

# JUDICIAL DISCRETION IN DERIVATIVE ACTIONS UNDER THE COMPANIES ACT OF 2008

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*The judicial discretion to grant leave for a derivative action, in terms of s 165(5)(b) of the Companies Act 71 of 2008, involves a tension between two equally important policy objectives. On the one hand is the benefit of a right of redress, where a stakeholder may seek redress on the company's behalf; on the other hand is the indisputable need to protect companies and their directors from nuisance actions by stakeholders. The guiding criteria for the granting of leave attempt to draw a proper balance between these two objectives. They serve as checks and balances to curtail the abuse of the derivative action, by weeding out claims that are frivolous, vexatious or meritless. Much depends on the application by the courts of the open-textured criteria for leave to institute derivative proceedings. The legislature has left it to the courts to flesh out the interpretation, application and contours of the guiding criteria and, thereby, to determine effectively the success or failure of this remedy in South African law. This article focuses on two leading criteria, namely that the proposed action must involve the 'trial of a serious question of material consequence to the company', and that it must be 'in the best interests of the company'. Guidelines are suggested for the proper judicial approach to these preconditions for a derivative action, based on the jurisprudence developed in Australia, Canada, New Zealand and the United Kingdom, all of which have influenced the relevant provisions of the Companies Act.*

## I INTRODUCTION

The court is entrusted with a pivotal function under the new statutory derivative action and serves as the gatekeeper to derivative actions under s 165 of the Companies Act 71 of 2008 ('the Act'). The court has a vital discretion to grant or refuse permission to a minority shareholder or other suitable stakeholder to pursue derivative litigation on behalf of the company in order to redress a wrong done to the company, when those in control of it improperly refuse or fail to do so. The discretion of the court is a screening mechanism designed primarily to filter out claims that are frivolous, vexatious or meritless.

There are five statutory prerequisites, all of which must be satisfied for the court to grant leave for a derivative action. First, a minority shareholder or other applicant with standing,<sup>1</sup> who knows of a wrong done to the company and who seeks to have it rectified, must have served a demand on the

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<sup>1</sup> Standing is regulated by s 165(2) of the Act. In this regard, those who have standing are a registered shareholder or a person entitled to be registered as a shareholder of the company or a related company, a director or prescribed officer of the company or a related company, a registered trade union representing employees of the company or another employee representative, or a person who has been

company requiring it to commence or continue legal proceedings to protect its own legal interests.<sup>2</sup> Secondly, the company must have served a notice refusing to comply with the demand; alternatively, the company must have failed to have complied at all or failed to have complied properly with its obligations relating to the investigation of the demand and its response to the demand.<sup>3</sup> The remaining three requirements for the court to grant leave to bring or continue derivative proceedings are that the court must be satisfied, under s 165(5)(b), that the applicant is acting in good faith; that the proceedings involve the trial of a serious question of material consequence to the company; and that it is in the best interests of the company that the applicant be granted leave. Notably, ratification or approval by shareholders of any particular wrongdoing is not fatal to a derivative action, although the court may take it into account.<sup>4</sup> If these criteria are satisfied, the court ‘may’ grant leave; in other words, the court retains a discretion to refuse leave even if all these criteria are met. Conversely, in order for the court to grant leave, all five criteria must be met.<sup>5</sup> Once an applicant has been granted leave, he or she is then in a position to commence or continue the derivative action on behalf of the company.

The court is thus bound to exercise its discretion with reference to the three vague and general guiding criteria set out in s 165(5)(b). Instead of rigid and detailed technical legal requirements, the legislature has enacted guiding criteria that are general and open-textured, and has left it to the courts to flesh out the details and the practical application of these criteria. Consequently, the judiciary has a dominant and a decisive role in deciding the fate of the statutory derivative action. The approach that the courts adopt in interpreting the guiding criteria will have a major impact on the success or failure of the new statutory derivative action in South African law. A wide, flexible and robust approach ought to be favoured by the courts, as opposed to a restrictive or narrow one that would stifle a very useful and instrumental remedy of minority shareholders.

The three central guiding criteria for leave (under s 165(5)(b)) are designed to serve as checks and balances to curtail the abuse of the derivative action by minority shareholders and other applicants, and to weed out nuisance claims. The judicial discretion to grant leave for derivative proceedings entails a tension between two equally important policy objectives, which must be balanced against each other. On the one hand is the benefit of a right of redress, where a stakeholder may seek redress on the company’s behalf if the company or those in control of it improperly fail or refuse to do so, and on

granted standing by the court has standing under s 165(2) to seek the leave of the court to pursue a derivative action on behalf of the company.

<sup>2</sup> The requirement of a demand may be waived in exceptional circumstances, in terms of s 165(6).

<sup>3</sup> As set out in s 165(5)(a).

<sup>4</sup> Section 165(14).

<sup>5</sup> In this regard s 165(5) states that the court ‘may’ grant leave ‘only if’ these criteria are satisfied.

the other hand is the indisputable need to protect companies and their directors from nuisance actions by stakeholders. The friction between these two opposing policies is an underlying theme of s 165, which will influence its practical application. The three leave criteria in s 165(5)(b) are intended to lay the foundation for a proper balance to be drawn between these conflicting principles. But the achievement of a steady equilibrium turns ultimately on the proper application by the courts of the open-textured preconditions for leave.

This article focuses on two leading guiding criteria with which the court must be satisfied, namely, that the proposed action must involve the 'trial of a serious question of material consequence to the company' and that it must be 'in the best interests of the company' to grant leave.<sup>6</sup> With reference to underlying principles in South African law, and the jurisprudence developed by the courts in comparable jurisdictions, particularly Australia, Canada, New Zealand and the United Kingdom, guidelines will be suggested for the proper judicial approach to these preconditions for a derivative action. It must be borne in mind that s 5(2) of the Act specifically provides that a court interpreting or applying the Act may, to the extent appropriate, consider foreign law.

## II A TRIAL OF A SERIOUS QUESTION OF MATERIAL CONSEQUENCE

### (a) *Anchoring policies and purposes*

Leave may be granted to an applicant for derivative litigation only if the court is satisfied that the proposed proceedings or the continuing proceedings involve the trial of a serious question of material consequence to the company (s 165(5)(b)(ii)). The exact interpretation of the requirement of a 'trial of a serious question' is a matter that falls to be decided by the courts and it remains to be seen what meaning the courts will attach to the concept. This precondition for leave is a threshold test, which concerns the evidence that the applicant must establish in support of his claim.

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

To elaborate, from the perspective of the company, a derivative action may have an adverse impact on the conduct of its business. Not only are legal costs incurred, but in addition a legal action would divert the time and distract the attention of the management and employees of the company,

<sup>6</sup> For a discussion of the criterion of 'good faith' see Maleka Femida Cassim 'The statutory derivative action under the Companies Act of 2008: The role of good faith' (2013) 130 *SALJ* 496.

thereby disrupting its business. It could also potentially damage the company's image or reputation. There is the possibility of adverse costs orders if the litigation is unsuccessful. The courts must consequently require some demonstration that the claim has merit.

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

Similar trends may be gleaned from the (now-abolished) common-law derivative action and the previous statutory derivative action under the Companies Act 61 of 1973. In terms of s 266 of the Companies Act 61 of 1973, a member (or shareholder) at the initial stage of a statutory derivative action, when applying for a court order to appoint a provisional curator ad litem, was required to show that there were prima facie grounds for the proceedings. The court in *Van Zyl v Loucol (Pty) Ltd*<sup>7</sup> and *Thurgood v Dirk Kruger Traders (Pty) Ltd*<sup>8</sup> explicitly recognised the fundamental need for a court, in exercising its discretion, to prevent frivolous and vexatious applications.<sup>9</sup>

As an essential aspect in creating a satisfactory balance between the two policies discussed above — the test of a serious question to be tried or 'the trial of a serious question' — is a welcome and commendable improvement in the Act. It is not the same as the standard of a prima facie case,<sup>10</sup> but may instead be a lower and a more lenient threshold to surmount. A prima facie test<sup>11</sup> is inappropriate in the context of the derivative action, as it carries the risk that the merits of the action may be assessed or tried at the stage of the application for leave to institute the derivative action. A lighter standard of proof, as represented by the test of a serious question to be tried, resonates better with the nature and the purpose of the derivative action.

<sup>7</sup> 1985 (2) SA 680 (NC) at 685.

<sup>8</sup> 1990 (2) SA 44 (E).

<sup>9</sup> In *Brown v Nanco (Pty) Ltd* 1976 (3) SA 832 (W) at 835 and *Thurgood v Dirk Kruger Traders (Pty) Ltd* supra note 8 it was held that in the context of the statutory derivative action, the prima facie test at the initial stage did not necessitate proof of a probability of success.

<sup>10</sup> *Beecham Group Ltd v B-M Group (Pty) Ltd* 1977 (1) SA 50 (T).

<sup>11</sup> See the approach to the degree of proof formulated in *Webster v Mitchell* 1948 (1) SA 1186 (W) at 1189, as subsequently qualified by the Cape Provincial Division in *Gool v Minister of Justice* 1955 (2) SA 682 (C); see also *Beecham Group v B-M Group (Pty) Ltd* supra note 10 at 55A–G.

