting of liability to the company for negligent breaches of directors' duties, and whether it waters down or undermines the director's duty of care and skill. However, for several reasons, D & O insurance is essentially in the interests of the company. First D & O insurance cover boosts the likelihood that the company would be compensated,¹⁶⁰ given that directors who are held personally liable to the company may lack sufficient personal funds to compensate the company for its

¹⁵⁹ That is, if he is held liable for wilful misconduct or wilful breach of trust; or for reckless trading or other liability arising in terms of s 77(3)(a) – (c); or a fine in terms of s 78(3).

¹⁶⁰ Hirt, HC 'The company's decision to litigate against its directors: legal strategies to deal with the board of directors' conflict of interest' (2005) *Journal of Business Law* 159 at 160.

loss. Without adequate insurance cover, the legal action is practically superfluous. The court may even withhold leave for a derivative action if the defendant directors would be financially unable to meet a potential judgment in favour of the company, on the basis that it would not be in the company's best interests.¹⁶¹ Secondly, in light of the hazy and vague distinction between a patent lack of care in decision-making and mere commercial misjudgments,¹⁶² directors would be loathe to engage in entrepreneurial risk-taking or from serving as directors, without insurance against directorial negligence. It is evidenced by statistics in the USA that successful derivative actions for directors' negligence or wasteful management are rare, and it is primarily intentional misconduct and self-dealing at which the derivative action is directed.¹⁶³

7.6 ACCESS TO INFORMATION

In a dispute between a minority shareholder and the controllers of the company, a second major obstacle for the former is asymmetry of information. The issue of access to information was introduced in Chapter 3 (at paragraph 3.3), where it was explained that the minority shareholder's lack of access to inside corporate information is a great stumbling block in his application to court for leave to institute derivative proceedings, and particularly in establishing the second guiding criterion or gateway for leave, namely that there is a serious question to be tried. This paragraph builds on the earlier discussion of the hurdle of access to information.

¹⁶¹ In terms of s 165(5)(b)(iii) of the Act; see Chapter 4. However, the matter should not be solely determined by a cost-benefit analysis. Other factors, such as the deterrence value of the action, must also be considered by the court.

¹⁶² Mere negligence is actionable in a statutory derivative action under s 165 of the Act. Directors' negligence no longer has to be self-serving to form the basis of a derivative action, in contrast with the (now abolished) common law derivative action in which where a complex distinction was made between negligence per se (which was not an exception to the rule in *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189) and negligence benefiting the wrongdoer (which qualified as fraud on the minority and was thus an exception to the rule in *Foss v Harbottle*); see *Pavlides v Jensen* [1956] Ch 565 Ch D; *Daniels v Daniels* [1978] Ch 406.

¹⁶³ RM Jones M & Welsh, M 'Toward a Public Enforcement Model for Directors' Duty of Oversight' (2012) 45(2) *Vanderbilt Journal of Transnational Law* 343 at 343 – 365.

The minority shareholder's lack of access to inside corporate information, which is in the hands of the controllers and managers of the company, will at the outset block many derivative actions. For an effective derivative action it is vital that shareholders have full preliminary information on the facts and background underpinning the derivative action, beyond the company records available to them by right in terms of s 26 of the Act, in order to found their claim and to adequately particularise their allegations of corporate misconduct. It must be kept in mind that even with full and proper rights of access to corporate information, it may remain difficult for an outsider to unscramble the evidence and trail of wrongdoing.

The right to inspect the books of the company, under s 165(9)(e) of the Act, applies only on the grant of judicial leave to the shareholder to commence a derivative action. This right is of no use to the shareholder or applicant in the critical early stages of the procedure when preparing his application for leave in the first place.¹⁶⁴ This is a disappointing lacuna in the Act. A more balanced approach would be to grant to *prospective* applicants under s 165 a statutory right to apply to court to inspect the books of the company, provided that a 'proper purpose' is shown. A useful model or precedent is provided by s 247A(3) of the Australian Corporations Act, 2001.¹⁶⁵ A 'proper purpose' may include an inspection of the books for the pursuit of a reasonable suspicion that directors have been in breach of their duties,¹⁶⁶ while an application for inspection merely to challenge the wisdom of a routine business decision would fail for want of a proper purpose.¹⁶⁷ A further advantage is that the transparency which flows from allowing shareholders and other prospective applicants a right of inspection could prevent groundless derivative actions in some cases, and in other cases the knowledge of management that they are being watched could deter misconduct and mismanagement.

¹⁶⁴ The applicant may be able make a request for information in reliance on the Promotion of Access of Information Act 2 of 2000; see eg *Davis v Clutchco (Pty) Ltd* 2004 (1) SA 75 (C).

¹⁶⁵ See *Stewart v Normandy NFM Ltd* (2000) 18 ACLC 814.

¹⁶⁶ *Humes Ltd v Unity APA Ltd* (No 1) [1987] VR 467; *Barrack Mines Ltd v Grants Patch Mining Ltd* (No 2) [1988] 1 Qd 606.

¹⁶⁷ *Re Augold NL* [1987] 2 Qd R 297.

The investigation by an independent and impartial person or committee, in terms of s 165(4) of the Act, is an unsuitable channel for yielding information to applicants or prospective applicants. There are a number of inherent difficulties and uncertainties in this provision. First, the investigator is not armed by the Act with wide investigative powers, which may render the investigation a toothless one that may be thwarted by the directors, managers and controllers of the company. Secondly, the investigator is appointed by the company itself, presumably by the board of directors, which results in an inherent bias and is open to abuse. The board (who are often the wrongdoers or their supporters) is able to select, out of self-interest, an investigator who has a pro-defendant bias. The third problem is that the investigator reports directly to the board of directors, not to the court. The Act is silent on whether the investigator's report must inevitably be disclosed to the applicant and/or to the court. The explicit statutory duty of the investigator is to report only to the board.¹⁶⁸ Section 165(4) may be contrasted with the previous statutory derivative action,¹⁶⁹ which turned on the appointment of a provisional curator ad litem, who was granted the same extensive investigatory powers as an inspector appointed by the Minister.¹⁷⁰ The curator ad litem was appointed by the court and was duty-bound to report directly to the court. The result was an assurance of greater impartiality, a report that was more neutral and objective, and a clear right of access by both the court and the applicant to the information in the report. It is notable that the Australian legislation gives the court the discretionary power to appoint an independent person to investigate and to report directly to the court on the company's financial affairs, the relevant facts or circumstances, and the costs.¹⁷¹

¹⁶⁸ Although s 165(5)(a)(iii) of the Act gives the shareholder or applicant the right to challenge the report on the ground that it is unreasonable or inadequate, this does not necessarily imply that all applicants have an automatic right of access to the report. It merely means that a particular applicant may have been given access to the report.

¹⁶⁹ Under s 266 of the Companies Act 61 of 1973.

¹⁷⁰ See s 267 and s 260 of the Companies Act 61 of 1973.

¹⁷¹ Section 241 of the Australian Corporations Act, 2001. In French law too, there is a useful role for an independent business expert or special auditor (*expert de gestion*) who is appointed by the court on petition by holders of at least 5% of the issued share capital, to examine certain management activities

It is regrettable that the South African Act has failed to adequately address the minority shareholder's predicament of access to corporate information on which to found his derivative claim.

7.7 THE ROLE OF PUBLIC ENFORCEMENT

A useful mechanism is, however, provided in the Act to overcome the obstacles that the derivative litigant faces. The Companies and Intellectual Property Commission ('Companies Commission') is empowered to act as a watchdog both to investigate and to enforce violations of company law. An investigation by the Companies Commission surmounts the minority shareholder's hurdle of access to information, while derivative litigation by the Companies Commission averts the minority shareholder's risk of liability for legal costs. The issue of public enforcement was introduced in Chapter 1 (at paragraph 1.2.3.)

To resort to this avenue, the minority shareholder (or other complainant) must first file a complaint with the Companies Commission,¹⁷² which may in its discretion direct an investigation of the complaint by an inspector or investigator.¹⁷³ Wide supporting powers are conferred by the Act to support investigations and inspections, including the power to investigate any persons who are reasonably considered to have relevant information, the power to issue summons to appear to be questioned under oath or to compel the production of documents and other objects, and the power to enter and search premises on authorisation by a judge or magistrate and to take extracts from or make copies of any book or document that is on the premises, or to attach and remove from the premises anything that has a bearing on the investigation.¹⁷⁴ The shareholder or complainant has a right to receive a copy of the investigator's

and to gather information on business decisions, often at the company's expense (Article 226 of the Companies Law 1966, as modified by the law of 1 March 1984). This may help to expose self-dealing by directors or the abuse by directors of corporate assets.

¹⁷² Section 168(1).

¹⁷³ Section 169(1)(c).

¹⁷⁴ As set out in Part E of Chapter 7 of the Act; see ss 169(3) and 176 – 179.

report,¹⁷⁵ and may thus gain access to valuable corporate information which would not otherwise be readily available to him. This information could be instrumental to the minority shareholder in establishing the factual and evidentiary basis for his derivative claim.

Following an investigation, the Companies Commission has the discretion to institute derivative proceedings to enforce corporate rights and duties in the name of (and with the consent of) the minority shareholder.¹⁷⁶ The interposition of the Companies Commission in this way dispels the barrier of legal costs and funding that the derivative litigant would otherwise face.

An investigation and litigation by the Companies Commission would protect not only private interests within the company, but also the wider public interest in managerial accountability and enhanced investor confidence in the integrity of the corporate system. Whether this crucial link between investigations and subsequent derivative actions will materialise, remains to be seen. It ultimately depends on the manner in which the Companies Commission, in practice, exercises its powers and its discretion. A proper balance must be struck. The Companies Commission should not set the level too high, for this would defeat the purpose of the investigation. The standard of proof should be less rigorous than that required to gain relief under s 165. But by the same token, the Companies Commission should not permit its investigatory powers to be misused by shareholders to harass or badger the management of companies, or to embark on fishing expeditions to justify vague suspicions of mismanagement.¹⁷⁷

While it is envisaged or hoped¹⁷⁸ that part of the burden of enforcing directors' duties would ultimately be shifted from private enforcement by shareholders to public enforcement by the Companies Commission, South

¹⁷⁵ Section 170(2)(b).

¹⁷⁶ Section 165(16); see also s 170(1)(e).

¹⁷⁷ See in this regard s 169(1)(a), which provides that the Companies Commission may refuse to investigate a complaint if it appears to be frivolous or vexatious, or does not allege facts that, if proven, would constitute grounds for a remedy under the Act.

¹⁷⁸ 'Company Law for the 21st Century' supra note 1 at para 2.2.3, para 4.4.1; see also Chapter 1 at paragraph 1.2.3.

Africa currently does not have a well-established public enforcement agency that rigorously enforces company law. The legal control and the policing of boards of directors presently depends principally on shareholders and other suitable stakeholders to play an active role through the use of the statutory derivative action—despite the strong disincentives which they encounter. This key factor must be taken into account by the courts when exercising their discretion to grant leave to minority shareholders for derivative actions under s 165, and when exercising their discretion to indemnify from the corporate treasury shareholders who take the initiative of pursuing litigation for the company's benefit.

Finally, it would be impractical to presume that the Companies Commission would in due course assume exclusive, or even primary, responsibility for the enforcement of corporate rights and directorial accountability. Investigations and inspections are bound to be costly. State regulatory bodies, no matter how strong or high-powered, frequently endure limitations on funding and other resources,¹⁷⁹ insufficient staff, and a dearth of experts. A key role will always remain for private enforcement, through civil actions and derivative actions initiated by aggrieved parties. For the effective deterrence and punishment of corporate misconduct in South African law, both public enforcement by the Companies Commission and private enforcement by stakeholders must be facilitated and encouraged, and both should work in tandem for the achievement of their individual objectives.

