WHEN COMPANIES ARE HARMED BY THEIR OWN DIRECTORS: THE DEFECTS IN THE STATUTORY DERIVATIVE ACTION AND THE CURES (PART 2)

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

Until the Act is amended (or failing amendment), the courts will have to engage more intimately with the business judgment rule. As explained above (in part 1 of this article), the business judgment rule is incorporated, in modified form, in the derivative action through the third limb of the rebuttable presumption.[59] Paragraphs IV and V of the present article focus on the application of the business judgment rule and the rebuttable presumption in the context of derivative actions.

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** In part 1 of this article it was submitted that the Achilles heel of the new statutory derivative action lies squarely in the rebuttable presumption in terms of s 165(7) read with (8) of the Companies Act of 2008. For the purposes of the rebuttable presumption, wrongdoing directors who have inflicted harm on the company which they are bound to serve are regarded as 'third parties' to the company, with the result that miscreant directors benefit from the presumption that the grant of leave by the court for derivative proceedings against them is *contrary* to the best interests of the company. This serious defect has the potential to sound the death-knell for the derivative action where it is most greatly needed. Part 1 of this article suggested that this egregious defect in the Act must be cured by urgent legislative amendment, in order to carve out the directors of the company from the ambit and the benefit of the presumption. Until such time as the amendment to the Act is effected (or failing an amendment), the judiciary may have to take prophylactic measures to circumvent the presumption. These prophylactic measures that may be taken by the courts are discussed in part 2 of this article.

[59] See para II above (in part 1 of this article) and, further, para V below. The third limb, very briefly, requires the directors to be in good faith, to be disinterested (that is, to have no personal financial interest), to make a reasonable inquiry and to have a reasonable belief that their decision is in the company's best interests.

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

To express it more simply, a two-step inquiry is involved in the judicial scrutiny of the board decision not to sue a miscreant director or third-party wrongdoer:[60]

(i) The first step concerns the decision-making process or the *form* of the board's litigation decision. This determines whether the protective presumption operates or not. If the presumption does not operate, that is clearly the end of the inquiry and the board's decision is disregarded. If, on the other hand, the presumption does apply, one must proceed to the second step of the inquiry.

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

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

[60] The formulation of this two-step inquiry is based both on s 165(7) of the Companies Act 71 of 2008 (the Act) and on the US approach as expressed in the leading case *Zapata Corp v Maldonado* 430 A 2d 779 (Del 1981); see also Franklin A Gevurtz *Corporation Law* 2 ed (2010) 294–5, 437 for a discussion of the distinction in US law between the decision-making process and the substance of the decision itself. The relevance of US law is discussed in para V*(b)* below.

(a) Further problems failing amendment

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

It must be stressed at the outset that there are two important circumstances in which the protective presumption will *not* apply to directorial misconduct. First, where the company has been wronged by one or more of its directors and the errant director votes on, or even merely participates in, the litigation decision, the presumption cannot operate, for it would be impossible to satisfy its third limb. The wording of the third limb makes it clear that for the presumption to operate, 'all' the directors who participate in the litigation decision must be disinterested, in the sense of having no 'personal financial interest'[61] in the decision. As a matter of principle, if the defendant or miscreant director is permitted to vote, or is allowed to participate in the deliberations at the board meeting, this would taint any decision not to proceed against him and the presumption would not apply. Secondly, in the unusual situation where the entire board has committed the alleged wrong against the company, the presumption can never apply, since none of the directors would be disinterested nor would they be acting in good faith for a proper purpose in deciding not to litigate against themselves.

But problems arise in many other situations, most notably, where the company has been harmed by its own directors who constitute a majority of the board. In these cases, the presumption may still apply.[62] The consequence is that the commencement of derivative litigation against the errant majority may be rebuttably presumed to *oppose* the best interests of the company. If only those minority directors who were uninvolved in the wrongdoing participate in the litigation decision in which they resolve that the company will not litigate against their fellow directors, the presumption may yet apply – assuming, of course, that the decision-making directors meet the four formal and procedural requirements set out in the third limb. The practical question arises whether it is possible in the first place for the minority directors to pass a board resolution validly, bearing in mind that the majority of the board (that is, the wrongdoers) is disabled from voting on the litigation decision. In view of the statutory provisions relating to board meetings and board

[61] Section 165(7)*(c)*(ii) of the Act.

[62] Provided that the errant directors do not participate in the litigation decision of the board.

resolutions, this evidently is achievable.[63] However, one wonders whether minority directors, in making their litigation decision in these circumstances, would really be acting free from any latent pressure or bias in favour of the defendants, their fellow directors, and the majority of their board.