In this regard the statutory derivative action is a paramount protective measure which enables a minority shareholder, who knows of a wrong inflicted on the company that has remained unremedied by management (often because they are the wrongdoers), to institute legal proceedings on behalf of the company. The derivative action is directed not only at enabling a minority shareholder (or other qualified applicant) to obtain compensation for the company from errant directors and others who injure it, but is aimed also at the deterrence of future misconduct by directors.<sup>12</sup> The potential for shareholders to play a valuable role in promoting good corporate governance in South African law could be realised by giving the remedy a full life as an effective tool by which shareholders may monitor corporate misconduct and hold corporate management accountable, particularly in the light of the increasing global emphasis on minority shareholder protection in corporate governance. Without effective mechanisms to enforce the fiduciary and statutory duties of directors and prescribed officers, directors would be immune from legal control and accountability.

In the light of these vital objects of the derivative action, the test of ‘the trial of a serious question’ is a laudable improvement in the legislation. In interpreting this test, the courts should, however, not impose unnecessary restrictions on the availability of the remedy. For the new statutory derivative action to play a useful role as a watchdog in policing boards of directors, it must be given teeth by the courts by means of a liberal and robust interpretation of the guiding criteria for leave.

(b) *Meaning of ‘trial of a serious question’ in South African law*

The key question is what the benchmark should be for the merits or the standard of proof before the court may grant leave for a derivative action. The test of a ‘serious question to be tried’ has been used in several South African cases on constitutional matters arising under the interim Constitution<sup>13</sup> to determine whether interim relief should be granted.<sup>14</sup> To satisfy the test of a ‘serious question to be tried’, according to the judgment of Heher J in *Ferreira v Levin*<sup>15</sup> (relying on the decision of the House of Lords in *American*

<sup>12</sup> See for example the decision of the Ontario Court of Appeal in *Richardson Greenshields of Canada Ltd v Kalmacoff* [1995] BLR (2d) 197 (CA) at 205; the USA case of *Diamond v Oreamuno* 24 NY 2d 494, 248 NE 2d 910, 301 NYS 2d 78 (1969); J C Coffee ‘New myths and old realities: The American Law Institute faces the derivative action’ (1992–1993) 48 *The Business Lawyer* 1407 at 1428–9.

<sup>13</sup> The Interim Constitution of the Republic of South Africa Act 200 of 1993, prior to its amendment by the Constitutional Court Complementary Act 13 of 1996 (s 16).

<sup>14</sup> See for example *Ferreira v Levin*; *Vryenhoek v Powell* 1995 (2) SA 813 (W) per Heher J; *Reitzer Pharmaceuticals (Pty) Ltd v Registrar of Medicines* 1998 (4) SA 660 (T). However, other decisions approached interim interdicts in constitutional matters using the traditional approach that the applicant must show a prima facie right to the relief sought. See also *Beecham Group Ltd v B-M Group (Pty) Ltd* supra note 10.

<sup>15</sup> Supra note 14.

*Cyanamid Co v Ethicon Ltd*<sup>16</sup>), the applicant must establish that his or her claim is neither frivolous nor vexatious; that is to say, that there is a serious question to be tried.<sup>17</sup> The approach in the *American Cyanamid* case, as originally articulated by Lord Diplock, is that '[t]he court no doubt must be satisfied that the claim is not frivolous or vexatious; in other words, that there is a serious question to be tried'.<sup>18</sup>

This is plainly relevant to the interpretation of the phrase 'the trial of a serious question of material consequence to the company' in the context of s 165(5)(b)(ii) of the Act, notwithstanding the fact that the application for leave to institute a derivative action under s 165 is a final application and not an interim one.

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

'It is no part of the court's function at this stage of the litigation to try to resolve conflicts of evidence on affidavit as to facts on which the claims of either party may ultimately depend nor to decide difficult questions of law which call for detailed argument and mature considerations. These are matters to be dealt with at the trial.'<sup>19</sup>

After referring to *American Cyanamid Co v Ethicon Ltd*,<sup>20</sup> the South African court in *Nchabeleng v Phasha*<sup>21</sup> similarly proclaimed that the test of a serious question to be tried 'will usually free the court considering such an application from trying to decide difficult factual issues on affidavit and having to go a long way towards pre-judging issues which are best left to the trial of the matter'.

The test of a serious question to be tried is manifestly not the same as the standard of a prima facie case.<sup>22</sup> It is more favourable and better suited to the statutory derivative action than the prima facie test. The criterion of a serious question to be tried avoids the danger inherent in the prima facie standard that the merits of the action could be assessed or tried at the stage of the leave application, and a heavier burden of proof could be imposed on the applicant. As the court candidly stated in *Hurley v BGH Nominees (Pty) Ltd*,<sup>23</sup> 'in many cases a hearing to determine whether there was a prima facie case would be almost as long as a full trial and a good deal less satisfactory'. In contrast, the modern criterion of 'the trial of a serious question' is in keeping with the policy principle that leave applications for derivative actions should

<sup>16</sup> [1975] AC 396; [1975] 1 All ER 504 (HL).

<sup>17</sup> See also *Chief Nchabeleng v Chief Phasha* 1998 (3) SA 578 (LCC), per Dodson J; *Beecham Group Ltd v B-M Group (Pty) Ltd* supra note 10.

<sup>18</sup> *American Cyanamid* supra note 16 at 510C-F.

<sup>19</sup> *Ibid.*

<sup>20</sup> *Ibid.*

<sup>21</sup> *Supra* note 17.

<sup>22</sup> *Beecham Group Ltd v B-M Group (Pty) Ltd* supra note 10.

<sup>23</sup> (1982) 1 ACLC 387 at 394.

be relatively simple, short and inexpensive. It promotes the underpinning policy that an application for leave to bring derivative proceedings should not be turned into a trial of the substantive issues without the applicant having had the benefit of discovery.

The enactment of a lower threshold test on the merits in terms of the Act is thus a commendable and welcome step by the legislature. It would, nonetheless, be preferable had the legislature adhered to the familiar phrase of a 'serious question to be tried', as opposed to the 'the trial of a serious question', in s 165 of the Act — although there seems to be little difference in meaning between the two formulations, the adherence to the more familiar formulation would have removed any room for lingering doubt about whether there is a difference in the standard or the threshold of the two descriptions of the tests. It is to be hoped that the courts in applying this test, will avoid becoming enmeshed in detailed investigations into the merits at the stage of the application for leave. But by the same token, it is crucial that the courts do not permit s 165 to be used by minority shareholders and other applicants to conduct fishing expeditions. Rather than broad or bare allegations or mere suspicions of liability, an applicant should be required to make specific allegations of wrongdoing and ought to be able to identify the legal rights that are in issue. Bearing in mind the potentially adverse effects of a derivative action on the company and its directors, an applicant should be able to particularise his or her claim or allegations, supported by sufficient documentary evidence and material, to satisfy the court that the claim is viable and that there is indeed a serious question to be tried.

In practice this may present a stumbling block for prospective applicants. A minority shareholder or other applicant would only be able to make specific allegations and show that the claim has some merit if he or she has access to the relevant information. But this information is usually in the hands of the controllers of the company who, in the vast majority of derivative claims, are also the alleged wrongdoers. Access to information is not particularly problematic in owner-managed companies, where minority shareholders also have access to the relevant company information in their capacity as directors, but it is the dilemma or pitfall in larger companies where, due to the split between ownership and control, shareholders do not have ready access to information, books, records and documents of the company. The hurdle of access to information remains one of the greatest predicaments in leave applications for derivative proceedings. Although a person to whom leave has been granted has the right under s 165(9)(e) of the Act to inspect any books of the company for any purpose connected with the derivative litigation, this right applies only to successful applicants who have already been granted leave by the court — this right will be of no use to an applicant in preparing his or her application for leave. It may be open to the applicant, if it is



applicable in the particular circumstances, to make a request for information by relying on the Promotion of Access of Information Act 2 of 2000.<sup>24</sup>

As I have already indicated, the requirement in s 165(5)(b)(ii) is that the proposed derivative proceedings must involve ‘the trial of a serious question of material consequence to the company’. Regarding the phrase ‘of material consequence to the company’, the word ‘material’, when used as an adjective, is unhelpfully defined in the Act as ‘significant in the circumstances of a particular matter, to a degree that is of consequence in determining the matter, or might reasonably affect a person’s judgment or decision-making in the matter’.<sup>25</sup> The requirement that the issue must be of ‘material consequence to the company’ would serve to block superfluous derivative actions such as proposed claims for the recovery of trifling, negligible or nominal amounts, or claims brought to abash or disparage directors and prescribed officers who have made imprudent, yet honest, decisions that have caused little harm to the company.

There is a significant degree of overlap between the requirement that the question must be of ‘material consequence to the company’, and the third guiding criterion in s 165 — that the grant of leave must be ‘in the best interests of the company’ (in terms of s 165(5)(b)(iii)). In assessing the criterion of the best interests of the company, relevant factors include the amount at stake and the potential benefit to the company, as I will discuss further below. These considerations are best grappled with in considering whether the grant of leave under s 165 is in the best interests of the company.

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

(c) *Guidelines from Australia, Canada and New Zealand*

When courts have to consider applications for leave for derivative actions, and particularly when they have to assess the threshold test that the proceedings must involve the trial of a serious question of material consequence to the company, the courts would benefit from resorting to the decisions of the Australian courts for constructive guidelines. The Canadian and New

<sup>24</sup> See *Davis v Clutchco (Pty) Ltd* 2004 (1) SA 75 (C).

<sup>25</sup> Section 1.



