

# **Evolution of the derivative action as an enforcement of rights mechanism under the Companies Act 71 of 2008**

by

**Alexandra Stylianou**

Student number: 10302400

Submitted in partial fulfillment of the requirements for the degree  
Master in Laws (LLM) Corporate Law

In the Faculty of Law, Mercantile Department,  
University of Pretoria

November 2016

Supervisor: Professor P.A. Delpont

## Summary

The purpose of this dissertation a focus on derivative actions as a method a minority shareholder can employ as an enforcement of rights mechanism. In so doing I will be examining the derivative action procedure from its inception in the common law through to the current dispensation. This dissertation describes and explains the rights, interests and obligations of shareholders and will explore the pitfalls for shareholders in the implementation of the derivative action as a protective measure. I submit that the derivative action found under the common law and the previous statutory regime provided the stepping stone in molding the statutory derivative action evidenced by section 165 of the Companies Act.

In Chapter 1, I explore the derivative action under the common law as a conceptual framework and as a movement that initially arose in the renowned case of *Foss v Harbottle*. Whose core principles were subsequently embraced by the South African judiciary.

In Chapter 2 I discuss the availability of the statutory derivative action and the limitations of section 266. Further, I make a comparative study between the common law and the statutory derivative action. The comparison is essential in an attempt to portray that the statutory derivative action refined the common law to a certain extent in its attempts to provide a minority shareholder protective measure.

In chapter 3 I examine section 165 of the Companies Act to evaluate to what degree the derivative action has transformed against the backdrop of its statutory predecessor and the common law. This chapter breaks down the constituent principles of section 165 and examines the requirements necessary to implement the measure.

Finally, in Chapter 4 I make a comparative study with foreign jurisdictions to determine the extent, if any, section 165 relates to the principles laid down in other jurisdictions.

## Acknowledgments

This dissertation owes its existence to the patience, understanding and support some very important people to me.

I thank God, the Lord Almighty and sincerely acknowledge the gift of patience, perseverance, endurance and knowledge bestowed upon me to complete this dissertation.

To my family I love you all eternally. To my parents Chris and Pam, I cannot thank you enough. None of this would have been possible without your constant love, care and guidance. Thank you for the opportunities you have provided me with, I am infinitely grateful. To my siblings Eleni, Joanna, Michelle, Michael and Bradley your backing, endless love and encouragement has been incredible in my endeavors. Thank you for giving me more than I could have ever have asked for. I love you all.

To my boyfriend Kyle who has been through this all with me especially during the stressful periods. Thank you for your unfailing love, support and endless faith. I love you, you have opened my eyes and heart to so much and I am extremely excited for the adventures that await us.

Finally, my sincere appreciation goes to Professor Piet Delpont, for the guidance, passion and wisdom he provided as I undertook this dissertation and degree.

## Declaration of originality

Full names of student:

.....

Student number:

.....

### Declaration

1. I understand what plagiarism is and am aware of the University's policy in this regard.
2. I declare that this dissertation is my own original work. Where other people's work has been used (either from a printed source, Internet or any other source), this has been properly acknowledged and referenced in accordance with departmental requirements.
3. I have not used work previously produced by another student or any other person to hand in as my own.
4. I have not allowed, and will not allow, anyone to copy my work with the intention of passing it off as his or her own work.

Signature of student:

.....

Signature of supervisor:

.....

## Table of contents

<b>Introduction.....</b>	<b>1</b>
<b>1. Chapter 1: A synopsis of the common law rule in <i>Foss v Harbottle</i> .....</b>	<b>4</b>
1.1. Introduction.....	4
1.2. Foundational principles.....	5
1.2.1. <i>The two parts of the rule and the point of their interaction</i> .....	5
1.2.2. <i>Exceptions to the rule</i> .....	7
1.2.3. <i>Limitations to the common law derivative action</i> .....	8
1.3. Conclusion .....	9
<b>2. Chapter 2: The derivative action under section 266 of the Companies Act 61 of 1973 .....</b>	<b>11</b>
2.1. Introduction.....	11
2.2. Section 266 of the old Act .....	12
2.2.1. <i>The availability and procedure of section 266</i> .....	12
2.2.2. <i>Problems identified under section 266</i> .....	13
2.2.3. <i>A comparison between the common law and section 266</i> .....	15
2.3. Conclusion .....	16
<b>3. Chapter 3: The derivative action under section 165 of the Companies Act 71 of 2008 .....</b>	<b>17</b>
3.1. Introduction.....	17
3.2. Analysis of the procedure to be followed under section 165 of the Act.....	18
3.2.1. <i>Standing and the demand</i> .....	18
3.2.2. <i>The role of judicial discretion</i> .....	21
3.2.3. <i>The rebuttable presumption</i> .....	24
3.2.4. <i>Acquisition of necessary information and the limitation thereof</i> .....	25
3.2.5. <i>Costs</i> .....	26
3.2.6. <i>Substitution and ratification or approval</i> .....	28
3.3. Conclusion .....	28
<b>4. Chapter 4: A Comparison of foreign legal principles in relation to the new statutory derivative action in South Africa .....</b>	<b>31</b>
4.1. Introduction.....	31

4.2. Which jurisdictions impact on section 165 as a hybrid of foreign legal principles? .....	32
4.2.1. <i>Australia</i> .....	33
4.2.2. <i>Canada</i> .....	35
4.2.3. <i>United States of America (USA)</i> .....	36
4.2.4. <i>United Kingdom (the UK)</i> .....	37
4.3. Conclusion .....	39
<b>Conclusion .....</b>	<b>40</b>
<b>Bibliography .....</b>	<b>42</b>

## Introduction

Since the derivative action is not an entirely modern concept in South African law it is critical to examine its history, development and purpose(s) to ascertain a comprehensive understanding of it. This forms the foundation upon which this dissertation rests, as it offers a good indication of the drive for which the remedy was introduced into our law. The effectiveness of the statutory derivative action, as an enforcement of rights mechanism for minority shareholders, can then systematically be considered.

It is argued that the common law offered restricted protection to safeguard minority shareholders' rights.<sup>1</sup> The motive advanced in support of this is that a company is a separate legal entity and should be treated independently.<sup>2</sup> Within the realm of the common law, rights and interests of shareholders in the minority are subject to decisions made lawfully on the affairs of the company by the majority; as a result, the courts usually decline to interfere in the conduct of a company's affairs at the instance of the minority.<sup>3</sup> It is imperative, however, that the majority rule be 'balanced' against the need to protect minority shareholders of a company.<sup>4</sup> Another principle, which sprouted from the *Foss* judgment, is the proper plaintiff principle.<sup>5</sup> In terms of this, the proper plaintiff is the company itself who is to institute legal action when a wrong has been committed against it.<sup>6</sup> This, however, is subject to exceptions, the most prevalent one being the common law derivative action.

---

<sup>1</sup> L Coetzee 'A comparative analysis of the derivative litigation proceedings under the Companies Act 61 of 1973 and the Companies Act 71 of 2008' (2010) *Acta Juridica: Modern company law for a competitive South African economy* 290.

<sup>2</sup> *Salomon v Salomon & Co Ltd* 1897 AC 22 (HL). This case enunciates that separate legal personality is the cornerstone for the proper functioning of corporate law, and is a rule that cannot lightly be ignored.

<sup>3</sup> See *Foss v Harbottle* 1843 Hare 461, 67 ER 189 which initially set out the common law right of a member to institute proceedings for a wrong committed against a company. See also *Sammel v President Brand Gold Mining Co Ltd* 1969 (3) SA 629 (A) 678 - 679 where it is highlighted that a general principle of corporate law is that one who becomes a shareholder in a company undertakes to be bound by decisions taken lawfully by the majority of shareholders, even where a minority shareholders' rights are affected adversely by such a decision.

<sup>4</sup> MF Cassim 'The statutory derivative action under the Companies Act of 2008: the role of good faith' (2013) 130 *The South African Law Journal* 496.

<sup>5</sup> *Foss* (n 3 above). This case is the primary case on the 'proper plaintiff' rule.

<sup>6</sup> HS Cilliers *et al Cilliers & Benade Corporate Law* 3ed (2000) 297.

A derivative action is a measure that may be brought by a person on behalf of the company to protect a legal interest or assert the rights of a company in instances where the controlling interest of a company declines to do so.<sup>7</sup> It is a manner in which minority members can armour themselves to effect good corporate governance and redress malfeasance committed against a company. This is usually apparent where the directors of a company have committed a transgression and it is improbable that they will institute action on behalf of the corporation against themselves.<sup>8</sup> Accordingly, the importance of the derivative action is that it acts as a restriction against directors from exploiting the proper functioning of an entity by undertaking decisions that adversely influence the company. Despite this, it has been expressed that the common law derivative action received minimal attention and the procedure to be followed was vague and uncertain, although there has been recognition of such a principle in South African corporate law.<sup>9</sup>

Due to the limited protection and procedural uncertainty under the common law, improved measures aimed at the protection of minorities developed over time.<sup>10</sup> The introduction of section 266 of the old Act<sup>11</sup> was an attempt to remedy and supplement the deficiencies of the common law derivative action and provide a statutory exception to the proper plaintiff principle. Whether section 266 achieved what it was implemented to cure will be a point of concern in this dissertation.

I find that it is instructive to trace the progression of the derivative action in an effort to investigate whether section 165 of the Act<sup>12</sup> remedies the complications encountered by the common law and section 266 of the old Act. Consequently, for a proper determination of section 165 of the Act, it is empirical to disassemble the

---

<sup>7</sup> MF Cassim 'Shareholder remedies and minority protection' in FHI Cassim *et al Contemporary company law* 2ed (2012) 775.

<sup>8</sup> Cassim (n 7 as above) 776.

<sup>9</sup> Cilliers (n 6 above) 305.

<sup>10</sup> The Van Wyk de Vries Commission of Enquiry into the Companies Act, Main Report 1970 para 42.10 (Van Wyk de Vries Commission) recognised that the possibility of shareholders interfering in legal action pertaining to the company is strangely limited by the rule in *Foss* (n 3 above), consequently, improvements were proposed.

<sup>11</sup> Companies Act 61 of 1973 (the old Act).

<sup>12</sup> Companies Act 71 of 2008 (the Act).



principle and consider it in relation to its various foundational and integral principles.<sup>13</sup> It is crucial to examine when a derivative claim may be brought, who can commence a claim, against whom it can be instituted and the procedure to be followed when bringing such an action. This examination will serve to determine the approach that the courts should take when faced with applications in terms of section 165.

Furthermore, the derivative action under section 165 of the Act appears to be a hybrid action as it incorporates rules applicable to foreign jurisdictions. Accordingly, a comparative analysis will be made between the functioning of section 165 of the Act and the relevant principles in Australia, Canada, the United States of America and the United Kingdom.

---

<sup>13</sup> K Idensohn 'The fate of *Foss* under the Companies Act 71 of 2008' (2012) 24 *South African Mercantile Law Journal* 355.

# 1. Chapter 1: A synopsis of the common law rule in *Foss v Harbottle*

## 1.1. Introduction

Company law is founded on certain principles that have proven empiric to the proper functioning of corporate law. These principles include the majority rule and the concept of separate legal personality. The incorporators, shareholders and directors of an entity are entirely separate from the metaphorical body known as the corporation.<sup>14</sup> As such a company must sustain its own legal obligations and maintain its own rights. Justification for the majority rule springs naturally from the treatment of companies as separate legal personalities. The majority rule can be explained as follows: in vital matters of business, an entity cannot function proficiently without the prerogative of the majority prevailing. The crux of this is that the minority is compelled to subject itself to the desires of the majority.<sup>15</sup> The position of the minority is therefore not favourable as their rights and interests are at the disposal of the majority.<sup>16</sup> In *Foss*, the court held that the majority of proprietors in the company have the power to bind the minority and the courts will refuse to interfere in the running of the company while the majority is acting lawfully.<sup>17</sup>

The principles discussed above constitute the fundamentals of the ‘proper plaintiff’ and the ‘internal management’ rule, which find expression in *Foss*.<sup>18</sup> Under the common law it is apparent that the majority rule, separate legal personality, the proper plaintiff principle and the internal management rule are intimately connected and actually fuel off of one another in their application.