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

This, in practice, may prove to be a difficult feat. The directors are unlikely to act without at least appearing to make a reasonable inquiry and appearing to be reasonably informed. Moreover, a decision would seldom be so absurd that one could confidently conclude that the directors were unreasonable, particularly bearing in mind the numerous commercial and business factors that come into play when making the litigation decision for a company, such as the likely legal costs, the potential damage to the company's image and reputation, and the disruption of the company's business operations. As for the bias or

[63] See s 75(5)*(b)*–*(f)* of the Act.

the lack of independence of the decision-making directors, although the concept of independence is an aspect of the directors' fiduciary duty of good faith,[64] it may in practice be a Herculean task for an applicant to prove that the decision-making directors by reason of their lack of independence were in bad faith.[65] If independence were, instead, a specific and explicit requirement of the third limb, it would be much easier to exclude the application of the presumption in cases where the board decides to absolve a dominant or influential director from his corporate misconduct.

The issue of who bears the onus of proof is an important, but unanswered, question in South African law. In Australian law the *Explanatory Memorandum to the Corporate Law Economic Reform Program Bill*[66] states that a presumption is created in favour of the directors. In other words, there is a presumption that the directors have complied with the prescribed decision-making process, and the onus is on the applicant to overturn this presumption and to establish that the directors have violated at least one of the four stated criteria. This is despite the literal wording and the formulation of the statutory rule (in terms of section 180(2) and section 273(3)) which states that the protection applies only 'if' the directors meet the four stated criteria. The Australian courts, however, have not yet decisively ruled on the matter. Under the law of the United States of America, which is the original source of these concepts, the principle operates also as a procedural rule of evidence, whereby the burden of proof rests usually upon the applicant (or plaintiff) to establish that the directors in making their decision have failed to comply with their duty to act in good faith, in the corporation's best interest and on an informed basis.[67] In other words,

[64] Farouk H I Cassim 'The Duties and the Liability of Directors' in Farouk H I Cassim et al *Contemporary Company Law* 2 ed (2012) 524, 529; see also L C B Gower *The Principles of Modern Company Law* 2 ed (1957) 474 and 5 ed (1992) 553 in respect of long-standing common-law principles on the duty to act in good faith; see also Simon Mortimore QC *Company Directors: Duties, Liabilities and Remedies* (2009) 257.

[65] And thus in breach of s 165*(c)*(i). See further para IV*(b)* below.

[66] *Explanatory Memorandum to the Corporate Law Economic Reform Program Bill*, 1998 para 6.4; see, for example, R P Austin & Ian M Ramsay *Ford's Principles of Corporations Law* 14 ed (2010) 438, in respect of the business judgment rule, which is incorporated in modified form in the rebuttable presumption in the statutory derivative action.

[67] *Aronson v Lewis* 473 A 2d 805, 812–16 (Del 1984); *Grobow v Perot* 539 A 26 180 (Del 1988); *Citron v Fairchild Camera and Instrument Corp* 569 A 2d 53 (Del 1989). Some cases, however, have placed the burden of proof on the company: see, for example, *Zapata v Maldonado* supra note 60; cf *Auerbach v Bennett* 393 NE 2d 994 (NY 1979). It is noteworthy that the structure and formulation of the rule under the US Model Business Corporation Act § 7.44 and the American Law Institute *Principles of Corporate Governance: Analysis and Recommendations, As Adopted and Promulgated by the American Law Institute at Washington,*

the presumption applies unless the applicant adduces sufficient evidence to rebut it: for example, bad faith or self-dealing. The reasoning is that, in accordance with the ordinary rules of civil procedure, the applicant or plaintiff has the burden of proving his case – accordingly, a person who challenges a decision of the board of directors not to litigate against a wrongdoer must bear the burden of proving his case. Perhaps the South African courts would adopt a similar approach to the onus of proof of the four requirements (of directorial decision-making) under the third limb of the presumption in section 165(7)*(c)*.

Even in situations where a miscreant director is neither dominant over his fellow directors nor holds the majority of the votes at board meetings, the presumption would still apply to his benefit (as long he does not participate in the litigation decision and all the decision-making directors meet the procedural requirements of the third limb). This is problematic, for even directors who sincerely wish to make an honest and good faith decision on whether to sue a fellow director may be swayed by empathy or even by subconscious bias in favour of their fellow directors. As so aptly proclaimed by Quillen J in the leading Delaware case, *Zapata Corp v Maldonado*:[68]

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

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

(b) The solution: The concept of directorial 'independence'

Failing an amendment of section 165, the concept of 'independence' would go a long way to mitigating the above problems associated with statutory derivative actions against miscreant directors. The concept of independence is distinct from the concept of disinterestedness.