Zealand decisions are also instructive to some extent. The submissions made above about the anchoring purposes and the interpretation in South African law of the statutory threshold test on the merits (as represented by the test of a 'serious question to be tried') are buttressed by legal authority in these comparable jurisdictions.

The South African Act has evidently adopted the Australian approach to the standard of proof. The Australian Corporations Act<sup>26</sup> similarly requires an applicant to satisfy the court that there is a serious question to be tried before leave will be granted for the institution of derivative proceedings on the company's behalf. The Australian jurisprudence holds valuable lessons for the South African courts on the benchmark level for the assessment of the merits of the claim, especially in view of s 5(2) of the Act, which enables a court in interpreting or applying the Act to consider foreign law. The criterion of a serious question to be tried is construed in Australian law as simply requiring the applicant to show that proceedings should be commenced, as opposed to the applicant actually having to prove the substantive issues (for instance, a breach by directors of their duties to the company). As such, this criterion is intended to prevent abuse of the derivative action by frivolous or vexatious claims.<sup>27</sup> The test of a serious question to be tried is a low-threshold test in Australian law.<sup>28</sup> It is similar to the well-known test used in that jurisdiction for interlocutory (interim) injunction applications, according to the leading case of *Swansson v Pratt*.<sup>29</sup> Although it does call for some consideration of the merits of the case, the courts ardently avoid turning this into a mini-trial of the issues, and consequently do not examine the merits of the proposed derivative action in any great depth. Significantly, cross-examination of the merits has been allowed, but only with the leave of the court and then too, only to a limited extent.<sup>30</sup>

Regarding the degree of specificity of the applicant's allegations, *Ragless v IPA Holdings Pty Ltd (in liq)*<sup>31</sup> laid down that the applicant must establish that there is a real question to be tried; that is to say, he or she must be able to specify the legal rights to be determined at the trial. An applicant must show that there is a serious question to be tried with reference to the infringement of some legal right or the commission of some legal wrong.<sup>32</sup>

<sup>26</sup> Australian Corporations Act, 2001, s 236(2)(d).

<sup>27</sup> *Explanatory Memorandum to the Corporate Law Economic Reform Programme Bill, 1998* (1998) para 6.46.

<sup>28</sup> *Swansson v R A Pratt Properties Pty Ltd* (2002) 42 ACSR 313 para 25; see also *Carpenter v Pioneer Park Pty Limited (in liq)* [2004] NSWSC 1007; *Maher v Honeysett & Maher Electrical Contractors Pty Ltd* [2005] NSWSC 859 para 19.

<sup>29</sup> *Supra* note 28.

<sup>30</sup> *Swansson v Pratt* *ibid* para 25; *Maher v Honeysett* *supra* note 28 para 19; see for example *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* [2001] QSC 324.

<sup>31</sup> (2008) 65 ACSR 700 at para 40.

<sup>32</sup> *Goozee v Graphic World Group Holdings Pty Limited* [2002] NSWSC 640; *Ragless v IPA Holdings Pty Ltd (in liq)* *supra* note 31.

It has been held in Australian law that the applicant must at least provide the court with sufficient evidence and material to enable it to determine whether there is a serious question to be tried.<sup>33</sup> This could, for instance, be a comprehensive legal opinion on the merits of the action, incorporating an analysis of the documentary evidence and the applicable legal principles.<sup>34</sup> The approach of the Australian courts suggests that a reasonable body of reliable evidence is required to convince the court that the proposed action is viable,<sup>35</sup> or that it appears ‘to have a solid foundation in terms of giving rise to a serious dispute’,<sup>36</sup> although the merits of the action will not be canvassed in any great detail.<sup>37</sup> The Australian approach is plainly in harmony with the submissions made above about the appropriate interpretation in South African law of the criterion of the trial of a serious question (in terms of s 165(5)(b)(ii) of the Act). Moreover, the Australian law yields useful lessons for the practical application of the test, which the South African courts would do well to use as a springboard for the implementation of our Act.

Similar trends may be gleaned from a consideration of the legal position in New Zealand and Canada. The threshold tests for the grant of leave in the New Zealand and Canadian legislation are framed quite differently to those in South African and Australian law. Yet despite the differences in the legislative wording, conspicuously similar trends may be found in the judicial expositions and approaches to the various threshold tests in all these Commonwealth models of the statutory derivative action. This is perhaps unsurprising, given the shared history of the statutory derivative action in these jurisdictions. In this regard the influential Canadian model served as the fountainhead for the statutory derivative action in New Zealand, Australia and other jurisdictions, and is apparently also the wellspring of the modernised South African statutory derivative action. A cursory survey of the judicial experience and guiding principles in Canada and New Zealand is apposite. These jurisdictions have had more experience with the statutory derivative action than Australia, which only introduced its statutory derivative action just over a decade ago.

In New Zealand the relevant statutory criterion is ‘the likelihood of success’. The New Zealand legislation states<sup>38</sup> that the court shall have regard to the ‘likelihood of the proceedings succeeding’. Unlike South African law, this is not a firm precondition for the grant of leave for a derivative action, but is merely a factor that the court must consider. The test of ‘the likelihood of success’ at first blush appears to impose a higher threshold or standard of

<sup>33</sup> *Charlton v Baber* [2003] NSWSC 745; see also *Maher v Honeysett* supra note 28 para 19.

<sup>34</sup> *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 28.

<sup>35</sup> *Herbert v Redemption Investments Ltd* [2002] QSC 340.

<sup>36</sup> *BL & GY International Co Ltd v Hypec Electronics Pty Ltd* [2001] NSWSC 705 para 75.

<sup>37</sup> *Charlton v Baber* supra note 33; *Chapman v E-Sports Club Worldwide Ltd* (2000) ACSR 462; *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 28.

<sup>38</sup> New Zealand Companies Act, 1993, s 165(2)(a).

proof than the South African (and Australian) test of a serious question to be tried. However, in the application of this test, the New Zealand courts have effectively liberalised and lowered the threshold. This was settled in *Vrij v Boyle*,<sup>39</sup> the first New Zealand case on the statutory derivative action.

The court in *Vrij v Boyle*, in adopting the test laid down in the English case *Smith v Croft*,<sup>40</sup> did not consider the ultimate merits of the case. Instead it proclaimed clearly that it was not for the court to conduct an interim trial on the merits.<sup>41</sup> The importance of avoiding a full assessment of the merits of the claim and of the supporting evidence at the stage of the leave application has received equal recognition in later cases — for instance, *Techflow (NZ) Ltd v Techflow Pty Ltd*<sup>42</sup> and *Needham v EBT Worldwide Ltd*.<sup>43</sup>

In assessing the ‘likelihood of the proceedings succeeding’, *Vrij v Boyle* declared that ‘[t]he appropriate test is that which would be exercised by a prudent business person in the conduct of his or her own affairs when deciding to bring a claim’.<sup>44</sup> Although the test of a ‘prudent business person’, purely on its wording, appears to signal a conservative and rigorous approach, the test when actually applied in *Vrij v Boyle*, and subsequently by the New Zealand courts, involves a lighter standard of proof and a much lower threshold than a prudent business person might employ.<sup>45</sup> In this regard Fisher J in *Vrij v Boyle* focused chiefly on the legal and evidential basis of the claim in assessing the likelihood of success by means of the prudent business person test, and accepted that leave would be granted if there was sufficient evidence that ‘might be thought to take the claim some distance’.<sup>46</sup> As Fitzsimons contends,<sup>47</sup> this is an even less rigorous test than ‘an arguable case’ or a test of ‘reasonable prospects’. Subsequent New Zealand cases, including *MacFarlane v Barlow*<sup>48</sup> and *Techflow*,<sup>49</sup> have adopted the approach laid down in *Vrij v Boyle*. Accordingly, the threshold test in New Zealand law is a fairly liberal standard and, as such, is broadly in tandem with the low standard of proof that is likely to be required by the South African and Australian test of a ‘serious question to be tried’.

Regarding the particularisation of the claim, the New Zealand courts, like the Australian courts, require the applicant at the time of the leave application to be able to particularise his or her claims adequately and to provide

<sup>39</sup> [1995] 3 NZLR 763.

<sup>40</sup> [1986] 1 WLR 580.

<sup>41</sup> *Supra* note 39 at 765.

<sup>42</sup> (1996) 7 NZCLC 261, 138.

<sup>43</sup> (2006) 3 NZCCLR 24 (HC).

<sup>44</sup> *Supra* note 39 at 765. The court stated further that ‘[t]his decision must take account of matters such as the amount at stake, the apparent strength of the claim, the likely costs and the prospect of executing any judgment’ (at 765).

<sup>45</sup> Peter Fitzsimons ‘The Companies Act 1993: A new approach to shareholder litigation in New Zealand’ (1997) 18 *Company Lawyer* 306 at 308.

<sup>46</sup> *Supra* note 39 at 766.

<sup>47</sup> *Op cit* note 45 at 311.

<sup>48</sup> (1997) 8 NZCLC 261, 470.

<sup>49</sup> *Supra* note 42.

sufficient evidence to enable the court to assess in a general manner the credibility of the allegations made.<sup>50</sup> An applicant may not simply state that the discovery process is likely to yield the necessary evidence.

