

THE STATUTORY DERIVATIVE ACTION UNDER THE COMPANIES ACT OF 2008: THE ROLE OF GOOD FAITH

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The new statutory derivative action under the Companies Act 71 of 2008 is a paramount protective measure or weapon for minority shareholders, which will be very useful in good corporate governance and in policing boards of directors. The court is entrusted in terms of s 165 with a pivotal role as the gatekeeper, and has a crucial screening function in the exercise of its discretion to grant leave to a minority shareholder (or other applicant) to institute derivative litigation to seek redress for the company, when those in control of it improperly fail or refuse to do so. The approach that the courts adopt to the application of the three guiding criteria in s 165(5)(b) for the exercise of their discretion — particularly the open-textured criterion of ‘good faith’ — is a matter of supreme importance that will have a major impact on the effectiveness (or lack thereof) of the new statutory derivative action. The focus of this article is this particularly elusive criterion of good faith, and its many nuances, interpretations and applications in relevant foreign jurisdictions. A framework for good faith in South African law is proposed, and further fundamental facets of good faith are explored, with reference both to existing principles in our common law and valuable lessons gleaned from other comparable jurisdictions such as Canada, Australia, New Zealand and the United Kingdom.

I INTRODUCTION

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

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

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

² (1843) 2 Hare 461, 67 ER 189.

Under the new statutory derivative action in terms of s 165 of the Act, the court is entrusted with a key function. The court serves as the gatekeeper under s 165, and plays a vital screening role in the exercise of its discretion to grant or refuse permission to a minority shareholder (or other applicant) to pursue derivative litigation on behalf of the company. The court is bound to exercise its discretion with reference to the three vague guiding criteria set out in s 165(5)(b), one of which is that the applicant must be acting in good faith. This article focuses on the particularly elusive concept of good faith, and its many interpretations, contours and applications in the field of the statutory derivative action. Before turning to an exploration of the requirement of good faith, it is instructive first to consider certain foundational policies and principles relating to the statutory derivative action.

II ANCHORING POLICIES AND PRINCIPLES

(a) *The need for, and purpose of, the derivative action*

It must be borne in mind that a derivative action is brought by another person (such as a minority shareholder) on behalf of a company, in order to protect the legal interests of the company. The derivative action is so called because the shareholder ‘derives’ his or her right of action from that of the company, to redress a wrong done to the company.³ In other words, the shareholder is seeking to protect not his or her own rights, but the company’s rights. This is distinct from the situation where shareholders wish to enforce their own personal shareholder rights, in which case they would have personal redress and would rely on a personal action rather than a derivative action.

It is trite that where a wrong is done to the company, the ‘proper plaintiff’ to take legal action in respect of the wrong is the company itself, and not individual shareholders. As Lord Davey stated in *Burland v Earle*,⁴ ‘in order to redress a wrong done to the company . . . the action should prima facie be brought by the company itself’. The proper plaintiff rule stems from ‘the elementary principle that A cannot, as a general rule, bring an action against B to recover damages or secure other relief on behalf of C for an injury done by B to C’.⁵ The basis of the rule is the cardinal tenet of company law that a company is a separate legal entity, distinct from its shareholders.⁶ Closely related to the proper plaintiff rule is the democratic principle of majority rule and the internal management principle: that the affairs of a company are decided by the rule of the majority and that the courts will not intervene in the internal affairs of the company at the instance of an individual shareholder when the majority acts lawfully. As the court stated in *Sammel v President*

³ This is the position according to jurisprudence in the United States of America — see *Schiowitz v IOS Ltd* (1971) 23 DLR (3d) 102; see also the English case *Estmanco (Kilner House) v Greater London Council* [1982] 1 WLR 2 (QB).

⁴ [1902] AC 83 (PC) at 93.

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

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

Brand Gold Mining Co Ltd,⁷ ‘by becoming a shareholder in a company a person undertakes . . . to be bound by the decisions of the prescribed majority of the shareholders, if those decisions on the affairs of the company are arrived at in accordance with the law, even where they adversely affect his own rights as a shareholder’. The proper plaintiff principle and the principle of majority rule are compositely⁸ referred to as the rule in *Foss v Harbottle*.⁹

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

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

There is however a well-established common-law exception to this general principle, in that the shareholders in general meeting may intervene in the powers of the board where the board refuses to institute legal proceedings on behalf of the company, or is unable to do so, for example because of a deadlock.¹⁰ It remains to be seen whether this would still apply under the new legislative regime. It is debatable whether this common-law reserve power of shareholders in general meeting would override s 66(1) of the Act in the absence of an explicit provision in a company’s Memorandum of Incorporation conferring on shareholders control of the decision whether or not to enter into litigation. There is Australian authority that rejects the

⁷ Supra note 1 at 678.

⁸ See K W Wedderburn ‘Shareholders rights and the rule in *Foss v Harbottle*’ (1957) 194 *Cambridge LJ* 194 at 198.

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

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

view that shareholders in general meeting may have this default power over legal proceedings.¹¹

On the face of it, the theoretical rule that the company is the proper plaintiff to bring a legal action when it is the wronged party is a sound and logical approach. But the rule gives rise to practical problems and may be the cause of injustice and inequity. The potential for abuse arises where the wrongdoers who commit a wrong against the company are the directors themselves; for instance where the directors defraud the company by usurping for themselves a corporate opportunity that belongs to the company. The classic case or the genesis of the derivative action is where the alleged wrongdoers who have harmed the company are the controllers of the company, so that the wrongdoers subsequently use their control to prevent the company from instituting legal proceedings against them to remedy the wrong that they themselves have perpetrated against the company. The danger is particularly acute when the wrongdoers have control of both the board of directors as well as the shareholders in general meeting. This occurs, for instance, where the wrongdoers are the majority on the board of directors (or are otherwise able to dominate or influence the board of directors) and, concurrently, are the majority shareholders of the company — so that the wrongdoers are able to exploit both their dominant position on the board as well as over the shareholders in general meeting to frustrate any decision or resolution by the company to institute legal proceedings against them. For this purpose, the wrongdoers need not even hold a majority of the company's voting rights themselves; the spectrum could extend to control of a majority of the votes held in combination by the offending directors themselves and those voting with them as a result of their influence, support, or simply because of apathy.¹² This is the classic case for a derivative action. The need for a minority shareholder to bring a derivative action on behalf of the company, to redress a wrong done to the company, generally arises where the company itself does not institute legal action to redress the wrong done to it.¹³ As Lord Denning explained in *Wallersteiner v Moir (No 2)*:

'The [proper plaintiff] rule is easy enough to apply when the company is defrauded by outsiders. The company itself is the only person who can sue. Likewise, when it is defrauded by insiders of a minor kind, once again the company is the only person who can sue. But suppose it is defrauded by insiders who control its affairs — by directors who hold a majority of shares — who then can sue for damages? Those directors are themselves the wrongdoers. If a board meeting is held, they will not authorise proceedings to be taken by the

¹¹ See eg *Massey v Wales*; *Massey v Cooney* (2003) 57 NSWLR 718 CA (NSW). There are pertinent similarities between the Act and the Australian legislation, as will be discussed further below.

¹² See eg *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] 1 All ER 354 at 364.

¹³ See eg Maleka Femida Cassim 'Shareholder remedies and minority protection' in Farouk H I Cassim (managing ed) *Contemporary Company Law* 2 ed (2012) 776; Bruce Welling *Corporate Law in Canada: The Governing Principles* 3 ed (2006) 509.

company against themselves. If a general meeting is called, they will vote down any suggestion that the company should sue themselves. Yet the company is the one person who is damnified. It is the one person who should sue. In one way or another, some means must be found for the company to sue. Otherwise the law would fail in its purpose. Injustice would be done without redress.¹⁴

The statutory derivative action is thus a paramount protective measure for minority shareholders. It enables a minority shareholder, who knows of a wrong done to the company that has remained unremedied by management (often because they are the wrongdoers) to institute proceedings on behalf of the company. The derivative action is directed at enabling the minority shareholder to recover damages or property for the company when the directors have improperly refused to do so. It is, furthermore, progressively regarded as a fundamental corporate governance tool to monitor corporate conduct and to deter managerial or directorial wrongdoing.¹⁵

But the new streamlined statutory derivative action in terms of s 165 is much wider than this, and its reach extends beyond instances of wrongdoer control of the company, in contradistinction with the now obsolete common-law derivative action as laid down in *Foss v Harbottle*.¹⁶ Section 165 is available to a wider class of applicants than just minority shareholders.¹⁷ Moreover, its use is not limited to wrongs that are committed by the management or the controllers of the company — it even extends to wrongs that are committed by third parties or outsiders, including those outsiders against whom the controllers of the company decline to act because they are related parties, or because of their association with the outsider, or because of their desire to shield the outsider (although practically it could be more difficult to bring a derivative claim against third parties, in view of the rebuttable presumption in s 165(7) and (8) that the grant of leave is not in the best interests of the company if the proceedings, inter alia, involve a third party).¹⁸

(b) *The discretion of the court to grant leave for a derivative action*

It is only 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, or a registered trade union representing employees of the company or another employee representative,

¹⁴ [1975] All ER 849 (CA) at 857.