D.C., May 13, 1992 vol 1 (1994) §§ 4.01*(c)*, 7.07–7.10 is substantially parallel to the statutory formulation of the rule in the South African and Australian legislation.

[68] Supra note 60.

Although the third limb of the presumption requires disinterestedness on the part of decision-making directors – in the sense of not having a personal financial interest in the decision or transaction being challenged[69] – it overlooks independence.

Disinterestedness is narrower than independence. Although the concept of 'independence' includes 'disinterestedness', the converse does not apply. Disinterestedness entails not having a personal interest in the challenged or impugned transaction,[70] whereas 'independence' means not being influenced in favour of the defendants by reason of personal or other relationships.[71] An independent director is in a position to base his decision on the objective merits of the issue rather than being governed by extraneous or subjective considerations or influences.[72] The question of independence has been said to turn on 'whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind'.[73] This takes into account both past relationships and existing influence.[74] A useful case in point is *In re Oracle Corp Derivative Litigation*,[75] in which the Delaware court found that the committee of directors in making the litigation decision for the company had lacked independence, even though its members had not been named as defendants in the derivative suit and even though they had sought the legal advice of a reputable law firm. The basis of the court's finding was that the directors on the committee had long-standing professional or academic relationships with the defendants through Stanford University. An independent director need not necessarily be an outside director or a non-executive director – depending on the circumstances, an officer or executive director may be independent.

The presumption in section 165 of the Act takes cognisance of 'independence' to a limited extent only: that is, only in so far as a decision-making director is related to the wrongdoer[76] or the litigation concerns a person who has control over the majority of the board.[77] But

[69] Section 165(7)*(c)*(ii) of the Act.

[70] US Model Business Corporation Act, Official Comment to § 7.44.

[71] See, for example, *Aronson v Lewis* supra note 67 at 812–16.

[72] *Kaplan v Wyatt* 499 A 2d 1184 (Del 1985); see also *Einhorn v Culea* 612 NW 2d 78 (Wis 2000).

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

[74] See, for example, *Beam ex rel. Martha Stewart Living Omnimedia, Inc v Stewart* 845 A 2d 1040, 1051 (Del Supr 2004).

[75] 824 A 2d 917 (Del Ch 2003). The relevance of US law is discussed further below.

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

[77] In which event the first limb of the presumption will not be met.

this does not go far enough. The adoption of a more comprehensive notion of independence would serve as a safeguard against several of the abuses identified in paragraph IV*(a)* above, such as wrongdoing by a director who is dominant or who has close or long-standing personal relationships with his fellow board members. The latter situation must, however, be distinguished from mere casual acquaintance or collegiality, which would not unduly influence a decision-making director. The question of independence would frequently depend on the particular facts and circumstances of each case.

It is submitted that the South African courts should endow the concept of independence with an elevated status as a key element of the presumption, and that it ought to be a pivotal inquiry whether the decision-making directors who had made the litigation decision were truly independent. Should the directors fail to meet this threshold, the courts must exclude the presumption from applying. The notion of independence may thus function as a valuable tool by which to circumvent the decision of a biased board that refuses to sue a miscreant director. It is furthermore submitted that the South African courts may emphasise the notion of independence by using the requirement of good faith under the third limb of the presumption. The duty to exercise an independent judgment is, at common law, part of the overarching fiduciary duty to act in good faith.[78] Accordingly, the proposed judicial inquiry into independence could and should logically form part of the third limb of the presumption. More specifically, it would fall under the requirement in terms of section 165(7)*(c)*(i) that the directors who participate in the litigation decision must *act in good faith* for a proper purpose. Section 165(7)*(c)*(i) thus offers a ready platform by which the courts may give greater prominence and weight to the concept of independence.

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

[78] See note 64 above and the authorities cited there.

would arise more frequently in these circumstances than it would against 'pure' outsiders. Although the application of the presumption may be clearly debarred in some of these cases by its third limb (for instance, if the board had been involved with the outsider in the commission of the wrong), in many other circumstances it might be more difficult to prove in practice that the decision-making directors had violated the third limb of the presumption (for instance, if the board wished to shield an outsider who had assisted the majority shareholders (or even a fellow director) in the commission of the wrong). It is submitted that in these scenarios, the concept of 'independence' would be of great assistance to the court as a basis for excluding the inappropriate application of the presumption.

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

Paragraph IV focused on the requirements for the board's decision-making process or the *form* of the decision, which determines whether the rebuttable presumption applies. It is apt to turn now to a discussion of the *substance* or the merits of the board decision, the second step of the two-step inquiry.[79] When all the *formal* requirements of the presumption are satisfied and the presumption thus applies, the court (rebuttably) presumes that the board decision not to litigate against a miscreant director or third-party wrongdoer is in the company's best interests. How much weight should the court give to this presumption, bearing in mind that it is *rebuttable*?