Turning to the legal position in Canada, the Canadian legislation — in marked contrast with the South African, Australian and New Zealand legislation — does not contain an express threshold test. Instead, the Canadian judiciary simply uses the criterion that the claim must appear to be ‘in the interests of the corporation’<sup>51</sup> to assess the strength of the case and to conduct a preliminary review of the merits of the proposed derivative action. The criterion of the best interests of the company, in South African law, is a separate and distinct precondition from that of a serious question to be tried, both of which must be independently fulfilled in order for the court to grant leave for a derivative action.

Canadian legislation in general requires merely that ‘the court is satisfied that it *appears* to be in the interests of the corporation’ (emphasis added) that the action be brought. This is the case, for instance, under both the Canada Business Corporations Act and Ontario Business Corporations Act.<sup>52</sup> However the statutes of some Canadian provinces<sup>53</sup> differ and provide that it must appear ‘prima facie’ to be in the corporation’s interests. Despite these differences in legislative wording among the various Canadian statutes, the courts in evaluating the strength of the case do not generally require an applicant to make out a prima facie case, but only an arguable case that is not bound to fail.<sup>54</sup> This may be contrasted with Canadian injunction proceedings, in which an applicant must show a prima facie case on the merits. In other words, injunction proceedings involve a higher threshold on the merits than derivative proceedings.

The Canadian threshold test for derivative proceedings — the test of an arguable case that is not bound to fail — is also described in some cases as an arguable case<sup>55</sup> with reasonable prospects of success.<sup>56</sup> The ‘reasonable prospects’ aspect of the test may at first blush be misleading, in that it may be more stringently construed to mean that the proposed action must have a reasonable chance of success (as occurred for instance in *Intercontinental Precious Metals v Cooke*,<sup>57</sup> where the court imposed a higher burden of proof

<sup>50</sup> *Rasheen v People & Project Solutions Ltd HC Christchurch* unreported decision CIV-2003-409-2877, 4 March 2004.

<sup>51</sup> Canada Business Corporations Act, RSC 1985 c C-44, s 239(2)(c); Ontario Business Corporations Act RSO 1990, c B16, s 246(2)(c).

<sup>52</sup> *Ibid.*

<sup>53</sup> Such as the previous British Columbia Company Act, RSBC 1996, c 62, s 201(3)(c). But this has now been changed by the more recent Business Corporations Act RSBC 2002, c 57, s 232.

<sup>54</sup> *Re Northwest Forest Products Ltd* [1975] 4 WWR 724 (BCSC); *Primex Investments Ltd v Northwest Sports Enterprises Ltd* [1995] 13 BCLR (3d) 300 (SC).

<sup>55</sup> *Re Bellman and Western Approaches Ltd* (1981) 33 BCLR 45 (BCCA).

<sup>56</sup> *Re Bellman and Western Approaches Ltd* *ibid.*; *Title Estate v Harris* (1990) 67 DLR (4th) 619 (Ont HC); *Re Marc-Jay Investments Inc & Levy* (1974) 5 OR (2d) 235 (HCJ).

<sup>57</sup> (1994) 10 BLR (2d) 203.

on the complainant by requiring proof of ‘a reasonable prospect of success’; and in *Re MacRae and Daon Development Corp*<sup>58</sup>). The Canadian courts have subsequently clarified the test. The court in *Primex Investments Ltd v Northwest Sports Enterprises Ltd*,<sup>59</sup> proclaimed, quoting with approval the leading case *Re Marc-Jay Investments Inc & Levy*,<sup>60</sup> that the court does not attempt to try the case, but rather to evaluate ‘whether the proposed action has a reasonable prospect for success or is bound to fail’. Significantly, the court qualified this statement in the following way: ‘It is not necessary for the applicant to show that the action will be more likely to succeed than not.’<sup>61</sup> The judicial approach is accordingly not to try the action but to conduct a preliminary review of the merits only insofar as necessary to avoid a proposed action that is ‘frivolous or vexatious or is bound to be unsuccessful’.<sup>62</sup>

The courts require applicants to adduce sufficient evidence which ‘on the face of it’ discloses that it is in the interest of the company to pursue the action.<sup>63</sup> The real issue is whether it is prima facie in the interests of the company that the action be brought — it does not require that the applicants prove a prima facie case.<sup>64</sup> This is an important distinction that needs to be emphasised.

Canadian courts may thus take into account the apparent merits of the claim, although the court may not decide the merits at the stage of the application for leave.<sup>65</sup> The function of the court at this stage is not to try the case, for it should not be a mini-trial or a trial within a trial.

With regard to the degree of specificity of the applicant’s allegations, it has been held that a mere suspicion of detriment to the company,<sup>66</sup> or a loose or generalised allegation of liability will not suffice to obtain leave for a derivative action in Canadian law. The pleadings must clearly stipulate some interest of the company that is in issue.<sup>67</sup> Specific allegations of wrongdoing must be made and sufficient evidence must be disclosed to satisfy the court that the claim has merit.<sup>68</sup> Judges require some affirmative evidence that the corporation’s legal rights have been violated.<sup>69</sup> The Canadian standard of proof for the grant of leave for derivative proceedings and the underpinning principles espoused by the courts thus broadly parallel the approach proposed

<sup>58</sup> (1984) 54 BCLR 235 (SC of BC).

<sup>59</sup> *Supra* note 54 paras 39–41.

<sup>60</sup> *Supra* note 56.

<sup>61</sup> *Primex Investments Ltd v Northwest Sports Enterprises Ltd* *supra* note 54 paras 39–41, quoting with approval *Re Marc-Jay Investments Inc v Levy* *supra* note 56.

<sup>62</sup> *Ibid.*

<sup>63</sup> *Re Northwest Forest Products Ltd* *supra* note 54.

<sup>64</sup> *Re Bellman and Western Approaches Ltd* *supra* note 55.

<sup>65</sup> *Commonwealth Trust Co v Canada Deposit Insurance Corp* [1990] 79 CBR (NS) 183 (SC).

<sup>66</sup> *Re Loeb & Provigo Inc* (1978) 20 OR (2d) 497 (Ont HC).

<sup>67</sup> See also *Re Besenski* (1981) 15 Sask R 182 (Sask QB); *Re Loeb & Provigo Inc* *supra* note 66.

<sup>68</sup> *Re Jolub Construction Ltd* [1993] OJ No 2339, 21 CBR (3d) 313 (Gen Div in Bankruptcy); *Peddie v Peddie* [1996] AJ No 994, 38 Alta LR 434 (QB).

<sup>69</sup> *Re Besenski* *supra* note 67; *Re Loeb & Provigo* *supra* note 66.

above for South African law, and the principles adopted in Australian and New Zealand law.

It is noteworthy that, notwithstanding the lenient standard of proof stemming from the liberal interpretation of the test on the merits by the Canadian courts, in practice the merits of the action (at least in British Columbia) have become complicated, expensive and time-consuming battlefields in applications for leave. Leave applications for derivative actions frequently involve extensive affidavits, cross-examinations on affidavits, document production applications and numerous other applications and orders.<sup>70</sup> This has been triggered, not by strict judicial standards for leave, but rather by the dynamics and tactics between the parties involved in intra-corporate disputes.<sup>71</sup> It is to be hoped that such undesirable practices will not take root in South African law.

From the above discussion, it is clear that parallel lines of reasoning and broadly similar judicial approaches have emerged in Canada, Australia and New Zealand. These trends and guiding principles may work as valuable building blocks to craft a suitable South African judicial approach.

*(d) Synopsis*

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

<sup>70</sup> See William Kaplan & Bruce Elwood 'The derivative action: A shareholder's "Bleak House"?' (2003) 36 *University of British Columbia LR* 459 at 460–1.

<sup>71</sup> *Ibid.*

### III THE BEST INTERESTS OF THE COMPANY

#### (a) *Anchoring policies in South African law*

The ‘best interests of the company’ is a key criterion for the courts to take into consideration. The court may not grant leave to commence or continue proceedings on behalf of the company unless it is satisfied that it is in the best interests of the company that the applicant be granted leave (in terms of s 165(5)(b)(iii)). In assessing the best interests of the company, the rebuttable presumption in s 165(7) of the Act is applicable in certain circumstances. The rebuttable presumption echoes the well-established principle that the courts should have regard to properly deliberated views of the company’s directors on commercial matters, in line with the business judgment rule.<sup>72</sup>

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

While the criterion of the ‘trial of a serious question of material consequence to the company’ centres on the legal viability of the claim and the strength of the case, the criterion of the ‘best interests of the company’ focuses on the commercial viability of the claim. Nevertheless, the strength of the case and its prospects of success are relevant to and are interwoven with the ‘best interests’ inquiry — if the proposed action is a tenuous one with little prospect of success, it is unlikely to be in the best interests of the company to grant leave for the derivative action.<sup>73</sup> The Canadian courts, when considering whether the grant of leave ‘appears to be in the interests of the corporation’,<sup>74</sup> focus primarily on the strength of the case.<sup>75</sup>

The ‘best interests of the company’ is a familiar concept in the field of directors’ duties. In the context of the duty of directors to act in the best

<sup>72</sup> The rebuttable presumption is not discussed in detail in this article. See Maleka Femida Cassim ‘When companies are harmed by their own directors: The defects in the statutory derivative action and the courts’ Part 1 (2013) 20 *SA Merc LJ* 168 and Part 2 (2013) 20 *SA Merc LJ* 301.

<sup>73</sup> See for example the Australian cases *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* supra note 30; *Herbert v Redemption Investments Ltd* supra note 35; *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 28.