---

<sup>14</sup> No case illustrates this better than the case of *Salomon* (n 2 above). Cilliers (n 6 above) 297 demonstrates that the rule in *Foss* (n 3 above) is based on the two preceding principles jointly, namely, separate legal personality and majority rule. See also KW Wedderburn ‘Shareholders’ rights and the rule in *Foss v Harbottle*’ (1957) 15 (2) *Cambridge Law Journal* 194 195 where it is explained that the the two principles are usually compositely referred to as ‘the Rule in *Foss v Harbottle*’. (Hereinafter mentioned as ‘the rule’).

<sup>15</sup> Cilliers (n 6 above) 296. See *Sammel* (n 2 above) 678 where it is emphasised that the rule of supremacy of the majority is necessary to the proper functioning of companies.

<sup>16</sup> PG Xuereb *The Rights of Shareholders* (1989) 163.

<sup>17</sup> *Foss* (n 3 above) 203 - 204.

<sup>18</sup> n 3 as above.

## 1.2. Foundational principles

### 1.2.1. The two parts of the rule and their point of interaction

The proper plaintiff principle is relatively straightforward,<sup>19</sup> however, it is notorious among scholars of company law for the problems evident beneath its ‘simple surface’.<sup>20</sup> If a wrong is committed against a company, the decision of whether or not to seek redress from the wrongdoer(s) lies with the company and not with the discontented minority.<sup>21</sup> Individual members cannot bring an action on its behalf,<sup>22</sup> regardless of whether such wrong produced a reduction in member value. As a result, the dissenting minority is bound to accept any decision taken by the majority unless and until the minority can show that the control of the company has been abused. This principle clearly stems from the separate legal personality<sup>23</sup> and majority rule.<sup>24</sup> As a consequence, the decision of whether or not to institute action is taken by the majority because they decide the matters relating to the corporation.<sup>25</sup>

The second rule is the ‘internal management’ principle which emphasises that it is not the policy of the courts to interfere in the internal affairs of a company at the

---

<sup>19</sup> VR Ngalwana ‘Majority rule and minority protection in South African company law: a reddish herring’ (1996) 113 *South African Law Journal* 527 528.

<sup>20</sup> Wedderburn (n 14 above) 194.

<sup>21</sup> Idensohn (n 13 above) 356 accentuates that this principle arises out of the general jurisprudential ‘direct harm’ principle that where a wrong is committed, the only person(s) entitled to seek redress are those who suffered direct harm as a result of the wrongdoing. See also Ngalwana (n 19 above) 528 where it is emphasised that because companies are legal persons, they alone are competent to complain about and bring action to redress wrongs committed against the company.

<sup>22</sup> JT Pretorius *et al Hahlo’s South African company law through the cases* 6ed (1999) 381 - 382. See also *TWK Agriculture Limited v NCT Forestry Co-operative Limited and Others* 2006 ZAKZHC 17 para 9 which highlights that as a general rule, where a wrong is alleged to have been committed against a company, it is the company which must seek redress in respect thereof. The case further states that the reason for the rule lies in the separate legal existence of the company as a legal *persona*. *Foss* (n 3 above) 190 illustrates that ‘there was nothing to prevent the company from obtaining redress in its corporate character in respect of the matters complained of’. See also Cilliers (n 6 above) 296 - 297.

<sup>23</sup> Idensohn (n 13 above) 356 affirms that in instances where the ‘direct harm’ principle is applied in the context of company law, it attracts the ‘corporate principle’ of company law that a company is a separate legal person with rights and obligations that are distinct from all members, directors and incorporators.

<sup>24</sup> Pretorius *et al* (n 22 above) 380 states that ‘the law looks upon companies as autonomous democracies in which the minority has to abide by the will of the majority’.

<sup>25</sup> *Foss* (n 3 above) 203 states that every incorporator must enter the entity ‘upon the terms of being liable to be so bound’ by the majority.

instance of disgruntled minority shareholders or members.<sup>26</sup> As a result, an individual member cannot assert his right against the company if the irregularity is ratifiable by the majority.<sup>27</sup> This is because matters of domestic management are under the control of the majority.<sup>28</sup> Thus, it is clear that the majority rule is the common denominator upon which both principles find their application. Consequently, the internal management principle can be merged into the proper plaintiff principle.<sup>29</sup>

The importance of the rule has been emphasised for centuries as a vital mechanism for corporations. The implications are that without the rule, pointless actions, tyrannical claims, a multiplicity of actions<sup>30</sup> and the incurrence of costs would ensue, resulting in companies being destroyed by legal process.<sup>31</sup> Moreover, if a single member had the right to bring an action against any person that harmed the company, the company later ratifying what that person had done could render all proceedings completely ineffective.<sup>32</sup> A decision of this nature could obviously be influenced by the majority because of the entrenched principle of the majority rule.<sup>33</sup> Further, allowing the minority to pursue action against a wrongdoer would potentially result in a return of corporate assets to shareholders without first paying the creditors of the company.<sup>34</sup> A shift in risk from the shareholder to the creditors would therefore arise resulting in an abuse of control which is prohibited in company law. Having said this, the minority would hold negligible rights if these concepts were uncompromisingly applied. Accordingly, the principles are not absolute and are subject to certain exceptions.

---

<sup>26</sup> *Yende v Orlando Coal Distributors (Pty) Ltd* 1961 (3) SA 314 (W) para 33. See also Ngalwana (n 19 above) 528 and Pretorius *et al* (n 22 above) 403.

<sup>27</sup> Cilliers (n 6 above) 297.

<sup>28</sup> Wedderburn (n 14 above) 198 further illustrates that the long standing recognition of the majority rule as a central principle concerning corporations, resulted in there being no difficulty in expressing the majority rule as the reasoning for the refusal to interfere in internal management.

<sup>29</sup> Wedderburn (n 14 as above) 198. See however Idensohn (n 13 above) 356 where it is emphasised that ‘although these two parts are closely interrelated, they are also conceptually distinct in both their nature and application’.

<sup>30</sup> Pretorius *et al* (n 22 above) 381. See further *McLelland v Hulett and Others* 1992 (1) SA 456 (D) 467 where it is stated that the subsistence of the rule is linked to the separate legal personality of the company and as such avoids potential ‘double jeopardy’.

<sup>31</sup> Wedderburn (n 14 above) 195.

<sup>32</sup> Cilliers (n 6 above) 297.

<sup>33</sup> RC Beuthin & SM Luiz *Beuthin’s basic company law* (1999) 156. See also Pretorius *et al* (n 22 above) 381 for similar justification of the rule laid down in *Foss* (n 3 above).

<sup>34</sup> Coetzee (n 1 above) 292. See also Pretorius (n 22 above) 381 and Ngalwana (n 19 above) 528.

### 1.2.2. Exceptions to the rule

If a company, as the proper plaintiff, failed to institute action where a wrong was committed against it, a shareholder could bring an action on behalf of the company by way of the common law derivative action. However, a shareholder was unable to do so if a simple majority of shareholders condoned or ratified the alleged wrong or irregularity.<sup>35</sup> Simply expressed, the rule in *Foss*<sup>36</sup> was only applicable in respect of wrongs and irregularities ratifiable by a simple majority; therefore, unratifiable wrongs and irregularities fell outside the scope of this rule.<sup>37</sup>

It is commonly considered that the rule in *Foss*<sup>38</sup> is immutable, save for certain exceptions. Four exceptions existed justifying a departure from the rule. A derivative action could have been brought in situations, where:

- a. the act done was an illegal act;
- b. the act was ultra vires the company;<sup>39</sup>
- c. although the act could be validly done only by way of a special resolution, there was an attempt to do it by way of a simple majority; and
- d. those who controlled the company committed a ‘fraud on the minority’.<sup>40</sup>

It is advocated that a ‘fraud on the minority’<sup>41</sup> was the only true common law exception to the rule in *Foss*.<sup>42</sup> Generally, a derivative action could be employed if an ‘unratifiable wrong’ was perpetrated on the company and the company could not or would not institute the action because the wrongdoers were in control of the company.<sup>43</sup> In such an instance, the rule was relaxed in favour of the aggrieved minority who was then permitted to bring a minority shareholders’ action on behalf of the company as, otherwise, ‘the wrongdoers themselves, being in control, would not allow the company to sue’.<sup>44</sup> The derivative action has therefore been defined as a unique remedy because

---

<sup>35</sup> Cassim (n 7 above) 778. See also Cilliers (n 6 above) 297.

<sup>36</sup> n 3 above.

<sup>37</sup> Cilliers (n 6 above) 298.

<sup>38</sup> n 3 above.

<sup>39</sup> Ngalwana (n 19 above) 529 highlights the trouble is that the pursuit of *ultra vires* activities could also amount to a wrong to the company and as the proper plaintiff rule indicates in such a situation only the company has *locus standi* to institute action.

<sup>40</sup> Pretorius (n 22 above) 388 see also *Edwards v Halliwell* 1950 (2) All ER 1067.

<sup>41</sup> Wedderburn (n 14 above) 201 considers ‘a fraud on the minority’ more strictly as ‘a fraud on the company’.

<sup>42</sup> n 3 above. Idensohn (n 13 above) 358. See also Wedderburn (n 14 above) 204.

<sup>43</sup> Cilliers (n 6 above) 303. See also PJ Davies ‘Derivative Actions and Foss v Harbottle’ (1981) 44 *The Modern Law Review* 204 where it is stated that control must be alleged and proved.

<sup>44</sup> *Edwards* (n 40 above) 1067. See also AJ Boyle *Minority Shareholders’ Remedies* (2002) 25.

it allows a person to bring an action that belongs to someone else.<sup>45</sup> The company then, being unable to act as plaintiff, needed to be joined as nominal defendant so that it was a party to the action and any order of the court could be applied to it.<sup>46</sup>

### 1.2.3. Limitations to the common law derivative action

The rule in *Foss*<sup>47</sup> has been the subject of criticism for various reasons. The rule is riddled with practical problems and serious inadequacies as far as the protection of minority shareholders are concerned.<sup>48</sup> It tended to promote the interests of the legal person to the detriment of the minority shareholder. This is one of the reasons why it is seen as a limitation rather than a development of the right of a minority shareholder in seeking judicial intervention.<sup>49</sup> When judicial intervention was sought, a difficulty that sprouted was placing the company on the right side of the equation to make it a party to the proceedings. It was an interesting deviation to name the company as co-defendant when the plaintiff was actually a shareholder that was asserting the company's cause of action.<sup>50</sup>

A further setback and one of the most predominant defects apparent was that of costs. Under the common law, a member had to financially sustain the action. On the one hand, where a person was successful, the benefits accrued to the company without the person recovering all expenses and costs incurred in pursuing the action. On the other hand, if the action was unsuccessful, the costs would wholly be borne by the member who took the decision to initiate the derivative action.<sup>51</sup> Moreover, even if the action was sustainable by the minority complainant, limited accessibility to information became a further hindrance to the minority shareholders' endeavors. Therefore, even if the wrongdoing by the majority was blatant, the limited access permitted to information

---

<sup>45</sup> L Griggs 'The statutory derivative action: lessons that may be learnt from the past!' (2002) 6(1) *University of Western Sydney Law review* para 1.1.

<sup>46</sup> Cilliers (n 6 above) 303. See Wedderburn (n 14 above) 202 where it is illustrated that 'a minority, even under an exception to the Rule, ought not to sue in defense of the corporation's rights until it has tried to get the company to sue'. A refusal by the proper authority will then suffice to bring the minority under the exception of 'fraud on the minority'. However, see Griggs (n 45 above) para 1.1 where it is demonstrated that there is an inherent conflict between allowing shareholders to institute an action where the board of directors refuse to litigate and the power granted to the board of directors to resolve internal conflict.