¹⁵ See e.g. the decision of the Ontario Court of Appeal in *Richardson Greenshields of Canada Ltd v Kalmacoff* [1995] BLR (2d) 197 (CA) at 205; the United States of America case *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. This issue is discussed further below.

¹⁶ *Supra* note 2.

¹⁷ See s 165(2) of the Act.

¹⁸ Maleka Femida Cassim *op cit* note 13 at 788–90. For a discussion of the rebuttable presumption see further Maleka Femida Cassim 'When companies are harmed by their own directors: Defects in the statutory derivative action and the cures' Parts 1 and 2 (2013) 25 *SA Merc LJ* (forthcoming).

or a person who has been granted standing by the court, who may pursue a derivative action on behalf of the company: and only with the leave of a court¹⁹ in the exercise of its discretion. The court is thus entrusted with a pivotal role in the statutory derivative action under s 165 of the Act. It has a crucial filtering or screening function in deciding whether or not to permit the applicant to institute derivative proceedings on behalf of the company. This judicial screening mechanism is essential, since the company itself has chosen not to sue, and the institution of a derivative action would involve the company in litigation against its will. The requirement of the leave of the court provides a safeguard against unwarranted interference by disgruntled shareholders, individual directors or other applicants in the internal management of the company, and prevents them from improperly arrogating the management function which is vested in the board of directors. This approach, moreover, averts opening the floodgates to a multiplicity of actions; if the leave of the court were not required, multiple actions could be brought by a multitude of individual shareholders and other applicants concerning the same wrong inflicted on the company.²⁰

There are five prerequisites for the court to grant leave for derivative proceedings. First, a shareholder (or other applicant with standing under s 165(2)) who knows of a wrong done to the company and who wishes to see it rectified must serve a demand on the company to institute or to continue legal proceedings to protect its own legal interests. Although s 165(2) of the Act states that 'a person *may* [not *must*] serve a demand' (my insertion), the requirement of a demand (when read with s 165(5)²¹) is clearly a mandatory requirement for a derivative action.²² The court, in exceptional circumstances, may waive the requirement of a demand.²³ Secondly, the company must serve a notice refusing to comply with the demand or, alternatively, the company must have failed to take any particular step required by s 165(4) (relating to the investigation of the demand and its response to the demand), or must have appointed an investigator or committee who was not independent and impartial, or must have accepted a report that was inadequate in its preparation or was irrational or unreasonable in its conclusions or recommendations, or must have acted in a manner that was inconsistent with the reasonable report of an independent, impartial investigator or committee.²⁴ Without this requirement of inaction or improper action by the board, the power and authority of the board of directors to manage the company would

¹⁹ Section 165(5).

²⁰ See e.g. Maleka Femida Cassim op cit note 13 at 784; R P Austin & I M Ramsay *Ford's Principles of Corporations Law* 14 ed (2009) 729.

²¹ Section 165(5) permits only a '*person who has made a demand* in terms of subsection (2)' (emphasis supplied) to apply to a court for leave to bring derivative proceedings.

²² See Maleka Femida Cassim op cit note 13 at 784; this was recently confirmed in *Mouritzen v Greystone Enterprises (Pty) Ltd* 2012 (5) SA 74 (KZD) para 24.

²³ In terms of s 165(6).

²⁴ Section 165(5)(a).

be flouted or undermined. The decision to litigate is a commercial decision which is vested in the board of directors, and a shareholder or other relevant stakeholder cannot be permitted to litigate derivatively to protect the company's legal interests unless the board of directors as a corporate organ is aware of the complaint, but has refused to take action or to take diligent action. Parallel recognition is given in other jurisdictions to the requirement of inaction by the board. For instance, in the Ontario legislation²⁵ it is a precondition to the grant of leave that the directors of the corporation will not bring the action, and in terms of the Australian legislation²⁶ the court must be satisfied that it is improbable that the company will itself bring the proceedings or properly take responsibility for them.²⁷ Interestingly, the requirement in the South African legislation is stricter than its Australian equivalent. While the Australian Corporations Act states that it must be 'probable'²⁸ that the company will not itself bring the proceedings, the South African Act requires an explicit notice of refusal by the company and grants the company a period of up to 60 business days (ie twelve weeks) in which to serve it (or an even longer period if the court permits).²⁹ This stricter requirement under the Act is perhaps unnecessarily rigorous, and could foreseeably lead to practical difficulties.

The remaining three prerequisites for the judicial grant of leave for a derivative action are: the court must be satisfied, in terms of s 165(5)(b), that the applicant is acting in good faith; 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, the ratification or approval by shareholders of any particular wrongdoing is not a bar to a derivative action, although the court may take this into account.³⁰ The judicial discretion to grant or refuse leave for derivative proceedings must be exercised with reference to the three guiding criteria set out in s 165(5)(b). If these criteria are satisfied, the court 'may' grant leave; in other words, it still has a discretion to refuse leave even if these criteria are met. But, conversely, in order for the court to grant leave, all three criteria must be met. In this regard, s 165(5) states that the court may grant leave 'only if' these criteria are satisfied.

The approach that the courts adopt in exercising their discretion to grant leave is a matter of supreme importance, which will have a major impact on the effectiveness (or lack of effectiveness) of the new statutory derivative

²⁵ Section 246(2)(a) of the Ontario Business Corporations Act RSO 1990, c B16.

²⁶ Section 237(2)(a) of the Australian Corporations Act, 2001.

²⁷ In terms of the New Zealand Companies Act, 1993, the court in deciding whether to grant leave must consider any action already taken or intended to be taken by the company (see s 165(2)(c) and (3)(a)).

²⁸ *Op cit* note 26.

²⁹ Section 165(4)(b).

³⁰ Section 165(14). See Maleka Femida Cassim 'Judicial discretion in derivative actions under the Companies Act of 2008' (2013) 130 *SALJ* (forthcoming) for a discussion of the requirements in s 165(5)(b) of the 'trial of a serious question' and the 'best interests of the company'.

action. Due to the open-textured nature of the guiding criteria in s 165(5)(b), and particularly the elusive requirement of good faith, the approach that the courts take in interpreting and applying the criteria will largely determine the fate of this remedy in South African law. Hopefully the courts will deal with leave applications in a flexible and robust manner so as to advance and promote the use of s 165, as opposed to adopting a narrow or restrictive interpretation of the leave criteria that would stultify the use of the statutory derivative action and relegate it to a redundant status as a ‘white elephant’. This would serve only to frustrate the object of the new statutory provisions.

(c) *The exercise of the court’s discretion in the light of the purpose and objects of the derivative action*

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

‘[A] derivative action brought by an individual shareholder on behalf of a corporation serves a dual purpose. First, it ensures that a shareholder has a right to recover property or enforce rights for the corporation if the directors refuse to do so. Second, and more important for our present purposes, it helps guarantee some degree of accountability and to ensure that control exists over the board of directors by allowing shareholders the right to bring an action against directors if they have breached their duty to the company.’³¹

Similarly, the court in the US case of *Diamond v Oreamuno*³² proclaimed that the purpose of the derivative suit is not merely to compensate the company, but also to deter. A successful derivative action has the added benefit of deterring future misconduct by directors, to the advantage of the shareholders. It may also deter misconduct at other companies.³³ The real prospect of liability, with attendant financial loss, reputational loss and loss of

³¹ [1995] BLR (2d) 197 (CA) at 205. The Canadian statutory derivative action has influenced the South African statutory derivative action, and Canadian jurisprudence is accordingly relevant in the South African context. This is discussed further below. See in this context s 5(2) of the Act.

³² *Supra* note 15. The relevance of American jurisprudence is discussed further below.

³³ *Coffee op cit* note 15 at 1428–9.

social status,³⁴ serves as a deterrent to directorial wrongdoing and violations of the duties owed by directors to their companies, and would thereby ensure some degree of accountability by directors and managers of companies. The derivative action could potentially be very useful in promoting good corporate governance in South African law, provided that it is given a full life as an effective remedy by which shareholders may hold corporate management accountable and punish managerial misconduct.

In light of these vital purposes of the derivative action, the courts should not impose artificial confines on its availability. Without effective mechanisms to enforce the fiduciary and statutory duties of directors and prescribed officers, directors would be immune from legal control and accountability. The previous common-law derivative action was hampered to a large extent by an underlying policy and attitude of hostility to minority shareholder litigation. As long ago as 1970 the Van Wyk de Vries Commission³⁵ recognised the strong need for a change in policy in the arena of the derivative action. More recently, the policy paper of the Department of Trade and Industry, entitled 'Company Law for the 21st Century',³⁶ highlighted the importance of directorial accountability, the protection of shareholder rights, the advancement of shareholder activism and the need for enhanced protection for minority shareholders.³⁷ For the new statutory derivative action to play a useful role as a watchdog in policing boards of directors, it must be given teeth by the courts by means of a liberal and robust interpretation.