<sup>74</sup> Canada Business Corporations Act, RSC 1985 c C-44, s 239(2)(c).

<sup>75</sup> As I have discussed above, under the South African Act the guiding criteria of the best interests of the company and the strength of the case are separate and distinct preconditions for the grant of leave. By contrast, the Canadian legislation does not contain an express threshold test on the merits and the judiciary generally assesses the strength of the case by using the criterion that the proposed claim must appear to be in the interests of the corporation.



interests of the company, the concept of the ‘best interests of the company’ refers as a general rule to the interests of the shareholders as a general body.<sup>76</sup> It reflects the interests of the collective body of shareholders as a whole, including future shareholders.<sup>77</sup> There is no reason in principle why this recognised interpretation of the test of the best interests of the company, albeit in the sphere of the fiduciary duties of directors, should not also be imported into the domain of the statutory derivative action. Just as a director has a duty to act in the best interests of the company in conducting the company’s affairs, so a minority shareholder or other applicant who wishes to institute legal proceedings on behalf of the company under s 165 of the Act ought to act according to a similar standard. This analogy is now buttressed by the recent case *Mouritzen v Greystone Enterprises (Pty) Ltd*,<sup>78</sup> in which the KwaZulu-Natal High Court stated 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>79</sup>

Consequently, the criterion of the best interests of the company should not involve inquiries into the personal characteristics or circumstances of the applicant himself or herself, such as whether the applicant has personal disputes with or personal animosity against the shareholders or directors of the company, or whether the applicant is self-interested in the outcome of the matter. Bearing in mind that a derivative action is brought to enforce a right that is, in substance, vested in the company itself and not personally in the applicant, it would be detrimental to the ‘best interests of the company’ to exclude applicants who apply for leave on the basis of a genuine and valid grievance merely because they have a personal interest in the outcome of the proposed action, or a personal animus against the respondents. In any event, such factors come into play in the good faith inquiry when the court must assess, as a precondition for the grant of leave for a derivative action, whether the applicant is acting in good faith (under s 165(5)(b)(i) of the Act).<sup>80</sup>

The prerequisite of the ‘best interests of the company’ is an open-textured criterion, which may be subject to varying interpretations. Significant factors in the inquiry into the best interests of the company under s 165 of the Act may include the following: the strength of the claim and its prospects of success (as discussed above); the costs of the proposed proceedings; the amount at stake, or the potential benefit to the company; the defendants’ financial position and their ability to satisfy a judgment in favour of the

<sup>76</sup> *Greenhalgh v Ardenne Cinemas Ltd* [1950] 2 All ER 1120 (CA); *Ngurli Ltd v McCann* (1953) 90 CLR 425; *Parke v Daily New Ltd* [1962] 2 All ER 929 (ChD).

<sup>77</sup> *Gaiman v National Association for Mental Health* [1970] 2 All ER 362; *Miller v Bain sub nom Pantone 485 Ltd* [2002] BCLC 266 (ChD); see further Farouk H I Cassim ‘The duties and the liability of directors’ in Farouk H I Cassim (managing ed) *Contemporary Company Law* 2 ed (2012) 514–16.

<sup>78</sup> 2012 (5) SA 74 (KZD).

<sup>79</sup> *Ibid* para 60.

<sup>80</sup> See further Maleka Femida Cassim *op cit* note 6.

company; the disruption of the company's operations and the conduct of its business by having to focus on the litigation, including the distraction of the attention and diversion of the time of the company's directors, management and employees; the potential damage to the company's reputation; negative effects on the company's relationship with its suppliers, customers and financiers, and adverse impacts on the share price of the company; and the availability of alternative means to obtain the same relief.<sup>81</sup> These elements are discussed further below.

The judicial assessment of the commercial viability of the claim is not entirely new to the statutory derivative action in South African law. Under the previous statutory derivative action in terms of s 266 of the Companies Act 61 of 1973, the court, for instance, refused to grant leave for a derivative action in *Brown v Nanco (Pty) Ltd*<sup>82</sup> even though there were valid legal grounds for it. The court, based on the report of the curator ad litem, took account of commercial factors that made the action undesirable, such as the consideration that the proposed action would impose a strain on the fabric of the company and particularly on the relationship between the company and the defendant directors, and that this would prejudice the future of the company. (It is noteworthy, however, that the fact that the applicants had sold their shares and were no longer shareholders in the company, and that all the other remaining shareholders in the company were unanimously opposed to the action, were vital considerations in the decision of the court.)

Turning to the onus and the standard of proof, it is submitted that the burden of proof lies on the applicant who wishes to institute derivative proceedings to satisfy the court, on a balance of probabilities, that the grant of leave is in the best interests of the company. This evidently is the purpose of the legislation, as the wording of the Act is that the court must be satisfied that 'it is in the best interests' (my emphasis) of the company for leave to be granted (in terms of s 165(5)(b)(iii)). This means that the court must be satisfied, 'not that the proposed derivative action *may be, appears to be, or is likely to be* in the best interests of the company, but that it *is* in the best interests', as observed in the Australian case *Swansson v Pratt*,<sup>83</sup> and quoted with approval in the recent South African case *Mouritzen v Greystone Enterprises (Pty) Ltd*.<sup>84</sup>

The KwaZulu-Natal High Court in *Mouritzen v Greystone Enterprises* did not consider in any depth or detail the criterion of the best interests of the company, and instead focused primarily on the criterion of good faith. The statement of the court that '[i]n most, but not all, instances this requirement [the best interests of the company] will overlap with the requirement of good faith'<sup>85</sup> is, with respect, most regrettable. This is because, as I have pointed out above, the inquiry into the best interests of the company relates to the

<sup>81</sup> The authorities are discussed further below.

<sup>82</sup> 1977 (3) SA 761 (W).

<sup>83</sup> *Swansson v R A Pratt Properties Pty Ltd* supra note 28.

<sup>84</sup> Supra note 78.

<sup>85</sup> Ibid paras 63 and 64.

welfare of the *company*; the personal characteristics or circumstances of the applicant are not relevant to the assessment of this requirement. The focus should, and must, be on the company. There may admittedly be some overlap between the two criteria, in so far as a finding that leave is in the best interests of the company may shed some light on the applicant's good faith and motives in seeking leave.<sup>86</sup> However, the two requirements are nevertheless separate and distinct criteria, to be independently satisfied, and should not be conflated by the courts, as occurred in *Mouritzen v Greystone Enterprises*. This view is also reinforced by authority in Australian law and other jurisdictions, as I shall show next.

(b) *The legal position in Australia, Canada, New Zealand and other jurisdictions*

The South African precondition that the grant of leave for a derivative action must be in the best interests of the company is apparently modelled on the Australian legislation. The Australian Corporations Act<sup>87</sup> similarly requires the court to be satisfied that the grant of leave for a proposed derivative action 'is' in the 'best interests' of the company. The Australian judiciary in *Swansson v R A Pratt Properties Pty Ltd*<sup>88</sup> has consequently stipulated that the applicant must establish that the proposed action is in the best interests of the company on a balance of probabilities, and not merely make out a prima facie case. *Carpenter v Pioneer Park Pty Limited (in liq)*<sup>89</sup> spelled out further that the inquiry is 'not an inquiry into possibility or potential'. These dicta are instructive on the interpretation of the parallel South African provision relating to the criterion of the best interests of the company.

While this precondition in the South African Act is modelled directly on the Australian legislation, it differs significantly from the Canadian legislation. Canadian legislation contains a more lenient test, namely that 'it *appears to be* in the *interests* of the corporation'.<sup>90</sup> That the action must 'appear to be' in the corporation's interests clearly entails a lower standard of proof than the South African equivalent. The crux of the matter in Canadian law is whether it is prima facie in the interests of the company that the action be brought.<sup>91</sup> The test, according to the Canadian courts, is whether the applicant has adduced sufficient evidence which on the face of it discloses that it is in the interests of the corporation to pursue the action.<sup>92</sup>

<sup>86</sup> See for example the Australian cases *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* supra note 30; *Goozee v Graphic World Group Holdings Pty Limited* supra note 32; *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 28; *Maher v Honeysett* supra note 28.

<sup>87</sup> Australian Corporations Act, 2001, s 237(2)(c).

<sup>88</sup> Supra note 28.

<sup>89</sup> Supra note 28 para 19.

<sup>90</sup> Canada Business Corporations Act, RSC 1985 c C-44, s 239(2)(c); Ontario Business Corporations Act RSO 1990, c B16, s 246(2)(c) (emphasis supplied).

<sup>91</sup> *Re Bellman and Western Approaches Ltd* supra note 55. See further the discussion above on the threshold test or strength of the case in Canadian law.

<sup>92</sup> *Re Northwest Forest Products Ltd* [1975] 4 WWR 724 (BCSC).

The New Zealand judiciary, like the Canadian courts, has also considered the interests of the company on a *prima facie* basis.<sup>93</sup> The New Zealand legislative provision is at odds with the South African one, in that the New Zealand Companies Act refers to ‘the interests of the company’, as opposed to its best interests. Furthermore, the New Zealand court is required merely to ‘have regard to the interests of the company’.<sup>94</sup> This is not a firm precondition for the grant of leave, as in South African law, but is simply a relevant factor to be considered. (The only prerequisite for the grant of leave for a derivative action in New Zealand law<sup>95</sup> is that it is in the interests of the company that the conduct of the proceedings should not be left to the directors or the determination of the shareholders as a whole, or alternatively, that the company itself does not intend to bring proceedings.) This is a less exacting test than the corresponding South African counterpart.