¹⁷⁹ Commendably the Act (s 169(2)(b)) provides for cost sharing between the Companies Commission and the company, or even the imposition of the full costs of the investigation on the company itself, where the dispute is internal to the company.

CHAPTER 8: CONCLUSION

This concluding chapter summarises the overarching recommendations, conclusions and suggestions that were set forth and developed in the preceding chapters of this thesis. As such, the purpose of this chapter is to encapsulate and summarise the *framework* or the *guidelines* for the courts to use in exercising their judicial discretion with regard to the new statutory derivative action in South African company law.

This framework or these guidelines address three main aspects of the judicial discretion in the sphere of the new statutory derivative action.

First, guidelines are respectfully suggested for the proper exercise of the judicial discretion to grant leave for a derivative action, with a particular focus on the three gateways set out in s 165(5)(b) of the Companies Act of 2008 ('the Act'). The importance of these three gateways or guiding criteria cannot be overemphasised, for they form the nub of the new statutory derivative action. The approach that the courts adopt will shape the future and the effectiveness of this much-needed new remedy in South African law. It thus is fundamentally important for the courts to find and adopt the proper balance to the interpretation and application of the three gateways for leave and their many nuances. The guidelines that have been proposed in this thesis for the exercise of the judicial discretion to grant leave, take into account the well-established and relevant principles of South African common law, recent decisions of the South African courts on s 165 of the Act, and the valuable lessons derived from other comparable jurisdictions which have influenced the relevant provisions of the South African Companies Act of 2008, such as Canada, Australia, New Zealand, the United Kingdom and the USA.

Secondly, this thesis establishes that a glaring defect plagues the new statutory derivative action, and that it has the potential to sound the death knell of the remedy in situations where there is a desperate need for it. This egregious flaw, which lies in the rebuttable presumption contained in s 165(7)

read with (8) of the Act, requires prompt amendment to the Companies Act. Pending such legislative amendment, this thesis respectfully suggests guidelines for the proper judicial approach to the problematic statutory presumption, and recommends prophylactic measures that the courts may use to circumvent the presumption. In this regard, a detailed two-step approach to the presumption is formulated for the courts, with specific emphasis on the newly-introduced business judgment rule. This is supported by reasoned analysis and by research based on the experience and jurisprudence in the USA.

Thirdly, a framework is proposed in this thesis for the exercise of the judicial discretion to make orders of costs. The framework for costs orders not only contains guiding principles to be adopted by the courts but also sets out the traps and hazards that our courts should be aware of so that they can avoid them. The building blocks of the framework for costs orders comprise, first, existing principles in South African common law; secondly, guiding principles gleaned from other comparable jurisdictions; and thirdly and most importantly, underlying policies and principles that are fundamental to a good understanding of the issues surrounding orders of costs, especially the dual rationale of the derivative action, and the new safeguards against shareholder abuse of the statutory derivative action. The rationale of the derivative action and the safeguards against abuse are crucial for a proper understanding of the policy issues underlying legal costs. They are also taken directly into account in designing the framework for costs orders and indemnity orders. The importance of costs orders must not be overlooked. It must be borne in mind that the greatest practical obstacle to the commencement of derivative proceedings is the risk of the plaintiff being saddled with liability for the costs of the derivative litigation, when he is litigating not for himself but for the benefit of the company. If the new statutory derivative action is to be an effective remedy, it is vital that the courts do not unwittingly stifle the use of the remedy by the imposition of adverse costs orders on shareholder litigants. Apart from the plaintiff's hurdle of costs orders, this thesis, in order to provide a comprehensive analysis,

discusses other well-known hurdles and obstacles to the derivative action, and other significant aspects that form part of the background or the wider context of the issue of orders of costs. These matters include the legal costs of the defendant directors in derivative actions, which are generally covered by indemnification and directors' and officers' insurance; the hurdle of access to information that applicants encounter; and the role of the public enforcement of company law as a useful new means to overcome not only the obstacle of costs but also the obstacle of access to information.

8.1 Foundational Policies

At the heart of any sophisticated corporate law system lies the proper protection of minority shareholders, and one of the chief safeguards for minority shareholders is the statutory derivative action. Under s 165 of the new Companies Act of 2008, the court is entrusted with a key function as the gatekeeper to derivative actions. The court plays a pivotal role in filtering or screening applications by a minority shareholder (or other suitable applicant with standing under the Act) to institute derivative litigation on behalf of the company, when those in control of the company improperly fail or refuse to litigate in the name of the company itself. The judicial discretion to grant or refuse leave is a control mechanism that is intended to curtail the abuse of the derivative action by minority shareholders or other applicants, and to weed out nuisance claims that are frivolous, vexatious or meritless. The discretion of the court to grant leave to institute derivative proceedings thus entails a tension between two important principles; first, the benefit of a right of redress by a stakeholder on behalf of the company when a wrong done to the company has been left unremedied by management and, secondly, the indisputable need to protect companies and their directors from nuisance actions instituted by stakeholders.

The court is required to exercise its discretion with reference to the three vague guiding criteria or gateways set out in s 165(5)(b). The guiding criteria

are an attempt to draw a proper balance between these two equally important, though opposing, principles. Much depends on the approach that the courts adopt to the interpretation and application of the vague and open-textured criteria for leave. In enacting guiding criteria that are general and open-textured, rather than prescribing detailed and circumscribed technical legal requirements, the legislature has effectively placed it in the hands of the judiciary to shape the boundaries, the contours and the practical application of these criteria. The courts, consequently, have a powerful and decisive role. The approach that the courts adopt to the interpretation and application of the three guiding criteria will effectively seal the fate of this new remedy and sculpt its future as a success or failure in South African law.

It is strongly submitted that the courts should interpret the leave criteria flexibly and robustly in a manner that will promote the use of the statutory derivative action. A restrictive interpretation of the leave criteria would stifle the use of s 165 and relegate it to redundancy. This would serve only to frustrate the object and purpose of the new statutory provisions, which *inter alia* is to balance the rights and obligations of shareholders and directors within companies and to encourage the efficient and responsible management of companies, as required by s 7(i) and (j) of the Companies Act of 2008.

With regard to the object and purpose of the statutory derivative action, it must be borne in mind that the remedy has a dual purpose. It is fundamentally a protective device that enables a minority shareholder (or other qualified applicant) to remedy a wrong inflicted on the company—and left unremedied by management (often because they are the wrongdoers)—by bringing legal proceedings on behalf of and for the benefit of the company. The objective of the derivative action is to recover compensation, not for the plaintiff but for the company, from miscreant directors and others who cause harm to it, and also to prevent future misconduct by directors. In other words, it is important to realise that it is both a remedial and a deterrent device; its purpose is not merely to compensate the company, but also to deter. It is vital that this two-fold purpose is not overlooked by the courts and by legal practitioners. The derivative action

is meant to serve a significant prophylactic purpose. The remedy is also increasingly viewed as a valuable tool in promoting good corporate governance practices (as required by s 7(b)(iii) of the Companies Act of 2008). It is thus essential, in the light of the increasing global emphasis on minority shareholder protection in corporate governance,¹ that the remedy be used effectively as an instrument by which shareholders may monitor corporate misconduct and hold corporate management accountable. In the absence of effective remedies for the enforcement of the fiduciary and statutory duties of directors and prescribed officers, directors would be virtually immune from accountability.

For the new derivative action to play a useful and decisive role in monitoring and policing boards of directors, it must be cultivated and carefully crafted by the courts by means of a liberal and robust interpretation of the three guiding criteria for the exercise of the judicial discretion to grant leave. As pointed out above, a liberal approach is supported by the stated purposes of the Act, in particular, the purposes set out in s 7(b)(iii), (c), (i), (j) and (l) of the Act, which the court is enjoined (by s 158(b)(ii) of the Act) to promote when determining a matter in terms of the Act.

8.2 Guidelines for the Criterion of Good Faith

This elusive guiding criterion that the court, in order to grant leave for derivative litigation, must be satisfied that the applicant is acting in 'good faith' (s 165(5)(b)(i)) is discussed in Chapter 2 of this thesis. The purpose of the 'good faith' criterion is to sift out frivolous and vexatious claims, and thereby to foster the litigation of grievances that are genuinely aimed at protecting the interests of the company as a whole. The good faith requirement is essentially designed to protect the company from the abuse of derivative actions that are brought in pursuit of the private interests and private purposes of the applicant himself.

¹ See also Chapter 7 for a discussion of the rationale of the derivative action.

8.2.1 Framework for Good Faith

A framework for 'good faith' in South African law is proposed. It is submitted² that two key criteria lie at the heart of the inquiry into good faith:

- (i) first, the good faith criterion in s 165 is a subjective one, but qualified by an objective criterion. The test of good faith relates to the applicant's state of mind and depends largely, though not exclusively, on honesty. The subjective aspect is that the applicant must honestly believe that the company has a valid cause of action. This is qualified by an objective test, viz, whether a reasonable person in the position of the applicant, and in light of the circumstances, could reasonably have believed that the company has a valid cause of action. In the absence of reasonable grounds for believing that the company has a valid cause of action, the applicant in derivative proceedings may be disbelieved and may be found by the court to be lacking in good faith; and
- (ii) secondly, the applicant's actions must be motivated by the honest purpose of protecting the legal interests of the company, and not by a collateral purpose. A collateral purpose or ulterior purpose entails that the applicant's actions are motivated, not by the proper purpose of protecting the company's interests, but by an improper purpose involving the pursuit of the applicant's own private interests or some other interest for which the derivative action was not intended. For instance, an applicant who is motivated by a personal or private vendetta acts for a collateral purpose, as does an applicant who uses the derivative action for a 'strike suit' or for 'greenmail'. Where an applicant acts for a collateral purpose or has an ulterior motive in bringing a derivative action, it constitutes an abuse of the derivative action and thus destroys

² Based on an adaptation and an extension of existing common law principles on the meaning of good faith in South African company law, and now reinforced by dicta in the recent case *Mouritzen v Greystone Enterprises (Pty) Ltd* 2012 (5) SA 74 (KZD), and further bolstered by foreign authority on the meaning of good faith.

good faith.

8.2.2 Further Facets of Good Faith

Besides the above two criteria for good faith, other fundamental facets of good faith also come to light. These are as follows:

(i) Complicity or participation in the wrongdoing:

First, it is submitted that complicity by an applicant, or participation by an applicant, in the wrong inflicted on the company would negate good faith and should consequently result in the refusal of judicial leave for the particular applicant to bring a derivative action. It is further submitted, however, that the denial of leave to such an applicant should not inevitably terminate or obstruct all prospects for a derivative action on the matter. That is to say, the court should remain open to the possibility of granting leave to another suitable applicant who is acting in good faith and is motivated by the genuine and proper purpose of protecting the interests of the company.

(ii) Personal animosity, acrimony or malice:

Secondly, the issue of a collateral or ulterior purpose must not be confused with mere self-interest in the outcome of the action or even with personal animosity on the part of the applicant. A distinction must be drawn between applicants who on the one hand are driven by a collateral purpose, and on the other hand applicants who have an acrimonious relationship or personal animosity or hostility against the respondents (or against the board of directors of the company or the majority of the shareholders). While the former amounts to bad faith, the latter of itself would not necessarily constitute bad faith. If personal animosity were to bar shareholders from bringing derivative actions, most derivative actions would be frustrated, in light of the fact that personal animosity commonly surfaces in the sorts of disputes that lead to derivative actions.