A robust judicial interpretation of the leave criteria is now buttressed by the stated purposes of the Act. Among the relevant purposes of the Act are the encouragement of high standards of corporate governance,³⁸ the encouragement of the efficient and responsible management of companies,³⁹ and balancing the rights and obligations of shareholders and directors within companies.⁴⁰ The promotion of these purposes of the Act by an efficient and effective derivative action may, in turn, strengthen investor confidence and promote investment in the South African markets (yet another object of the Act⁴¹), and may also promote an effective environment for the efficient regulation of companies.⁴² Significantly, the court is enjoined by s 158(b)(ii), when determining a matter or making an order in terms of the Act, to promote the spirit, purpose and objects of the Act.

³⁴ Ibid.

³⁵ *Van Wyk de Vries Commission of Enquiry into the Companies Act, Main Report* RP 45/1970 paras 42.13–42.14.

³⁶ See GG 26493 of 23 June 2004 paras 2.2.3 and 4.4.1.

³⁷ See also *Memorandum on the Objects of the Companies Bill, 2008*, Companies Bill 61D of 2008 para 1.2.4.

³⁸ Given the significant role of enterprises within the social and economic life of the nation (s 7(b)(iii)).

³⁹ Section 7(j).

⁴⁰ Section 7(i).

⁴¹ Section 7(c).

⁴² As required by s 7(l).

As a practical matter of administration and enforcement, it must be borne in mind that South Africa currently does not have a strong established state body or enforcement agency which rigorously enforces company law. The imposition of personal liability on directors for wrongdoing and breaches of their duties depends largely on shareholder enforcement. It is envisaged⁴³ that part of the burden will ultimately be shifted from shareholder enforcement to enforcement by the Companies and Intellectual Property Commission (and the Takeover Regulation Panel), and in this spirit s 165(16) usefully clarifies that the right to apply to court for leave for derivative proceedings may be exercised by the Companies Commission (or Takeover Regulation Panel) on behalf of a minority shareholder or other suitable applicant. Nevertheless, presently in South Africa the success of the statutory derivative action largely depends on shareholders (and other suitable applicants) to enforce the rights of the company and to play an active role in the legal control of directors, often at their own personal expense, time and convenience. In striking contrast is Australia with its Australian Securities and Investments Commission ('ASIC'), which is a prominent state regulatory body, also responsible for the investigation and enforcement of the provisions of the Corporations Act, 2001, including the general statutory duties of directors under ss 180 to 184 of the Corporations Act. This is a further practical factor which the South African courts must bear in mind in dealing with applications for leave under s 165 that are brought by shareholders who prepared to protect the legal interests of the company.

But in applying the judicial discretion to grant or refuse leave, it is an equally important policy consideration that there should be checks and balances to prevent the abuse of the derivative action. There is a risk of applicants bringing frivolous or vexatious proceedings to harass the management of the company. There also exists the potential for opportunistic shareholders (and other applicants) to exploit s 165 by using it for 'strike suits' or 'greenmail', in order to extract personal benefits for the applicants themselves, as opposed to bringing benefits for the company (as I shall discuss further below). The prime control measure or safeguard is that the leave of the court is required to commence or continue derivative proceedings. This enables the court to weed out frivolous, vexatious or unmeritorious claims. The three criteria for leave in terms of s 165(5)(b), including the criterion that the applicant must be acting in good faith, are designed to curtail such frivolous and vexatious claims.⁴⁴

The judicial discretion to grant leave for derivative proceedings thus involves a tension between two conflicting policy objectives, which must be balanced against each other. On the one hand is the benefit of a right of redress, which enables a stakeholder to seek redress on the company's behalf where the company fails to do so; and on the other hand is the need to

⁴³ Department of Trade and Industry 'Company Law for the 21st Century' op cit note 36 paras 2.2.3 and 4.4.1.

⁴⁴ See e.g. Maleka Femida Cassim op cit note 13 at 777 and 786.

prevent nuisance actions that are frivolous or vexatious or without merit. The tension between the benefit of a right of redress and the risk of nuisance actions is an underlying theme of s 165 and may be expected to cause difficulties and complexities in practice.⁴⁵

(d) *Comparable jurisdictions*

It is noteworthy that the South African statutory derivative action is based on similar models to those adopted in some commonwealth jurisdictions like Australia, Canada, New Zealand and Singapore, all of which turn on the need to obtain the leave of the court before commencing a derivative action. Useful lessons may be gleaned from the experiences and decisions of the courts on leave applications in these jurisdictions.

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

Historically, South Africa was one of the earliest commonwealth countries to enact a statutory derivative action, in terms of the previous Companies Act 61 of 1973, following Ghana, which was the first commonwealth country to do so in its Companies Code, 1963. These early models, however, differ in significant ways from the new South African statutory derivative action, and are not directly relevant to its interpretation. The most influential model of the statutory derivative action is the Canadian model, which has inspired the modern trend in commonwealth countries to enact statutory derivative actions rather than to rely on an ineffectual common-law derivative action. This has formed part of Canadian legislation since the 1970s, and centres on an application to court for leave, combined with judicial oversight of the remedy. Canada was perhaps positively influenced by the law of the United States of America, in which the derivative action is long-standing, having originated from common-law principles established in 1882 in *Hawes v City of Oakland*,⁴⁶ and which are now found in statutory form.⁴⁷ The Canadian prototype served as the basis for the New Zealand derivative action which was introduced in its Companies Act, 1993, and which similarly controls

⁴⁵ See e.g. *Cohen v Beneficial Industrial Loan Corp* (1949) 337 US 541; see also *ibid*.

⁴⁶ 104 US 450 (1882) (US Supreme Court). The derivative action was first recognised in the United States of America in 1855 — see *Dodge v Woolsey* 59 US (18 How) 331 (1855) (US Supreme Court).

⁴⁷ See the Model Business Corporation Act of 2002; the American Law Institute's *Corporate Governance Principles* (1992 Pt VII, Ch1); rule 23.1 of the Federal Rules of Civil Procedure, 1966.

access to the remedy by tight judicial supervision. Singapore, at around the same time as New Zealand, enacted a statutory derivative action⁴⁸ which was also modelled on the Canadian version. In turn Australian law, informed by the New Zealand version, followed suit by introducing the remedy into its Corporations Act with effect from 2000.

Although similar trends and undercurrents may be discerned in all these commonwealth models which were based on the Canadian model, some significant variances exist in the criteria for the grant of leave. But it is instructive to note, and it must also be stressed, that despite these variations, ultimately the courts in all these jurisdictions emphasise and take account of strikingly similar considerations in their overall assessment of whether or not to grant leave. The South African Act, in so far as the provisions on the guiding criteria for the grant of leave are concerned, is most closely aligned with the Australian model of the derivative action.⁴⁹

The United Kingdom, which had formulated the problematic common-law derivative action and the rule in *Foss v Harbottle*, enacted its statutory derivative action at a relatively late stage, in the Companies Act, 2006. Similarly, Hong Kong only recently enacted a court-supervised statutory derivative action in 2005. All the above models depend on court supervision of the remedy, in stark contrast with the United States model.

The discretion of the court to grant leave to institute derivative proceedings, as discussed above, entails a conflict between two equally important principles: first, the benefit of a right of redress by a stakeholder on behalf of the company; and, secondly, the prevention of nuisance actions. The three leave criteria in s 165(5)(b) are designed to lay the foundation for a proper balance between the use of the remedy for the protection of minority shareholders and the abuse of the remedy by minority shareholders. This ultimately turns on the appropriate interpretation by the courts of the open-textured preconditions for the grant of leave. The remainder of this article focuses on the problematic requirement that the court, in order to grant leave for derivative litigation, must be satisfied that the applicant is acting in good faith. Guidelines will be suggested for the proper interpretation of the precondition of good faith, with reference to underlying principles in South African law, as well as the experience and jurisprudence of the courts in comparable jurisdictions, particularly Australia, Canada and New Zealand and, where relevant, the United Kingdom.

III THE CRITERION OF GOOD FAITH: A FRAMEWORK

(a) *The meaning and interpretation of good faith in South African law*

An applicant who seeks leave to institute derivative proceedings must satisfy the court that he or she is acting in good faith (in terms of s 165(5)(b)(i)).

⁴⁸ Section 216A and B of the Companies Act, 1994 cap 50.

⁴⁹ Compare in this regard s 237(2)–(4) of the Australian Corporations Act, 2001 and s 165(5), (7) and (8) of the Act.

'Good faith' is an elusive concept, the precise meaning and ambit of which is difficult to pin down. It is submitted that in the context of s 165 the concept of good faith may be interpreted with reference to well-established common-law principles on the meaning of good faith in South African company law. These principles are rooted both in the (now abolished) common-law derivative action as well as the fiduciary duty of directors to act in good faith in the best interests of the company. Just as a director has a duty to act in good faith in conducting the affairs of the company, so an applicant who wishes to pursue litigation on behalf of the company in terms of s 165 ought to act according to a similar standard of good faith. This analogy is now reinforced by the recent case *Mouritzen v Greystone Enterprises (Pty) Ltd*,⁵⁰ in which the Kwazulu-Natal High Court stated: '[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"'.⁵¹ Based on an adaptation and an extension of existing common law principles, it is submitted that the good faith criterion in s 165 comprises two facets.