<sup>47</sup> n 3 above.

<sup>48</sup> Ngalwana (n 19 above) 531.

<sup>49</sup> Griggs (n 45 above) para 2.1.

<sup>50</sup> Ngalwana (n 19 above) 532.

<sup>51</sup> Cilliers (n 6 above) 305.

made it close to impossible to prove. Notably, it was the wrongdoers in control of the company that were likewise in possession of all the information necessary to pursue a derivative action.<sup>52</sup> This made it highly unlikely that the information required would be given up cooperatively. Directors of a company could therefore use their status in a company as a means to augment themselves by virtue of information available to them and thereby act in contravention of the best interests of the company. As such, it became apparent that a delicate balance of the rights afforded to shareholders and the entitlement of the board of directors to manage the affairs of the company needed to be struck. Finally, the uncertainty of what conduct was capable or incapable of being ratified by the majority made the scope of the remedy indistinct.<sup>53</sup>

### 1.3. Conclusion

The common law derivative action was overwhelmed with practical complications and severe shortfalls in so far as being a mechanism to protect the rights of minority shareholders. Although the decision handed in *Foss*<sup>54</sup> represented a key statement of the law regarding minority shareholders' rights; it cannot be seen as a major improvement.<sup>55</sup> The two parts of the rule in *Foss*<sup>56</sup> and the restrictions of that rule lie along the boundaries of the majority rule and separate legal personality of a company. The decisions of a company are therefore taken by those who dominate the reins of control, being the majority shareholders. As a result, the cause of action could be nullified by any act of condonation on the part of the company, further limiting the extent of protection afforded by the common law derivative action, but this is often overlooked.

Consequently, stern application of the rules expressed above would have been unduly harsh and unfair on the minority, and circuitously, the company. It is perhaps based on this motivation that the common law was forced into disuse in South Africa

---

<sup>52</sup> Ngalwana (n 19 above) 531.

<sup>53</sup> D Davis *et al Companies and other business structures in South Africa* (2011) 188. See also Cilliers (n 6 above) 306.

<sup>54</sup> n 3 above.

<sup>55</sup> Griggs (n 45 above) para 2.1.

<sup>56</sup> n 3 above.

and a strategy was established to develop the protection of minority shareholders in a company from the totalitarianism of the majority within a company. In this light, the common law derivative action painted a desperate call for transformation in this area of law.



## 2. Chapter 2: The derivative action under section 266 of the Companies Act 61 of 1973

### 2.1. Introduction

The complications surrounding the common law derivative action presented a stumbling block to the protection afforded to minority shareholders. To move forward, statutory measures were introduced in an effort to counter the defective minority protection apparent under the common law dispensation.<sup>57</sup> The legislature became aware of the vital inefficiencies of the common law and the obvious irregularities which it presented, for it instigated what seems at first glimpse a remedy for its defects.<sup>58</sup> As a result of a direct suggestion made by the Van Wyk de Vries Commission,<sup>59</sup> the legislature developed procedure, in the form of section 266, that would permit a member of a corporation to protest wrongdoing by the controllers of a company even when such a wrong was ratifiable by the majority. If such legislation were not developed and statutorily recognised such malfeasance would go without remedy, leaving the controllers with a free hand to divert corporate assets to their own use.<sup>60</sup> According to Blackman, the chief purpose of the statutory derivative action was to overcome the disadvantages of the common law derivative action. Further, the statutory derivative action could satisfy the need to prevent frivolous and vexatious proceedings.<sup>61</sup> In essence it can be submitted that the procedure under section 266 had a principally deterrent purpose. By permitting members to invoke section 266 it served to discourage directors or officers, past or present, from engaging in misconduct by imposing a threat of liability.

The legislature, however, faced major complications in attempting to balance all rights in the process of codifying the common law derivative action.<sup>62</sup> This of course stems from the fact that on the one side of the coin, the independence of the company

---

<sup>57</sup> Pretorius (n 22 above) 382.

<sup>58</sup> Ngalwana (n 19 above) 532.

<sup>59</sup> n 10 above para 42.15.

<sup>60</sup> Griggs (n 45 above) para 2.

<sup>61</sup> M S Blackman 'Companies' in WA Joubert (ed) *LAWSA* vol 4(2) (1996) para 210 fn 2.

<sup>62</sup> HH Stoop 'The derivative action provisions in the Companies Act 71 of 2008' (2012) 129(3) *The South African Law Journal* 530.

and the deciding opinion of the majority have to be esteemed. However, on the flip side of the coin, a remedy had to be established to counter the situation where the board was unwilling to enforce the rights of the company for unlawful motives or due to the fact that the directors were the culprits.

## 2.2. Section 266 of the old Act

### 2.2.1. The availability and procedure of section 266

Section 266 made provision for the implementation of the statutory derivative action to be instituted in instances where a company had suffered damages or losses or had been deprived of any benefit by virtue of a wrong, breach of trust or breach of faith committed by any director or officer, past or present, of the company. The provision could have been instituted on behalf of the company by any member of the company where the company had not instituted any action and irrespective of whether the majority of the company had ratified or condoned any such wrong.<sup>63</sup>

As a prerequisite, however, and prior to the invocation of the section, it was required that the complainant member, through written notice, called on the company to institute such proceedings within one month of being furnished with the said notice.<sup>64</sup> In this respect, what needed to form part of the notice was somewhat ambiguous. It has been indicated, however, that the notice ‘be sufficiently specific to enable the company to know what proceedings it is being called upon to institute’.<sup>65</sup> Should the company have failed to react to the notice, the member would be entitled to apply to court for an order for the appointment of a *curator ad litem* for the company to institute action and conduct the proceedings on the company’s behalf against the transgressor.<sup>66</sup>

The court would then have to exercise a discretion. It could only appoint the *curator ad litem* through a provisional order to conduct the proceedings if it were

---

<sup>63</sup> Sec 266(1).

<sup>64</sup> Sec 266(2)(a).

<sup>65</sup> *Loeve v Loeve Building and Civil Engineering Contractors (Pty) Ltd* 1987 (2) SA 92 (D) 101.

<sup>66</sup> Sec 266(2)(b).

satisfied that; (i) the company had not instituted proceedings;<sup>67</sup> (ii) that there were *prima facie* grounds for the conduct of proceedings; and (iii) that justification was present for the investigation into the grounds and desirability of instituting such proceedings.<sup>68</sup> The court in this instance should have satisfied itself that each requirement mentioned had been met.

Significantly, the discretion of the court extended beyond that conferred in section 266(3). The court, on the return day, could either discharge the provisional order in subsection (3) or confirm the appointment of the *curator ad litem* for the company and issue such directions as to the institution of proceedings on behalf of the company by the *curator ad litem*, as it may have thought necessary.<sup>69</sup> Further, it could order that ‘any resolution ratifying or condoning the wrong, breach of trust or breach of faith or any act or omission in relation thereto shall not be of any force or effect’.<sup>70</sup>

#### 2.2.2. Problems identified under section 266

The statutory derivative action apparent under section 266 of the old Act was to some extent restrictive in its procedure and has been subject of heavy censure. The proceedings contemplated under the section were limited to that of remedying loss or deprivation suffered by the company as a result of a specific wrong, breach of trust or breach of faith committed by a director or officer, past or present, of the company.<sup>71</sup> Consequently, in situations where the cause of action fell outside of that mentioned in section 266, shareholders had to rely on the more challenging and stringent common law derivative action.<sup>72</sup> This left minority shareholders with hardly any where to turn for a right of recourse where the company encountered a wrongdoing beyond the scope of that mentioned in section 266. Further, the provision in section s266(2)(a) that required the member to demand from the company to institute the relevant proceedings,

---

<sup>67</sup> This relates to any proceedings pertaining to the conduct complained of and served to exclude the possibility of a company having to face multiple actions for the same wrong committed.

<sup>68</sup> Sec 266(3)(a) - (c). The case of *Van Zyl v Loucol (Pty) Ltd* 1985 (2) SA 680 (NC) 685 points out that the company at this stage is not required to be satisfied that probable success exists in the contemplated proceedings. See also *Brown and Others v Nanco (Pty) Ltd* 1977 (3) SA 761 (W) 764 which confirms the discretion possessed by the court.

<sup>69</sup> See n 70 below. See JA Kunst *et al Henochsberg on the Companies Act 61 of 1973* (1994) 511 where it is illustrated that this further proves the virtually unlimited discretion of the courts especially pertaining to the payment of costs incurred in appointing the *curator ad litem*.

<sup>70</sup> Sec 266(4).

<sup>71</sup> Kunst (n 69 above) 511.

<sup>72</sup> Cassim (n 7 above) 777.

prior to taking any further steps, placed an unnecessarily burdensome procedural requirement on the member.<sup>73</sup>

Additionally, the latter part of section 266(4) appeared to imply that the court could allow the application to ensue without first setting aside the purported ratification or condonation of the wrong for it stated that the ratification or condonation may have been declared void on the return day. This presented a procedural difficulty because once ratified by general meeting of the majority, it became valid and thus no court had jurisdiction to attend to a complaint unless it first dealt with the resolution by setting it aside. Ngalwana submits that it would have been more sensible if the discretion afforded to the court were extended to allow the court to set aside a resolution to ratify or condone a wrong at the provisional application phase and not on the return date.<sup>74</sup> However, there are varying opinions in respect to neutralising ratification. According to Kunst, it was necessary that the courts had the power to make such an order since the hypothesis upon which the section operated was the use by the majority of the members of their majority vote, which precluded the institution of proceedings by the company.<sup>75</sup>

Despite the array of issues apparent above, potentially the most problematic and disturbing factor of section 266 and the biggest obstacle for minority shareholders remained that of costs. Should an action have been successful and damages awarded, the damages award would accrue to the company and not the member who instituted the action on his own account. Such a member would only benefit circuitously.<sup>76</sup> The underlying purpose was to compensate the company without taking into consideration costs incurred by the member in instituting the action. Should the court have been satisfied with the requirements in section 266(3) and confirmed the appointment of the *curator ad litem* it would, in its directions, have to include a provision for the payment by the company of the *curator ad litem*. Ultimately, however, if the company were successful in opposing the proceedings, even after a *curator ad litem*'s appointment was confirmed by the court, all costs would be borne by the applicant minority

---

<sup>73</sup> Coetzee (n 1 above) 296.

<sup>74</sup> Ngalwana (n 19 above) 533.

<sup>75</sup> Kunst (n 69 above) 514(1).

<sup>76</sup> Coetzee (n 1 above) 296. See also *Brown* (n 68 above) 765 where all costs of the application were to be borne by the unsuccessful party, being the minority shareholders of the company.

member.<sup>77</sup> To my mind, the only justification of this negative impact of costs was to deter frivolous and vexatious litigation by a discontent minority. In addition to the very expensive nature associated with enforcing section 266 it also amounted to being a lengthy and complex process. In my view it is for this reason that section 266 was hardly invoked, bar a few cases.

### 2.2.3. A comparison between the common law and section 266

As a point of departure, the common law offered the derivative action whereas section 266 of the old Act advanced minority protection to that protected by statute and hence made provision for the statutory derivative action.<sup>78</sup> It is imperative to note that the statutory derivative action supplemented the derivative action under the common law instead of replacing or extinguishing it. From the evaluation of section 266 of the old Act above, it is apparent that there was a degree of overlap with the common law derivative action. This is specifically so in respect to costs. Under both the common law and section 266, it was extremely burdensome financially on a member to institute an action where the company was unwilling to do so. Upon closer evaluation, however, vital differences do surface.<sup>79</sup>

The derivative action was narrower in that it could not be implemented in cases where the company's action was against the majority of its members in general meeting. On the other hand, the statutory derivative action was wider due to the fact that it was also available against present and former directors or officers, did not require the wrongdoers to have benefitted from their actions, and superseded the significances of majority and internal management rule by rendering ineffective any resolution ratifying the wrong.<sup>80</sup> The statutory derivative action applied even if the wrongs were ratifiable, thereby obviating the necessity of distinguishing between wrongs which could be ratified and those which could not.<sup>81</sup> This was the most significant difference.