One must, similarly, differentiate between mere self-interest in the outcome of the derivative action—which does not of itself constitute bad faith—and an ulterior purpose or personal vendetta, which amounts to an abuse of process and destroys good faith.

But in practice there is a hazy line between (permissible) intense personal animosity and the (impermissible) pursuit of a private vendetta. This is ultimately an issue that depends on the facts and the circumstances of each particular case. In a nutshell, the question should be whether the action has merit and whether it is in the best interests of the company. These inquiries may be used to draw inferences about the applicant's purpose and motive in seeking leave, which are the crux of the good faith inquiry.

The three guiding criteria for the court to grant leave in terms of s 165(5)(b) are thus clearly interlinked with each other.

(iii) Where an applicant is motivated by a collateral purpose but the action is in the company's best interests:

Thirdly, the dilemma arises whether our courts should grant leave for a derivative action that is in the best interests of the company and that is a meritorious action with prospects of success, where the person who applies for leave is driven by a collateral purpose³. From an analysis of foreign judicial decisions and other authorities, two conflicting approaches come to light. Based on the experience of other comparable jurisdictions, it is submitted that the preferable approach for South African law to adopt is that even if the proposed derivative claim is a meritorious one that is in the best interests of the company as a whole, the courts must refuse to grant leave for the action if the applicant has an ulterior or collateral purpose—the grant of leave in these situations would be tantamount to allowing an abuse of the derivative action. Three reasons have been furnished for this submission, based not only on

³ Ie an applicant who seeks to use the derivative action for some personal benefit for which the remedy was not conceived.

considerations of policy and principle but also on the wording of s 165(5)(b) of the Act.

(iv) 'Clean Hands' Doctrine:

Fourthly, it is a critical issue whether the courts, when assessing the good faith of an applicant, should consider the 'clean hands' doctrine, with the consequence that any applicant who does not come to court with 'clean hands' would be automatically or quite mechanically refused leave to bring the derivative action. While the clean hands principle was applied to the (now abolished) derivative action at common law, it is submitted that for the purpose of the new statutory derivative action the South African courts should shun the 'clean hands' doctrine. To apply this doctrine would be anomalous as a matter of principle. It must be emphasised that this does not mean that all applicants with 'dirty hands' would be permitted to bring derivative actions—there are other more suitable legal grounds (other than the clean hands principle) on which to disqualify such applicants (for instance collateral purpose, participation in the wrongdoing, etc).

(v) Proving good faith:

Fifth, in respect of the proof of good faith, the onus lies on the applicant to satisfy the court, on a balance of probabilities, that he is acting in good faith and that he fulfils the other criteria for leave as set out in s 165(5)(b).

Proof of good faith is problematic. To require an applicant to actually prove his good faith would be to impose too weighty a burden. This would serve only to dissuade prospective applicants from seeking the court's permission to litigate derivatively in order to vindicate the company's rights. It would, moreover, cause difficulties as to how applicants are to prove their good faith and what type of evidence would be required, bearing in mind that good faith is principally a subjective test which depends on one's state of mind or one's

honest belief (that the company has a valid cause of action). It is accordingly submitted that the preferable approach in South African law should be that where a derivative action appears to have merit and is in the best interests of the company, the courts should presume that the applicant is in good faith, unless there are objective facts and circumstances that show bad faith.

As regards the role of self-interest, although an applicant's self-interest does not inevitably negate his good faith (as discussed above), the converse does not necessarily apply. The absence of any self-interest at all may be taken to show an absence of good faith. In this regard, where the applicant has little to gain and little incentive to sue on behalf of the company, it would be more difficult to establish good faith. Pure altruism is rarely the motive for costly and lengthy derivative litigation, particularly bearing in mind that it is not the applicant himself but rather the company that stands to benefit directly from the success of the derivative action. A useful test which provides a valuable point of reference for the South African courts is to be found in the Australian case of *Chahwan v Euphoric Pty Ltd*.⁴ The *Chahwan* test is, whether as a shareholder or director of the company, the applicant would suffer a real and substantive injury if a derivative action were not permitted, provided that the injury was dependant on or connected with the applicant's status as such shareholder or director and the remedy afforded by the derivative action would reasonably redress the injury. The *Chahwan* test may also be extended so as to apply to other applicants with standing under s 165(2) of the Act, such as employees who are represented by the registered trade unions that have standing under s 165(2)(c).

Notably, although the court may be more vigilant in scrutinising the good faith of an applicant who has nothing obvious to gain from a derivative action, it is not impossible for such an applicant to satisfy the good faith requirement even though he has neither a financial interest in the company nor any

⁴ (2008) 65 ACSR 661; see also *Swansson v Pratt* (2002) 42 ACSR 313 at para 42.

involvement in its management. This, however, would present challenges for the applicant, and additional evidence to show bona fides may be required.

8.3 Guidelines for the Criterion of the Trial of a Serious Question

This is the second precondition for leave and is a threshold test, relating to the evidence that the applicant must establish in support of his claim.

When applying this guiding criterion it is essential for the courts, as a matter of principle, to preserve a proper equilibrium between the opposing interests of the company and those of the applicant. To this end, the courts must steer a middle course between safeguarding the company from claims that are frivolous, vexatious, unmeritorious or unworthy and, by the same token, exercising caution to avoid the risk of escalating the leave application into a 'mini-trial' of the merits of the case. It is a crucial policy principle that leave applications should be kept fairly simple, short and inexpensive. It would, furthermore, be inappropriate for the courts to become enmeshed in trying the substantive issues of the case at the preliminary stage of the leave application, without the applicant at this stage having had the benefit of discovery of the documents of the company and/or the true defendants such as the errant directors of the company.

The test of 'the trial of a serious question' (s 165(5)(b)(ii)) is a commendable step by the legislature. It should be interpreted by our courts as a low, lenient and liberal threshold. In interpreting this test, the courts should avoid imposing unnecessary restrictions on the availability of the remedy. This is bolstered by the Australian, New Zealand and Canadian judicial approaches. In essence, it is submitted based on the wording of s 165(5)(b)(ii) that in order to grant leave to the applicant for the institution of derivative proceedings, the test or standard of proof is that the court must be satisfied that the claim is not frivolous or vexatious, in other words, that there is a serious question to be tried. This test is derived from the decision of the House of Lords in *American*

*Cyanamid Co v Ethicon Ltd*⁵ concerning the meaning of the test of a 'serious question to be tried', as subsequently adopted in several South African cases on constitutional matters.

In applying this test, it is notable that the courts may have to consider the apparent merits of the claim. But the courts must at this stage of the proceedings avoid a detailed consideration of the merits. In short, the courts must be wary of becoming embroiled in lengthy and disruptive interim trials on the merits at the stage of the application for leave to institute derivative proceedings. But conversely, in order to attain a proper balance between the interests of the company and those of the applicant, and particularly to prevent the abuse of the statutory derivative action by nuisance claims and improper attempts to harass the management of the company, the applicant must at least be able to specify the legal right (or legal wrong) in question and to particularise his allegations of wrongdoing, supported by sufficient evidence and material to show the court that the legal action is viable and that there is a serious question to be tried. Mere loose allegations or suspicions of wrongdoing ought not to succeed, nor should attempts to use the derivative action to carry out fishing expeditions in the hope that discovery will later yield the necessary information.

This, in practice, may present a dilemma for prospective applicants. To prove that there is a serious question to be tried, the minority shareholder or other applicant requires access to information that generally lies in the hands of the company's controllers and managers who (in the vast majority of derivative claims) are also the alleged wrongdoers. In owner-managed companies access to information is not particularly problematic, but it is the great stumbling block in larger companies where ownership and control are split. The hurdle of access to information continues to be one of the greatest barriers in leave applications for derivative proceedings. Regrettably, s 165(9)(e) of the new Companies Act of 2008 does little to improve the position of the applicant. (This hurdle of access to information is further addressed in more detail below.)

⁵ [1975] AC 396; [1975] 1 All ER 504 (HL).

It is noteworthy that the test of ‘the trial of a serious question of material consequence to the company’ would usually be satisfied more effortlessly in instances where an applicant seeks leave to *continue* existing derivative proceedings, as opposed to seeking leave to *commence* new derivative proceedings. The simple reason is that, in respect of the continuation of existing derivative proceedings, the court would already have granted leave under s 165 (albeit to another applicant), with the implication that the claim has already met the threshold test of the trial of a serious question.

The requirement as stated in s 165(5)(b)(ii) is that the proposed derivative proceedings must involve ‘the trial of a serious question *of material consequence to the company*’ [emphasis added]. The requirement of ‘material consequence to the company’ would operate to thwart superfluous derivative actions, such as claims brought to embarrass directors and prescribed officers who have made unwise, yet honest, decisions that have caused negligible harm to the company, or claims for the recovery of trivial or nominal amounts. Since it overlaps to a considerable extent with the guiding criterion that the grant of leave must be ‘in the best interests of the company’ (s 165(5)(b)(iii)), it is submitted that these considerations are best grappled with in considering whether the grant of leave under s 165 is ‘in the best interests of the company’.

8.4 Guidelines for the Criterion of the Best Interests of the Company

The criterion of the ‘best interests of the company’ (s 165(5)(b)(iii)) is a key criterion for the grant of leave under s 165, which gives recognition to sound commercial and business reasons for companies declining to pursue valid legal claims. Even if there are legitimate legal grounds for an action, litigation may be undesirable on commercial grounds. For instance, litigation may be disruptive to the conduct of the company’s business and the time spent on litigation might be more profitably used elsewhere; or the wrongdoers may be financially unable to meet a judgment in favour of the company if the litigation is successful; or the loss suffered by the company may have been nominal or insignificant. The

inquiry into the best interests of the company consequently entails a weighing up of the potential benefit of the derivative action against any potential detriment.

The guiding criterion of the ‘trial of a serious question of material consequence to the company’ (as discussed above) turns on the legal viability of the claim and the strength of the case, whereas the commercial viability of the claim is the primary focus of the guiding criterion of the ‘best interests of the company’. It is notable, however, that these two guiding criteria overlap with each other. In this regard, the strength of the case and its prospects of success are relevant to and are interwoven with the ‘best interests’ inquiry—if the proposed derivative action is a weak one with little prospect of success, it is unlikely to be in the best interests of the company for the court to grant leave for the derivative action.

8.4.1 *Framework for the ‘Best Interests of the Company’*

It is submitted⁶ that the criterion of the ‘best interests of the company’ must focus on the company and, consequently, this criterion should not encompass inquiries into the personal qualities or personal circumstances of the applicant himself (for instance whether the applicant bears personal animosity against the company’s shareholders or directors, or has a self-interest in the outcome of the action). The focus must remain on the company, particularly in light of the fact that a derivative action is brought to enforce a right that is, in substance, vested in the company itself and not personally in the applicant.

The gateway of the ‘best interests of the company’ is an open-textured criterion, the precise meaning and interpretation of which is difficult to pinpoint. In the inquiry into the best interests of the company under s 165 of the Act, significant elements for the courts to consider would include the following:

⁶ Based on an extension of existing common law principles on the meaning of the ‘best interests of the company’ in South African company law, and now supported by dicta in *Mouritzen v Greystone Enterprises* supra note 2, and further reinforced by comparable foreign authority.