The first facet is that the test of good faith is subjective, not objective, and relates to the applicant's state of mind. The test of good faith depends principally, but not exclusively, on honesty.⁵² Although honesty is subjective, there are limits to the subjective test. In the context of the duty of directors to act in good faith, the test as formulated in *Charterbridge Corporation Ltd v Lloyds Bank Ltd*,⁵³ is whether an intelligent and honest person in the position of the director could, in the whole of the circumstances, have reasonably believed that he or she was acting in the interests of the company.⁵⁴ These principles relating to the fiduciary duties of directors may be suitably adapted for the statutory derivative action. It may consequently be said that the quintessence of the good faith criterion in s 165 is that it is a subjective criterion, qualified by an objective criterion. The subjective aspect is that the applicant must honestly believe that the company has a valid cause of action, while the objective test is whether a reasonable person in the position of the applicant could, in the light of the circumstances, reasonably have believed that the company has a valid cause of action. In the absence of reasonable grounds for believing that the company has a valid cause of action, the applicant in derivative proceedings may be found to be lacking in good faith.⁵⁵

⁵⁰ Supra note 22.

⁵¹ Ibid para 60.

⁵² Farouk H I Cassim 'The duties and the liability of directors' in Farouk H I Cassim et al op cit note 13 at 524, in the context of the duty of directors to act in good faith.

⁵³ [1970] Ch 62 at 74. See also *Shuttleworth v Cox Brothers & Co (Maidenhead) Ltd* [1927] 2 KB 9; *Teck Corp Ltd v Millar* (1972) DLR (3d) 288 (BCSC).

⁵⁴ Farouk Cassim op cit note 52 at 524–5.

⁵⁵ This approach is consistent with the test for the duty of directors to act in good faith in the best interests of the company.

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

It is submitted that the second facet of the good faith criterion relates to the purpose or the motive of the applicant in bringing the proposed derivative action. Bearing in mind that the purpose of a derivative action is to do justice to the company and to protect the company's legal interests (not directly those of the applicant), the good faith criterion must entail that the applicant's actions are motivated by the honest purpose of protecting the legal interests of the company, and not by the ulterior purpose of pursuing his or her own private interests or pursuing some advantage for which the derivative action was not conceived.⁵⁶ This typically applies if the derivative action is used, for instance, as 'a strike suit' or for 'greenmail',⁵⁷ where the shareholder institutes derivative proceedings with the purpose of blackmailing the management of the company into a settlement of the claim in which he or she obtains some private benefit such as the purchase of his or her shares above the market price. If an applicant acts for a collateral purpose or has an ulterior motive in bringing a derivative action, this is tantamount to an abuse of the derivative action, and the applicant is in bad faith.

This submission concerning the second facet of good faith under s 165 is supported by, and is consistent with, the principles on good faith under the (now abolished) common-law derivative action. In this regard, a plaintiff was disqualified from bringing a common-law derivative action by a lack of good faith if he or she did not sue in the interests of the company, but for some collateral purpose. For instance, in *Barrett v Duckett*⁵⁸ (concerning the common-law derivative action in English law, on which South African law was previously based), a shareholder was barred by the court from bringing a derivative action on the basis that she had a collateral purpose in pursuing the action as part of a personal vendetta against the defendant, and the action was consequently not in the interests of the company. The issue of a collateral purpose is pertinent to good faith not only in the sphere of the common law derivative action but also in the field of the fiduciary duty of directors to act in good faith.⁵⁹ At common law the duty to act in good faith and the duty to act for a proper purpose are regarded as separate and distinct, yet are also

⁵⁶ This submission is based on an adaptation and extension of the reasoning of the court in *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821 (PC).

⁵⁷ See e.g. *Maleka Femida Cassim* op cit note 13 at 777.

⁵⁸ [1995] 1 BCLC 243 (CA).

⁵⁹ Shareholders clearly do not owe fiduciary duties to the company but, nonetheless, some consideration of the meaning of the good faith of directors is apposite.

cumulative.⁶⁰ This is now reinforced by the statutory duty of directors in terms of s 76(3)(a) of the Act, which couples the directors' duty to act in good faith with the duty of directors to act for a proper purpose. The duty to act for a proper purpose at common law has always meant that a power must be exercised for the objective purpose for which the power was conferred and not for a collateral or ulterior purpose.⁶¹ There is accordingly ample authority in South African company law in support of the contention that the duty of good faith under s 165(5)(b) encompasses the absence of any collateral purpose on the part of the applicant.⁶²

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

A collateral purpose is thus present if an applicant is using the derivative action not as a means of protecting the company's legal interests but as a means of seeking some other personal advantage for which the derivative action was not intended. A collateral purpose was found to exist in the context of the common-law derivative action in *Portfolios of Distinction Ltd v Laird*,⁶³ where minority shareholders who had participated in and had benefited from the wrongdoing brought a derivative action for the collateral purpose of drawing attention away from their own wrongdoing; and in *Konamaneni v Rolls-Royce Industrial Power (India) Ltd*,⁶⁴ where a derivative action was used as a tactic in a battle for control of the company. Other illustrations of typically bad faith derivative actions that are motivated by ulterior purposes are actions brought with the true purpose of disrupting the company's business in order to benefit a business competitor, and actions brought by competitors as a tactic to gain access to confidential corporate information by means of discovery.

The purpose of the good faith criterion is accordingly to protect the company against frivolous, vexatious and unmeritorious claims, and to foster the litigation of genuine grievances that are in the interests of the company.

⁶⁰ Farouk Cassim op cit note 52 at 525.

⁶¹ Ibid.

⁶² The issue of a collateral or ulterior purpose must not be confused with self-interest in the outcome of the action or with personal animosity on the part of the applicant. While a collateral purpose amounts to an abuse of the derivative action and negates good faith, the same does not necessarily apply to self-interest or personal animosity. This issue is discussed further in part IV below. (A collateral purpose entails that the applicant's actions are motivated, not by the proper purpose of protecting the company's interests, but by an improper purpose involving the pursuit of some other interest for which the derivative action was not conceived.)

⁶³ [2004] EWHC 2071 (Ch).

⁶⁴ [2002] 1 WLR 1269.

The good faith requirement will serve to filter out the abuse of derivative actions to pursue the personal purposes of the applicant himself or herself, rather than the interests of the company as a whole.

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

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

(b) Good faith in Australia, Canada, New Zealand and other jurisdictions

Good faith is also a precondition for the grant of leave for derivative actions in Australian and Canadian law. It is not, however, an explicit requirement in the New Zealand legislation,⁶⁵ nor in the United States of America under the Federal Rules of Civil Procedure. The criteria for the grant of leave under the South African Act are similar to those under the equivalent Australian legislative provisions, and the latter may accordingly be of much assistance in the interpretation of the former.⁶⁶ Decisions of the Canadian and New Zealand courts are also instructive.

The Australian 'Explanatory Memorandum to the Corporate Law Economic Reform Programme Bill'⁶⁷ envisaged that a court in assessing good faith would consider, first, whether there was any complicity by the applicant in the matters complained of and, secondly, whether the application is made in pursuit of a private interest rather than the interests of the company. This explanation of good faith was referred to by the court in *Fiduciary Limited v Morningstar Research Pty Limited*.⁶⁸ The leading Australian case of *Swansson v R A Pratt Properties Pty Ltd*⁶⁹ laid down that there are two interrelated questions in determining good faith: first, whether the applicant honestly believes that a good cause of action exists and that it has a reasonable prospect of success; and, secondly, whether the applicant is seeking to bring the derivative suit for a collateral purpose. These two factors will in most cases — though not always — overlap.⁷⁰ The approach of Palmer J in *Swansson v Pratt* was approved in *Maher v Honeysett & Maher Electrical Contractors Pty Ltd*⁷¹ and has since been followed in numerous cases, including *Charlton v Baber*,

⁶⁵ Section 239(2)(b) of the Canada Business Corporations Act, RSC 1985 c C-44; s 246(2)(b) of the Ontario Business Corporations Act RSO 1990, c B16; s 237(2)(b) of the Australian Corporations Act, 2001.

⁶⁶ Maleka Femida Cassim op cit note 13 at 785.

⁶⁷ Paras 6.34–6.48.

⁶⁸ [2005] NSWSC 442.

⁶⁹ (2002) 42 ACSR 313.

⁷⁰ Ibid paras 36–7.

⁷¹ [2005] NSWSC 859.