---

<sup>77</sup> In this respect see *Brown* (n 68 above), *Van Zyl* (n 68 above) and *Loeve* (n 65 above). Further, in terms of sec 268 of the old Act under certain circumstances the applicant would have to furnish security for costs including the costs of the provisional curator ad litem before a provisional order was made. If the appointment was confirmed and the company successfully opposed the proceedings, the court would direct that the costs be paid in full by the minority applicants.

<sup>78</sup> Coetzee (n 1 above) 291.

<sup>79</sup> Cilliers (n 6 above) 306.

<sup>80</sup> See Stoop (n 62 above) 533. See also Beuthin (n 33 above) 156.

<sup>81</sup> Cilliers (n 6 above) 306.

### 2.3. Conclusion

The loopholes pertinent under the common law were partially redressed through the implementation of section 266 of the old Act. The problems identified under the common law were incompletely redressed because the law pertaining to the enforcement of rights measure for the minority under section 266 was still lacking. The procedural hindrances and restrictive nature of wrongdoings that could potentially be remedied by section 266 hindered its application. By restricting wrongdoings to those mentioned in section 266, a need arose for an effective safety measure that protected the minority irrespective of the nature of the wrong committed.

It is submitted that the only sensible policy decision in respect to section 266 was that any purported ratification or condonation of the wrong did not prevent a disgruntled minority member from instituting action on behalf of the company to redress a wrong that had been committed on the company.<sup>82</sup> Therefore, the inadequate ambit of section 266 prompted the legislature to reform the statutory derivative action and further progress this area of law through the implementation of section 165 of the Act.

---

<sup>82</sup> Ngalwana (n 19 above) 533.

### 3. Chapter 3: The derivative action under section 165 of the Companies Act 71 of 2008

#### 3.1. Introduction

The new Act has made some salient additions to the statutory derivative action under the old Act and is therefore envisioned as a revolutionised statutory equivalent to its predecessors.<sup>83</sup> One commitment of the Act is to ‘balance the rights and obligations of shareholders and directors within companies’.<sup>84</sup> In an attempt to achieve this, the Act overtly excises the operation of the common law derivative action and substitutes it with the provisions contained in section 165.<sup>85</sup>

The statutory derivative action is an imperative minority enforcement of rights mechanism. It protects those in the minority from the majority and separate legal personality rule<sup>86</sup> laid down in *Foss*.<sup>87</sup> The new Act has extended the scope of the derivative action as a right of recourse. As a result, the minority are given statutory powers to institute action on behalf of the company where they are aware of a wrong that has not been remedied.<sup>88</sup> The procedure in section 165, however, extends much wider than this in that it is not only minority shareholders that are equipped with this right but also other categories of persons. Furthermore, section 165 encompasses wrongs that are not only committed internally by those in control of the company, but also those that are committed by third parties and outsiders against whom the controllers of the company refuse to act.<sup>89</sup>

---

<sup>83</sup> Stoop (n 62 above) 528.

<sup>84</sup> Sec 7(i).

<sup>85</sup> Sec 165(1). Coetzee (n 1 above) 298. See also *Gihwala v Grancy Property Ltd* 2016 ZASCA 35 para 85. However, also note Cassim (n 4 above) 498 where it is expressed that notwithstanding the abolition of the common law derivative action, the proper plaintiff principle is retained in South African law.

<sup>86</sup> Cassim (n 7 above) 776. See, however, the recent decision of *Itzikowits v ABSA Bank Limited* 2016 ZASCA 43 para 9 where Ponnann JA enunciated the cardinal importance of the separate legal personality of a company and the majority rule. Indicating that the principles remain of importance.

<sup>87</sup> n 3 above.

<sup>88</sup> Cassim (n 7 above) 776. See, however, Stoop (n 62 above) 528 where it is highlighted that it is usually the directors that are armed with the authority to institute legal proceedings on behalf of the company, making this the inherent complexity that surrounds any manifestation of a derivative action.

<sup>89</sup> MF Cassim ‘When companies are harmed by their own directors: the defects in the statutory derivative action and the cures (part 1)’ (2013) 25 *South African Mercantile Law Journal* 170.

The derivative action proceeding is now exclusively legislative and as a consequence thereof, intrinsically new jurisprudence needs to be founded to facilitate the effective functioning of the principle. Hardly any cases have been reported putting this newly formulated doctrine to the test. Yet, upon examination of the limited cases that have been reported in terms of section 165, it is clear that the common law and section 266 of the old Act will guide the new statutory derivative action in its application and will aid in its interpretation, where clarification in this respect is lacking. The substantive and procedural matters of section 165 will be examined in this chapter. Additionally, the cases that have been reported will be scrutinised so as to gain a better understanding of the trends surrounding the application of this recently formulated statutory derivative action.

### **3.2. Analysis of the procedure to be followed under section 165 of the Act**

#### **3.2.1. Standing and the demand**

Section 165 makes use of a demand process in an effort to attain an equilibrium between the autonomy of the board of directors and the shareholders' need to approach the court for protection where necessary and appropriate.<sup>90</sup> The section states that a derivative litigant 'may' serve a demand on the company to commence or continue legal proceedings, or to take related steps, to protect the legal interests of the company.<sup>91</sup> The demand required by the Act can be made by numerous stakeholders of a company. These include 'a shareholder or a person entitled to be registered as a shareholder', a director, prescribed officer and trade union representative or another representative of the employees of a company.<sup>92</sup> Furthermore, the court may grant leave to any person to serve a demand, but only if the court is satisfied that it is necessary or expedient to do

---

It is suggested by Cassim, that the controllers usually refuse to act against outsiders in an effort to protect them or because they are associated with those outsiders.

<sup>90</sup> Stoop (n 62 above) 535. Stoop further highlights that the section is phrased in such a manner 'to accommodate the enforcement of any legal rights that the company may have'.

<sup>91</sup> Sec 165(2).

<sup>92</sup> Sec 165(2)(a) - (c). This section also allows for a shareholder or person entitled to be registered as a shareholder, a director or prescribed officer of a related company to serve the demand to continue or commence legal proceedings. See *Mbethe v United Magnesium of Kalahari (Pty) Ltd* 2016 ZAGPJHC 8 para 41 that states that this can only be exercised if 'it can be established that this is to protect the legal interests of the company'.



so to protect a legal right of that other person<sup>93</sup> and quite notably not a company's legal interests. This section can consequently be used by any person to safeguard themselves in advance from any human right violations by the company.<sup>94</sup> The purpose of serving the demand is to notify the board of directors of a certain wrong that has been perpetrated on the company and to give the directors a chance to remedy the wrong. The person intent on safeguarding the company is therefore not entitled to institute action directly without first informing the board of directors. As such, it is argued that the demand process is a measure implemented to prevent the litigious floodgates from being opened.

It is contended that the use of the term 'may' when referring to the service of the demand can be criticised for its lack of certainty in terms of whether the demand process is compulsory or discretionary. Two interpretations unfold in respect to this. On the one hand, it is submitted that 'may' can be construed to mean that the party instituting proceedings has a right to elect whether or not to serve the demand.<sup>95</sup> On the other hand, it is suggested that the interests of the company that the provision seeks to protect would mean that the statutory derivative action in section 165 will be the only remedy of its kind available. As a result, the complainant would be obliged to serve a letter of demand when pursuing this form of redress.<sup>96</sup> The *Mouritzen*<sup>97</sup> case follows the latter interpretation as the court indicated that the use of the word 'may', be understood in the context that an applicant 'must' serve the demand on the company. Contrary to that followed by the *Mouritzen* case, I complement the non-peremptory nature of the use of the word 'may' primarily because of the fact that the section makes provision for exceptional circumstances in terms of which the demand may not have to be served at all.<sup>98</sup> However, should exceptional circumstances not be present, I submit

---

<sup>93</sup> Sec 165(2)(d).

<sup>94</sup> M Gwanyanya 'The South African Companies Act and the realisation of corporate human rights responsibilities' (2015) 18(1) *Potchestroom Electronic Law Journal* 3102.

<sup>95</sup> In *Mouritzen v Greystone Enterprises (Pty) Ltd* 2012 ZAKZDHC 34 para 24 the court acknowledged that the use of the word 'may' has the potential of obscuring the legislative intent to the extent that the legislature might be perceived to have intended to confer some 'degree of discretion' on the party concerned.

<sup>96</sup> Coetzee (n 1 above) 300. Stoop (n 62 above) 537 advocates for the latter interpretation by referring to the demand process as 'mandatory'.

<sup>97</sup> n 95 above, para 24.

<sup>98</sup> Sec 165(6). The sec is only applicable in exceptional circumstances with leave of the court based on guiding criteria in considering whether leave should be granted. It can be noted that although the demand, as contemplated in subsec (2), is peremptory to the operation of subsec (5), subsec (6) does away with the need to serve a demand in exceptional circumstances. I am of the opinion

that the demand be a mandatory requirement in order to give the company a chance to decide whether it will institute proceedings in its own right, as the proper plaintiff.

It is noted that the statutory derivative remedy in section 165 does not specify a particular cause of action for which the derivative action may be utilised, but stipulates a broad description of its availability to guard the ‘legal interests’ of a company. It is averred that ‘legal interests’ in the context of derivative actions, is not defined or expressly provided for in the Act. Coetzee<sup>99</sup> suggests that this might be interpreted in extremely broad terms, and it has further been submitted that it covers not only rights but may even incorporate potential rights.<sup>100</sup>

The provisions of section 165 regulate the avenues that the company may take in responding to a demand. A company, that has been served a demand, is given the opportunity to apply to court within 15 business days to set aside a demand on the basis of it being ‘frivolous, vexatious or without merit’.<sup>101</sup> If the company does not apply to court to set the demand aside or the court decides not to set the demand aside, the company must appoint an independent and impartial committee to investigate the demand.<sup>102</sup> It is then the duty of the independent person or committee to report to the board of directors of the company on any relevant circumstances that may give rise to, or which relates to, the cause of action or proceedings contemplated in the demand.<sup>103</sup> Additional matters to be considered by the individual or committee appointed include the probable cost implication and whether it ‘appears to be in the best interests of the company’ to pursue or continue such proceedings.<sup>104</sup> After being served with the demand, the company has one of two avenues it can follow. The company must within 60 business days<sup>105</sup> initiate or continue legal proceedings, or take related steps to protect the legal interests of the company, as indicated in the demand.<sup>106</sup> Alternatively, if the

---

that it was for this reason that the legislature opted for the use of the word ‘may’ when drafting subsec (2) of the Act.

<sup>99</sup> n 1 above, 298.

<sup>100</sup> PA Delpont *et al Henochsberg on the Companies Act 71 of 2008* 590.

<sup>101</sup> Sec 165(3).

<sup>102</sup> Sec 165(4)(a). In this regard see Stoop (n 62 above) 539 where it is highlighted that what is meant by ‘an independent and impartial person or committee’ is indeterminate.

<sup>103</sup> Sec 165(4)(a)(i).

<sup>104</sup> Sec 165(4)(a)(ii) and (iii).

<sup>105</sup> This is not an absolute time period that must be adhered to as sec 165(4)(b) allows the company to make an application to court for an extension of the stipulated 60-day limit.