- the strength of the claim and its prospects of success;
- the costs of the proposed proceedings;
- the amount at stake, or the potential benefit to the company;
- the defendants' financial position and their ability to satisfy any judgment (or even a substantial part of any judgment) in favour of the company;
- the effect of the proposed litigation on the company's operations and the proper conduct of its business, and particularly the disruption to the company's business by having to focus on the litigation, including the distraction of the attention and diversion of the time of the company's directors, management and employees;
- the potential harm to the company's reputation, and the potential for negative publicity;
- the character of the company or the nature of its operations;
- adverse effects on the company's relationship with its suppliers, customers and financiers, and harmful impacts on the company's share price; and
- the availability of other means of obtaining substantially the same redress (discussed further below).

It is submitted—based on the wording of s 165(5)(b)(iii) of the Act that the court must be satisfied that 'it *is* in the *best* interests' [emphasis added] of the company for leave to be granted—that the burden of proof lies on the applicant (who wishes to bring derivative proceedings) to satisfy the court, on a balance of probabilities, that the grant of leave is in the best interests of the company. It evidently is the intention of the legislature that the court must be satisfied, not that the proposed derivative action *may be*, *appears to be*, or *is likely to be* in the best interests of the company, but that it *is* in the best interests.⁷ Merely making out a prima facie case will not suffice in South African law.

⁷ As observed in the Australian case *Swansson v Pratt* supra note 4 and quoted with approval in the recent South African case *Mouritzen v Greystone Enterprises (Pty) Ltd* supra note 2.

It is important that the statutory criterion of the ‘good faith’ of the applicant and that of the ‘best interests of the company’ are not conflated, as was sadly done by the Kwazulu-Natal High Court in *Mouritzen v Greystone*. The court in *Mouritzen v Greystone*, with respect, focused principally on the criterion of good faith, and failed to inquire into the criterion of the best interests of the company in any depth. The court, with respect, made a most regrettable statement that ‘[i]n most, but not all, instances this requirement [of the best interests of the company] will overlap with the requirement of good faith’.⁸ This statement overlooks the point that the assessment of ‘good faith’ relates to the good faith of the applicant, while the assessment of the ‘best interests of the company’ relates to the welfare of the *company*. As explained above, the personal characteristics, qualities or circumstances of the applicant himself bear little relevance to the inquiry into the ‘best interests of the company’, for the focus should, and must, be on the company. It is notable that to a certain extent there may be some intersection between the two criteria, in that a finding that the grant of leave is in the best interests of the company may throw light on the applicant’s motives in seeking leave and his good faith. Nevertheless, the two requirements are separate and distinct criteria or gateways, and both must be independently satisfied.

8.4.2 Further Facets of the ‘Best Interests of the Company’

(i) A ‘cost-benefit analysis’?

It is a thorny question whether a ‘cost-benefit’ analysis is involved in the assessment of the ‘best interests of the company’. Where the costs of the derivative litigation are likely to outweigh any potential corporate recovery or economic benefit to the company, must the court refuse leave for the derivative action on the ground that it would not be in the company’s best interests? It is

⁸ Supra note 2 at para 63; see also para 64.

submitted that the inquiry into the best interests of the company in South African law is not intended to be restricted to a purely 'cost-benefit' analysis. Such a rigid and narrow approach should be firmly rejected by the courts. The wording of the Act does not require it. It would, moreover, shackle and frustrate both the purposes of the Act and the intention of the legislature. The statutory derivative action is directed not only at compensation for the company, but also at the deterrence of future misconduct by directors and managers of companies. If a strict cost-benefit rule were to be adopted, leave would be granted only for derivative actions that are motivated by a compensatory rationale, but a purely deterrent rationale would not suffice for derivative proceedings. This clearly is unsatisfactory and inappropriate.

It cannot be overstressed that instead of a strict cost-benefit analysis, the approach of the South African courts should be to weigh up the benefit of the action against the potential detriment, in the sense of benefit and detriment that go *beyond* the economic costs of the litigation and the purely economic benefits or financial return to the company. This would give full recognition and effect to the twin objects of the statutory derivative action. The deterrent value of a derivative action and the long term public benefits of deterring corporate mismanagement may in certain circumstances outweigh the company's private economic interests in avoiding legal actions that are unlikely to yield a net financial recovery.⁹

Notwithstanding the above submissions, it must be noted that a cost-benefit analysis is not entirely irrelevant in the South African context. A balance must be struck at some point. Where the costs of the derivative action too heavily outweigh the likely recovery by the company, it becomes inappropriate to pursue the objective of deterrence, and leave for derivative proceedings should then be refused. The courts must thus find a happy medium between the twin objectives of compensation and deterrence. This ultimately would depend on the circumstances of each case.

⁹ See further Chapter 7 para 7.1 for a more detailed discussion of the objectives of the derivative action.

(ii) Availability of an alternative remedy:

It is submitted that where there are alternative measures that would address the grievance of an applicant, and would produce substantially the same redress, the court should refuse to grant leave to the applicant for derivative proceedings on the ground that to do so would be contrary to the company's best interests. The court, in this way, would avoid thrusting the company into litigation against its corporate will. Examples of a suitable alternative remedy are, for instance, dispute resolution by means of arbitration, as may be required by the company's Memorandum of Incorporation, or an action that the applicant may pursue in his own name and in his own right, to which the company is not a party. In applying this principle of an alternative remedy, it is vital that:

- (a) first, the proposed alternative remedy enables the applicant to obtain the redress he desires or provides substantially the same redress as a derivative action would have yielded; and
- (b) secondly, the alternative remedy has a real prospect of success.

It must be stressed that a personal action¹⁰ and a derivative action are not alternative remedies or alternative measures for producing substantially the same redress—they are clearly designed to produce different results. Consequently if a minority shareholder, who applies for leave to institute derivative proceedings, may also pursue a personal claim against the defendants, this of itself should pose no obstacle to his leave application for derivative litigation. It is respectfully submitted that the South African courts should be mindful of this.

A related issue that must be borne in mind is the 'no reflective loss'

¹⁰ In *Communicare & Others v Kahn* 2013 (4) SA 482 (SCA) the Supreme Court of Appeal recently held – citing with approval the views expressed by Maleka Femida Cassim 'Shareholder Remedies and Minority Protection' in Farouk HI Cassim et al *Contemporary Company Law* 2ed (2012) at 821 – that s 165 of the Act does not abolish the personal action, and that the personal action and the statutory derivative action thus co-exist (at para 20 read with footnote 8 of the judgment).

principle.¹¹ In circumstances where the ‘no reflective loss’ principle applies, the only available remedy is an action brought by the company or an action brought on behalf of the company as a derivative action. There is no possibility in these circumstances of a personal shareholder action as well.

(iii) Companies in Liquidation:

It is submitted that, similarly to the common law derivative action, the new statutory derivative action under s 165 of the Act is not intended to apply, and should not be available, when a company is in liquidation.

It is further submitted that this controversial issue should be decisively clarified by way of an amendment to the Act in order to obliterate the current lacuna in s 165. In this regard, a simple amendment to s 165 of the Act to exclude companies in liquidation would suffice. Failing an amendment by the legislature, the present uncertainty in the Act may create a quandary in practice, with the need to ultimately seek the intervention of the courts to clarify the legal position. It is significant that judicial intervention on this vexed issue could potentially generate conflicting judgments by the courts, which notably has been the experience in Australian law.

In the interim and until such time as the suggested amendment to the Act is effected (or in the absence of an amendment), it is submitted that s 165 should be interpreted—based on its literal wording, the purpose and the intention of the legislature, and also on the lessons gleaned from judicial experience in comparable jurisdictions—to exclude companies in liquidation from its ambit.

¹¹ The ‘no reflective loss’ principle applies when both the company and the shareholder have a claim against the directors or other defendants based on the same set of facts, and the shareholder’s loss, insofar as this may be a diminution in the value of his shares or a loss of dividends, merely reflects the loss suffered by the company. In such cases the shareholder’s claim is restricted by the principle that he cannot recover a loss that is simply reflective of the company’s loss (*Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257; [1982] Ch 204 (CA); *Johnson v Gore, Wood & Co* [2002] 2 AC 1 (HL) 62).

8.5 Guidelines for the Residual Discretion of the Court

The court is thus guided in the exercise of its discretion to grant leave to an applicant for derivative proceedings by the three guiding criteria or gateways discussed above. This is coupled with a residual discretion to withhold leave for a derivative action, despite proof of all the statutory criteria. It is submitted, in this regard, that in light of the wording in s 165(5) that the court ‘may’ (not ‘must’) grant leave only if the listed criteria are satisfied, there is leeway for the court to consider additional factors and to exercise a residual discretion to refuse leave to an applicant even though he has fulfilled all the prescribed statutory criteria for leave.

The reason for this approach in terms of s 165 of Act is obscure. It is submitted that in exercising their residual discretion to refuse leave, the courts should adopt a restrained and careful approach. It has been contended that judges must be mindful that all they are doing in exercising their discretion to grant leave for a derivative action is allowing an otherwise suppressed grievance to be heard. The judicial approach, as a general rule, should be to grant leave to an applicant once all the listed criteria of s 165(5) are satisfied, except in exceptional circumstances where there are other compelling factors for swaying the court’s discretion.

8.6 The Rebuttable Presumption: Defects and Cures

The classic case for a derivative action is where the wrongdoers who inflict harm on the company are the directors or controllers of the company, who have the power to subsequently exploit their control to prevent the company from instituting legal proceedings against them. Far from giving full and proper recognition to this, the statutory derivative action under s 165 of the Act sets up additional barriers to the availability of the derivative action especially in cases of directorial misconduct, where directors have harmed the company that they are bound to serve. The defect lies squarely in the rebuttable presumption in terms of s 165(7) read with (8).

In this regard, the gateway of the ‘best interests of the company’ is coupled with a far-reaching rebuttable presumption that the decision of the board of directors not to litigate is, in certain circumstances, in the best interests of the company. Although the presumption originates from underlying policies that at first blush appear to be commendable, a more detailed analysis shows that the flaws and defects of the presumption render it a major chink in the armoury of the minority shareholder.

The effect of the presumption is as follows. When a ‘third party’ harms the company, and the directors—who comply fully with the formal decision-making procedure prescribed in the third limb of the presumption¹²—decide not to institute legal proceedings, it generally is (rebuttably) presumed that the grant of leave for a derivative action is *contrary* to the company’s best interests. Although leave may yet be granted, the applicant now bears a heavier burden—in order to succeed he must rebut the presumption. On the other hand, when the company is harmed by a person who is ‘related’ or ‘inter-related’ to it, the presumption is inapplicable, and the court would more readily grant leave for the derivative action. This exclusion of ‘related’ and ‘inter-related’ parties is a logical one, as it avoids the potential for abuse by the majority shareholders and, furthermore, provides a buffer against ‘tunnelling’. Tunnelling is the abuse by a dominant shareholder (or a dominant syndicate of shareholders) who engages in self-dealing in various forms, so as to opportunistically siphon off or ‘tunnel’ corporate wealth or resources out of the company to himself or even to other companies controlled by him.

The dichotomy between third parties and related parties ostensibly seems to be a rational one. But it is in fact plagued by a serious defect, in that it regards directors to be ‘third parties’ to the company. Directors are thus the (undeserving) beneficiaries of the presumption that the grant of leave for derivative proceedings against them would be *against* the best interests of the company. This is the Achilles heel or the most egregious defect of the new

¹² In terms of s 165(7)(c); see further para 8.6.2(i) below.

statutory derivative action, which has the potential to sound the death knell for the remedy where it is most needed.

8.6.1 *Suggested Reform of the Act*

It is submitted that this glaring defect in the Act must be cured by legislative amendment. There are no less than four aspects of the presumption that are in dire need of amendment.