(a) Position in South African law

To succeed in an application for leave to institute derivative litigation against the wrongdoer, the applicant must satisfy the court, on a balance of probabilities, that the derivative action is in the company's best interests.[80] When the rebuttable presumption operates – and it is thus presumed that the board decision *not* to litigate is in the company's best interests – it is more difficult for an applicant to succeed in his leave application. To satisfy his onus of proof, the applicant would have to adduce sufficient evidence to overturn or rebut the presumption. Consequently, when the rebuttable presumption operates, the applicant

[79] As discussed in para IV above.
[80] In terms of s 165(5)*(b)*(iii) of the Act.

is clearly burdened with a heavier standard of proof.[81] The question of the weight that the courts should give to the presumption is essentially linked with the degree of judicial deference that the courts should give to the judgment or decision of the company's board of directors not to litigate against the wrongdoer.

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

It is submitted that in the particular field of the statutory derivative action, the court should avoid giving too much deference or too much weight to the judgment of the directors on whether or not to litigate. The court should instead apply its own independent judgment or its discretion on whether the commencement of derivative litigation would be in the best interests of the company. The court should thus balance the board's views on the company's best interests and the valid claims of the company as represented by the applicant. Litigation decisions of the board may be contrasted with normal commercial or business decisions made by directors. In the sphere of ordinary commercial decisions, the *merits* and the wisdom of the directors' decision fall outside the scope of judicial review when the *formal* requirements of the business judgment rule contained in section 76(4) of the Act are met. The business judgment rule, which protects directors from liability for their business decisions and from the risk of hindsight bias, is justifiable on the basis that it encourages entrepreneurship, innovation and legitimate risk-taking by directors. In stark contrast to ordinary business decisions, directors' decisions not to litigate expose them to little risk of personal liability, even if the court reverses their decision and grants leave for a derivative action.[82] Consequently, the merits of the board decision whether to sue should not be insulated from judicial scrutiny. The Act specifically recognises this distinction between ordinary commercial decisions and litigation decisions by providing in section 165(7)

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

[82] John C Coffee & Donald E Schwartz 'The survival of the derivative suit: An evaluation and a proposal for legislative reform' (1981) 81 *Columbia LR* 261 at 302–5.

that the presumption – which protects the *merits* or the wisdom of the board's decision not to litigate – is *rebuttable.* This is distinct from ordinary commercial decisions that fall under the protection of the business judgment rule in section 76(4) and are insulated from a judicial assessment of the merits.

The court should thus evaluate not only the directors' decision-making process but also its decision not to litigate. The court may assess the *form* as well as the *substance* of the directors' litigation decision. If the form of the decision-making process was defective (for example, if the decision-making directors made a fraudulent or dishonest decision), the rebuttable presumption cannot operate at all. This is because of lack of compliance with the third limb of the presumption.[83] If, on the other hand, the substance or the merits of the directors' litigation decision (but not the form) are defective, the rebuttable presumption does operate, but it may be successfully rebutted on a robust judicial scrutiny of the merits of the decision.

As a matter of policy, excessive deference by the courts to the litigation decisions of directors would defeat the purpose of the statutory derivative action, bearing in mind that its chief function is to monitor the conduct of the board to ensure directorial accountability and to deter wrongdoing by directors themselves. If the courts routinely or extensively deferred to directors' litigation decisions and rarely questioned their merits or wisdom, the practical result would effectively be to reduce the statutory derivative action to redundancy in so far as third-party wrongdoing and directorial wrongdoing are concerned, for leave would very seldom be granted in these cases. Such an approach would effectively sound the death-knell for the derivative action as an effective instrument for shareholder control of corporate misconduct.

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

The rebuttable presumption may thus be used robustly as an instrument by which the courts may weigh up the views of the directors and

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

the claims of the minority shareholder (or applicant), by applying their own independent and objective judgment. Three further advantages flow from this approach. First, it is worth emphasising that by an objective scrutiny of the *substance* or merits of the board's litigation decision, the court is merely permitting a shareholder grievance to be heard. This would thwart the potential for abuse by the board, which would otherwise have the power to prematurely terminate worthy grievances.[84] A second benefit of judicial assessment of the merits of the board decision is the attendant awareness by directors that they are accountable for and must justify their litigation decision to the court. This would deter complacency, and would serve to enhance the quality and the integrity of the board's decision. Thirdly, one may question the contention that courts are not qualified to make litigation decisions for companies, on the ground that the courts have a special aptitude for examining or evaluating the merits of initiating lawsuits.[85] Although directors may be better equipped than judges to make normal business decisions, the decision not to sue is quite a different and distinct one. In this arena, the courts' expertise and ability to appraise the proposed litigation must obviously surpass that of the board.

