

# WHEN COMPANIES ARE HARMED BY THEIR OWN DIRECTORS: THE DEFECTS IN THE STATUTORY DERIVATIVE ACTION AND THE CURES (PART 1)

MALEKA FEMIDA CASSIM\*

*Senior Lecturer, Department of Mercantile Law, University of Pretoria*

## I INTRODUCTION

At the heart of any sophisticated system of corporate law lies the proper protection of minority shareholders. A chief safeguard for them is the statutory derivative action. A derivative action is brought on behalf of a company, to redress a wrong done to the company. In other words, the minority shareholder is seeking to protect not his own rights but the company's rights. A derivative action may be pursued on behalf of the company by a shareholder, director or prescribed officer of the company, or any other person with standing<sup>1</sup> under the Companies Act 71 of 2008 ('the Act'), but only with the leave of the court. This judicial screening mechanism is essential, because the company itself has chosen not to sue and the institution of a derivative action would involve the company in litigation against its corporate will. The requirement of the leave of the court provides a buffer against interference by disgruntled shareholders and other stakeholders in the internal management of the company, and prevents them from improperly arrogating the management function that is vested in the board of directors.

There are five prerequisites for the court to grant leave to institute derivative proceedings, one of which is that the court must be satisfied that it is in the best interests of the company.<sup>2</sup> The 'best interests' criterion is coupled with a far-reaching rebuttable presumption that the decision of the board not to bring legal proceedings is, in certain

\* MBBCh (cum laude) LLB (cum laude) LLM (cum laude) (Wits). Attorney and Notary Public of the High Court of South Africa. Senior Lecturer, Department of Mercantile Law, Faculty of Law, University of Pretoria.

<sup>1</sup> In terms of s 165(2) of the Act.

<sup>2</sup> Section 165(5)(b)(iii) of the Act. See further Maleka Femida Cassim 'The statutory derivative action under the Companies Act of 2008: The role of good faith' (2013) 130 *SALJ* and 'Judicial discretion in derivative actions under the Companies Act of 2008' (2013) 130 *SALJ* (forthcoming).

circumstances, in the best interests of the company.<sup>3</sup> As a broad general concept, the presumption stems from underpinning policies that, on the surface, appear commendable. On a more detailed examination, though, the flaws and defects of the presumption render it a major chink in the armour of the minority shareholder. The presumption requires urgent legislative amendment.

Paragraph I of this article contains a brief introduction. Paragraph II discusses the anchoring policies and the jurisprudence underpinning the rebuttable presumption, which is essential to a proper understanding of this novel concept in South African law. The flaws and defects in the rebuttable presumption and the resulting practical predicaments when companies are betrayed by their own directors are canvassed in paragraph III, where four proposals are submitted for its cure by legislative amendment.

Until the amendments to the Act are effected (or failing amendment), the courts will have to engage more intimately with the business judgment rule, which is incorporated in the rebuttable presumption.<sup>4</sup> This rule presumptively protects the board decision not to litigate against a miscreant director, despite the harm that he has inflicted on the company. Two aspects of the board decision must be considered by the courts — its formal aspect and its substantive aspect — which are discussed in paragraphs IV and V respectively. Paragraph IV focuses on the *form* of the board's decision-making process: this determines whether the protective presumption applies in the first place. Paragraph V addresses the *substance* or the merits of the board decision — that is, the weight (or the 'rebuttability') of the presumption when it does in fact apply. The concept of directorial 'independence' in decision-making is also evaluated as a useful judicial tool to mitigate practical dilemmas.

While the rebuttable presumption centres on the views of the company's board of directors regarding the proposed derivative action, one must also consider the views of the other main organ of the company — the shareholders in general meeting. The role and the relevance of shareholder ratification are accordingly discussed in paragraph VI.

<sup>3</sup> In terms of s 165(7) read with s 165(8) of the Act.