<sup>106</sup> Sec 165(4)(b)(i).

company refuses to comply with the demand it must serve a notice on the person making the demand indicating that the company is refusing to comply with it.<sup>107</sup>

Notably, the demand process may only be avoided in exceptional circumstances by a person with the requisite standing. This is so if the court is satisfied that the delay in complying with the procedures encompassed in sections 165(3) to 165(5) may result in: irreparable harm to the company; or substantial prejudice to the interests of the applicant or another person. Further, ‘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 the requirements in section 165(5)(b) are met.<sup>108</sup>

### 3.2.2. The role of judicial discretion

The essential discretion afforded to the judiciary by the legislature is extensive and particularly ostensible in section 165(5) of the Act.<sup>109</sup> The discretion bestowed on the court is an assessment mechanism intended predominantly to strike a balance between two equivalently important principles. On one hand is the need to prevent companies and their directors from actions that are irrational on the part of the stakeholders. On the other is the benefit to pursue a right of recourse on the companies behalf in situations where the company or the controllers refuse or fail to do so.<sup>110</sup> If the company has failed to take any particular step prescribed in section 165(4); appoints an individual or committee that is not impartial or independent; or accepts an inadequate, irrational or unreasonable report, then the court may grant leave to a derivative litigant, who has followed the demand procedure, to bring or continue proceedings on the company’s behalf. Additionally, an application may be brought if the company has acted in a manner inconsistent with a reasonable report or served a notice refusing to comply with the demand.<sup>111</sup> Of importance is that these principles are disjunctive which enables an applicant to apply to bring a derivative action if any of the abovementioned

---

<sup>107</sup> Sec 165(4)(b)(ii).

<sup>108</sup> Sec 165(6). This section further reflects the discretion possessed by the court discussed below.

<sup>109</sup> MF Cassim ‘The statutory derivative action under the Companies Act 71 of 2008: guidelines for the exercise of the judicial discretion’ unpublished PhD thesis, University of Cape Town, 2014 9 correctly states that the approach 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 of the new statutory derivative action.

<sup>110</sup> MF Cassim ‘Judicial discretion in derivative actions under the Companies Act of 2008’ (2013) 130 *The South African Law Journal* 778 - 779. See also Cassim (n 109 above) 8.

<sup>111</sup> Sec 165(5)(a).

requirements are met.<sup>112</sup> However, these procedural requirements are not absolute and the courts are subject to guiding principles in applying their discretion to grant leave. The imprecise criteria of good faith, serious questions of material consequence and best interest of the company are the regulatory provisions upon which the above are to be balanced.<sup>113</sup>

### 3.2.2.1. *The Good faith criterion*<sup>114</sup>

An applicant who seeks leave to bring or continue proceedings in the name of the company needs to prove that he or she is acting in ‘good faith’. The criterion of good faith has always been a contentious principle in company law because of its imprecise ambit.<sup>115</sup> For guidance of how this principle should be interpreted, we revert to the (eradicated) common law derivative action,<sup>116</sup> other provisions in the Act relating to the component of good faith<sup>117</sup> and the explanations given by foreign jurisdictions<sup>118</sup>.

In the *Mouritzen* case, the court was tasked with the influential role of deciding whether to grant leave to institute legal proceedings in terms of section 165(5). Before the court could grant leave, the derivative litigant had to prove he was acting in good faith. The court held that the good faith requirement meant that the applicant has established good conscience for instituting a derivative action and genuinely believes in the existence of reasonable prospects of success in the proposed litigation.<sup>119</sup> This

---

<sup>112</sup> *Mbethe* (n 92 above) para 46.

<sup>113</sup> Sec 165(5)(b).

<sup>114</sup> Sec 165(5)(b)(i).

<sup>115</sup> *Stoop* (n 62 above) 545. See also *Cassim* (n 4 above) 508.

<sup>116</sup> See *Cassim* (n 4 above) 509. Under the common law, an applicant was precluded from instituting a common law derivative action founded on a collateral purpose in undertaking the action as part of a personal vengeance against the respondent, and the action was accordingly not in the best interests of the company.

<sup>117</sup> Sec 76(3) encompasses a director’s fiduciary duties. In this respect it is imperative to note the analysis made by the court in *Mouritzen* (n 95 above) para 60 where it was opined that 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” and “in the best interests of the company”’.

<sup>118</sup> The understandings of the term ‘good faith’ by foreign jurisdictions will be considered in chapter 4.

<sup>119</sup> *Mouritzen* (n 95 above) para 58. See also *Cassim* (n 4 above) 509 where it is enunciated that good faith is a subjective, not objective test, and relates to the state of mind of the applicant. *Cassim* takes this stance by relying on the premise that honesty is principally, but not exclusively the dependent upon which good faith is tested. *Cassim*, however, concedes that although honesty is subjectively determined, there are limitations to the subjective test. I, however, side with the view of *Delpport* (n 100 above) 590(4) in that ‘the belief must be honest, which is a subjective objective test’. The applicant may be disbelieved, resulting in the application being dismissed, if no reasonable person in the same circumstances will hold that belief.

indicates that there should not be a concealed motive or personal vendetta in the application for the leave of the court.

Successfully presenting good faith as an applicant is extremely important when approaching the court with an application to bring or continue proceedings on behalf of the company. It is stressed that when a person institutes such action, the focus should be aimed at protecting the legal interests of the company and not for any personal motive.<sup>120</sup> The person ought not have anything to achieve bar that his entitlements as a minority shareholder are safeguarded. However, one will still be able to establish good faith irrespective of a personal feud. In *Mouritzen*,<sup>121</sup> it was imperatively illustrated that the presence of personal hostility does not conclusively exclude good faith on the part of the applicant, but this must be considered in determining whether, on a balance of probabilities, an applicant has fulfilled the ‘good faith’ requisite.

### 3.2.2.2. *Serious questions of material consequence to the company*<sup>122</sup>

As yet, no case law exists exposing this section to judicial scrutiny. It is therefore up to the courts, when the occasion presents itself, to determine the meaning of this requirement. Until then, we rely on other interpretations in case law, albeit not in relation to derivative proceedings. It is submitted that the applicant need not prove the substantive issue, but merely illustrate that the claim is a genuine one indicating that proceedings should commence.<sup>123</sup> This provision is therefore another filtering stage of applications that are potentially frivolous, vexatious or meritless. It is a measure by which the courts determine whether the action has merit.<sup>124</sup> Traditionally, an applicant needs to prove a prima facie case before a court will entertain a dispute. However, it is suggested that trial of a serious question of material consequence may instead be a more reasonable threshold to overcome and this resonates better with the nature of the present-day derivative action.<sup>125</sup>

---

<sup>120</sup> See Stoop (n 62 above) 546 where it is submitted that good faith ‘implies that the courts will not allow claims based exclusively on personal crusades’.

<sup>121</sup> n 95 above, para 59 & 61. The court found that irrespective of the animosity between the applicant and opposing respondent, the applicant in being prepared to subject himself to the same examination as the respondent, in terms of credit card spending facilities linked to the company’s account, showed signs consistent with a person acting in ‘good faith’.

<sup>122</sup> Sec 165(5)(b)(ii).

<sup>123</sup> Delport (n 100 above) 590(5).

<sup>124</sup> Cassim (n 109 above) 43.

<sup>125</sup> Cassim (n 110 above) 781.

### 3.2.2.3. *Best interests of the company*<sup>126</sup>

In evaluating the principle of the best interests of the company, pertinent influences include the amount at risk and the possible advantage to the company. This requirement therefore allows the court the opportunity to take into account the commercial feasibility of the application to continue or commence a derivative action, despite the presence of validly sustainable legal grounds upon which the application is founded.<sup>127</sup>

In the *Mouritzen* judgment, it was held that in the majority of scenarios the obligation of the application having to be in the best interests of the company will overlap with the criterion of good faith. Where it has been found that good faith is lacking, it is probable that granting an applicant leave to commence or continue derivative proceedings will not be in the best interests of the company.<sup>128</sup> Contrary to this, Cassim argues that the overlap is actually apparent between the principle of best interests of the company and the standard that the question tried must be a serious one that has a material consequence to the company.<sup>129</sup>

### 3.2.3. The rebuttable presumption

Section 165(7) provides a rebuttable presumption that granting leave in terms of section 165(5) is not in the best interests of the company under certain circumstances. When the presumption operates, it is still possible for leave to be granted, but the applicant endures a heavier standard of proof. The applicant must present adequate evidence to refute the presumption.<sup>130</sup> The presumption relates to instances where the board, acting in good faith and without having any personal financial interest in the matter, and after informing themselves about the subject matter, is of the opinion that it is not in the best interests of the company to pursue the proceedings.<sup>131</sup> This presumption is only applicable in situations where the proceedings are being instituted by or against a third

---

<sup>126</sup> Sec 165(5)(b)(iii).

<sup>127</sup> Cassim (n 110 above) 792.

<sup>128</sup> *Mouritzen* (n 95 above) para 63.

<sup>129</sup> Cassim (n 110 above) 785 & 794 - 795 where she refers to the finding of the overlap expressed in *Mouritzen* (n 95 above) para 63 to be 'most regrettable' on the basis that the inquiry into the best interests of the company is in respect to guarding the well-being of the company notwithstanding the surrounding characteristics or factors driving the applicant.

<sup>130</sup> Cassim (n 89 above) 171.

<sup>131</sup> Sec 165(7). See Delpont (n 100 above) 590(6) where it is noted that the rebuttable presumption is referred to as 'a modified business judgment rule'. See also Cassim (n 89 above) 174 where the business judgment rule is explained as a safe haven for directors from liability for business decisions that are honest and reasonable.

party; the latter being defined as a person that is not ‘related or interrelated’ to the company.<sup>132</sup> Consequently, the courts are more likely to grant leave for derivative proceedings if a person is related or inter-related to the company.<sup>133</sup>

It is advocated that the real flaw of section 165 is the rebuttable presumption in subsections (7) and (8) which requires ‘urgent legislative amendment’.<sup>134</sup> Cassim’s reasoned analysis portrays that one of the consequences of section 165(7) is that directors may be able to benefit from the provision except in instances where the directors are in control of the company.<sup>135</sup> This implies that there is a rebuttable presumption that derivative proceedings between a company and its director would be contrary to the best interests of the company, unless the director is also in control of the company. Regrettably, this does not take into account one important aspect of the derivative action in that it is a measure classically intended on protecting the company from errant directors and it is in these circumstances that the derivative action should be ‘more (not less) accessible’.<sup>136</sup> Nonetheless, it is apparent that the main purpose of incorporating the rebuttable presumption provision in section 165 is to defend the decision made by a board or directors not to litigate.<sup>137</sup> This presumption is therefore in line with the ‘internal management rule’ in that the court will decline to interfere with the domestic affairs of a company when decisions are taken honestly and with the belief that the decision is the best one for the company.<sup>138</sup>

#### 3.2.4. Acquisition of necessary information and the limitation thereof

Section 165(9)(e) of the Act makes provision entitling a person ‘to whom leave has been granted’, upon reasonable notice to the company, to inspect any books of the company for any ‘purpose relating to the legal proceedings’. The section does not provide an applicant with a particular right of access to information prior to the court

---

<sup>132</sup> 165(8)(a). See also Stoop (n 62 above) 548.

<sup>133</sup> Cassim (n 7 above) 789.

<sup>134</sup> Cassim (n 89 above) 169 & 171. Cassim refers to subsec (7) as the ‘achilles heel’ of the new statutory derivative action.

<sup>135</sup> Cassim (n 7 above) 789.

<sup>136</sup> Cassim (n 7 as above) 789. See also Cassim (n 89 above) 180 - 181 where it is emphasised that it is strange that directors are regarded as third parties in relation to the company. This results in wrongdoing directors being inappropriately guarded by the presumption under sec 165 and creates a major quandary that could restrict the effectiveness of the derivative action when it is most required.

<sup>137</sup> Cassim (n 89 above) 173.