Goozee v Graphic World Group Holdings Pty Limited and Fiduciary Limited v Morningstar Research Pty Limited.⁷² Australian courts have also stated that good faith means that the application should be made in good faith having regard to the interests of the company.⁷³ *Cannon Street Pty Ltd v Karedis* proclaimed that the concept of good faith is inextricably linked with the duty to act honestly and for no ulterior purpose.⁷⁴

There are clear congruencies between the interrelated factors on good faith in Australian law, as proclaimed by *Swansson v Pratt*, and the twin aspects of the good faith criterion in the South African context (which are derived from existing common law principles in South African law, as I have discussed above). The Australian approach to good faith should therefore be regarded as being strongly persuasive in South African law.⁷⁵ The KwaZulu-Natal High Court in *Mouritzen v Greystone Enterprises (Pty) Ltd*⁷⁶ has recently quoted with approval the test of good faith laid down in *Swansson v Pratt*.

In considering whether the applicant honestly believes that a good cause of action exists and has a reasonable prospect of success, the Australian court in *Swansson's* case added that '[c]learly, whether the applicant honestly holds such a belief would not simply be a matter of bald assertion; the applicant may be disbelieved if no reasonable person in the circumstances could hold that belief'.⁷⁷ This clearly harmonises with the submission made above that the test of good faith in the South African setting is a subjective test qualified by an objective criterion. This dictum is relevant also in respect of how good faith is proved, which is a vital matter that will be addressed below. With regard to the issue of a collateral purpose, the Australian court in the *Fiduciary Limited* case has held that acting for a collateral purpose means to act 'in pursuit of interests other than those of [the company]'.⁷⁸ An applicant acts for a collateral purpose, for instance, if his or her true objective is to force the defendant directors either to pay dividends or alternatively to arrange for the purchase of his or her shares — something which occurred in *Goozee v Graphic World Group Holdings Pty Ltd*.⁷⁹

Turning to Canadian law, according to the Report of the Dickerson Committee,⁸⁰ the purpose of the requirement of good faith is to preclude

⁷² *Charlton v Baber* [2003] NSWSC 745; *Goozee v Graphic World Group Holdings Pty Limited* [2002] NSWSC 640; *Fiduciary Limited v Morningstar Research Pty Limited* supra note 68; see also *Carpenter v Pioneer Park Pty Limited (in liq)* [2004] NSWSC 1007.

⁷³ *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* [2001] QSC 324 para 27; *Cannon Street Pty Ltd v Karedis* [2004] QSC 104 paras 169–175.

⁷⁴ *Ibid* para 175.

⁷⁵ See Maleka Femida Cassim op cit note 13 at 785.

⁷⁶ Supra note 22 para 58.

⁷⁷ Supra note 69 para 36.

⁷⁸ *Fiduciary Limited v Morningstar Research Pty Limited* supra note 68 para 21.

⁷⁹ Supra note 72; see also *Maher v Honeysett & Maher Electrical Contractors Pty Ltd* supra note 71; *Ehsmann v Nutec International Pty Ltd* (2006) 58 ACSR 7051; *Magafas v Carantinos* [2006] NSWSC 1459.

⁸⁰ Robert Warren Vincent Dickerson, John L Howard & Leon Getz *Proposals for a New Corporations Law for Canada* (1971) para 482.

private vendettas. Good faith is found to exist where there is prima facie evidence that the complainant (or applicant) is acting with proper motives such as a reasonable belief in the claim.⁸¹ The assessment of good faith, as laid down in *L&B Electric Ltd v Oickle*⁸² and in *Winfield v Daniel*,⁸³ is essentially a question of fact to be determined on the circumstances of each case. The concept of good faith is founded on honesty.⁸⁴ Strategic motives for applying for leave are indicative of bad faith.⁸⁵ Good faith has been said to relate to the intention of the applicant — that is, whether the application is brought with the motive and intention of benefiting the company or whether it is brought for some subliminal purpose or benefit outside that interest.⁸⁶ A complainant who uses the derivative action for an improper purpose, such as to exact a personal advantage from the company, or is motivated by a personal vendetta will not in Canadian law be regarded as being in good faith.⁸⁷ The same applies when an action is frivolous or vexatious. It is thus evident that Canadian law gives weight to similar factors as those suggested for South African law and espoused in Australian law.

The New Zealand legislation does not, as I have stated above, incorporate an explicit requirement of good faith. Unlike the position in the Australian, Canadian and South African legislation, good faith is not a mandatory consideration in New Zealand law. Nevertheless, the question of a collateral purpose is of paramount importance to the New Zealand courts, which do take account of whether the applicant has an ulterior motive in seeking leave to litigate derivatively.⁸⁸ An ulterior motive has been held to mean more than mere self-interest in the outcome of the derivative action,⁸⁹ and relates instead to whether there is an abuse of process.

IV FURTHER FACETS OF GOOD FAITH

The fundamental framework of good faith, comprising the two main facets highlighted above, forms the heart of the inquiry into good faith under s 165. Besides these twin aspects of good faith, other elements may also be pertinent to the assessment of the good faith of an applicant who seeks leave to institute derivative proceedings. These further facets of good faith are likely to be built

⁸¹ *Winfield v Daniel* [2004] AF No 37, 352 AR 82 (QB).

⁸² [2006] NSJ No 119, 15 BLR (4th) 195 (CA).

⁸³ *Supra* note 81.

⁸⁴ *1172773 Ontario Ltd v Bernstein* [2000] OTC 758, [2000] OJ No 4102 (QL) (Sup Ct J).

⁸⁵ *Abraham v Prosoccer Ltd* (1981) 119 DLR (3d) 167 (Ont HC); *Vedova v Garden House Inn Ltd* (1985) 29 BLR 236 (Ont HC).

⁸⁶ *Tremblett v SCB Fisheries Ltd* (1993) 116 Nfld & PEIR 139, [1993] NJ No 348 (QL) (SC).

⁸⁷ See generally *Primex Investments Ltd v Northwest Sports Enterprises Ltd* [1995] 13 BCLR (3d) 300 (SC); *Discovery Enterprises Inc v Ebco Industries Ltd* [1997] 40 BCLR (3d) 43 (SC); *Jennings v Bernstein* 2000 Carswell Ont 4039 (SC).

⁸⁸ *Tweedie v Packsys Ltd* (2005) 2 NZCCLR 584 (HC); *Needham v EBT Worldwide Ltd* (2006) 3 NZCCLR 57 (HC).

⁸⁹ *Discovery Enterprises v Ebco Industries Ltd* [1999] 4 WWR 56 (BCCA).

up by the courts on a case-by-case basis as the need and the opportunity arises. Likewise in Australian law, in *Chahwan v Euphoric Pty Ltd*⁹⁰ it was held that the inquiry into the applicant's good faith is not necessarily limited to the two main factors elucidated in *Swansson v Pratt*. Other key factors that are likely to be considered are discussed below.

(a) *Complicity or participation in the wrongdoing*

An essential aspect of good faith is whether the applicant was complicit in the wrong of which he or she complains. In relation to the (recently eradicated) common-law derivative action, there is clear authority that any complicity by the shareholder, or participation or acquiescence in the wrong of which he or she complains, would preclude the shareholder from bringing a derivative action by reason of his or her bad faith.⁹¹ It is submitted that complicity or participation by the applicant in the wrongdoing would probably continue to destroy good faith for the purpose of instituting the new statutory derivative action.

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

Regarding the position in comparable jurisdictions, in Australian law the requirement of good faith was designed inter alia to prevent derivative proceedings being used where there was any complicity by the applicant in the matters that motivated the complaint.⁹² An applicant will not be permitted by means of the derivative action to benefit from his or her own wrongdoing.⁹³ If an applicant was a direct and knowing participant in the

⁹⁰ (2008) 65 ACSR 661; see also *Swansson v Pratt* supra note 69 para 35.

⁹¹ See for instance *Towers v African Tug Co* [1904] 1 Ch 550 (CA); *Eales v Turner* 1928 WLD 173 at 181; *Nurcombe v Nurcombe* [1985] 1 All ER 65 (CA) at 69; *Portfolios of Distinction Ltd v Laird* supra note 63. But see further the discussion of the 'clean hands' doctrine below.

⁹² *Explanatory Memorandum to the Corporate Law Economic Reform Programme Bill 1998* paras 6.34–6.48.

⁹³ *Swansson v Pratt* supra note 69 para 43.

injury inflicted on the company, the court will refuse to grant leave to the applicant to bring a derivative action on behalf of the company, since the applicant seeks to receive a benefit which, in good conscience, he or she should not receive. A useful illustration is provided by the facts of *Swansson v Pratt*,⁹⁴ in which the court refused to grant leave to a plaintiff (who was both a shareholder and director of the company) to bring derivative litigation against a former director of the company, who was also her ex-husband, for an alleged breach of his fiduciary and statutory duties. The plaintiff alleged that the defendant had concluded transactions on behalf of the company while benefiting himself and other companies in which he held an interest, and in which the plaintiff herself also held an interest. The court ruled that it was not satisfied that the plaintiff was acting in good faith or that the action was in the company's best interests, and refused leave for a derivative action.