<sup>4</sup> In its third limb, that is, s 165(7)(c) of the Act. See further paragraph II below.

## II FOUNDATIONAL POLICIES AND PRINCIPLES

### (a) *Background to the derivative action*

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

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

As a rule, when harm is inflicted on a company, the 'proper plaintiff' to take legal action in respect of the wrong is the company itself and not individual shareholders,<sup>5</sup> because the company is a separate legal entity distinct from its shareholders.<sup>6</sup> Closely linked to the proper plaintiff rule are the democratic principle of majority rule and the internal management principle. These are that the affairs of a company are decided by the rule of the majority, and that the courts will not intervene in the internal affairs of the company at the instance of an individual shareholder so long as the majority acts lawfully.<sup>7</sup> By becoming a shareholder in the company, a person generally undertakes to be bound by the lawful decisions of the prescribed majority of the company's shareholders, even where they adversely affect his own rights as a shareholder.<sup>8</sup>

Although the proper plaintiff rule is in theory a logical approach, it

<sup>5</sup> *Foss v Harbottle* (1843) 2 Hare 461, 67 ER 189; *Burland v Earle* [1902] AC 83 (PC) 93; *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] Ch 204 (CA).

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

<sup>7</sup> *Foss v Harbottle* supra note 5; see also *Edwards v Halliwell* [1950] 2 All ER 1064 (CA) 1066. The proper plaintiff principle and the principle of majority rule are compositely referred to as the rule in *Foss v Harbottle*.

<sup>8</sup> *Sammel and Others v President Brand Gold Mining Co Ltd* 1969 (3) SA 629 (A) 678.

gives rise to practical difficulties and injustice. The potential for abuse arises where the wrongdoers who inflict harm on the company are the directors themselves, for instance where they seize for themselves a corporate opportunity that belongs to the company. This is the classic scenario for a derivative action, since these directors are able to use their control to prevent the company from instituting legal proceedings against them to remedy the wrong. This hazard is heightened when the wrongdoers control both the board of directors and the shareholders in general meeting.<sup>9</sup>

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

*(b) The rebuttable presumption*

The court may not grant leave to a minority shareholder (or other qualified stakeholder) to institute a derivative action on the company's behalf unless the minority shareholder satisfies the court that this would, *inter alia*, be in the best interests of the company.<sup>10</sup> In the evaluation of the best interests of the company, a statutory presumption arises that the grant of leave would not be in the best interests of the company in certain circumstances. This is a rebuttable presumption. When the presumption applies, it is still possible for leave to be granted, but the minority shareholder (or other applicant) bears a heavier burden or standard of proof: to succeed, he must adduce sufficient evidence to rebut the presumption.

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

- (a) the proceedings are by the company against a 'third party', or by a 'third party' against the company. A person is a 'third party' for the purpose of the rebuttable presumption if the company and that

<sup>9</sup> See, for example, *Wallersteiner v Moir (No 2)* [1975] QB 373 (CA) 390; see also *Cook v Deeks* [1916] 1 AC 554 (PC).

<sup>10</sup> In terms of s 165(5)(b)(iii) of the Act.

person are not ‘related’ or ‘inter-related’.<sup>11</sup> This provision, which has a critical impact on the effectiveness of the statutory derivative action, is considered further in paragraph III below, and is referred to as ‘*the first limb*’ of the presumption;

- (b) the company has decided not to bring the proceedings (or not to defend the proceedings, or has decided to discontinue, settle or compromise the proceedings, as the case may be).<sup>12</sup> This is referred to as ‘*the second limb*’ of the presumption; *and*
- (c) in terms of section 165(7)(c), all the directors who participated in that decision (referred to as ‘the decision-making directors’):
  - (i) acted in good faith for a proper purpose;
  - (ii) did not have a personal financial interest in the decision, and were not ‘related’ to a person who had a personal financial interest in the decision. A ‘personal financial interest’ means a direct material interest of a financial, monetary or economic nature, or to which a monetary value may be attributed.<sup>13</sup> A person ‘related’ to a director could, for instance, be the spouse or a child of the director or a company ‘controlled’ directly or indirectly by him, by reason of his control of the majority of the voting rights or his control of the majority of the board;<sup>14</sup>
  - (iii) informed themselves about the subject-matter of the decision to the extent they reasonably believed it to be appropriate; *and*
  - (iv) reasonably believed that the decision was in the best interests of the company.