First, a vital amendment must be made to s 165(8)(a) to expressly provide that a person is a ‘third party’ to the company if the company and that person are not related or inter-related, *or if that person is not a director of the company*.¹³ This simple and straightforward amendment would carve out the directors of the company from the ambit and the benefit of the presumption.

Secondly, any person who is related to a director of the company must also be excluded from the definition of a ‘third party’ in 165(8)(a)—with the effect that the presumption would not operate in favour of such defendants. It must be borne in mind that when an applicant seeks leave to launch derivative proceedings against a relative of a director (such as his mother or his child) or against a company or other entity that is related to a director, the risk of a ‘structural bias’ or biased decision-making by the board would clearly arise.

Thirdly, the presumption should not operate where the defendant is a former director of the company.

Fourthly, for the purpose of the amendment to the Act, a former director ought to be excluded from the benefit of the presumption for at least a period of 24 months after his resignation or vacation of office as a director. The adoption of a 24 month window period for former directors would also harmonise with s 162(2)(a) of the Act, which permits applications for orders of delinquency or

¹³ This submission is buttressed by the equivalent rebuttable presumption in the Australian Corporations Act, 2001, which regards directors to be ‘related’ parties and not ‘third parties’ to the company, and thus sensibly excludes directors from the benefit of the presumption. (See further Chapter 5, para 5.3.3.)

probation to be brought for a period of up to 24 months after former directors ceased to be directors of the company.

8.6.2 *Suggested Judicial Approach and Guidelines*

Until the suggested amendment to the Act is effected (or failing an amendment), the judiciary may have to take prophylactic steps to circumvent the presumption. The courts will have to engage more closely with the business judgment rule, which is contained in modified form in the third limb of the rebuttable presumption.¹⁴ This rule presumptively protects a board decision *not* to litigate against a miscreant co-director despite the harm that he has inflicted on the company. It is submitted that the judicial scrutiny of the decision of the board not to litigate against a miscreant co-director or a third party wrongdoer involves a two-step inquiry, as follows:¹⁵

- (i) The first step focuses on the directors' decision-making *procedure* or the *form* of the decision. This determines whether or not the protective presumption in s 165(7) applies in the first place. If any of its four requirements are not fulfilled—ie good faith, disinterestedness, reasonably informed and a reasonable belief—the protective presumption *cannot apply*

The concept of directorial 'independence' in the decision-making process—as distinct from the narrower concept of 'disinterestedness'¹⁶—would serve as a useful judicial tool to mitigate the practical dilemmas associated with statutory derivative actions against miscreant directors.¹⁷ It is submitted that a ready platform, from which the courts may give greater emphasis to the concept of 'independence', is provided by the requirement of 'good faith' under the third limb of the presumption (in

¹⁴ In terms of s 165(7)(c) of the Act. The business judgment rule is set out in s 76(4) of the Act.

¹⁵ The formulation of this inquiry is based both on s 165(7) and on the US approach as expressed in the leading case *Zapata v Maldonado* 430 A 2d 779 (Del Sup Ct 1981).

¹⁶ See further Chapter 5, para 5.4.2.

¹⁷ The notion of independence would be of assistance also where the company has been harmed by an outsider who has some association with the company's controllers or directors.

s 165(7)(c)(i)), since the duty to exercise an independent judgment at common law is part of the overarching fiduciary duty to act in good faith. The adoption of a more comprehensive concept of 'independence' would come to the rescue in thorny situations involving wrongdoing by the majority directors, or wrongdoing by a director who is dominant or influential over the board due to close or enduring personal friendships, or the ability to materially influence the economic interests or career paths of his fellow directors. It is questionable whether a decision by his fellow board members not to sue such a director would really be made free from any latent pressure, bias or influence in his favour. It is acknowledged that even directors who may genuinely wish to make an honest and good faith decision on whether or not to sue an ordinary fellow director (who is neither dominant nor influential) may be swayed by empathy or by subconscious bias in his favour.¹⁸

If the application of the presumption in s 165(7) is excluded on any of the above formal/procedural grounds, that is the end of the inquiry and the board's decision not to litigate may be disregarded by the court. If on the other hand the rebuttable presumption in 165(7) does apply, one must proceed to the second step of the inquiry.

- (ii) The second step of the two-step inquiry concerns the *substance* or the *merits* of the board's litigation decision. It relates to the weight (or the 'rebuttability') of the presumption when it does in fact apply. The courts should avoid giving too much weight to the presumption or too much deference to the judgment of the board not to litigate against the wrongdoer. The court should instead robustly apply its own discretion or its own independent judgment on the *merits* or *substance* of the board's litigation decision. It would defeat the very purpose of the statutory derivative action if the courts were to routinely or excessively defer to the views of the directors, because in the typical situation directors would not

¹⁸ As so aptly proclaimed in the leading Delaware case *Zapata v Maldonado* supra note 15.

be devoid of bias, even if this is subconscious.¹⁹ It must be borne in mind that board decisions on whether or not to *litigate* are protected by the presumption in s 165(7) on a *rebuttable* basis. They are thus distinct from ordinary commercial decisions of the board, which fall under the protection of the business judgment rule in s 76(4) of the Act, and which are shielded by s 76(4) from judicial scrutiny of the *merits* of the decision.

8.7 Guidelines for Shareholder Ratification

While the rebuttable presumption in s 165(7) and (8) requires the court to focus on the views of the company's board of directors on the proposed derivative action, the court must also have regard to the views of the other main organ of the company, namely the shareholders in general meeting.

Under s 165 of the Act, neither the ratification nor the ratifiability by shareholders of any particular wrong done to the company is necessarily fatal to a derivative action. Ratification or approval is now merely a factor that the court may take into account in determining the outcome of an application for leave to bring a derivative action—as opposed to a mechanical rule that automatically blocks a derivative claim. This is a commendable, modern approach that frees the courts from the dilemma that prevailed at common law in distinguishing between ratifiable and non-ratifiable actions. The neutralisation by the Act of shareholder ratification or approval laudably gives the court the discretion to decide each case on its own particular facts and merits.

However, while this clearly is the intention of the legislature, the peculiar wording of the legislative provision in s 165(14) runs the risk of being declared by a court to be nonsensical. Section 165(14) incorrectly refers to shareholder ratification or approval of 'any particular conduct *of the company*' [emphasis

¹⁹ The views of the directors could have greater relevance when the defendant in the derivative action is a third party who has no association with either the shareholders or directors of the company (ie a pure outsider). In contrast, the views of the board on the merits of a case against a miscreant director should be given little presumptive weight, even if the form of the directors' decision meets the procedural requirements of s 165(7)(c).

added], when it should in fact relate to shareholder ratification or approval of the conduct of the *wrongdoer*. Since the company in a derivative action is the harmed party, any ratification or approval by shareholders must obviously relate to approval of the wrongdoer's conduct—and not approval of the company's conduct. It is submitted that to rectify this defect, the words 'of the company' should be deleted from the phrase 'ratified or approved any particular conduct of the company' [emphasis added] in s 165(14). This simple statutory amendment would suffice to solve the problem. Alternative, if a more comprehensive statutory provision is preferred, the latter phrase may be replaced with the following (or similar) wording: 'ratified or approved any alleged breach of a right or duty owed to the company'.

In the exercise of the judicial discretion to take into account shareholder ratification or approval, it is submitted that there are a number of factors that the courts may consider, namely:

- whether the shareholders who voted were both independent and disinterested;
- how well-informed the shareholders were at the time they had ratified or approved the wrongdoing;
- whether the character of the act renders it ratifiable or non-ratifiable, for instance, an illegal act or a fraud on the minority can never be ratifiable;
- whether the company has large numbers of shareholders that are widely dispersed, as in the case of listed companies, where ownership and control are split.

It appears that the court under s 165 may simply disregard the ratification decision of the majority shareholders, by making the derivative action available. Under s 165 the court apparently is no longer required to strike down the decision of the shareholders to ratify the act of the wrongdoers.

8.8 Guidelines for Orders of Costs, and Other Hurdles and Obstacles

Notwithstanding the liberalisation of the new statutory derivative action, the gravest impediment to derivative proceedings continues to be the practical hurdles and obstacles faced by the minority shareholder (or other applicant), particularly his lack of access to corporate information and his risk of liability for the costs of the legal proceedings. If the new derivative action is to have any hope of surviving and flourishing in South African law, the courts must exercise their discretion wisely, so as to surmount the practical obstacle of costs that has long frustrated and deterred shareholder litigants in derivative proceedings. It is a most serious anomaly that the plaintiff shareholder in a derivative action runs the risk of having to bear the costs of an action in which he is, in effect, not the true plaintiff.

It must be borne in mind that a minority shareholder who brings a derivative action acts for the company, and not for himself. In a similar vein, the damages or other benefit of a derivative action, if successful, accrue directly to the company and not to the minority shareholder. Unless the courts approach their judicial discretion with regard to costs in a balanced, flexible and more shareholder-friendly manner, it could smother the use of the new statutory derivative action and effectively reduce s 165 to a dead letter in our law.

Exaggerated concerns have been raised that the floodgates of shareholder litigation would be opened by the new shareholder-friendly derivative action, coupled with the partial codification of directors' duties in the Act, and furthermore, that the increased exposure of directors to personal liability could make them risk-averse or even cause them to surrender their positions on the board. However, an assessment of the empirical evidence and the experience in comparable jurisdictions has been encouraging, for it has shown these fears to be largely misguided.

A framework is suggested in this thesis²⁰ for the exercise of the judicial discretion to make orders of costs. The main guidelines for orders of costs are

²⁰ In Chapter 7.

summarised below.

8.8.1 *A Right of Indemnification*

It is respectfully submitted that, as a general rule, the courts should apply the following guiding principle on costs: once the court grants leave or permission under s 165 to an applicant (such as a minority shareholder) to bring a derivative action, he should be entitled to an indemnity from the company for his reasonable costs and expenses, save in exceptional circumstances where the interests of justice or equity dictate otherwise. To express it differently, the successful applicant who has obtained leave for a derivative action under 165 should automatically acquire a mandatory right of indemnification by the company (barring exceptional circumstances). The courts ought effectively to apply a presumption in favour of company funding. This approach is based on an extension of existing common law principles in South African company law, and is further reinforced by comparable foreign authority. At this stage of the proceedings (ie once leave has been granted), the minority shareholder will have fulfilled the three gateways or threshold tests for leave in terms of s 165(5)(b)—namely, good faith, a serious question to be tried, and the best interests of the company test. It is patently significant that the conditions for an indemnity at common law, as laid down in the renowned case *Wallersteiner v Moir (No 2)*,²¹ are precisely the statutory criteria that a minority shareholder must now satisfy under s 165(5)(b) of the Act.

It is further submitted that neither the financial need of the minority shareholder nor his wealth should deprive him from indemnification. The financial needs test is glaringly inappropriate, for it contradicts the essential nature and purpose of the derivative action in which the minority shareholder seeks a remedy not for himself personally but for the company. Even prosperous shareholders would be hesitant to expose their own wealth to the risk of litigation on behalf of another.

²¹ [1975] QB 373 (CA).

Other pitfalls and traps that should be avoided by the South African courts, and that should be discarded as prerequisites or tests for an indemnity from the corporate treasury, include the following:

- the strength of the claim on its merits;
- the true defendant's stake in the company;
- whether the benefit is sought more for the company or more for the plaintiff;
- the likely amount of the recovery;
- a conflation with the application for leave (whereby an applicant's ability and willingness to fund the derivative action himself is taken to substantiate his claim that, in the context of his leave application under s 165(5), he is acting in good faith and/or in the best interests of the company);
- a connection between the wrongdoing and the applicant's financial inability.