The United Kingdom Companies Act, 2006 requires the court to consider the importance that a person acting in accordance with s 172 (that is, the duty to promote the success of the company) would attach to continuing the claim. This duty arises in two subsections of the legislation. First, permission for a derivative action must be refused if the court is satisfied that a person acting in accordance with s 172 would not seek to continue the claim. Secondly, in considering whether to give permission for the derivative action, the court must take into account the importance that a person acting in accordance with s 172 would attach to continuing it.<sup>96</sup> The duty to promote the success of the company under s 172 is linked with the concept of acting in the best interests of the company. Certain principles laid down by the United Kingdom courts may consequently serve as useful guidelines in the interpretation and application of the best interests of the company criterion in South African law.

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

(c) *Lessons from Australia and other comparable jurisdictions*

The Australian experience and the body of case law on the issue of the best interests of the company may furnish indicators for the interpretation and application of this criterion in South African law. It may also shed light on the foreseeable difficulties which are likely to crop up. The requirement that a derivative action must be in ‘the best interests of the company’ has been the

<sup>93</sup> *Vrij v Boyle* supra note 39; *Techflow (NZ) Ltd v Techflow Pty Ltd* supra note 42.

<sup>94</sup> New Zealand Companies Act, 1993, s 165(2)(d). The New Zealand courts must also have regard to the likelihood of the proceedings succeeding, the costs in relation to the likely relief and any action already taken by the company to obtain relief (s 165(2) of the New Zealand Companies Act, 1993).

<sup>95</sup> New Zealand Companies Act, 1993, s 165(3).

<sup>96</sup> United Kingdom Companies Act, 2006, s 263(2)(a) and (3)(b), respectively.

most problematic for the Australian courts. According to the ‘Explanatory Memorandum to the Corporate Law Economic Reform Program Bill’,<sup>97</sup> which is referred to in *Fiduciary Limited v Morningstar Research Pty Limited*<sup>98</sup> and *Maher v Honeysett & Maher Electrical Contractors Pty Ltd*,<sup>99</sup> this requirement acknowledges that there may be sound business reasons for a company not to pursue a legal action open to it. In some circumstances, pursuing a cause of action would be contrary to the best interests of the company. For instance, a breach of duty by a director may have resulted in an insignificant or nominal loss to the company, with the effect that the costs of legal proceedings could outweigh any potential benefit to the company. The best interests criterion clearly involves a weighing up of the benefit of an action against any potential detriment.

The phrase ‘best interests of the company’ is concerned with the welfare of the company.<sup>100</sup> Consequently, in *Goozee v Graphic World Group Holdings Pty Ltd*,<sup>101</sup> where the applicant sought a remedy entailing the winding-up of a group of companies which were trading profitably, the court found that this could not be in the best interests of those companies, for their best interests would clearly entail continuing to trade profitably.

The personal qualities of the applicant do not come into play in determining this requirement, for the focus is on the company.<sup>102</sup> A personal interest or personal animus should not be decisive or even be significant in determining whether an application is in the best interests of the company, as the courts held in *Maher v Honeysett & Maher Electrical Contractors Pty Ltd*<sup>103</sup> and *Ehsmann v Nutectime International Pty Ltd*,<sup>104</sup> as this is commonly a feature in the types of disputes that lead to derivative actions.<sup>105</sup> There are clear congruencies between the principles propounded by the Australian courts and the guidelines submitted above on the meaning in South African law of the ‘best interests of the company’ criterion, as adapted from existing common-law principles in South Africa.

Turning to the factors that are pertinent in evaluating the best interests of the company, an applicant in Australia must give evidence at least of the

<sup>97</sup> (1998) para 6.38–6.39.

<sup>98</sup> [2005] NSWSC 442.

<sup>99</sup> Supra note 28.

<sup>100</sup> *Charlton v Baber* supra note 33; *Fiduciary Limited v Morningstar Research Pty Limited* supra note 98 para 46; *Maher v Honeysett* supra note 28.

<sup>101</sup> Supra note 32.

<sup>102</sup> *Maher v Honeysett* supra note 28 paras 46–9.

<sup>103</sup> Supra note 28 para 45.

<sup>104</sup> (2006) 58 ACSR 7051.

<sup>105</sup> The court may consider the benefit that will be gained by the applicant for leave. In *Transmetro Corp Ltd v Kol Tov Pty Ltd* [2009] NSWSC 350 it was held that it would be contrary to the best interests of the company to grant leave to an applicant where this would put him or her in a position of breaching his or her directors’ duties owed to another company.

following matters described in *Swansson v Pratt*<sup>106</sup> and *Ragless v IPA Holdings Pty Ltd (in liq)*:<sup>107</sup>

- The character of the company or the nature of its operations: for instance, whether the company is a small, private, family-owned company or a large, listed, public company. In a closely held family company, the effect of the proposed derivative action on the purpose of the company and on its shareholders could be material; but these elements would, conversely, be immaterial in a listed public company. Another example is that in a joint venture company in which the parties are deadlocked, it would be apt to consider whether the proposed derivative litigation is being used inappropriately to vindicate the position of one side.<sup>108</sup>
- The business of the company. The effect of the proposed litigation on the proper conduct of the company's business must be understood.
- The ability of the defendant to meet any judgment in favour of the company, or even a substantial part of it. This enables the court to ascertain whether the proposed litigation would have any true practical benefit for the company.
- Whether there are other means of obtaining substantially the same redress, so that the company does not have to be brought into litigation against its will. This issue is discussed separately below.

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

Many of the commercial and business factors that play a role in Australian law have also gained a foothold in the United Kingdom. In the United Kingdom, the court in *Franbar Holdings Ltd v Patel*<sup>109</sup> was faced with an application for permission for a derivative action. In assessing the importance that a hypothetical director would attach to continuing the claim when acting in accordance with s 172 or the duty to promote the success of the company — which (as I have discussed above) is linked with the concept of acting in the best interests of the company — the court identified a beneficial list of factors. These include the prospects of success of the claim; the ability of the company to recover any award of damages; the disruption to the company's business caused by the claim; the costs of the proceedings; and any damage to the company's reputation if the proceedings were to fail. The court in *Wishart v Castlecroft Securities Ltd*<sup>110</sup> added to this list of factors the

<sup>106</sup> *Supra* note 28 paras 57–60.

<sup>107</sup> *Supra* note 31.

<sup>108</sup> See for example *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* *supra* note 30.

<sup>109</sup> [2008] EWHC 1534 (Ch) para 36; see also *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526 (Ch) para 86.

<sup>110</sup> [2009] CSIH 65.

amount at stake, and the prospects of obtaining a satisfactory result without litigation. This range of matters is, however, not intended to be comprehensive.<sup>111</sup>

Comparable elements feature in decisions of the New Zealand judiciary. Over and above this, in evaluating whether the grant of leave would be in the interests of the company, the New Zealand decisions suggest that the potential for adverse publicity and damage to the company's reputation is likely to be given little weight by the court.<sup>112</sup> This possibly applies also to the adverse effects of the derivative action on the company's operations and trading contracts. However, the exception would be where the negative publicity in question is likely to have a financial impact on the company, for instance that it would cause a fall in the market price of the shares of a publicly-traded company<sup>113</sup> — this factor would indeed be germane to the inquiry into the interests of the company.

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

The inquiry into the best interests of the company thus involves a weighing up of the benefit of the proposed derivative action against any potential detriment. This guiding criterion gives recognition to solid commercial and business reasons for companies to decline to pursue legitimate legal claims. For instance, the time spent on litigation might be more beneficially used elsewhere and may consequently be detrimental to the conduct of the company's business in the light of the nature of its business and operations; or the wrongdoers — due to lack of financial means — may be unable to meet the judgment even if the litigation is successful; or the loss to the company may have been minor or trivial; or the costs of legal proceedings may outweigh the potential benefit or recovery and may thus be unjustified.

#### IV FURTHER FACETS OF THE 'BEST INTERESTS OF THE COMPANY'

##### (a) A 'cost-benefit' analysis?

The thorny question must inevitably arise whether the inquiry into the 'best interests of the company' entails a 'cost-benefit' analysis. In other words, if the costs of the litigation are likely to outweigh any potential benefit to the

<sup>111</sup> *Stimpson v Southern Private Landlords Association* [2010] BCC 387.

<sup>112</sup> *McFarlane v Barlow* (1997) 8 NZCLC 261 (HC).

<sup>113</sup> *Presley v Callplus Ltd* [2008] NZCCLR 37 (HC).



company, is the court bound to refuse leave for a derivative action on the ground that a derivative action would not be in the company's best interests?

It is submitted that such a narrow and restrictive approach should be firmly shunned in South African law. The inquiry into the best interests of the company in South African law is not intended to be a pure 'cost-benefit' analysis. The wording of the Act does not require it, and it would not be consistent with the purposes of the Act. The approach of the South African courts should be to weigh up the benefit of the action against the potential detriment — the terms 'benefit' and 'detriment' to be understood as going beyond the direct costs of the litigation and the purely economic benefits. Far less emphasis should be placed on comparing or weighing up the economic costs of the derivative action against the possible economic return — the importance of this point cannot be overstated.