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

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

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

<sup>11</sup> Section 165(8)(a) of the Act.

<sup>12</sup> Proceedings by or against the company include any appeal from a decision made in proceedings by or against the company (s 165(8)(b) of the Act). For the purpose of clarity and simplicity, this article will refer only to the institution of legal proceedings on behalf of the company.

<sup>13</sup> Section 1 of the Act.

<sup>14</sup> See further s 2 of the Act.

presumed that a derivative action would *not* be in the best interests of the company.<sup>15</sup>

*(c) Policies underpinning the presumption*

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

The decision to litigate may be regarded as a commercial decision. The decision involves not only the legal viability of the claim, but also its commercial viability, as litigation could undesirably interfere with the conduct of the company's business. In deciding whether to litigate, the board of directors would have to consider both legal issues as well as commercial and business factors. These include the likely costs of the litigation, the amount at stake or the potential benefit to the company, the defendant's financial position, the risk of corporate funds in costly litigation, the disruption of the company's operations including the diversion of managerial time and resources, and the potential harm to the company's image and its relationships with customers, suppliers, financiers and others.<sup>16</sup>

In treating the directors' litigation decision as a commercial decision, section 165(7) accords with the general judicial approach to the management of companies. It has been acknowledged in several leading cases that the directors of a company are better equipped than are judges to evaluate the best interests of the company, for directors have more knowledge, time and expertise at their disposal.<sup>17</sup> A court consequently will not readily substitute its own commercial judgment on the merits of a decision for that of the directors, nor will it presume to act as a kind of supervisory board over directors' decisions that are honestly arrived at within the powers of their management.<sup>18</sup> The established principle

<sup>15</sup> Subject to s 165(7)(c).

<sup>16</sup> See *Maleka Femida Cassim* op cit 'Judicial discretion' note 2.

<sup>17</sup> See, for example, *Darvall v North Sydney Brick & Tile Co Ltd* (1989) 15 ACLR 230 (NSWCA); see further below.

<sup>18</sup> *Howard Smith Ltd v Ampol Petroleum Ltd* [1974] AC 821; *Hogg v Cramphorn Ltd* [1967] Ch 254 at 268; *Re Smith v Fawcett Ltd* [1942] Ch 304 (CA) 306.

thus is that the courts are not business experts, and do not have the expertise to review the commercial merits of business decisions.<sup>19</sup>

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

*(d) Link with the business judgment rule*

The third limb of the presumption<sup>20</sup> is effectively linked with and incorporates the business judgment rule as set out in section 76(4). The business judgment rule provides a safe harbour from liability for directors for their honest and reasonable business decisions. To the extent that the directors' reasonable decision that the company should not litigate against a third party<sup>21</sup> is rebuttably presumed to be in the company's best interests, it is (presumptively) treated like any other business judgment or business decision that is normally left to the directors to determine. This applies only if all the directors who had participated in the decision complied with the decision-making procedure prescribed in the third limb: that is, all were acting in good faith and were disinterested in the matter, were reasonably informed and reasonably believed the decision to be in the best interests of the company.<sup>22</sup> The rebuttable presumption thus provides an important link between the statutory derivative action and the business judgment rule.

<sup>19</sup> *Howard Smith Ltd v Ampol Petroleum Ltd* supra note 18 at 832; see Farouk H I Cassim 'The Duties and the Liability of Directors' in F H I Cassim et al *Contemporary Company Law* 2 ed (2012) 524, 565.