Regarding the timing of the order of indemnification or costs, it is submitted that the order ought to be made at the stage at which leave is granted to bring a derivative action. To delay it until the termination of the substantive derivative action would be to create uncertainty and anxiety as to the litigation costs. It is disappointing that this conservative approach was adopted in the first South African case on the new statutory derivative action, *Mouritzen v Greystone Enterprises (Pty) Ltd*,²² in which the court reserved the issue of costs for determination by the court hearing the substantive action. This approach creates a formidable financial disincentive for prospective derivative litigants that would undercut the proper use of the remedy.

One must differentiate between the costs of the *substantive* derivative action itself (discussed above) and the costs of the prior application to court in

²² Supra note 2 at para 67.

terms of s 165 for *leave* or permission to pursue the derivative action. In respect of the latter, a successful applicant who is granted leave should, as a general principle, have the right to the immediate payment or reimbursement by the company of his costs incurred in bringing the leave application. It is regrettable that *Mouritzen's* case took a retrograde stance by also reserving the costs of the leave application for determination by the court hearing the actual derivative action.²³ This tentative approach imposes an excessive burden on litigants suing derivatively. One hopes that it does not set a trend in South African law, and that a future court would be prepared to reconsider the approach adopted in *Mouritzen*.

The prospect for an award of interim costs is implicitly acknowledged under s 165(10) of the Act. Provided that the company is in a financial position to finance the derivative proceedings, a shareholder who has been granted judicial leave to bring a well-founded derivative action should in appropriate circumstances be granted access to corporate funds, on an ongoing basis, to fund the litigation. An order of interim costs would relieve the shareholder of the burden, and would ensure that he is not dissuaded from litigating to vindicate the company's rights by an inability to meet the interim costs and expenses of the substantive proceedings.

8.8.2 *Security for Costs*

It is respectfully submitted that s 165(11) of the Act should be amended to disempower and prohibit the courts from ordering derivative litigants to furnish security for costs, both for the costs of the application for leave as well as the costs of the substantive derivative action. Furthermore, pending an amendment to the Act, the courts should resolutely refuse to encumber derivative litigants with the additional burden of an order of security for costs.

There are three strong grounds on which the provision in s 165(11) on

²³ Supra note 2 at para 68.

security for costs may be criticised. The most important of these is that there is no real rationale for the requirement of security for costs. Although it is purportedly designed as a safeguard against strike suits and secret settlements, a demand for security for costs is no true antidote to strike suits. The more correct and more obvious solution or safeguard is to prohibit collusive settlements—which is what s 165(15) of the Act already does. As shown by the experience in the USA, any advantages of security for costs are greatly outweighed by its disadvantages. The requirement of security for costs is, paradoxically, a serious deterrent to worthy and meritorious derivative actions.

8.8.3. Other Issues of Costs

First, in respect of remuneration and expenses, s 165(9)(a) is a gremlin in the Act that must be removed by way of a legislative amendment. This provision is ambiguous, in that it is uncertain to whom the phrase ‘the person appointed’ is intended to refer.

Secondly, in respect of the issue of personal recovery by shareholders, it is submitted that it would be beneficial to include in the Act a judicial power to award individual recovery or personal recovery to former or current shareholders in a derivative action. This discretionary judicial power would serve a very useful role in avoiding inequitable results in certain circumstances. Such orders are notably permitted in several comparable jurisdictions. If, however, the discretion to order pro rata relief to shareholders is made available in South African law, it must be exercised cautiously and restricted to exceptional situations only.

8.8.4 Directors’ Indemnity and Insurance

While the obstacle of costs confronts the minority shareholder or other *plaintiff* who seeks to vindicate the company’s rights in a derivative action, the *defendant* director conversely is in a more advantageous position. Directors are

generally protected against legal costs and expenses by means of indemnification or directors' and officers' insurance, with the result that the defendant director in a derivative action has access to the funds of the company for his defence.

In an important respect, the provision on indemnification in s 78 of the Act is a strange provision. It oddly permits the negligent director to be indemnified by the company against the harm that he has caused to the company itself. Its practical consequence is that directors who have *negligently* harmed the company are free of any personal responsibility to the company—they stand to lose nothing, for they are exempt from both the payment of the award of damages to the company and the payment of the legal costs of their defence. It is submitted that this defect in s 78 of the Act must be corrected by the legislature. A statutory distinction ought to be adopted between, on the one hand, directors' liability for negligence to *third parties*—which should remain indemnifiable by the company—and, on the other hand, directors' liability for negligence to the *company itself*, which should sensibly be prohibited from indemnification.

In light of the consideration that the indemnification of directors under s 78 is merely an election rather than a mandatory obligation of the company, , should the board of directors decide to indemnify a fellow director who has been held liable to the company in a derivative action for negligence, the board decision may be contested. The basis of the challenge is that the decision of the board to indemnify a negligent director amounts to a breach of their fiduciary duty to act in good faith and in the best interests of the company. In the event that the negligent director's right to an indemnity is rooted in his contract of service, questions may arise as to its enforceability.

8.8.5 Access to Information

Many derivative actions are frustrated at the outset by the applicant's hurdle of lack of access to inside corporate information on which to found his claim. In a

dispute between a minority shareholder and the company's management, the asymmetry of information, which falls under the control of the company's managers and directors, is the second key obstacle for the minority shareholder. This presents a major predicament in the application to court for leave to bring a derivative action and particularly in satisfying the second gateway for leave (that there is a serious question to be tried, as discussed above). It is disappointing that the Act has failed to adequately address the hurdle of access to information.

Although the Act makes provision for an investigation by an independent and impartial person or committee, in terms of s 165(4), this is not an adequate channel for yielding information to applicants or prospective applicants. Several difficulties and uncertainties are inherent in this provision, which require attention and clarification.

In respect of the right of inspection of the books of the company, s 165(9)(e) of the Act is triggered only once judicial leave is granted to the shareholder (or other applicant) to commence a derivative action. This provision is thus of no use to the shareholder or applicant in the critical early stages of the procedure when preparing his application for leave in the first place—which is precisely when the right of inspection is most desperately needed. This is a regrettable lacuna in the Act, that ought to be cured by legislative amendment. It is respectfully submitted that a more suitable approach would be to grant to *prospective* applicants under s 165 a statutory right to apply to court to inspect the books of the company, provided that the prospective applicant establishes a 'proper purpose'.

8.8.6 The Role of Public Enforcement

The Act provides a useful and important mechanism to surmount the chief hurdles that confront the derivative litigant. In this regard, the Companies and Intellectual Property Commission is empowered to function as a watchdog both to investigate and to enforce infringements of company law. The minority

shareholder's obstacle of access to information may be surmounted by an investigation conducted by the Companies Commission, while derivative litigation launched by the Companies Commission overcomes the minority shareholder's risk of liability for legal costs.

However, it is yet to be seen whether this critical link between investigations and subsequent derivative actions will actually materialise. It ultimately hinges on the way in which the Companies Commission, in practice, uses its powers and exercises its discretion. Suggestions are made in this thesis (at paragraph 7.7) for the appropriate balance to be struck.

The effective enforcement of corporate rights and deterrence of directorial misconduct depends on the facilitation and encouragement of both public enforcement by the Companies Commission as well as private enforcement by shareholders and other stakeholders. Private and public enforcement should ideally work in tandem. Presently, however, the policing of boards of directors depends largely on private enforcement by shareholders through the use of the statutory derivative action, bearing in mind the absence of a well-established public enforcement agency in South Africa. It is submitted that the courts should remain cognisant of this fundamentally important factor when exercising their discretion to grant leave to applicants for derivative actions and when exercising their discretion to make indemnity orders and orders of costs.

8.9 Final Comments

In closing, the courts have a wide discretion both to grant leave to minority shareholders and stakeholders for derivative actions under s 165, and to order indemnification from the corporate treasury for shareholders and stakeholders who take the initiative of pursuing litigation to vindicate the company's rights. The courts must first find and then maintain the proper balance between the competing interests that come into play in derivative actions. It is to be hoped that a flexible and robust approach will be adopted by the courts that will

cultivate and breathe full life into this potentially valuable minority shareholder remedy rather than to smother it. A whole array of safeguards is built into s 165 of the Act to deter abuse of the remedy by opportunistic shareholders and others. Overly cautious judicial decisions on the new remedy in its germinal stages would unwittingly derail the legitimate use of the derivative action and bring to an abrupt halt any hopes for the realisation of its worthy objectives in holding corporate delinquents accountable for their misconduct.

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APPENDIX 1: STATUTORY PROVISIONS

1.1 South African Companies Act 71 of 2008, section 165

165. *Derivative actions*

(1) Any right at common law of a person other than a company to bring or prosecute any legal proceedings on behalf of that company is abolished, and the rights in this section are in substitution for any such abolished right.

(2) A person may serve a demand upon a company to commence or continue legal proceedings, or take related steps, to protect the legal interests of the company if the person—

- (a) is a shareholder or a person entitled to be registered as a shareholder, of the company or of a related company;
- (b) is a director or prescribed officer of the company or of a related company;
- (c) is a registered trade union that represents employees of the company, or another representative of employees of the company; or
- (d) has been granted leave of the court to do so, which may be granted only if the court is satisfied that it is necessary or expedient to do so to protect a legal right of that other person.

(3) A company that has been served with a demand in terms of subsection (2) may apply within 15 business days to a court to set aside the demand only on the grounds that it is frivolous, vexatious or without merit.

(4) If a company does not make an application contemplated in subsection (3), or the court does not set aside the demand in terms of that subsection, the company must—

- (a) appoint an independent and impartial person or committee to investigate the demand, and report to the board on—
 - (i) any facts or circumstances—
 - (aa) that may have given rise to a cause of action contemplated in the demand; or
 - (bb) that may relate to any proceedings contemplated in the demand;
 - (ii) the probable costs that would be incurred if the company pursued any such cause of action or continued any such proceedings; and

- (iii) whether it appears to be in the best interests of the company to pursue any such cause of action or continue any such proceedings; and
 - (b) within 60 business days after being served with the demand, or within a longer time as a court, on application by the company, may allow, either—
 - (i) initiate or continue legal proceedings, or take related legal steps to protect the legal interests of the company, as contemplated in the demand; or
 - (ii) serve a notice on the person who made the demand, refusing to comply with it.
- (5) A person who has made a demand in terms of subsection (2) may apply to a court for leave to bring or continue proceedings in the name and on behalf of the company, and the court may grant leave only if—
- (a) the company—
 - (i) has failed to take any particular step required by subsection (4);
 - (ii) appointed an investigator or committee who was not independent and impartial;
 - (iii) accepted a report that was inadequate in its preparation, or was irrational or unreasonable in its conclusions or recommendations;
 - (iv) acted in a manner that was inconsistent with the reasonable report of an independent, impartial investigator or committee; or
 - (v) has served a notice refusing to comply with the demand, as contemplated in subsection (4) (b) (ii); and
 - (b) the court is satisfied that—
 - (i) the applicant is acting in good faith;
 - (ii) the proposed or continuing proceedings involve the trial of a serious question of material consequence to the company; and
 - (iii) it is in the best interests of the company that the applicant be granted leave to commence the proposed proceedings or continue the proceedings, as the case may be.
- (6) In exceptional circumstances, a person contemplated in subsection (2) may apply to a court for leave to bring proceedings in the name and on behalf of the company without making a demand as contemplated in that subsection, or without affording the company time to respond to the demand in accordance with subsection (4), and the court may grant leave only if the court is satisfied that—