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

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

action may serve a vitally important purpose as a warning and a deterrent to future wrongdoing by both the board of the company itself as well as the directors of other companies.<sup>114</sup>

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

As opposed to the South African Act, which does not refer to a ‘cost-benefit’ analysis, the New Zealand legislation expressly requires it. The New Zealand Companies Act<sup>115</sup> explicitly states that the court must have regard to ‘the costs of the proceedings in relation to the relief likely to be obtained’. This is an entirely separate statutory provision from the criterion of the ‘interests of the company’.<sup>116</sup> The former provision involves a cost-benefit analysis.<sup>117</sup> It requires the court to consider ‘the economics of taking a derivative action relative to any possible return’.<sup>118</sup> The term ‘costs’ in this context refers to the ‘litigation costs of the proposed proceedings’.<sup>119</sup> When assessing the relief likely to be obtained by the company, the ability of the defendant to meet any judgment given against him or her is also taken into account. Moreover, the consideration of ‘the costs of the proceedings in relation to the relief likely to be obtained’ is linked also with the strength of the claim on the merits.<sup>120</sup> Accordingly, in the leading New Zealand case *Techflow NZ Ltd v Techflow Pty Ltd*<sup>121</sup> one of the reasons given by the court for its refusal of leave for a derivative action was that the costs of litigation seemed disproportionate to the amount realistically in issue.

In stark contrast, the Australian courts have declared in unambiguous terms that the criterion of the best interests of the company does not involve a ‘cost-benefit analysis of possible outcomes of prospective litigation’.<sup>122</sup> It is

<sup>114</sup> J C Coffee & D E Schwartz ‘The survival of the derivative suit: An evaluation and a proposal for legislative reform’ (1981) 81 *Columbia LR* 261 at 308.

<sup>115</sup> New Zealand Companies Act, 1993, s 165(2)(b).

<sup>116</sup> New Zealand Companies Act, 1993, s 165(2)(d).

<sup>117</sup> *Tweedie v Packsys Ltd* (2005) 2 NZCCLR 584 (HC) para 51.

<sup>118</sup> *Stichbury v One4All Ltd* (2005) 9 NZCLC 263, 792 (HC) para 37.

<sup>119</sup> *Vrij v Boyle* supra note 39; *Thorington v McCann* (1997) 8 NZCLC 261, 564.

<sup>120</sup> *Presley v Callplus Ltd* supra note 113 para 47.

<sup>121</sup> Supra note 42.

<sup>122</sup> *Metyor Inc (formerly Talisman Technologies Inc) v Queensland Electronic Switching (Pty) Ltd* QCA [2002] 269.

significant that even in New Zealand law, the decision of the courts to grant or refuse leave does not turn solely on the cost-benefit analysis: it is merely one of the factors that the courts must have regard to, and not a precondition for leave for a derivative action.<sup>123</sup> The New Zealand courts in *Frykberg v Heaven*<sup>124</sup> have in fact acknowledged the important role of the statutory derivative action as a deterrent to wrongdoing.

*(b) The availability of an alternative remedy*

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

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

In contrast, where a proposed alternative remedy would not produce the desired redress or substantially the same redress, it should pose no obstacle to the commencement of a derivative action and should be disregarded in the inquiry into the company's best interests. It must be stressed that in some circumstances a minority shareholder who applies for leave to institute derivative proceedings, may also have a personal claim against the defendants. But this of itself should not be fatal to his or her application for leave for derivative litigation. To elaborate, there could in many instances be an overlap between a personal claim and a derivative claim. In other words, the same wrong may violate the rights of both the shareholder personally as well as those of the company. This may accordingly give rise to both a personal claim by the shareholder with the purpose of asserting his or her individual shareholder rights and obtaining personal redress, as well as a derivative claim instituted by the shareholder on behalf of the company with the object of

<sup>123</sup> New Zealand Companies Act, 1993, s 165(2)(b).

<sup>124</sup> (2002) 9 NZCLC 262, 966.

obtaining redress and recovery for the company itself and not the shareholder directly. It must be borne in mind that a personal action and a derivative action are not alternative remedies or alternative means of obtaining substantially the same redress — they are plainly designed to produce different results. That an applicant has available to him or her a personal claim against the defendant, or has already commenced such a claim, is manifestly an insufficient basis for concluding that a derivative action is contrary to the best interests of the company. It is respectfully submitted that the South African courts should be mindful of this.

Nonetheless in the field of breach of directors' fiduciary and statutory duties, these wrongs, in the majority of cases, would cause harm to the company itself as opposed to its shareholders. Directors' duties are generally not owed to the shareholders individually, as was indicated in *Percival v Wright*.<sup>125</sup> But in certain circumstances, harm may be done by a director to a shareholder directly, in which case the shareholder would have personal redress against the director. For instance, it was accepted in *Coleman v Myers*<sup>126</sup> and *Peskin v Anderson*<sup>127</sup> that fiduciary duties may be owed by directors to individual shareholders where a 'special factual relationship' is established between them on the facts of the particular case.

A related issue, which must also be kept in mind, is the 'no reflective loss' principle. This principle applies when both the company and the shareholder have a claim against the directors or other defendants based on the same set of facts, and the shareholder's loss, in so far as this may be a diminution in the value of his or her shares or a loss of dividends, merely reflects the loss suffered by the company. In such cases the shareholder's claim is restricted by the principle that the shareholder cannot recover a loss that is simply reflective of the company's loss.<sup>128</sup> When the 'no reflective loss' principle applies, the only available remedy is an action brought by the company or on behalf of the company as a derivative action; there is no question of a personal shareholder action at all. An application of the 'no reflective loss' principle arose, for instance, in *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)*,<sup>129</sup> where the court decided that the personal claim by the shareholders should fail as the only loss the shareholders had suffered (as a result of a misrepresentation by the directors in a tricky and misleading circular, in the course of seeking the shareholders' consent to a transaction) was a diminution in the value of their shares. This loss was simply an indirect loss or a reflection of the loss that the company itself had suffered as a result of the wrong done to the company (by the acquisition of certain assets that at an over-value).

<sup>125</sup> [1902] 2 Ch 421 (ChD).

<sup>126</sup> [1977] 2 NZLR 225 CA (NZ).

<sup>127</sup> [2001] 1 BCLC 372 (CA).

<sup>128</sup> *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1981] Ch 257; [1982] 1 Ch 204 (CA); *Johnson v Gore, Wood & Co* [2002] 2 AC 1 (HL) at 62.

<sup>129</sup> *Ibid.*

A similar situation arose in *Stein v Blake (No 2)*,<sup>130</sup> where the loss sustained by a shareholder by a diminution in the value of his shares by reason of a misappropriation of the company's assets was held to be recoverable only by the company, and not by the shareholder who had suffered no loss distinct from that suffered by the company. The rationale for the 'no reflective loss' principle is that it prevents double recovery if the company were also to sue. It, moreover, prevents the individual shareholder from recovering at the expense of the company and its creditors and other shareholders.<sup>131</sup>

However the 'no reflective loss' principle will not pose an obstacle to a personal shareholder claim where the loss suffered by the shareholder and that suffered by the company are distinguishable.<sup>132</sup> In these instances it is possible to institute both a personal shareholder action as well as a company action, whether this is instituted by the company itself or by the shareholder as a derivative action on the company's behalf.

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

In this regard Australian courts have ruled that if an alternative means is available, and it has genuine prospects of recovery as well as the potential to yield a suitable remedy, it would be contrary to the best interests of the company to institute a derivative action.<sup>133</sup> This occurred, for instance, where an applicant could obtain the necessary redress by means of an order for specific performance of a contract in an action to which the company was not a party.<sup>134</sup> Regarding the critical question of the overlap between a personal action and a derivative action, there is judicial authority in both Australia<sup>135</sup> and New Zealand<sup>136</sup> to the effect that if an applicant could pursue a personal claim against the proposed defendant, this does not necessarily mean that a derivative action is contrary to the best interests of the company. Indeed, the Australian courts have stated that it may be advantageous to allow a derivative claim to be pursued in proceedings in which a personal claim is also pursued, particularly where there is a common substratum of fact underlying the two claims.<sup>137</sup>

In stark opposition is the legal position in the United Kingdom. The United Kingdom legislation<sup>138</sup> provides that the court must consider whether the

<sup>130</sup> [1998] 1 All ER 724 (CA).

<sup>131</sup> *Johnson v Gore, Wood & Co* supra note 128.

<sup>132</sup> See *Heron International Ltd v Lord Grade* [1983] BCLC 261.

<sup>133</sup> See for example *Hassall v Speedy Gantry Hire Pty Ltd* [2001] QSC 327; *Chapman v E-Sports Club Worldwide Ltd* supra note 37; see also *Swansson v Pratt* supra note 28.

<sup>134</sup> *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* supra note 30.

<sup>135</sup> See for example *Metyor Inc (formerly Talisman Technologies Inc) v Queensland Electronic Switching Pty Ltd* supra note 122 at 405; *Saltwater Studios Pty Ltd v Hathaway* [2004] QSC 435 para 10; *Ehsmann v Nutectime International Pty Ltd* supra note 104.

<sup>136</sup> See for example *Bendall v Marshall* (2005) 9 NZCLC 263, 772.

<sup>137</sup> *Ehsmann v Nutectime International Pty Ltd* supra note 104.