(b) Lessons from the United States of America

The derivative action in United States law is a long-standing shareholder remedy that originated from principles of common law established in 1882,[86] which are now found in statutory form.[87] The rich and well-developed United States jurisprudence as well as the judicial approach to business judgments of the company's directors contain instructive lessons for South African law. They yield valuable guiding principles, particularly on the weight that the South African courts should give to the rebuttable presumption in section 165(7). Unlike the Commonwealth models of the derivative action, which centre on judicial supervision and the need to obtain the leave of the court, the United States derivative action is supervised by a committee of independent directors of the company and not by the court. The Commonwealth model of the derivative action was first enacted in Canada, and later adopted (with

[84] As cogently pointed out in *Zapata Corp v Maldonado* supra note 60 at 788–9.

[85] This point was emphasised by the US Court of Appeals, Second Circuit in *Joy v North* 692 F 2d 880 (1982). See also *Zapata Corp v Maldonado* supra note 60.

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

[87] See, for example, Model Business Corporation Act; American Law Institute op cit note 67 Pt VII, Ch 1; rule 23.1 of the Federal Rules of Civil Procedure, 1966.

some modifications) in New Zealand, Australia, Singapore, Hong Kong, the United Kingdom and, significantly, also in South Africa. But the South African provisions are unique, because the Act contains a dual screening mechanism for a derivative action: first, an investigation must be conducted by an independent investigator or investigative committee appointed by the board of directors of the company; and, secondly, the leave of the court must be obtained. The latter requirement is derived from the Commonwealth models, but the former requirement is inspired by United States law.

In the United States of America, the business judgment rule plays a prominent role in the statutory derivative action.[88] The litigation decision made by the United States 'special litigation committee' of independent directors,[89] which is responsible for screening derivative actions, is protected by the business judgment rule. It must be borne in mind that in the United States, the committee of independent directors is ultimately responsible for both the investigation of the shareholder demand and for making the litigation decision.[90] By contrast, under the South African Act, these functions are split: the independent investigator or committee investigates the shareholder demand and reports to the board, while the disinterested board of directors is responsible for ultimately making the litigation decision. Parallels may thus be drawn between the litigation decision made by the disinterested directors of the company in South African law (whose decision is protected by the modified business judgment rule, as contained in the rebuttable presumption) and the litigation decision made by the United States special litigation committee of independent directors (whose decision is similarly protected by the business judgment rule).[91] An exploration of the extent to which

[88] See further below.

[89] Or by the independent board of directors, as the case may be.

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

[91] For two reasons, it would be misguided and incorrect to apply the US jurisprudence on judicial scrutiny of the decisions of special litigation committees under the business judgment doctrine, to the South African provisions on the independent investigator or committee under s 165(4)*(a)* and (5) of the Act. First, the US jurisprudence applies specifically to *litigation decisions* made by the special litigation committee of independent *directors*. In South African law, the litigation decision is made by the board of directors. The investigator or committee merely reports and makes a recommendation to the board (to facilitate the board's decision-making process). Secondly, the basis of these US decisions is the business judgment rule, which by definition can apply only to decisions made by *directors* on behalf of the company. The business judgment rule does not apply to the independent investigator or committee under the Act, which neither makes a decision for the company, nor is necessarily composed of directors. Accordingly, in so far as the above discussion relates to the board's litigation decision, it is apt to compare it with the US law on decisions of special litigation committees.

the United States courts scrutinise the litigation decisions of independent directorial committees under the United States business judgment rule is consequently instructive in South African law as regards the judicial scrutiny of directors' litigation decisions. In South African law, the courts are similarly required to apply the business judgment rule, as set out in the third limb of the rebuttable presumption.[92]

Apart from the United States, little guidance is derived from other jurisdictions. While both the South African and the Australian legislation take account of the views of the company's directors by means of the rebuttable presumption, Australian law yields little assistance, because its legislation sensibly carves out miscreant directors from the benefit of the presumption. By contrast, the Canadian, New Zealand and United Kingdom legislation contain no such presumption. But, despite the absence of an explicit presumption, the courts in these jurisdictions, when deciding whether a derivative claim is in the interests of the company, similarly consider the views of the company's directors on commercial matters[93] – which is, of course, the essence of the South African rebuttable presumption.