The Canadian courts have similarly held that a complainant who had participated in a decision taken by the directors in breach of their fiduciary duties could not be granted leave as an appropriate complainant.⁹⁵

There is thus authority not only in South African law but also in other comparable jurisdictions in support of the assertion that complicity by an applicant in the wrong of which he or she complains, or participation by an applicant in the wrong inflicted on the company, would destroy good faith and would result in the refusal of leave for the particular applicant to bring a derivative action. It is further submitted that this, however, should not inevitably obstruct the commencement or continuation of the derivative action by a more suitable applicant who is acting out of pure and genuine motives.

(b) Personal animosity, acrimony or malice

A distinction must be drawn between applicants who are driven by a collateral purpose on the one hand and, on the other hand, applicants who have an acrimonious relationship or personal animosity or hostility towards the respondents. Where an applicant has personal disputes with or bears ill-feeling against the board of directors of the company or the majority of the shareholders (or other respondents), this of itself would not necessarily amount to bad faith. As the court cogently stated in *Barrett v Duckett*,⁹⁶ in the context of the common-law derivative action, if personal animus prohibited a shareholder from bringing a derivative action, most derivative actions would be thwarted.

This approach is further supported and reinforced by foreign judicial authority. The Australian courts have compellingly stated that 'it is not the law that only a plaintiff who feels goodwill towards a defendant is entitled to sue'.⁹⁷ In *Swansson v Pratt* the court drew a distinction between an applicant

⁹⁴ *Ibid.*

⁹⁵ *Gartenberg v Raymond* [2004] BCJ No 2012 (CA).

⁹⁶ [1995] BCC 362 at 372.

⁹⁷ *Swansson v Pratt* supra note 69 para 41.

who is spurred on by ‘intense personal animosity, even malice’, against the respondent and an application that is brought ‘for the purpose of satisfying nothing more than the applicant’s private vendetta’.⁹⁸ While the former applicant may nevertheless be in good faith, the latter applicant would not clearly be acting in good faith. The issue of personal hostility also surfaces when determining whether the action is in the best interests of the company. The Australian courts in *Maher v Honeysett & Maher Electrical Contractors Pty Ltd* and *Ehsman v Nutectime International Pty Ltd*⁹⁹ found that the fact that an applicant has an element of self-interest in the outcome of the action or a high level of acrimony towards the other shareholders of the company will not necessarily be conclusive (or even significant) in assessing whether an application is in the best interests of the company, because this would occur frequently in the kinds of disputes which lead to derivative actions.

Comparable trends may be observed in Canadian and New Zealand law, which differentiate between mere self-interest and an ulterior purpose or personal vendetta. Self-interest in the outcome of the derivative action does not of itself constitute bad faith, whereas an ulterior purpose or a personal vendetta does. The Canadian courts have thus held that self-interest does not necessarily negate good faith.¹⁰⁰ Instituting a derivative action may permissibly have a subsidiary benefit for the applicant.¹⁰¹ Self-interest does not constitute bad faith when it coincides with the interests of the corporation.¹⁰² Furthermore, a quarrel between shareholders does not necessarily mean that either of them is in bad faith.¹⁰³ Similarly, the New Zealand courts have held that an ulterior motive means more than mere self-interest in the outcome of the derivative action¹⁰⁴ — it relates to whether there is an abuse of process.

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

⁹⁸ *Ibid.*

⁹⁹ *Maher v Honeysett & Maher Electrical Contractors Pty Ltd* supra note 71; *Ehsman v Nutectime International Pty Ltd* supra note 79.

¹⁰⁰ *1172773 Ontario Ltd v Bernstein* supra note 84.

¹⁰¹ *Tremblett v SCB Fisheries Ltd* supra note 86.

¹⁰² *Primex Investments Ltd v Northwest Sport Enterprise Ltd* supra note 87; *McAskill v TransAtlantic Petroleum Corp* [2002] AJ No 1580 (QB); *Abraham v Prosoccer Ltd* supra note 85; *Vedova v Garden House Inn Ltd* supra note 85.

¹⁰³ *Armstrong v Arbour* [1994] BCJ No 1548 (SC).

¹⁰⁴ *Discovery Enterprises v Ebco Industries Ltd* supra note 87.

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

The crisp question should thus be whether the action has merit and whether it is in the best interests of the company. If the action is in the company's best interests, the applicant should not be barred from instituting derivative litigation by reason of his or her personal animosity towards the respondents. But in the absence of a serious question to be tried, a court may be inclined to infer that the applicant could not reasonably believe that a good cause of action exists; in other words, that he or she lacks good faith. The merits of the case and the inquiry as to whether the proposed action is in the best interests of the company may shed light on the applicant's purpose and motive in seeking leave, which are central to the good faith inquiry. To this extent the three criteria that the court must consider in deciding whether to grant leave in terms of s 165(5)(b) are linked and closely interwoven with one another.¹⁰⁵

(c) *Where an applicant is motivated by a collateral purpose but the action is in the company's best interests*

In the majority of cases in which applicants for leave are motivated by an ulterior or collateral purpose, the proposed derivative proceedings will not be in the best interests of the company, but will instead be aimed at securing the private interests of the applicant. But this is not invariably the state of affairs. The conundrum arises whether the South African courts should grant an applicant leave to bring a derivative action that is in the best interests of the company and that is a meritorious action with prospects of success, even though the applicant is driven by a collateral purpose. Two divergent approaches emerge from an analysis of judicial decisions and other authorities.

One line of reasoning is that an applicant who has a collateral purpose and who thus seeks to use the derivative action for some personal benefit for which the remedy was not conceived, should plainly be refused the leave of the court under s 165 on the basis that to grant leave in these circumstances would be to permit an abuse of process or an abuse of the derivative action. Support for this view may be derived from the Australian case of *Swansson v Pratt*,¹⁰⁶ which states that if an applicant seeks by the derivative action to receive a benefit which, in good conscience, he or she should not receive (for example, if the applicant has participated in the wrongdoing with the alleged wrongdoers), the application is not made in good faith *even though the company itself stands to benefit if the derivative action is successful*. It seems that Australian

¹⁰⁵ See e.g. *Maher v Honeysett* supra note 71; *Goozee v Graphic World Group Holdings Pty Limited* supra note 72; *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 72; *Talisman Technologies Inc v Queensland Electronic Switching Pty Ltd* supra note 73.

¹⁰⁶ *Supra* note 69 para 43.

law will not permit the applicant to derive a benefit from his or her own wrongdoing.¹⁰⁷

The second, oppositional line of reasoning is that, since the purpose of the derivative action is that it is a watchdog over the management of the company and the rights of the company, the ulterior motives of the applicant should not be allowed to penalise the company. In questioning the need for the requirement of good faith in Canadian law, Maloney¹⁰⁸ has contended that if a wrong has been done to the company and the other prerequisites are satisfied, it should make little difference whether or not the applicant has pure motives. A parallel approach seems more recently to have been espoused by the English courts¹⁰⁹ in their interpretation of the statutory derivative action under the English Companies Act, 2006.¹¹⁰ In contrast to their approach to the common-law derivative action, the judicial attitude to the new English statutory derivative action, according to Mujih,¹¹¹ is apparently that an ulterior or collateral purpose or motive does not necessarily entail an absence of good faith, provided that the action is for the benefit of the company. Where the claim is for the benefit of the company as a whole, this is likely to override the ulterior motive of the applicant, and it is likely to pass the test of good faith in English law.

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

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

Secondly, as I have discussed above, where leave is denied on the basis that the applicant is driven by a collateral purpose, this is because the particular applicant is not a suitable or a qualified person to bring an action on the company's behalf. But the misconduct of an individual applicant ought not

¹⁰⁷ Ibid.

¹⁰⁸ MA Maloney 'Whither the statutory derivative action?' (1986) 64 *Canadian Bar Review* 309 at 320.

¹⁰⁹ See eg *Franbar Holdings Ltd v Patel* [2008] EWHC 1534; *Stimpson v Southern Provate Landlords Association* [2009] EWHC 2072 (Ch); *Iesini v Westrip Holdings Ltd* [2009] EWHC 2526; *Stainer v Lee* [2010] EWHC 1539 (Ch).

¹¹⁰ Section 263.

¹¹¹ E C Mujih 'The new statutory derivative claim: A paradox of minority shareholder protection (Part 2)' (2012) 33(4) *The Company Lawyer* 99 at 102–3; see also A Keay & J Loughrey 'Derivative proceedings in a brave new world for company management and shareholders' [2010] *JBL* 151 at 165–8.

automatically to disable the company from obtaining any relief, given that the purpose of a derivative action is to enforce a right that is in substance vested in the company itself, and not in the applicant personally. It is submitted that if the action is a meritorious one and is in the best interests of the company, it ought to remain open to another suitable applicant, who is indeed acting in good faith and with proper motives, to apply successfully for leave under s 165 of the Act.

Thirdly, it must be kept in mind that, in terms of s 165 of the Act, the requirements that the applicant must be acting in good faith and that the proposed derivative proceedings must be in the best interests of the company are separate and distinct prerequisites for the granting of leave. Both of them must be independently satisfied before leave may be granted to an applicant for derivative proceedings. The South African Act is cast in an entirely different mould to the English legislation, and gives more weight to the criterion of good faith as a firm and mandatory precondition for the granting of leave for a derivative claim. In contrast, the English statutory provision¹¹² merely lists good faith as one of the relevant criteria that the courts must take into account in considering whether to permit a derivative claim; it is not a mandatory condition for leave. Accordingly, a conflation of the requirements of good faith and the best interests of the company, in a similar vein to the approach of the English courts, would be inappropriate and misguided in the specific context of the South African Act.