<sup>138</sup> Companies Act, 2006, s 263(3)(f).

act or omission in respect of which a derivative claim is brought gives rise to an alternative cause of action which the shareholder could pursue *in his or her own right* rather than on behalf of the company. The existence of such an alternative remedy must be considered by the court, although it is not an absolute bar to the grant of permission for a derivative claim.<sup>139</sup> The relevant alternative remedy may be brought against the same defendants as the derivative action, but this is not necessarily required and the statutory provision extends also to an alternative remedy that is available against a different defendant. The only limitation is that the alternative claim must arise from the same act or omission that is the subject of the derivative claim.<sup>140</sup> The United Kingdom legislative provision is thus quite wide. It may include overlaps between a derivative claim and a personal action, including personal claims based on an unfairly prejudicial petition.<sup>141</sup> Frequently, both a derivative action and an unfairly prejudicial petition may be founded on breaches of directors' duties. The United Kingdom legislation may limit and exclude the availability of the derivative action in these situations.

It is submitted that in South African law such a wide and dilated construction should be firmly eschewed. There are significant differences between the statutory schemes for derivative action in the United Kingdom and South Africa. Unlike the United Kingdom legislation, the South African Act does not limit the availability of the derivative action to this extent. To do so in South African law would be consistent with neither the intention of the legislature nor the underlying nature and purposes of s 165 of the Act. It must also be borne in mind that, unlike the South African Act, the United Kingdom legislation expressly provides for a derivative action to be brought pursuant to a court order under the unfair prejudice remedy.<sup>142</sup>

(c) *Is the derivative action applicable to a company in liquidation?*

The concept of the 'best interests of the company', as discussed above, generally refers to the interests of the shareholders as a whole. But in the context of insolvency, the interests of the creditors of the company may come to the fore. Common-law authority in both the United Kingdom<sup>143</sup> and in

<sup>139</sup> *Iesini v Westrip Holdings Ltd* supra note 109.

<sup>140</sup> *Franbar Holdings v Patel* supra note 109.

<sup>141</sup> In terms of s 994 of the United Kingdom Companies Act, 2006, or a petition for a just and equitable winding up.

<sup>142</sup> Section 260(2)(b) of the UK Companies Act, 2006 provides that a derivative claim may be brought in pursuance of a court order in proceedings under s 994 for the protection of shareholders against unfair prejudice. Section 996(2)(c) provides that when a shareholder succeeds in a petition under s 994, one of the orders that may be made by the court is the authorisation of civil proceedings to be brought in the name of and on behalf of the company by such persons as the court may direct.

<sup>143</sup> See for example *Lonrho Ltd v Shell Petroleum Co Ltd* [1980] 1 WLR 627; *Liquidator of West Mercia Safetywear v Dodd* [1988] BCLC 250 (CA); *Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd* [2003] 2 BCLC 153.

Australia<sup>144</sup> requires directors, in discharging their duties to their company, to take into account the interests of creditors when the company is in financial difficulty; that is, when the company is insolvent or is nearing insolvency. A South African court is very likely to be persuaded to do the same. This principle on the duties of directors may be equally extended and applied to the statutory derivative action, with the effect that the precondition of the 'best interests of the company' could turn on the interests of the creditors of an insolvent or nearly insolvent company. The reason is that a successful derivative action would increase the assets of the insolvent or near-insolvent company, which would then be used to satisfy the claims of creditors. There is authority in the context of the Australian statutory derivative action that when a company is being wound up because of insolvency or is nearing insolvency due to financial difficulties, the company's best interests are reflected primarily by the interests of its creditors, or would at least require the directors to take creditors' interests into account.<sup>145</sup> This is because when a company is in insolvent circumstances, it is the creditors' assets that are at risk, rather than the proprietary interests of shareholders.

This, however, begs the question whether the statutory derivative action under s 165 of the Act should be available in the first place when companies are in liquidation. It is important to note that the derivative action at common law could not be brought when a company was in liquidation.<sup>146</sup> Since the statutory derivative action under s 165 of the Act does not explicitly exclude from its ambit companies in liquidation, it could give rise to disputes in South African law on this crucial matter.

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

<sup>144</sup> See for example *Walker v Wimborne* (1976) 137 CLR 1; *Linton v Telnet Pty Ltd* (1999) 30 ACSR 465.

<sup>145</sup> See *Charlton v Baber* supra note 33; *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 28.

<sup>146</sup> *Barrett v Duckett* [1995] 1 BCLC 243 (CA) 250, in the context of the English common law derivative action, on which South African law was historically based; *Fargo v Godfrey* [1986] 3 All ER 279; *Scarel Pty Ltd v City Loan and Credit Corporation Pty Ltd* (1988) 12 ACLR 730 (Fed C of A).



directors not to involve the company in litigation against a third party is in its best interests. Moreover, when a company is in liquidation, other more suitable remedies are available.

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

This has been the experience in Australian law, where the issue has precipitated ongoing confusion and debate for over a decade. The Australian courts have expressed conflicting views on whether the statutory derivative action may be brought when a company is in liquidation.<sup>147</sup> A watershed judicial pronouncement seems finally to have been made by the New South Wales Court of Appeal in *Chahwan v Euphoric Pty Ltd*,<sup>148</sup> which has proclaimed that the statutory derivative action is not available where a company is in liquidation.<sup>149</sup>

There is also some authority on this thorny issue in New Zealand, although it is not yet settled. *Hedley v Albany Power Centre Ltd (in liq)*<sup>150</sup> ruled that once a company is placed in liquidation ‘the Court no longer has — or at least ought not to exercise — its [statutory derivative action] jurisdiction’.

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

## V A RESIDUAL DISCRETION

The court may not grant leave to an applicant for derivative proceedings unless it is satisfied that all three of the guiding criteria in terms of s 165(5)(b)

<sup>147</sup> In New South Wales, the court in *BL & GY International Co Ltd v Hypec Electronics Pty Ltd* [2001] NSWSC 705 stated as an obiter dictum that the statutory derivative action is not applicable to a company in liquidation; cf *Roach v Winnote Pty Ltd (in liq)* [2001] NSWSC 822 which held, conversely, that the statutory derivative action is applicable to a company in liquidation. The Supreme Court of Victoria found in *Fresh Start Australia Pty Ltd; Suteri v Lofthouse and Cauchi as liquidators of Fresh Start Australia Pty Ltd (in liq)* (2006) 59 ACSR 327 that the statutory derivative action does apply to a company in liquidation, while the Federal Court of Australia has had divided opinions — see for example *Mhanna v Sovereign Capital Ltd* [2004] FCA 1040, [2004] FCA 1252, [2004] FCA 1300; *Promaco Conventions Pty Ltd v Deadline Printing Pty Ltd* (2007) 159 FCR 486.

<sup>148</sup> [2008] NSWCA 52.

<sup>149</sup> This has been followed in later cases; see for example *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 28.

<sup>150</sup> [2005] 2 NZLR 196 (HC) para 35.

are fulfilled. A final issue is whether the court has a residual discretion to entertain other criteria besides those listed in the section. In view of the wording in s 165(5) that the court ‘may’ — not ‘must’ — grant leave only if the listed criteria are satisfied, it is submitted that there is, theoretically, leeway for the court to consider additional factors and to exercise a residual discretion to refuse leave despite the fulfilment of all the statutory criteria for leave.

By contrast, in Australian law the court is bound to grant leave if all five of the criteria in the section have been satisfied.<sup>151</sup> The Australian courts have ruled that if the prescribed criteria under the legislation are met, the court has no residual discretion and ‘must’ or is bound to grant leave.<sup>152</sup> By the same token, the Australian courts are bound to refuse leave if unsatisfied that all the criteria have been fulfilled.<sup>153</sup> The relevant considerations in Australian law are thus limited to the five specified criteria.<sup>154</sup>

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

In Canadian law, the courts similarly have a residual discretion. If the complainant proves the three statutory prerequisites (namely good faith; that the action appears to be in the interests of corporation; and that notice was given to the corporation) the court still retains a residual discretion to give or withhold permission.<sup>155</sup> It has been cogently stated<sup>156</sup> that leave should be granted once all the statutory prerequisites are satisfied, and that judges must be mindful that all they are doing in exercising their discretion is permitting an otherwise suppressed grievance to be heard. This would encourage intra-corporate compromise instead of bullying.<sup>157</sup> This sensible contention

<sup>151</sup> The wording of the statutory provision in s 237(2) of the Corporations Act, 2001 makes this plain by the use of the word ‘must’.

<sup>152</sup> *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 28; *Maher v Honeysett & Maher Electrical Contractors Pty Ltd* supra note 28; *Fiduciary Ltd v Morningstar Research Pty Ltd* supra note 98; *Magafas v Carantinos* [2006] NSWSC 1459.

<sup>153</sup> *Jeans v Deangrove Pty Ltd* [2001] NSWSC 849; *Goozee v Graphic World Group Holdings Pty Ltd* supra note 32 at 541; *Herbert v Redemption Investments Pty Limited* supra note 35; *Charlton v Baber* supra note 33; *Fiduciary Limited v Morningstar Research Pty Ltd* supra note 98.

<sup>154</sup> *Maher v Honeysett & Maher Electrical Contractors Pty Ltd* supra note 28.

<sup>155</sup> Canada Business Corporations Act, RSC 1985 c C-44, s 239(2).

<sup>156</sup> Bruce Welling *Corporate Law in Canada: The Governing Principles* 3 ed (2006) 518.

<sup>157</sup> *Ibid.*

applies with equal force to the role and exercise of the residual judicial discretion in South African law.

## VI CONCLUSION

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