Turning to United States law: when shareholders attempt to bring derivative suits, a common defensive tactic is that the board of directors sets up a committee comprising independent directors, referred to as the special litigation committee, to which it delegates its power to decide whether it would be in the best interests of the corporation for it to pursue the lawsuit. In some United States jurisdictions, the special litigation committee is provided for in legislation[94] or rules of court,[95] while in others it has evolved in case law. In the majority of cases, these committees of independent directors recommend dismissal of the claim, on the basis that the claim is not in the best interests of the corporation, pursuant to which the corporation brings a motion to dismiss the suit. The approach of the United States courts to the recommendation of the special litigation committee varies in different states, but there are generally two main approaches.[96] These approaches are most useful in

[92] See s 165(7)*(c)*; see further para IV above.

[93] See, for instance, *Schafer v International Capital Corp* 1996 SJ No 770, 153 Sask R 241 (QB) in respect of the legal position in Canadian law. In the UK, the court is explicitly required to consider whether a director, or a person acting in accordance with the duty to promote the success of the company, would seek to continue the claim and the importance that they would attach to continuing it (s 263(2)*(a)* and (3)*(b)* of the Companies Act 2006 (c. 46)).

[94] For example, in s 88*(b)*(2) of the California Corporations Code.

[95] For example, Del Ch Ct R 23.1.

[96] Where a derivative suit is against a third party, such as a supplier for a breach of contract, the courts are generally deferential to the special litigation committee, unless the decision fails

providing guidelines for the South African courts, and to determine the appropriate weight that the South African courts should give to the *merits* of the board's litigation decision (that is, the 'rebuttability' of the presumption in section 165(7)).

The traditional approach, as expressed by the New York Court of Appeals in *Auerbach v Bennett*,[97] generally gives complete judicial deference to the recommendation of the committee of independent directors, under the business judgment doctrine, and allows for only minimal judicial review. The court's approach as expressed in *Auerbach v Bennett* is that the 'substantive decision falls squarely within the embrace of the business judgment doctrine [and] is outside the scope of our review', but '[a]s to the methodologies and procedures best suited to the conduct of an investigation of facts and the determination of legal liability, the courts are better qualified in this regard than are corporate directors in general'. In other words, this approach permits the court to evaluate the procedure or *form* of the decision-making process, but the *substance* or merits of the directors' (or committee's) decision will not be scrutinised or questioned by the court. This was followed in the well-known case *Lewis v Anderson*,[98] among others. Accordingly, to succeed, the plaintiff or shareholder must establish that the directors on the committee were not truly independent or disinterested, or did not act in good faith, or were not sufficiently diligent in their investigations and deliberations – all of which concerns the *form* of the decision.[99]

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

The contrasting approach in United States law – and the preferable

to satisfy the business judgment rule. The two approaches discussed below apply mainly in respect of derivative cases against directors or officers of the company.

[97] Supra note 67; see also *Gall v Exxon Corp* 418 F Supp 508 (DCNY 1976).

[98] 615 F 2d 778 (CA Cal 1979).

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

approach in the South African context – allows for greater judicial scrutiny of the *substance* or *merits* of the decision of the special litigation committee of independent directors. This approach originated in Delaware[100] and was lucidly expressed by the Supreme Court of Delaware in the famous case *Zapata Corporation v Maldonado*[101] to be a two-step process, as follows:

(i) The first step is for the court to inquire into the good faith of the directors on the committee, their independence from the defendant, the reasonableness of their investigation, and the reasonable bases for their findings and recommendations: that is, the first step concerns the *form* or procedure of the decision. (These requirements of the United States business judgment rule are similar to the South African requirements for the decision-making procedure as contained in the third limb of the presumption.)[102] If the court is not satisfied of any of these procedural grounds, it must permit the derivative litigation to proceed. Notably, the concept of 'independence' is of central significance in the first step on the inquiry, and special litigation committees have been recognised by several United States courts as having a structural bias in that the directors who are on the committee may feel silent pressure from, or may be influenced in favour of the miscreant directors,[103] as happened in *In re Oracle Corp Derivative Litigation*[104] (discussed above).

(ii) If the court is satisfied with the procedural grounds in the first step of the inquiry, it may proceed to the second step of the inquiry. In the second step the court, in its discretion, may apply its own independent judgment to the special litigation committee's decision to dismiss the suit. In other words, the court may evaluate the *merits* or *substance* of the independent directors' decision. The consequence is that the court may permit the derivative suit to proceed, despite the committee's decision to dismiss it.[105]

It was proclaimed in *Zapata Corp v Maldonado* that '[t]he second step is intended to thwart instances where corporate actions meet the criteria of

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

[101] Supra note 60.

[102] See para IV above.

[103] See *Hasan v CleveTrust Realty Investors* 729 F 2d 372, 376–7 (CA Ohio 1984); *Zapata Corp v Maldonado* supra note 60 at 788–9; *Joy v North* supra note 85.