<sup>138</sup> *Yende* (n 26 above) para 33.



granting leave to institute proceedings and therefore remains a major hindrance for minority shareholders (or other applicants).<sup>139</sup> Lack of access to information will often stop minority shareholders in their tracks from instituting derivative actions.<sup>140</sup> Furthermore it is illustrated that the information required is frequently in the possession of the controllers and directors of the company who are often the wrongdoers<sup>141</sup> and will not give necessary information up willingly. Cassim acknowledges that the approach taken to access information reflects a disheartening ‘lacuna’ in the Act and suggests that a more equitable approach would be to allow ‘prospective’ applicants to apply to court for access to information on condition that they can show ‘proper purpose’.<sup>142</sup> It is proposed, however, that section 26 of the Act may provide a minority shareholder with an avenue to access certain information. The section provides a mechanism whereby information and specifically the company records are accessible to the any person who has a ‘beneficial interest in the company’.<sup>143</sup> This provision will not extend to other stakeholders of a company who do not qualify as having a beneficial interest in the company. Access to information for these people will therefore remain an obstacle in the pursuit of a derivative claim.

### 3.2.5. Costs

The cost implication in bringing a derivative claim is a major disadvantage to many prospective litigants who aspire to defend the rights of the company.<sup>144</sup> There is little motivation to institute action on the company’s behalf bearing in mind that the

---

<sup>139</sup> Coetzee (n 1 above) 303.

<sup>140</sup> It is submitted that during the initial preparation stages, an applicant would have to gain access to relevant information through the provisions of the Promotion of Access to Information Act 2 of 2000 and section 32 of the Constitution of the Republic of South Africa, 1996 (the Constitution). In terms of sec 32(1)(b) of the Constitution, a person has to prove that the information is required to exercise or protect any right.

<sup>141</sup> Cassim (n 7 above) 791.

<sup>142</sup> MF Cassim ‘Obstacles and barriers to the derivative action: cost orders under section 165 of the Companies Act of 2008 (part 2)’ (2014) 26 *South African Mercantile Law Journal* 242. See also Coetzee (n 1 above) 303 where it is suggested that the Legislature could have added a provision entitling an applicant a right to discovery prior to making an application to the court and therefore possessing all relevant documentation pertaining to the application and subsequent proceedings.

<sup>143</sup> Sec 1 of the Act stipulates that a beneficial interest ‘when used in relation to a company’s securities, means the right or entitlement of a person, through ownership, agreement, relationship or otherwise, alone or together with another person to- receive or participate in any distribution in respect of the company’s securities; exercise or cause to be exercised, in the ordinary course, any or all of the rights attaching to the company’s securities; or dispose or direct the disposition of the company’s securities, or any part of a distribution in respect of the securities...’

<sup>144</sup> Cassim (n 142 as above) 246.



proceeds, should the action be successful, accrue to the company.<sup>145</sup> In terms of section 165, the court may make an appropriate order determining who will be liable for the remuneration and expenses of the ‘person appointed’.<sup>146</sup> Additionally, the court is granted a discretion to make any order it considers appropriate regarding the costs of (i) the person who applied for or was granted leave; (ii) the company; or (iii) any other party to the proceedings or application.<sup>147</sup> It is hoped that this discretion is exercised effectively so that the accessibility of the section is not hindered due to the lack of financial confidence.

The repercussion of costs under section 165 can potentially be seen as a preventive feature of the mechanism. The reason behind this is that should the litigation fail, the litigious applicant will be burdened with all the costs. It therefore serves to ensure that unfounded actions are not pursued. However, it has been submitted that it may even discourage applicants with laudable complaints from instituting derivative action proceedings. It must also be remembered that in certain circumstances, a minority shareholder does not have the financial backing to pursue derivative action proceedings.<sup>148</sup> The result of is that in the majority of situations, the rights of companies are not protected against directors who are acting wrongfully towards the company. Despite this, section 165(10) states that the court has the discretion to make ‘any’ cost order that it deems applicable. This implies that the court possesses the power to sway an order for costs in the direction of the company, as the proper plaintiff, where there are justifiable grounds to do so. If the court ignores such a power, the entire statutory derivative action may dismally fail. It is however, unpredictable how the courts will exercise its powers and until certainty in this respect is portrayed through orders by the court, the minority shareholder remains at the hands of the court.<sup>149</sup>

---

<sup>145</sup> Stoop (n 62 above) 549. See also MF Cassim ‘Cost orders, obstacles and barriers to the derivative action under sec 165 of the Companies Act 71 of 2008 (part 1)’ (2014) 26 *South African Mercantile Law Journal* 1 12 where it is stipulated that shareholders will only benefit indirectly if there is an increase in the value of their shares.

<sup>146</sup> Sec 165(9)(a).

<sup>147</sup> Sec 165(10). See also sec 165(11) where an order under sec 165 may require security for costs. Cassim (n 142 above) 8 - 9 states that the possibility of a minority shareholder being inconvenienced by cost orders or having to furnish security for costs is envisioned as an extended limit on shareholder abuse.

<sup>148</sup> Cassim (n 142 above) 12 - 13.

<sup>149</sup> Cassim (n 109 above) 161.

### 3.2.6. Substitution and ratification or approval

Once the court has granted leave to institute proceedings a person may apply to court for an order that they be substituted for the person to whom leave was originally granted. Such an applicant will have to prove to the court that he or she is acting in good faith<sup>150</sup> and it is appropriate to make the order in all the circumstances.<sup>151</sup> An order substituting one person for another has the effect that the grant of leave is taken to have been made in favour of the substituting party.<sup>152</sup> Additionally, 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.<sup>153</sup>

Approval or ratification of the conduct by the shareholder of a company does not prevent a person from making a demand, applying for leave, or bringing or intervening in proceedings and likewise does not jeopardise the outcome of any application for leave, or proceedings brought or intervened. The court is, however, entitled to take the ratification or approval into account in making any judgment or order.<sup>154</sup>

Furthermore, derivative proceedings may not be discontinued, compromised or settled without the leave of the court.<sup>155</sup> This may prove as a preventative measure in instances where a company takes over derivative proceedings without having the intention to continue them where there is merit in pursuing them. Should the proceedings be discontinued by the company, without any warranted reason, the court has the discretion to refuse to grant leave to discontinue the proceedings.

### 3.3. Conclusion

It is vital to note that section 165 is far more user-friendly than its predecessor. This is because section 266 only made provision for members of the company to approach

---

<sup>150</sup> Sec 165(12)(a).

<sup>151</sup> Sec 165(12)(b).

<sup>152</sup> Sec 165(13)(a).

<sup>153</sup> Sec 165(13)(b).

<sup>154</sup> Sec 165(14).

<sup>155</sup> Sec 165(15). These are not particularly contentious sections in the Act and I therefore deem it adequate to include them as they are in the Act for the sake of completeness.

the court and failed to allow the remedy to be utilised by other stakeholders as is the case under section 165 of the Act.<sup>156</sup>

The contemporary provisions in section 165 pertaining to derivative actions is commendable. Yet, there are numerous crucial points that the Legislature neglected to address that are likely to stir confusion as the remedy gains popularity. The derivative action is predominantly a mechanism by which shareholders are able to enforce the rights of a company when the company refuses to do so. This is even the case where a ‘shareholder of a company has ratified or approved any particular conduct of the company’ and such ratification or approval does not ‘automatically prevent a derivative claim’.<sup>157</sup> It further serves as a deterrent to the board from engaging in conduct that is abusive to the corporation by allowing shareholders to litigate against directors who have acted in a wrongful manner. However, this right afforded to stakeholders needs to be balanced against the need to protect a company from frivolous, vexatious and meritless litigation. Further, there is a necessity to respect a decision made by the board not to litigate where that decision is taken with the honest belief that it is in the best interests of the company.

The court is entrusted with a wide discretion under section 165 and is assigned a critical role under the new statutory derivative action in that it serves as a protector to derivative actions under the Act.<sup>158</sup> Of vital importance is that the courts exercise this wide discretion with creative perception, taking an equitable and flexible approach. Should the courts exercise their discretion in a manner that is overly careful and uncompromising, section 165 may remain as legislation but become obsolete through inaccessibility. It will be interesting to witness what stance the courts take in this regard as this could make or break the statutory derivative action as an enforcement of rights mechanism.

The provisions that are of concern in respect to the accessibility and application of the statutory derivative action are significant. These pertain to the exact ambit of

---

<sup>156</sup> Stoop (n 62 above) 537.

<sup>157</sup> MF Cassim *The new derivative action under the Companies Act guidelines for judicial discretion* (2016) 23.

<sup>158</sup> Cassim (n 110 above) 778.

good faith, the rebuttable presumption and the provisions relating to costs. Additionally, the access to information may still deter the availability of section 165 despite the fact that a person, to whom leave has been granted, may on reasonable notice to the company inspect any books of the company for any purpose connected with the legal proceedings.<sup>159</sup> Finally, litigation is a very time consuming route to follow. Therefore, it may take a very long time for any compensation (if any) to accrue to the company and indirectly to the derivative litigant.

---

<sup>159</sup> Sec 165(9)(e).

## 4. Chapter 4: A Comparison of foreign legal principles in relation to the new statutory derivative action in South Africa

### 4.1. Introduction

Over the past decade a more aggressive stakeholder activism trend is depicted by the United States of America, Australia and the United Kingdom. Although the provisions of section 165 are unique, the new statutory derivative action employed under section 165 of the Act similarly indicates this movement.<sup>160</sup> The section draws from legislation currently in operation in Australia, New Zealand, Canada, the United States of America and the United Kingdom. A comparison is made to some of these foreign jurisdictions. Further, foreign law will be examined and deliberated where it may aid our courts to shed light on some of the potentially problematic aspects of section 165.

The deliberation of foreign principles is armored by section 5(2) of the Act which indicates that consideration will be given to the application of the incorporated rules in foreign jurisdictions, where appropriate to do so. The encouragement to contemplate foreign law is further bolstered by the provision in the Act stipulating that the purposes of the Act are to promote compliance with the Bill of Rights as provided for in the Constitution<sup>161</sup> and boost the development of the South African economy by, *inter alia*, encouraging transparency and high standards of corporate governance.<sup>162</sup> The Constitution stipulates, amongst other things, that in the interpretation of the Bill of Rights, a court, tribunal or forum ‘must consider international law’ and ‘may consider foreign law’.<sup>163</sup> This makes it apparent that a court, in interpreting or applying the requirements of the new Act, is warranted to consider the provisions in foreign law where it is pertinent to do so.

---

<sup>160</sup> C Stein & G Everingham *The new Companies Act unlocked* (2011) 369.

<sup>161</sup> See chapter 2 of the Constitution (n 140 above).

<sup>162</sup> Sec 7(a) and (b).

<sup>163</sup> Sec 39 (a) and (b) of the Constitution.

#### **4.2. Which jurisdictions impact on section 165 as a hybrid of foreign legal principles?**

The South African position seems to have been built on a combination of positive principles from certain foreign jurisdictions. The relevant elements of each jurisdiction will be examined below insofar as the constituent components of section 165 are impacted.

It is evident that section 165 of the Act is an archetypal of sections 236 and 237 of the Australian Corporations Act of 2001 which stems from section 165 of the New Zealand Companies Act of 1993. The latter is fashioned from section 239 of the Canada Business Corporations Act of 1985.<sup>164</sup> Additionally, the United States of America and the United Kingdom have influenced the development of the statutory derivative action currently in place in South Africa.

Notably, all of the jurisdictions cited revolve around the need to obtain leave from the court in order to commence proceedings derivatively.<sup>165</sup> Thus, the criteria which our courts have to consider in determining whether leave should be granted will be examined with reference to guidelines from some of the foreign jurisdictions. Furthermore, certain distinctions will be drawn to the foreign law provisions. This will serve to portray the departure that the legislature sought to implement under the South African dispensation.