- (a) the delay required for the procedures contemplated in subsections (3) to (5) to be completed may result in—
 - (i) irreparable harm to the company; or
 - (ii) substantial prejudice to the interests of the applicant or another person;
 - (b) there is a reasonable probability that the company may not act to prevent that harm or prejudice, or act to protect the company's interests that the applicant seeks to protect; and
 - (c) that the requirements of subsection (5) (b) are satisfied.
- (7) A rebuttable presumption that granting leave is not in the best interests of the company arises if it is established that—
- (a) the proposed or continuing proceedings are by—
 - (i) the company against a third party; or
 - (ii) a third party against the company;
 - (b) the company has decided—
 - (i) not to bring the proceedings;
 - (ii) not to defend the proceedings; or
 - (iii) to discontinue, settle or compromise the proceedings; and
 - (c) all of the directors who participated in that decision—
 - (i) acted in good faith for a proper purpose;
 - (ii) did not have a personal financial interest in the decision, and were not related to a person who had a personal financial interest in the decision;
 - (iii) informed themselves about the subject matter of the decision to the extent they reasonably believed to be appropriate; and
 - (iv) reasonably believed that the decision was in the best interests of the company.
- (8) For the purposes of subsection (7)—
- (a) a person is a third party if the company and that person are not related or inter-related; and
 - (b) proceedings by or against the company include any appeal from a decision made in proceedings by or against the company.
- (9) If a court grants leave to a person under this section—
- (a) the court must also make an order stating who is liable for the remuneration and expenses of the person appointed;
 - (b) the court may vary the order at any time;

(c) the persons who may be made liable under the order, or the order as varied, are—

- (i) all or any of the parties to the proceedings or application; and
 - (ii) the company;
- (d) if the order, or the order as varied, makes two or more persons liable, the order may also determine the nature and extent of the liability of each of those persons; and
- (e) the person to whom leave has been granted is entitled, on giving reasonable notice to the company, to inspect any books of the company for any purpose connected with the legal proceedings.

(10) At any time, a court may make any order it considers appropriate about the costs of the following persons in relation to proceedings brought or intervened in with leave under this section, or in respect of an application for leave under this section—

- (a) The person who applied for or was granted leave;
- (b) the company; or
- (c) any other party to the proceedings or application.

(11) An order under this section may require security for costs.

(12) At any time after a court has granted leave in terms of this section, a person contemplated in subsection (2) may apply to a court for an order that they be substituted for the person to whom leave was originally granted, and the court may make the order applied for if it is satisfied that—

- (a) the applicant is acting in good faith; and
- (b) it is appropriate to make the order in all the circumstances.

(13) An order substituting one person for another has the effect that—

- (a) the grant of leave is taken to have been made in favour of the substituting person; and
- (b) if the person originally granted leave has already brought the proceedings, the substituting person is taken to have brought those proceedings or to have made that intervention.

(14) If the shareholders of a company have ratified or approved any particular conduct of the company—

- (a) the ratification or approval—
 - (i) does not prevent a person from making a demand, applying for leave, or bringing or intervening in proceedings with leave under this section; and

- (ii) does not prejudice the outcome of any application for leave, or proceedings brought or intervened in with leave under this section; or
 - (b) the court may take that ratification or approval into account in making any judgment or order.
- (15) Proceedings brought or intervened in with leave under this section must not be discontinued, compromised or settled without the leave of the court.
- (16) For greater certainty, the right of a person in terms of this section to serve a demand on a company, or apply to a court for leave, may be exercised by that person directly, or by the Commission or Panel, or another person on behalf of that first person, in the manner permitted by section 157.

1.2 Australian Corporations Act, 2001, sections 236 – 242

236 Bringing, or intervening in, proceedings on behalf of a company

- (1) A person may bring proceedings on behalf of a company, or intervene in any proceedings to which the company is a party for the purpose of taking responsibility on behalf of the company for those proceedings, or for a particular step in those proceedings (for example, compromising or settling them), if:
- (a) the person is:
 - (i) a member, former member, or person entitled to be registered as a member, of the company or of a related body corporate; or
 - (ii) an officer or former officer of the company; and
 - (b) the person is acting with leave granted under section 237.
- (2) Proceedings brought on behalf of a company must be brought in the company's name.
- (3) The right of a person at general law to bring, or intervene in, proceedings on behalf of a company is abolished.

237 Applying for and granting leave

- (1) A person referred to in paragraph 236(1)(a) may apply to the Court for leave to bring, or to intervene in, proceedings.
- (2) The Court must grant the application if it is satisfied that:
- (a) it is probable that the company will not itself bring the proceedings, or properly take responsibility for them, or for the steps in them; and

- (b) the applicant is acting in good faith; and
- (c) it is in the best interests of the company that the applicant be granted leave; and
- (d) if the applicant is applying for leave to bring proceedings—there is a serious question to be tried; and
- (e) either:
 - (i) at least 14 days before making the application, the applicant gave written notice to the company of the intention to apply for leave and of the reasons for applying; or
 - (ii) it is appropriate to grant leave even though subparagraph (i) is not satisfied.

(3) A rebuttable presumption that granting leave is not in the best interests of the company arises if it is established that:

- (a) the proceedings are:
 - (i) by the company against a third party; or
 - (ii) by a third party against the company; and
- (b) the company has decided:
 - (i) not to bring the proceedings; or
 - (ii) not to defend the proceedings; or
 - (iii) to discontinue, settle or compromise the proceedings; and
- (c) all of the directors who participated in that decision:
 - (i) acted in good faith for a proper purpose; and
 - (ii) did not have a material personal interest in the decision; and
 - (iii) informed themselves about the subject matter of the decision to the extent they reasonably believed to be appropriate; and
 - (iv) rationally believed that the decision was in the best interests of the company.

The director's belief that the decision was in the best interests of the company is a rational one unless the belief is one that no reasonable person in their position would hold.

(4) For the purposes of subsection (3):

- (a) a person is a third party if:
 - (i) the company is a public company and the person is not a related party of the company; or

- (ii) the company is not a public company and the person would not be a related party of the company if the company were a public company; and
- (b) proceedings by or against the company include any appeal from a decision made in proceedings by or against the company.

238 Substitution of another person for the person granted leave

- (1) Any of the following persons may apply to the Court for an order that they be substituted for a person to whom leave has been granted under section 237:
 - (a) a member, former member, or a person entitled to be registered as a member, of the company or of a related body corporate;
 - (b) an officer, or former officer, of the company.
- (2) The Court may make the order if it is satisfied that:
 - (a) the applicant is acting in good faith; and
 - (b) it is appropriate to make the order in all the circumstances.
- (3) An order substituting one person for another has the effect that:
 - (a) the grant of leave is taken to have been made in favour of the substituted person; and
 - (b) if the other person has already brought the proceedings or intervened—the substituted person is taken to have brought those proceedings or to have made that intervention.

239 Effect of ratification by members

- (1) If the members of a company ratify or approve conduct, the ratification or approval:
 - (a) does not prevent a person from bringing or intervening in proceedings with leave under section 237 or from applying for leave under that section; and
 - (b) does not have the effect that proceedings brought or intervened in with leave under section 237 must be determined in favour of the defendant, or that an application for leave under that section must be refused.
- (2) If members of a company ratify or approve conduct, the Court may take the ratification or approval into account in deciding what order or judgment (including as to damages) to make in proceedings brought or intervened in with leave under section 237 or in relation to an application for leave under that section. In doing this, it must have regard to:

- (a) how well-informed about the conduct the members were when deciding whether to ratify or approve the conduct; and
- (b) whether the members who ratified or approved the conduct were acting for proper purposes.

240 Leave to discontinue, compromise or settle proceedings brought, or intervened in, with leave

Proceedings brought or intervened in with leave must not be discontinued, compromised or settled without the leave of the Court.

241 General powers of the Court

(1) The Court may make any orders, and give any directions, that it considers appropriate in relation to proceedings brought or intervened in with leave, or an application for leave, including:

- (a) interim orders; and
- (b) directions about the conduct of the proceedings, including requiring mediation; and
- (c) an order directing the company, or an officer of the company, to do, or not to do, any act; and
- (d) an order appointing an independent person to investigate, and report to the Court on:
 - (i) the financial affairs of the company; or
 - (ii) the facts or circumstances which gave rise to the cause of action the subject of the proceedings; or
 - (iii) the costs incurred in the proceedings by the parties to the proceedings and the person granted leave.

(2) A person appointed by the Court under paragraph (1)(d) is entitled, on giving reasonable notice to the company, to inspect any books of the company for any purpose connected with their appointment.

(3) If the Court appoints a person under paragraph (1)(d):

- (a) the Court must also make an order stating who is liable for the remuneration and expenses of the person appointed; and
- (b) the Court may vary the order at any time; and
- (c) the persons who may be made liable under the order, or the order as varied, are:
 - (i) all or any of the parties to the proceedings or application; and
 - (ii) the company; and

(d) if the order, or the order as varied, makes 2 or more persons liable, the order may also determine the nature and extent of the liability of each of those persons.

(4) Subsection (3) does not affect the powers of the Court as to costs.

242 Power of the Court to make costs orders

The Court may at any time make any orders it considers appropriate about the costs of the following persons in relation to proceedings brought or intervened in with leave under section 237 or an application for leave under that section:

- (a) the person who applied for or was granted leave;
- (b) the company;
- (c) any other party to the proceedings or application.

An order under this section may require indemnification for costs.

1.3 Canada Business Corporations Act, 1985, sections 238 – 240 and 242

238. In this Part,

“action” means an action under this Act;

“complainant” means

- (a) a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates,
- (b) a director or an officer or a former director or officer of a corporation or any of its affiliates,
- (c) the Director, or
- (d) any other person who, in the discretion of a court, is a proper person to make an application under this Part.

Commencing derivative action

239. (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 a 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.

Conditions precedent

(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 notice to the directors of the corporation or its subsidiary of the complainant's intention to apply to the court under subsection (1) not less than fourteen days before bringing the application, or as otherwise ordered by the court, 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
- (c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.

Powers of court

240. In connection with an action brought or intervened in under section 239, the court may at any time make any order it thinks fit including, without limiting the generality of the foregoing,

- (a) an order authorizing the complainant or any other person to control the conduct of the action;
- (b) an order giving directions for the conduct of the action;
- (c) an order directing that any amount adjudged payable by a defendant in the action shall be paid, in whole or in part, directly to former and present security holders of the corporation or its subsidiary instead of to the corporation or its subsidiary; and
- (d) an order requiring the corporation or its subsidiary to pay reasonable legal fees incurred by the complainant in connection with the action.

Evidence of shareholder approval not decisive

242. (1) An application made or an action brought or intervened in under this Part 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 under section 214, 240 or 241.

Court approval to discontinue

(2) An application made or an action brought or intervened in under this Part shall not be stayed, discontinued, settled or dismissed for want of prosecution or, in Quebec, failure to respect the agreement between the parties as to the conduct of the proceeding without the approval of the court given on any terms that the court thinks fit and, if the court determines that the interests of any

complainant may be substantially affected by such stay, discontinuance, settlement, dismissal or failure, the court may order any party to the application or action to give notice to the complainant.

No security for costs

(3) A complainant is not required to give security for costs in any application made or action brought or intervened in under this Part.

Interim costs

(4) In an application made or an action brought or intervened in under this Part, the court may at any time order the corporation or its subsidiary to pay to the complainant interim costs, including legal fees and disbursements, but the complainant may be held accountable for such interim costs on final disposition of the application or action.