[104] Supra note 75.

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

step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation's interest'.[106] Notably, the *Zapata* approach was followed in a federal appeal court opinion, *Joy v North.*[107]

This approach gives the United States court the power to disregard the *substance* of the litigation decision of the independent directors (or committee). Despite the directors' decision not to litigate, the court may permit a shareholder to proceed with a derivative suit anyway. This approach thus avoids excessive deference to the litigation decision of the directorial committee.

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

VI THE RELEVANCE OF SHAREHOLDER RATIFICATION

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

(a) The position in South African law

The ratification or the ratifiability by shareholders of any particular wrong done to the company is not necessarily fatal to a derivative action. The Act provides that shareholder ratification or approval will neither

[106] Supra note 60 at 789.
[107] Supra note 85.

prevent, nor prejudice the outcome of, a derivative action or an application for leave to bring a derivative action. The court, however, may take the ratification or approval into account in making any judgment or order.[108]

In the exercise of its discretion to take into account shareholder ratification or approval, there are a number of factors that the court may consider:[109] first, whether the shareholders who voted were independent and disinterested; secondly, how well-informed the shareholders were at the time they ratified or approved the wrongdoing; and, thirdly, whether the character of the act renders it ratifiable or non-ratifiable, for instance, an illegal act or a fraud on the minority is never ratifiable. A fourth factor is that ratification or approval should perhaps be given less significance in companies with large numbers of widely dispersed shareholders, including listed public companies, in which there is a divorce between ownership and control. This is because of shareholder apathy. Most shareholders do not attend the shareholders' meeting or participate in the ratification vote. Those who do are not always sufficiently cognisant of the wrongdoing that they are asked to ratify. It must also be borne in mind that many shareholders in such companies often hold their shares as passive investors without any intention of being active in corporate affairs.

The neutralisation by the Act of shareholder ratification or approval gives the court the flexibility to decide each case on its particular facts and merits. This is the correct, modern approach and is to be welcomed. It frees the court from the fetters of the principle of majority rule, and replaces this with a judicial discretion to take into consideration the majority view. This approach concurrently overcomes the problems and uncertainties that prevailed at common law on the issue of shareholder ratification of wrongs done to the company.

(b) Other comparable jurisdictions

The South African approach to shareholder ratification is in harmony with the approach adopted in Canadian and Australian law. Ratification in the Canadian legislation is similarly a factor that the court may take into account, but it is not decisive and does not automatically result in a stay or dismissal of the action.[110] Likewise, under the Australian

[108] Section 165(14) of the Act.

[109] See Maleka Femida Cassim 'Shareholder Remedies and Minority Protection' in Farouk H I Cassim et al *Contemporary Company Law* 2 ed (2012) 795.

[110] Section 242(1) of the Canada Business Corporations Act, RSC 1985 c C-44; s 249(1) of the Ontario Business Corporations Act RSO 1990, c B.16.

legislation,[111] ratification or approval is not an obstacle to derivative proceedings, but may be taken into account by the court in its order or judgment. The court is required to consider two matters: first, how well informed the shareholders were when deciding to ratify or approve the conduct, and, secondly, whether the shareholders who ratified or approved the conduct were acting for proper purposes.

By contrast, though, under the New Zealand Companies Act, 1993, the effect of ratification is debatable and uncertain. A unique and unusual statutory provision[112] preserves the common-law rules relating to shareholder ratification of breaches of directors' duties. Consequently, the effect in New Zealand is that shareholder ratification of directorial misconduct could perhaps preclude a statutory derivative action. But the courts have not yet ruled on the matter, and the issue is still unsettled.[113] Conversely, a derivative action is not barred in New Zealand law by the mere ratifiability (that is, the possibility of ratification) of a wrong suffered by the company, although the court may take it into account in the exercise of its discretion.[114]

In the United Kingdom, too, the ratifiability principle has not been entirely neutralised. The Companies Act 2006[115] provides that permission for a derivative action *must* be refused if the court is satisfied that the cause of action arises from an act or omission that was authorised by the company before it occurred, or has been ratified by the company since it occurred. Even if no authorisation or ratification has taken place, the court in considering whether to give permission for a derivative action must take into account whether the relevant act or omission could be, and in the circumstances is likely to be, ratified by the company. In other words, authorisation or ratification cures the breach and quite mechanically prevents a derivative action in the United Kingdom.[116] This approach is problematic, because it evidently still

[111] Section 239(1) and (2) of the Australian Corporations Act 2001.

[112] Section 177(4) of the New Zealand Companies Act 1993 No 105, which states that '[n]othing in this section limits or affects any rule of law relating to the ratification or approval by the shareholders or any other person of any act or omission of a director or the board of a company'.