It is conceded that the statutory derivative action in South Africa is based on a two phase screening gage. First an investigation into the demand needs to be conducted by an independent and impartial person or committee selected by the company and second, leave of the court has to be obtained.<sup>166</sup> It is apparent that the former requirement is based on American law which follows an approach that entails supervision of the derivative proceedings by an independent committee of directors.

---

<sup>164</sup> Mouritzen (n 95 above) para 36.

<sup>165</sup> Cassim (n 109 above) 27.

<sup>166</sup> Sec 165(4) & (5) of the Act. See in this respect Stoop (n 62 above) 533 - 543.

However, the latter requirement is evidently adopted from the jurisdictions of, *inter alia*, Australia, Canada and New Zealand.<sup>167</sup>

#### 4.2.1. Australia

Under Australian law, the court ‘must’ grant leave to an applicant to bring legal proceedings on behalf of the company if the applicant has satisfied five requirements. The requirements entail that it must be probable that the company will not bring the proceedings itself or take responsibility for them; the applicant must be acting in good faith; it must be in the best interests of the company that leave be granted; there must be a serious question to be tried; and written notice with reasons must be given to the company of the intention to apply for leave.<sup>168</sup> Notably, the only discretion afforded to the courts under Australian law is in terms of the last requirement. The court may grant leave in absence of the notice only if it appropriate to do so. In terms of the first four factors, however, the court has no discretion to grant leave if any of these requirements are not satisfied or to deny leave where all of them are.<sup>169</sup>

Similar to the Australian position, the criteria of good faith, best interests of the company and the trial of a serious question are enunciated in our law. The requirements relating to the fact that the company will not bring the proceedings and the written notice do not appear in our legislation. It can be argued, however, that the demand required by section 165 is similar to that of the written notice in the Australian equivalent. Quite distinct from the Australian position, our courts are afforded a holistic discretion, albeit based on the principles mentioned, when determining whether an applicant should be afforded leave to litigate derivatively. Nonetheless, due to the intertwined factors portrayed by the two systems, it is obviously beneficial to examine the interpretation provided of these criteria in Australian law in applying the derivative action in South Africa.

---

<sup>167</sup> Cassim (n 109 above) 28.

<sup>168</sup> Sec 237(2) (a) - (e) in part 2F.1A of the Australian Corporations Act, 2001 (‘the Australian Act’).

<sup>169</sup> Stoop (n 62 above) 515.

As mentioned above, the good faith criterion is likewise a precondition under Australian law for leave to be granted to institute a derivative action.<sup>170</sup> As such, vital guidance may be drawn from this jurisdiction in considering what this imprecise measure entails. In *Mouritzen*<sup>171</sup> the court gave its approval and actually applied the assessment of ‘good faith’ and ‘best interests of the company’ portrayed in the Australian case of *Swanson v Pratt*.<sup>172</sup> In this case it was submitted that the good faith prerequisite<sup>173</sup> is construed with reference to two interconnected aspects which in most cases, but not always, overlap. First, consideration is given to ‘whether the applicant believes that a good cause of action exists and has a reasonable prospect of success’. Second, attention is directed at ‘whether the applicant is seeking to bring the derivative suit for such a collateral purpose as would amount to an abuse of process’.<sup>174</sup> Importantly, under South African law the presence of an ulterior motive, as indicated by the latter factor, is not conclusive proof that any applicant under section 165(2) is not acting in good faith. It does, however, remain an important factor that the court must consider.<sup>175</sup>

The rebuttable presumption in section 165(7) of the Act is clearly modelled on its Australian counterpart, and the two statutory provisions are very alike.<sup>176</sup> Best interests of the company in Australian law is interpreted to mean 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’. Our Act follows similar wording to Australian law, and our courts have therefore adopted a comparable stance to this construction.<sup>177</sup> However, it is regrettable that our law did not follow its Australian counterpart in that the directors of a company are indeed regarded as related parties and are not considered as third parties to the company. This would have the result that derivative proceedings between a company and its director will not be presumed to be against the best interests of the company and consequently offer directors undue protection as under South African law.<sup>178</sup>

---

<sup>170</sup> Cassim (n 4 above) 511.

<sup>171</sup> n 95 above, para 22 - 25.

<sup>172</sup> *Swanson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313 (*Swanson v Pratt*).

<sup>173</sup> Sec 237(3)(b) of the Australian Corporations Act of 2001.

<sup>174</sup> *Mouritzen* (n 95 above) para 58 quoting the case of *Swanson v Pratt* (n 172 above) para 36 - 37.

<sup>175</sup> *Mouritzen* (n 95 as above) para 59.

<sup>176</sup> Cassim (n 156 above) 106.

<sup>177</sup> *Mouritzen* (n 95 as above) para 63.

<sup>178</sup> Cassim (n 7 above) 789.



Further, it is submitted that the criterion of serious question of material consequence under Australian law holds essential lessons for the courts in South Africa.<sup>179</sup> The Australian position has held that the applicant must provide the court with, at least, adequate evidence to enable the court to determine whether there is a serious question to be tried.<sup>180</sup> This seems to be the interpretation that is most fitting with the same requirement under our statutory derivative action and the threshold must be a low one when this criterion is applied.<sup>181</sup> Finally, it can be emphasised that section 165 further follows the Australian position in that it does not restrict the grounds upon which a derivative action may be instituted<sup>182</sup> as is evidenced by the United Kingdom approach.

#### 4.2.2. Canada

In Canada there has been a movement away from the majority rule towards a more liberal and protective stance for minority shareholders. The most dominant model of the statutory derivative action is the Canadian one, which has been the driving force behind common law countries enacting a statutory derivative action.<sup>183</sup> It is for this reason that parts of the Canadian model are explored.

It is accepted that the Canadian model also requires good faith as a precondition for the grant of leave for derivative actions.<sup>184</sup> The submission in South Africa that an applicant should be presumed to be acting in good faith unless there are objective facts and circumstances to the contrary is supported by Canadian authority.<sup>185</sup> However, it is presented that the Canadian courts in their interpretation of good faith have adopted divergent views in respect to this criterion. It is therefore accepted that the Australian model is a superior system to rely on in this respect.

---

<sup>179</sup> Cassim (n 110 above) 785 - 786.

<sup>180</sup> Cassim (n 109 above) 65.

<sup>181</sup> Cassim (n 109 as above) 72.

<sup>182</sup> Stoop (n 62 above) 535.

<sup>183</sup> Cassim (n 109 above) 27.

<sup>184</sup> Sec 239(2)(a) of the Canada Business Corporation Act of 1985 (Canadian Business Corporations Act).

<sup>185</sup> Cassim (n 109 above) 50.

It is evident that, in contrast to the South African consideration of a trial of serious question of material consequence, the Canadian provision does not contain an express threshold test, but requires that the claim appears to be ‘in the best interests of the corporation’.<sup>186</sup> Canadian law is however most useful in that it encourages a lenient approach to the standard of proof.<sup>187</sup>

Further, under South African and Australian law, it is emphasised that in determining whether leave should be granted to the applicant to litigate derivatively the court must, *inter alia*, be satisfied that it is in the best interests of the company. The Canadian approach differs from this in that it must *prima facie* appear to be in the best interests of the corporation and not that it is in the best interests of the company. This portrays a more lenient approach to the Australian and South African provision.<sup>188</sup>

Although there are differences in the manner in which the derivative action is expressed in Canada, this does not mean that the approach under Canadian law is of no use to its South African equivalent. Consideration to this jurisdiction is appropriate as it has had more practice with derivative action proceedings than South Africa and Australia.<sup>189</sup> Notably, the South African Act followed the Canadian system in that the courts are provided with a residual discretion in determining whether leave should or should not be granted to an applicant to engage in derivative proceedings,<sup>190</sup> albeit based on differing criteria. It is submitted that the South African courts can therefore look to Canadian legislation for guidance in determining how to exercise this discretion.

#### 4.2.3. United States of America (USA)

American law follows a two stage process. The initial stage requires a demand that the company institutes proceedings, and the second that the derivative action instituted by a member on behalf of the company seeks to enforce the rights of the company or redress a harm committed against the company.<sup>191</sup> The requirement of the demand

---

<sup>186</sup> Sec 239(2)(c) of the Canada Business Corporations Act.

<sup>187</sup> Cassim (n 109 above) 791.

<sup>188</sup> Cassim (n 110 above) 795.

<sup>189</sup> Cassim (n 109 above) 67.

<sup>190</sup> Cassim (n 110 above) 808 - 809.

<sup>191</sup> S Aronson *et al* ‘Shareholder derivative actions: from cradle to grave’ June 2009 <http://www.mondaq.com/pdf/clients/87654.pdf> (accessed 4 September 2016).

process under USA law is clearly comparable with the demand necessitated by section 165 of the Act. The purpose of the demand in both these jurisdictions appears to uphold the importance of the company and to protect the company from encountering litigation against its will.

A similarity between the USA and South Africa is apparent in the application of the business judgment rule applicable in both jurisdictions. The South African Act clearly portrays the business judgment rule by including a rebuttable presumption that granting leave to institute derivative proceedings is not in the best interests of the company under certain circumstances.<sup>192</sup> The provision in South Africa was clearly influenced by the business judgment rule in the USA as the USA invented this rule.<sup>193</sup> Australian law also makes provision for the business judgment rule. South Africa can therefore turn to these jurisdictions in determining how to implement the business judgment principle.

A difference is, however, portrayed in that the USA model, similar to Canadian legislation, does not directly require good faith as a precondition for leave to institute derivative proceedings. The USA does, however, make reference to good faith in the business judgment principle. This is obviously similar to the South African position in that it is an explicit requirement that the directors acted in good faith as a vital component of the business judgment rule.<sup>194</sup>

#### 4.2.4. United Kingdom (the UK)

As is apparent under section 165, the UK Act completely banished the operation of the common law.<sup>195</sup> In terms of section 260 of the United Kingdom Companies Act<sup>196</sup> a member of a company may only institute proceedings in respect of a cause of action vested in the company, and arising from an actual or proposed act or omission involving negligence, default, breach of duty or breach of trust by a director of a company.<sup>197</sup> South African law does not make reference to a specific cause of action in order to rely

---

<sup>192</sup> Stoop (n 62 above) 548.

<sup>193</sup> Cassim (n 109 above) 106.

<sup>194</sup> Sec 165(7)(c)(i).

<sup>195</sup> Sec 260(2) of the UK Act.

<sup>196</sup> United Kingdom Companies Act 2006 (the UK Act).

<sup>197</sup> Sec 260(5) of the UK Act.

on the derivative action. In South Africa the measure can be implemented in any circumstance to protect the legal interests of the company.

The UK Act allows shareholders to apply directly to court for permission to institute proceedings on behalf of the company. However, if no *prima facie* case is made out, the court must dismiss the application and may make any consequential order it considers appropriate.<sup>198</sup> It is submitted that a *prima facie* case is unsuitable in the setting of derivative actions as it may result in the merits of the case being considered at the stage where application for leave is applied for. For this reason the lighter assessment represented by the test of the trial of a serious question in South Africa is applauded.<sup>199</sup>

A further distinction that can be draw between the South African and United Kingdom approach is in respect to the ratification of the act or omission giving rise to the proceedings. Under South African law, proceedings may be instituted irrespective of whether that which gave rise to the claim has been ratified, as the court will merely sidestep ratification by the company.<sup>200</sup> However, under the UK Act, permission to continue in proceedings will be rejected if the act or omission forming the basis of the application has been ratified by the company.<sup>201</sup>

From the analysis above, it is recommended that South Africa rely to a lesser extent on the UK for guidance than the jurisdictions of Australia, the USA and Canada. This is due to the disparity between the statutory derivative action under section 165 and the UK provisions.<sup>202</sup>

---

<sup>198</sup> Sec 261(2) of the UK Act.

<sup>199</sup> Cassim (n 110 above) 781.

<sup>200</sup> Cassim (n 109 above) 140. It is emphasised that this position is also different from the position under sec 266 of the old Act in that under the old Act the court had the power to order that any condonation by the company was unenforceable.