1.4 Ontario Business Corporations Act, 1990, sections 245 – 247 and 249

Definitions

245. In this Part,

“action” means an action under this Act

“complainant” means,

- (a) a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates,
- (b) a director or an officer or a former director or officer of a corporation or of any of its affiliates,
- (c) any other person who, in the discretion of the court, is a proper person to make an application under this Part. .

Derivative actions

246. (1) Subject to subsection (2), a complainant may apply to the court for leave to bring an action in the name and on behalf of a 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.

Idem

(2) No action may be brought and no intervention in an action may be made under subsection (1) unless the complainant has given fourteen days' notice to the directors of the corporation or its subsidiary of the complainant's intention to apply to the court under subsection (1) and the court is satisfied that,

- (a) the directors of the corporation or its subsidiary will not bring, diligently prosecute or defend or discontinue the action;
- (b) the complainant is acting in good faith; and
- (c) it appears to be in the interests of the corporation or its subsidiary that the action be brought, prosecuted, defended or discontinued.

Notice not required

(2.1) A complainant is not required to give the notice referred to in subsection (2) if all of the directors of the corporation or its subsidiary are defendants in the action.

Application

(3) Where a complainant on an application made without notice can establish to the satisfaction of the court that it is not expedient to give notice as required under subsection (2), the court may make such interim order as it thinks fit pending the complainant giving notice as required.

Interim order

(4) Where a complainant on an application can establish to the satisfaction of the court that an interim order for relief should be made, the court may make such order as it thinks fit.

Court order

247. In connection with an action brought or intervened in under section 246, the court may at any time make any order it thinks fit including, without limiting the generality of the foregoing,

- (a) an order authorizing the complainant or any other person to control the conduct of the action;
- (b) an order giving directions for the conduct of the action;
- (c) an order directing that any amount adjudged payable by a defendant in the action shall be paid, in whole or in part, directly to former and present security holders of the corporation or its subsidiary instead of to the corporation or its subsidiary; and
- (d) an order requiring the corporation or its subsidiary to pay reasonable legal fees and any other costs reasonably incurred by the complainant in connection with the action.

Discontinuance and settlement

249. (1) An application made or an action brought or intervened in under this Part 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 affiliate 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 under section 207, 247 or 248.

Idem

(2) An application made or an action brought or intervened in under this Part shall not be stayed, discontinued, settled or dismissed for want of prosecution without the approval of the court given upon such terms as the court thinks fit and, if the court determines that the interests of any complainant may be substantially affected by such stay, discontinuance, settlement or dismissal, the court may order any party to the application or action to give notice to the complainant.

Costs

(3) A complainant is not required to give security for costs in any application made or action brought or intervened in under this Part.

Idem

(4) In an application made or an action brought or intervened in under this Part, the court may at any time order the corporation or its affiliate to pay to the complainant interim costs, including reasonable legal fees and disbursements, for which interim costs the complainant may be held accountable to the corporation or its affiliate upon final disposition of the application or action.

1.5 New Zealand Companies Act, 1993, sections 165 – 168

165 Derivative actions

(1) Subject to subsection (3), the court may, on the application of a shareholder or director of a company, grant leave to that shareholder or director to—

- (a) bring proceedings in the name and on behalf of the company or any related company; or
- (b) intervene in proceedings to which the company or any related company is a party for the purpose of continuing, defending, or discontinuing the proceedings on behalf of the company or related company, as the case may be.

(2) Without limiting subsection (1), in determining whether to grant leave under that subsection, the court shall have regard to—

- (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.

(3) Leave to bring proceedings or intervene in proceedings may be granted under subsection (1), only if the court is satisfied that either—

- (a) the company or related company does not intend to bring, diligently continue or defend, or discontinue the proceedings, as the case may be; or
- (b) it is in the interests of the company or related company that the conduct of the proceedings should not be left to the directors or to the determination of the shareholders as a whole.

(4) Notice of the application must be served on the company or related company.

(5) The company or related company—

- (a) may appear and be heard; and
- (b) must inform the court, whether or not it intends to bring, continue, defend, or discontinue the proceedings, as the case may be.

(6) Except as provided in this section, a shareholder is not entitled to bring or intervene in any proceedings in the name of, or on behalf of, a company or a related company.

166 Costs of derivative action to be met by company

The court shall, on the application of the shareholder or director to whom leave was granted under section 165 to bring or intervene in the proceedings, order that the whole or part of the reasonable costs of bringing or intervening in the proceedings, including any costs relating to any settlement, compromise, or discontinuance approved under section 168, must be met by the company unless the court considers that it would be unjust or inequitable for the company to bear those costs.

167 Powers of court where leave granted

The court may, at any time, make any order it thinks fit in relation to proceedings brought by a shareholder or a director or in which a shareholder or director intervenes, as the case may be, with leave of the court under section 165, and without limiting the generality of this section may—

- (a) make an order authorising the shareholder or any other person to control the conduct of the proceedings:
- (b) give directions for the conduct of the proceedings:
- (c) make an order requiring the company or the directors to provide information or assistance in relation to the proceedings:
- (d) make an order directing that any amount ordered to be paid by a defendant in the proceedings must be paid, in whole or part, to former and present shareholders of the company or related company instead of to the company or the related company.

168 Compromise, settlement, or withdrawal of derivative action

No proceedings brought by a shareholder or a director or in which a shareholder or a director intervenes, as the case may be, with leave of the court under section 165, may be settled or compromised or discontinued without the approval of the court.

1.6 United Kingdom Companies Act, 2006, sections 260 – 264

260 Derivative claims

(1) This Chapter applies to proceedings in England and Wales or Northern Ireland by a member of a company—

- (a) in respect of a cause of action vested in the company, and
- (b) seeking relief on behalf of the company.

This is referred to in this Chapter as a "derivative claim".

(2) A derivative claim may only be brought—

- (a) under this Chapter, or
- (b) in pursuance of an order of the court in proceedings under section 994 (proceedings for protection of members against unfair prejudice).

(3) A derivative claim under this Chapter may be brought only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of the company.

The cause of action may be against the director or another person (or both).

(4) It is immaterial whether the cause of action arose before or after the person seeking to bring or continue the derivative claim became a member of the company.

(5) For the purposes of this Chapter—

- (a) "director" includes a former director;
- (b) a shadow director is treated as a director; and
- (c) references to a member of a company include a person who is not a member but to whom shares in the company have been transferred or transmitted by operation of law.

261 Application for permission to continue derivative claim

(1) A member of a company who brings a derivative claim under this Chapter must apply to the court for permission (in Northern Ireland, leave) to continue it.

(2) If it appears to the court that the application and the evidence filed by the applicant in support of it do not disclose a prima facie case for giving permission (or leave), the court—

- (a) must dismiss the application, and
- (b) may make any consequential order it considers appropriate.

(3) If the application is not dismissed under subsection (2), the court—

- (a) may give directions as to the evidence to be provided by the company, and
- (b) may adjourn the proceedings to enable the evidence to be obtained.

(4) On hearing the application, the court may—

- (a) give permission (or leave) to continue the claim on such terms as it thinks fit,
- (b) refuse permission (or leave) and dismiss the claim, or
- (c) adjourn the proceedings on the application and give such directions as it thinks fit.

262 Application for permission to continue claim as a derivative claim

(1) This section applies where—

- (a) a company has brought a claim, and
 - (b) the cause of action on which the claim is based could be pursued as a derivative claim under this Chapter.
- (2) A member of the company may apply to the court for permission (in Northern Ireland, leave) to continue the claim as a derivative claim on the ground that—
- (a) the manner in which the company commenced or continued the claim amounts to an abuse of the process of the court,
 - (b) the company has failed to prosecute the claim diligently, and
 - (c) it is appropriate for the member to continue the claim as a derivative claim.
- (3) If it appears to the court that the application and the evidence filed by the applicant in support of it do not disclose a prima facie case for giving permission (or leave), the court—
- (a) must dismiss the application, and
 - (b) may make any consequential order it considers appropriate.
- (4) If the application is not dismissed under subsection (3), the court—
- (a) may give directions as to the evidence to be provided by the company, and
 - (b) may adjourn the proceedings to enable the evidence to be obtained.
- (5) On hearing the application, the court may—
- (a) give permission (or leave) to continue the claim as a derivative claim on such terms as it thinks fit,
 - (b) refuse permission (or leave) and dismiss the application, or
 - (c) adjourn the proceedings on the application and give such directions as it thinks fit.

263 Whether permission to be given

- (1) The following provisions have effect where a member of a company applies for permission (in Northern Ireland, leave) under section 261 or 262.
- (2) Permission (or leave) must be refused if the court is satisfied—
- (a) that a person acting in accordance with section 172 (duty to promote the success of the company) would not seek to continue the claim, or
 - (b) where the cause of action arises from an act or omission that is yet to occur, that the act or omission has been authorised by the company, or
 - (c) where the cause of action arises from an act or omission that has already occurred, that the act or omission—

- (i) was authorised by the company before it occurred, or
 - (ii) has been ratified by the company since it occurred.
- (3) In considering whether to give permission (or leave) the court must take into account, in particular—
 - (a) whether the member is acting in good faith in seeking to continue the claim;
 - (b) the importance that a person acting in accordance with section 172 (duty to promote the success of the company) would attach to continuing it;
 - (c) where the cause of action results from an act or omission that is yet to occur, whether the act or omission could be, and in the circumstances would be likely to be—
 - (i) authorised by the company before it occurs, or
 - (ii) ratified by the company after it occurs;
 - (d) where the cause of action arises from an act or omission that has already occurred, whether the act or omission could be, and in the circumstances would be likely to be, ratified by the company;
 - (e) whether the company has decided not to pursue the claim;
 - (f) whether the act or omission in respect of which the claim is brought gives rise to a cause of action that the member could pursue in his own right rather than on behalf of the company.
- (4) In considering whether to give permission (or leave) the court shall have particular regard to any evidence before it as to the views of members of the company who have no personal interest, direct or indirect, in the matter.
- (5) The Secretary of State may by regulations—
 - (a) amend subsection (2) so as to alter or add to the circumstances in which permission (or leave) is to be refused;
 - (b) amend subsection (3) so as to alter or add to the matters that the court is required to take into account in considering whether to give permission (or leave).
- (6) Before making any such regulations the Secretary of State shall consult such persons as he considers appropriate.
- (7) Regulations under this section are subject to affirmative resolution procedure.

264 Application for permission to continue derivative claim brought by another member

- (1) This section applies where a member of a company ("the claimant")—

- (a) has brought a derivative claim,
 - (b) has continued as a derivative claim a claim brought by the company, or
 - (c) has continued a derivative claim under this section.
- (2) Another member of the company ("the applicant") may apply to the court for permission (in Northern Ireland, leave) to continue the claim on the ground that—
 - (a) the manner in which the proceedings have been commenced or continued by the claimant amounts to an abuse of the process of the court,
 - (b) the claimant has failed to prosecute the claim diligently, and
 - (c) it is appropriate for the applicant to continue the claim as a derivative claim.
- (3) If it appears to the court that the application and the evidence filed by the applicant in support of it do not disclose a prima facie case for giving permission (or leave), the court—
 - (a) must dismiss the application, and
 - (b) may make any consequential order it considers appropriate.
- (4) If the application is not dismissed under subsection (3), the court—
 - (a) may give directions as to the evidence to be provided by the company, and
 - (b) may adjourn the proceedings to enable the evidence to be obtained.
- (5) On hearing the application, the court may—
 - (a) give permission (or leave) to continue the claim on such terms as it thinks fit,
 - (b) refuse permission (or leave) and dismiss the application, or
 - (c) adjourn the proceedings on the application and give such directions as it thinks fit.