[113] The confusion is exacerbated by s 177(3) of the New Zealand Companies Act, which states:

> 'The ratification or approval under this section of the purported exercised of a power by a director or the board does not prevent the court from exercising a power which might, apart from the ratification or approval, be exercised in relation to the action of the director or the board.'

[114] In terms of s 165 of the New Zealand Companies Act.

[115] Section 236(2)*(c)*.

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

leaves the courts to grapple with the confusion and the predicament that existed at common law in determining which wrongs are ratifiable and which are unratifiable, as confirmed in *Franbar Holdings Ltd v Patel*.[117] The United Kingdom legislation[118] explicitly retains the common-law rules on acts that are not ratifiable by the company, such as illegal acts or fraud on the minority, which previously were commonly known as the exceptions to the rule in *Foss v Harbottle*.[119] It is also significant that the wrongdoers and connected shareholders are now disqualified from voting on the ratification of the wrong, even if it is ratifiable.[120] The issue of ratification may thus create elicit major difficulties in United Kingdom law, and the quandary of the ratifiability principle that began at common law is likely to continue to create jurisprudential and practical problems. South African law, with respect, has adopted a far wiser and more modernised approach than the United Kingdom and New Zealand, by the clear abrogation in the Act of the ratifiability principle.

(c) Proposed reform of the South African Companies Act 2008

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

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

As for the wording of the suggested amendment, it is submitted that the words 'of the company' should simply be deleted from the phrase

[117] [2008] BCC 885 897.
[118] Section 239(7) of the United Kingdom Companies Act.
[119] [1843] 2 Hare 461, 67 ER 189.
[120] Section 239 of the United Kingdom Companies Act.

'ratified or approved any particular conduct *of the company*' (emphasis supplied) in section 165(14). Alternatively, if a more comprehensive statutory provision is preferred, the latter phrase may be replaced with the following (or similar) wording: 'ratified or approved any alleged breach of a right or duty owed to the company'.

VII CONCLUSION

The genesis of the derivative action is where the wrongdoers who perpetrate harm on the company are the directors or controllers of the company, who have the power to use (or abuse) their control subsequently in order to prevent the company from instituting legal proceedings against them. The new statutory derivative action under section 165 of the Act has regrettably failed to give full and proper recognition to this cardinal principle, and instead imposes additional barriers and obstacles to the availability of the derivative action, specifically in cases of directorial misconduct. This Achilles heel of the new statutory derivative action may hinder the use of the remedy where it is most greatly needed. The weakness lies squarely in the rebuttable presumption in terms of section 165(7) read with section 165(8). The presumption is plagued by a serious shortfall, in that it regards directors as being 'third parties' to the company, and thus beneficiaries[121] of the presumption that the grant of leave for derivative proceedings against them would be contrary to the best interests of the company.

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

Until the suggested amendment to the Act is effected (or in the absence of an amendment), the judiciary may have to take prophylactic measures to circumvent the presumption. The courts will have to engage more intimately with the business judgment rule, which is contained in modified form in the third limb of the rebuttable presumption.[122] The judicial scrutiny of the board decision not to litigate against a miscreant director or third-party wrongdoer involves a two-step inquiry.

[121] In certain circumstances.
[122] Section s 165(7)*(c)* of the Act.

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

The second step of the two-step inquiry concerns the *substance* or the merits of the board's litigation decision. When the first step is satisfied and the rebuttable presumption does apply, the court should avoid giving too much weight to the presumption or too much deference to the judgment of the board not to litigate against the wrongdoer. The court should instead apply its own discretion or its own independent judgment on the *merits* or *substance* of the board's litigation decision. Excessive deference by the courts to the views of the directors would defeat the very purpose of the statutory derivative action. This is because in the typical situation, directors are not devoid of bias, even if this is a subconscious bias. Lessons may be drawn in this regard from United States law, and particularly from the approach laid down in the leading Delaware case *Zapata Corporation v Maldonado.*[123] Litigation decisions of the board are *rebuttably* protected by the presumption in section 165(7); they are thus distinct from ordinary commercial decisions of the board that fall under the protection of the business judgment rule in section 76(4) of the Act and are insulated from a judicial scrutiny of the merits.

Finally, it is a commendable approach that neither shareholder ratification of the wrong done to the company, nor the ratifiability of the wrong, will necessarily be fatal to a derivative action under section 165 of the Act. Although this is the clear intention of the legislature, the wording of the provision in section 165(14) is strange and could very likely be condemned by a court as nonsensical. Suggestions for its amendment are proposed above in this article.

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[123] Supra note 60.