<sup>201</sup> Sec 263(2)(a)-(c) of the UK Act.

<sup>202</sup> Cassim (n 109 above) 56.

### 4.3. Conclusion

Due to the reformation of the statutory derivative action, the interpretations and guidelines of the foreign jurisdictions mentioned prove to be a valuable aid in the interpretation and construction of the South African provision.<sup>203</sup> As such, it is imperative that our courts determine the provisions of the Act, taking into account the explanations afforded by the foreign jurisdictions, in order to ensure proper implementation under our law, especially where clarification is necessary.

An important aspect of all the jurisdictions considered, including the South African position is that each entail a screening process to prevent frivolous, vexatious and meritless proceeding, albeit in different manners. Such claims are not entertained by any of the jurisdictions. It is suggested that the measure of determining whether a claim is frivolous, vexatious or without merit has been implemented to protect a company where derivative actions are sought for the sole purpose of frustrating the company. It is hopeful that that the robust approach undertaken by the jurisdictions above will be adopted by South Africa to make it an efficient minority shareholder remedy in situations where a derivative action is appropriate. Reliance on the provisions in foreign jurisdictions is also useful in instances where our law has not been developed. A comprehensive understanding of the foreign law will therefore be of assistance to our courts as the derivative action gains popularity as an enforcement of rights mechanism.

---

<sup>203</sup> Stoop (n 62 above) 528-529.

## Conclusion

The conventional understanding of section 165 is that it is directed at protecting the private financial interests in the company of shareholders (and stakeholders).<sup>204</sup> Consequently, interested parties are provided with legal weapons that are far more effective than they previously were.

A question that arises with the implementation of section 165 is whether this statutory regime has completely abolished the rule in *Foss*.<sup>205</sup> It has been submitted that although section 165 mentions that the current statutory derivative action abolishes any right at common law, appropriately interpreted, it does not abolish the rule or any of its underlying principles.<sup>206</sup> This is in line with Cassim's reasoning that 'only the exceptions to the rule in *Foss*'<sup>207</sup> have been extinguished. The 'proper plaintiff' principle laid down in *Foss*<sup>208</sup> remains to exist as a general principle.<sup>209</sup> This is also evident from the case of *Gihwala v Grancy*<sup>210</sup> where the court afforded consideration to the rules laid down in *Foss*.<sup>211</sup> However, it was noted in this judgment that it was a curious feature of the case that the court was approached to apply a combination of rules that has been abolished by its country of origin.<sup>212</sup> The court went on to state that reliance of the rules in *Foss* were erroneous.<sup>213</sup> Consequently, section 165 drastically changes the scope, law and procedure in respect to derivative actions. As such, 'the procedural barriers and obstacles to the common law derivative action are jettisoned, as are the troublesome concepts of fraud on the minority, wrongdoer control and the ratifiability principle'<sup>214</sup>. Furthermore, section 165 differs to a dramatic extent from section 266 of the old Act. The departure taken by section 165 from its predecessors is extremely important insofar as the rights of minorities are concerned.

---

<sup>204</sup> Gwanyanya (n 94 above) 3111.

<sup>205</sup> n 3 above.

<sup>206</sup> Idensohn (n 13 above) 355.

<sup>207</sup> n 3 above. See Cassim (n 156 above) 10

<sup>208</sup> n 3 as above.

<sup>209</sup> Cassim (n 156 above) 10.

<sup>210</sup> n 85 above para 107.

<sup>211</sup> *Foss* (n 3 above).

<sup>212</sup> *Gihwala* (n 85 above) para 107.

<sup>213</sup> *Gihwala* (n 85 as above) para 116.

<sup>214</sup> Cassim (n 156 above) 1.

Although section 165 portrays a major transformation in our law relating to derivative actions it still has its downfalls especially in respect to costs and the access to information. Furthermore, what interpretations are given to certain provisions in the Act is still to be seen. As such the section is clouded by uncertainty and clarification in this respect is welcomed. Influence from other jurisdictions in transforming the derivative action procedure under South African law is also encouraged. Additionally, strict interpretation of the wording of section 165 of the Act is discouraged as giving the section stringent application will hinder its accessibility as an enforcement of rights mechanism to all that derive the right through section 165 of the Act.

As a closing remark it is submitted that the move to protect the minority was extremely necessary in South Africa. I am hopeful that minorities will be able to rely on the derivative action as a cause of action where a call to do so falls on the deaf ears of the company. Finally, it is anticipated that the courts balance the intricate processes in section 165 so that the remedy evolves into a measure that is reachable to all protected by it. The court can do so by exercising its ‘wide discretion’ in a manner that will enhance this enforcement of rights mechanism rather than stagnate it.<sup>215</sup>

---

<sup>215</sup> Cassim (n 156 above) 171.

## Bibliography

### 6.1. Legislation

#### 6.1.1. South African Legislation

Companies Act 61 of 1973.

Companies Act 71 of 2008.

Constitution of the Republic of South Africa, 1996.

Promotion of Access to Information Act 2 of 2000.

#### 6.1.2. Australian Legislation

Australian Corporations Act 2001.

#### 6.1.3. English Legislation

United Kingdom Companies Act 2006.

#### 6.1.4. New Zealand Legislation

New Zealand Companies Act of 1993.

#### 6.1.5. Canadian Legislation

Canada Business Corporation Act of 1985.

### 6.2. Case Law

#### 6.2.1. South African Cases

*Brown v Nanco (Pty) Ltd* 1976 (3) SA 832 (W).

*Gihwala v Grancy Property Ltd* 2016 ZASCA 35 (24 March 2016).

*Itzikowits v ABSA Bank Limited* 2016 ZASCA 43 (31 March 2016).

*Loeve v Loeve Building and Civil Engineering Contractors (Pty) Ltd* 1987 (2) SA 92 (D).

*Mbethe v United Magnesium of Kalahari (Pty) Ltd* 2016 ZAGPJHC 8 (11 February 2016).



*McLelland v Hulett and Others* 1992 (1) SA 456 (D).

*Mouritzen v Greystone Enterprises (Pty) Ltd* 2012 ZAKZDHC 34 (8 June 2012).

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

*TWK Agriculture Ltd v NCT Forestry Co-operative Ltd* 2006 (6) SA 20 (N).

*Van Zyl v Loucol (Pty) Ltd* 1985 (2) SA 680 (NC).

*Yende v Orlando Coal Distributors (Pty) Ltd* 1961 (3) SA 314 (W).

#### 6.2.2. English Cases

*Foss v Harbottle* (1843) Hare 461, 67 ER 189.

*Salomon v Salomon & Co Ltd* (1897) AC 22 (HL).

*Edwards v Halliwell* 1950 (2) All ER 1067.

#### 6.2.3. Australian Cases

*Swanson v R A Pratt Properties Pty Ltd* (2002) 42 ACSA 313.

### 6.3. Books

Beuthin, RC & Luiz SM *Beuthin's basic company law 3ed* (LexisNexis: South Africa 2000).

Blackman, MS *Companies* in Joubert, WA (ed) *Law of South Africa vol 4(2)* (LexisNexis: South Africa 1996).

Boyle, AJ *Minority shareholders' rights* (Cambridge University Press: United Kingdom 2002).

Cassim, FHI; Cassim, MF; Cassim, R; Jooste, R; Shev, J; Yeats *Contemporary company law 2ed* (Juta: Claremont 2012).

Cassim, MF *The new derivative action under the Companies Act guidelines for judicial discretion* (Juta: Claremont 2016).

Cilliers, HS; Benade, ML; Henning, JJ; Du Plessis, JJ; Delpont, PA; De Koker, L & Pretorius, JP *Corporate law 3ed* (Butterworths: Durban 2000).

Davis, D; Cassim, F; Geach WD & Mongalo T *Companies and other business structures in South Africa* (Oxford University Press: Cape Town 2011).

Delport, PA & Vorster, Q. Contributors: Burdette, D; Esser, I; Lombard *Henochsberg on the Companies Act 71 of 2008* (LexisNexis: Durban Service Issue 12 updated May 2016).

Kunst, JA; Delport, PA & Vorster, Q (eds) *Henochsberg on the Companies Act 61 of 1973* (LexisNexis: Durban 1994 last updated June 2011). Formerly edited by Meskin, PM.

Pretorius, JT; Delport, PA; Havenga, M & Vermaas, M *Hahlo's South African company law through the cases 6ed* (Juta: Cape Town 1999).

Stein, C & Everingham, G *The new Companies Act unlocked* (SiberInk: Cape Town 2011).

Xuereb, PG *The Rights of Shareholders* (Blackwell Scientific Publications Limited: Oxford 1989).

#### 6.3.1. Chapters in Books

Cassim, MF 'Shareholder remedies and minority protection' in Cassim, FHI; Cassim, MF; Cassim, R; Jooste, R; Shev, J; Yeats, J *Contemporary company law 2ed* (Juta: Claremont 2012).

### 6.4. Journal Articles

Cassim, MF 'Cost orders, obstacles and barriers to the derivative action under section 165 of the Companies Act 71 of 2008 (part 1)' (2014) 26 *South African Mercantile Law Journal* 1.

Cassim, MF 'Judicial discretion in derivative actions under the Companies Act of 2008' (2013) 130 *The South African Law Journal* 778.

Cassim, MF 'Obstacles and barriers to the derivative action: cost orders under section 165 of the Companies Act 71 of 2008 (part 2)' (2014) 26 *South African Mercantile Law Journal* 228.

Cassim, MF 'The statutory derivative action under the Companies Act of 2008: the role of good faith' (2013) 130 *The South African Law Journal* 496.

Cassim, MF ‘When companies are harmed by their directors: the defects in the statutory derivative action and the cures (part 1)’ (2013) 25 *South African Mercantile Law Journal* 168.

Cassim, MF ‘When companies are harmed by their directors: the defects in the statutory derivative action and the cures (part 2)’ (2013) 25 *South African Mercantile Law Journal* 301.

Coetzee, L ‘A comparative analysis of the derivative litigation proceedings under the Companies Act 61 of 1973 and the Companies Act 71 of 2008’ (2010) *Acta Juridica: Modern company law for a competitive South African* 290.

Davies, PJ ‘Derivative Actions and Foss v Harbottle’ (1981) 44 *The Modern Law Review* 202.

Griggs, L ‘The statutory derivative action: lessons that may be learnt from the past!’ (2002) 6(1) *University of Western Sydney Law review* 64.

Gwanyanya, MG ‘The South African Companies Act and the realisation of corporate human rights responsibilities’ *Potchestroom Electronic Law Journal* (2015) 18(1) 3102.

Idensohn, K ‘The fate of Foss under the Companies Act 71 of 2008’ (2012) 24 *South African Mercantile Law Journal* 355.

Ngalwana, VR ‘Majority rule and minority protection in South African company law: a reddish herring’ (1996) 113 *South African Law Journal* 527.

past!’ (2002) 6(1) *University of Western Sydney Law review* 64.

Stoop, HH ‘The derivative action provisions in the Companies Act 71 of 2008’ (2012) 129(3) *The South African Law Journal* 527.

Wedderburn, KW ‘Shareholders’ rights and the rule in *Foss v Harbottle*’ (1957) 15(2) *Cambridge Law Journal* 194.

## 6.5. Reports

The Van Wyk de Vries Commission of Enquiry into the Companies Act, Main Report RP 45/1970.

## 6.6. Dissertation and thesis

Cassim, MF ‘The statutory derivative action under the Companies Act of 2008: guidelines for the exercise of the judicial discretion’ unpublished PhD thesis, University of Cape Town, 2014.

## 6.7. Websites

S Aronson *et al* ‘Shareholder derivative actions: from cradle to grave’ June 2009  
<http://www.mondaq.com/pdf/clients/87654.pdf> (accessed 4 September 2016).