However, as I have discussed above, there may be some intersection between the criterion of good faith and the criterion of the best interests of the company. If a claim is in the best interests of the company, this could serve as an indication (but not conclusive proof) to the court of the applicant's good faith and his or her motives in seeking leave; whereas if the claim is not in the company's best interests, the court is more likely to reach the opposite conclusion. But, notwithstanding any such linkage between the two criteria, the requirements of good faith and the best interests of the company must both be independently satisfied in order for a South African court to grant leave under s 165. This is clear from the drafting and the wording of s 165(5)(b).

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

(d) The 'clean-hands' doctrine

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

¹¹² Section 263(3)(a) of the English Companies Act, 2006.

Under the (recently abolished) derivative action at common law, the ‘clean-hands’ principle was certainly relevant.¹¹³ If a shareholder did not come to court with ‘clean hands’, he or she would be barred by the court from bringing a common-law derivative action on the basis of a lack of good faith. According to *Nurcombe v Nurcombe*,¹¹⁴ the gist of the ‘clean-hands’ principle is that a minority shareholder had behaved in such a way that it would be unjust to allow a claim brought by him or her to succeed. In *Nurcombe’s* case a shareholder, who had received a lump sum in a divorce settlement which had made allowance for certain misappropriated company assets, was not allowed to bring a derivative action in respect of the misappropriated assets of the company. The effect of the clean-hands principle was that if a minority shareholder had, for instance, participated in or acquiesced in the wrong of which he or she complained,¹¹⁵ or if he or she sued not in the interests of the company but for an ulterior purpose,¹¹⁶ he or she could not be regarded as being in good faith and would be disqualified from bringing a derivative action on the ground that he or she lacked ‘clean hands’. The precise scope of this doctrine was, however, uncertain and undefined. *Loosley v National Union of Teachers*¹¹⁷ proclaimed that there must be an element of dishonesty or sharp practice.

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

It is submitted that the South African courts should steer clear of mechanically applying the clean-hands doctrine to the statutory derivative action. The clean-hands concept is a defence that exists between an applicant personally and the wrongdoers: because the applicant’s conduct is tainted or the applicant has not acted with propriety, he or she is disqualified from bringing the action. It would consequently be anomalous in principle, as Payne maintains,¹¹⁸ if the wrongdoers were permitted to rely on the ‘dirty hands’ of the applicant as a defence in a derivative action that is brought against them to vindicate rights that belong effectively or in substance to the wronged company which is a separate legal person from the applicant himself or herself. In short, there is no reason why the applicant’s failure to come to court with clean hands should be allowed to affect the legal interests of the company. This is not to say that all applicants with ‘dirty hands’ would be permitted to bring derivative actions. In instances where an applicant is

¹¹³ *Nurcombe v Nurcombe* supra note 91; *Towers v African Tug Co* supra note 91; see also *Eales v Turner* supra note 91.

¹¹⁴ Supra note 91; see also *Towers v African Tug Co* supra note 91.

¹¹⁵ *Nurcombe* ibid.

¹¹⁶ See e.g. *Barrett v Duckett* supra note 58.

¹¹⁷ [1988] IRLR 157 (CA).

¹¹⁸ Jennifer Payne ‘“Clean hands” in derivative actions’ (2002) 61 *Cambridge LJ* 76.

motivated by a collateral purpose, or where an applicant has been a participant in the wrong which is the subject of the complaint, leave ought to be withheld — but the legal basis for the refusal of leave should not be the clean-hands principle. There are other more suitable legal bases (which have been discussed above) on which to refuse leave, besides the clean-hands principle.

A rejection of the clean-hands doctrine in the sphere of the statutory derivative action would also be in accordance with the guideline laid down by the Australian court in *Magafas v Carantinos*,¹¹⁹ where it was ruled that the courts are not to scrutinise whether the applicant has clean hands or whether there are matters that are prejudicial to the credit of the applicant.

It is notable, however, that a converse trend appears to be emerging in English law, in that the court in the English case *Iesini v Westrip Holdings Ltd*¹²⁰ did indeed refer to the clean-hands concept in the context of the English statutory derivative action. The South African courts, with respect, and for the reasons advocated above, should carefully sidestep the ‘clean hands’ approach.

(e) *Proving good faith*

The onus lies on the applicant to satisfy the court, on a balance of probabilities, of his or her good faith and of his or her fulfilment of the other prerequisites for leave as set out in s 165(5)(b).¹²¹ Proving good faith may present challenges.

The question arises as to the level of evidence that is required to establish good faith. Must the applicant actually prove that this application is brought in good faith — in which case the onus of proof is a weighty one — or will the courts presume that the applicant is acting in good faith unless the facts and circumstances of the matter show a lack of good faith? It is submitted that the better approach for the South African courts to espouse would be the latter approach. Where a derivative action appears to have merit and is in the best interests of the company, it should be presumed that the applicant is acting in good faith, unless there are objective facts and circumstances to establish otherwise. To require the applicant to prove his or her good faith positively would be to impose a restrictively heavy burden that would discourage prospective applicants from seeking permission to litigate to protect the company’s legal interests. More importantly, it would also give rise to the problem of how the applicant is to prove his or her good faith and what type of evidence would suffice, bearing in mind that good faith is largely a subjective test which depends on the applicant’s state of mind or his

¹¹⁹ See *Magafas v Carantinos* supra note 79 para 23.

¹²⁰ Supra note 109.

¹²¹ On the Australian law, see e.g. *Swansson v Pratt* supra note 69 para 26, where it was held that the applicant bears the onus of satisfying the court that, on balance of probabilities, the requirements for leave have been fulfilled. See also *Mouritzen v Greystone Enterprises (Pty) Ltd* supra note 22 para 59.

or her honest belief that the company has a good cause of action. As I have discussed above, although the proposed test for good faith is a subjective one, it is limited or qualified by an objective inquiry; if a reasonable person, in the light of the objective circumstances of the matter, could not reasonably have believed that the company has a valid cause of action with reasonable prospects of success, the applicant's assertion of his or her honest belief and good faith stand to be rejected. This submission (ie that a South African applicant should be presumed to be in good faith unless there are objective facts and circumstances to the contrary) is buttressed by considerable authority in other comparable jurisdictions, especially Canada and Australia. It is nonetheless noteworthy that even in these jurisdictions this issue has elicited conflicting approaches.

In this regard, in Canadian law, good faith has been held to exist where there is prima facie evidence that the applicant has proper motives, such as a reasonable belief in the claim.¹²² The issue of good faith is a question of fact to be determined on the circumstances of each case.¹²³ Numerous Canadian cases have adopted the view that the applicant will be presumed to be acting in good faith where the proposed action appears to have merit. The onus then shifts to the respondents to show a lack of good faith — for instance, by showing that the applicant is pursuing a private vendetta or some other collateral purpose.¹²⁴ However, there are other Canadian decisions that have espoused a divergent approach, and have ruled that a substantial onus lies on the applicant who must prove positively that he or she is acting in good faith.¹²⁵

Similar trends may be observed in Australian law. By and large the general attitude of the Australian courts is that the applicant is to be regarded as acting in good faith unless there is some factor that indicates bad faith.¹²⁶ The applicant may generally prove his or her honest belief that a good cause of action exists and has a reasonable prospect of success, on fairly low evidence. But this would not simply be a matter of 'bald assertion', as the court proclaimed in *Swansson v Pratt*.¹²⁷ The applicant may be disbelieved if no reasonable person in the circumstances could hold that belief.¹²⁸ This view was approved in *Maher v Honeysett & Maher Electrical Contractors Pty Ltd*,¹²⁹ where the court added that there are no particular means by which to prove the applicant's state of mind or honest belief, because applicants rarely know whether or not a good cause of action exists, nor its prospects of success. The

¹²² *Winfield v Daniel* supra note 81.

¹²³ *L&B Electric Ltd v Oickle* supra note 82; *Winfield v Daniel* supra note 81.

¹²⁴ See eg *Primex Investments Ltd v Northwest Sport Enterprise Ltd* supra note 87; *Discovery Enterprises Inc v Ebco Industries Ltd* supra note 87.

¹²⁵ See eg *Tkatch v Heide* [1998] BCJ No 2613 (CA).

¹²⁶ See eg *BL & GY International Co Ltd v Hypec Electronics Pty Ltd* [2001] NSWSC 705; *Braga v Braga Consolidated Pty Ltd* [2002] NSWSC 603.

¹²⁷ Supra note 69 para 36.

¹²⁸ *Ibid.*

¹²⁹ Supra note 71 para 33.

applicant is generally dependent on the advice of legal counsel. Accordingly, a sworn statement of the applicant's good faith would usually carry little weight. '[T]he objective facts and circumstances will speak louder than the applicant's words.'¹³⁰

Although this is the approach commonly followed by the Australian courts, there are a few cases which have differed by deciding that in the absence of any evidence to support the applicant's claims of good faith, the court will find that there was no honest belief and therefore no good faith.¹³¹ Such an honest belief can be proved, for instance, by a reliance on legal advice from counsel that is reasonably based on factual evidence.¹³²

Accordingly, the better route for South African courts to take is to presume that the applicant is acting in good faith, unless there are objective circumstances that establish otherwise.

While an applicant's self-interest will not necessarily destroy his or her good faith (as I have discussed above), the absence of any self-interest may conversely be taken to show an absence of good faith. This certainly was the position under the common law derivative action, under which it was more difficult to establish good faith if the shareholder had little incentive to sue on behalf of the company. For instance in *Harley Street Capital v Tchigirinsky (No 2)*,¹³³ where a shareholder who sought to bring a common-law derivative action held less than one per cent of the company's shares, which it had purchased only after the alleged wrongdoing had entered the public domain (and thus at a price which reflected the market response to the alleged wrongdoing), the court found that the shareholder lacked good faith. Pure altruism is rarely the motive for costly and lengthy derivative litigation, particularly bearing in mind that it is the company that will benefit from the success of the action, while the applicant benefits only indirectly from the enrichment of the company.¹³⁴

A similar trend may be gleaned from Canadian and Australian law, in which useful signposts may be unearthed to navigate the way forward for South African courts. In this regard, in assessing whether an applicant has a collateral purpose, the Australian courts may rely on evidence to draw inferences about the applicant's motives, and the extent to which the courts scrutinise the good faith criterion varies depending on the applicant's financial interest in the company and his or her incentive to sue on behalf of the company: in other words, his or her self-interest. According to *Swansson v Pratt*,¹³⁵ when an applicant has nothing obvious to gain by the success of the derivative action, the court may have reason to be more circumspect in

¹³⁰ Ibid.

¹³¹ *Goozee v Graphic World Group Holdings Pty Ltd* supra note 72.

¹³² *Carpenter v Pioneer Park Pty Ltd (in liq)* supra note 72.

¹³³ [2006] BCC 209, an English case concerning the common-law derivative action (on which South African common law was previously based).

¹³⁴ See e.g. Maleka Cassim op cit note 13 at 792.

¹³⁵ Supra note 69 para 39; see also *Fiduciary Ltd v Morningstar Research Pty Ltd* supra note 68 at 740.

scrutinising the good faith criterion. Conversely, good faith may be more easily established, for instance, when the applicant in a derivative claim seeking the recovery of the company's property is currently a shareholder in the company with more than a token shareholding, with the consequence that the derivative action, if successful, would increase the value of the applicant's shares. This occurred in *Magafas v Carantinos*,¹³⁶ where the applicant held 50 per cent of the company's shares and the success of the derivative claim would have resulted in an increase in the value of the shares. Similarly, if an applicant is a current director or officer of the company, good faith may be proved by the applicant showing that he or she has a legitimate interest in the welfare and good management of the company, and that the purpose of the derivative action is to protect these interests. This would be sufficient to justify derivative litigation to recover the company's property or to ensure that the majority of the shareholders or board of directors do not act unlawfully to the detriment of the company as a whole.¹³⁷

On the other hand, it may be more difficult to establish good faith if the applicants are shareholders with merely a token shareholding in the company, or if the applicants have nothing obvious to gain by the success of the statutory derivative action or otherwise have little incentive to sue on behalf of the company. When an applicant has little to gain and little incentive to sue on behalf of the company, he or she is more likely to be found to be motivated by a personal vendetta amounting to an abuse of process — for instance where there is a history of grievances against the majority shareholders or the board of directors of the company. In contrast, an applicant who stands to gain by the success of a derivative action is more likely to be found to be acting in good faith even if he or she is spurred on by intense personal animosity or malice against the defendant.¹³⁸

According to *Chahwan v Euphoric Pty Ltd*,¹³⁹ the test is whether, as a (current or former) shareholder or director of the company, the applicant would suffer a real and substantive injury if a derivative action were not permitted, provided that the injury was dependant on or connected with the applicant's status as such shareholder or director and the remedy afforded by the derivative action would reasonably redress the injury. This test may provide a valuable point of reference for the South African courts. The Australian legislation¹⁴⁰ gives standing to both current and former shareholders and directors, in contrast with the South African legislation¹⁴¹ which does not grant standing to former shareholders or former directors (unless they obtain the leave of the court to proceed as applicants under s 165(2)(d)). Consequently the test in *Chahwan's* case must be modified in the South

¹³⁶ *Supra* note 79.

¹³⁷ *Swansson v Pratt supra* note 69 para 38.

¹³⁸ *Swansson v Pratt supra* note 69 paras 39–41.

¹³⁹ *Supra* note 76; *Swansson v Pratt supra* note 69 para 42.

¹⁴⁰ Section 236(1)(a) of the Australian Corporations Act, 2001.

¹⁴¹ Section 165(2) of the Act.

African context so as to apply only to current, but not to former, shareholders or directors of the company or a related company. The test may also be extended so as to apply to the employees who are represented by the registered trade unions (and the other employee representatives) who apply for leave to institute derivative proceedings under s 165(2)(e).

Although the court may be more circumspect in scrutinising the good faith criterion where the applicant has nothing obvious to gain,¹⁴² it nevertheless remains possible for an applicant to satisfy the requirement of good faith with neither a financial interest in the company nor any involvement in its present management. But this would be difficult to establish and additional evidence to show bona fides might be required. For instance, in *Charlton v Baber*,¹⁴³ a shareholder who was formerly a director of the company brought a derivative action in circumstances where, because of the company's debts, it was unlikely that in his capacity as a shareholder he would receive any financial benefit from the action. The court held that if in his capacity as a former director he had a sense of responsibility to creditors who had suffered losses, this would be consistent with good faith.

Turning to Canadian law, in a similar vein the absence of a personal interest on the part of the applicant has been raised as evidence of a lack of good faith. In *Richardson Greenshields of Canada Limited v Kalmacoff*,¹⁴⁴ for instance, it was contended (albeit unsuccessfully) that the applicant, who was an institutional investor, had no personal stake in the matter and must therefore have had ulterior objectives.¹⁴⁵ In *Discovery Enterprises Inc v Ebco Industries Ltd*,¹⁴⁶ where the complainant (or applicant) would not receive a direct monetary benefit from the derivative action, a similar issue was raised as to his good faith. The court found, however, that the applicant had an interest in ensuring that the company was financially strong, and was for this reason not acting for a collateral purpose.

It appears that evidence of ongoing participation by the applicant in corporate affairs would assist in proving good faith in Canadian law.¹⁴⁷ In contrast, good faith may be negated by proof of a delay by the applicant in pursuing the matter, or by a refusal by the applicant to have regard to explanations by the alleged wrongdoers, or by strategic motives for applying for leave.¹⁴⁸

¹⁴² *Swansson v Pratt* supra note 69; see also *Fiduciary Ltd v Morningstar Research Pty Ltd* supra note 68.

¹⁴³ Supra note 58.

¹⁴⁴ Supra note 31.

¹⁴⁵ The court held that the applicant by bearing the costs and risks would promote its relationship with its clients.

¹⁴⁶ (1997) 40 BCLR (3d) 43 (SC).

¹⁴⁷ *Appotive v Computrex Centres Ltd* (1981) 16 BLR 133 (BSC); *Johnson v Meyer* (1987) 62 Sask R 34 (Sask QB).

¹⁴⁸ *LeDrew v LeDrew Lumber Co* (1988) 223 APR 71; *Churchill Pulpmill Ltd v Manitoba* [1977] 6 WWR 109 (Man CA); *Benarroch v City Resource (Can) Ltd* (1991)

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

V CONCLUSION

In conclusion, the good faith criterion may serve to protect the company against frivolous and vexatious claims, and to encourage the institution of genuine claims that are aimed at protecting the interests of the company. The good faith requirement is designed to function as a screening mechanism to prevent the abuse of derivative actions for the pursuit of the private objectives and purposes of the applicant. It is submitted that two key criteria lie at the heart of the inquiry into good faith, while further fundamental facets of good faith also come to light. In view of the elusive nature of the concept good faith, the approach that the courts adopt in its interpretation will have a very significant impact on the efficacy of the derivative action. It is to be hoped that the courts will adopt a liberal approach that will advance and promote the use of the statutory derivative action. A narrow, restrictive or onerous interpretation that would emasculate the derivative action would serve only to frustrate the underlying object of the new statutory provisions relating to derivative actions. In retrospect, it is clear from this analysis that South African company law will now be placing more reliance on guiding principles from other jurisdictions, such as Australia, Canada, New Zealand, the United States of America and, to a lesser extent, from the United Kingdom. The courts will undoubtedly have to rely on decided cases in these jurisdictions in order properly to interpret and apply the provisions of the South African Companies Act of 2008 relating to derivative actions.