<sup>20</sup> As discussed above.

<sup>21</sup> As opposed to a related or inter-related party.

<sup>22</sup> As discussed above.

In so far as both the business judgment rule and the third limb of the presumption require directors to be disinterested and not to be self-dealing, to make a reasonably informed decision, and to have a reasonable or rational belief that their decision is in the company's best interests, they mirror each other. In two material respects, though, the third limb of the presumption goes further than the business judgment rule as expounded in section 76(4)(a) of the Act. First, unlike the business judgment rule, the presumption imposes an additional requirement, in that the decision-making directors must also have acted in good faith for a proper purpose.<sup>23</sup> The duty to act in good faith and for a proper purpose is manifestly not a requirement of the business judgment rule under section 76(4)(a). Secondly, the business judgment rule is more lenient in its requisite standard of disinterestedness. The rebuttable presumption requires all decision-making directors to have no personal financial interest in the matter and to be unrelated to a person with a personal financial interest.<sup>24</sup> The business judgment rule is more lenient and may yet apply in such circumstances, as long as the director had made due and proper disclosure of the personal financial interest<sup>25</sup> or had no reasonable basis for knowing of the personal financial interest of a related person.

The divergence between the rebuttable presumption and the business judgment rule is significant. It is unusual and rather mystifying that the business judgment rule does not require directors to act in good faith for a proper purpose. Good faith is an essential and vital element of the business judgment rule both in United States law,<sup>26</sup> which is the birthplace of the business judgment rule, and in Australian law.<sup>27</sup>

The rebuttable presumption in section 165(7) of the South African Act is evidently modelled on the Australian equivalent,<sup>28</sup> and the two statutory provisions are substantially similar. (The one minor difference is that the Australian version of the rebuttable presumption provides that the directors must have '*rationaly*' believed the decision to be in the best interests of the company, and not '*reasonably*' believed, as under

<sup>23</sup> Section 165(7)(c)(i) of the Act.

<sup>24</sup> Section 165(7)(c)(ii) of the Act, as discussed above.

<sup>25</sup> In compliance with s 75 of the Act.

<sup>26</sup> See, for example, *Aronson v Lewis* 472 A 2d 805, 812–16 (Del 1984); Model Business Corporation Act § 8.31; American Law Institute *Principles of Corporate Governance: Analysis and Recommendations, As Adopted and Promulgated by the American Law Institute at Washington, D.C., May 13, 1992* vol 1 (1994) § 4.01(c).

<sup>27</sup> Section 180(2)(a) of the Corporations Act 2001; see also Farouk H I Cassim *op cit* note 19 at 564.

<sup>28</sup> Section 237(3) of the Corporations Act 2001.



the South African Act.<sup>29</sup> However, the Australian legislation continues to state that the director's belief is a rational one unless the belief is one that no *reasonable* person in his or her position would hold.) Unlike the discrepancy under the South African Act, in the Australian legislation both the rebuttable presumption and the business judgment rule<sup>30</sup> eminently require directors to act in good faith for a proper purpose. Perhaps the aberration in the South African Act is simply the result of directly lifting or borrowing selected provisions from Australian legislation without a comprehensive and thorough study of their consequences and implications. In any event, as regards the statutory derivative action, it is submitted that the inclusion of good faith as a precondition for the rebuttable presumption is the correct approach. The requirement of good faith may play a potentially important role in solving the dilemmas that arise in relation to directorial misconduct.<sup>31</sup>

### III DEFECTS OF THE PRESUMPTION

The rebuttable presumption that a derivative action is *contrary* to the company's best interests operates only where an applicant seeks leave to institute derivative proceedings against a wrongdoing third party, whom the company itself has decided not to sue. For instance, this could entail a contractual or delictual dispute between the company and an outsider, such as a customer or a supplier. Conversely, when leave is sought to bring a derivative action against a related or inter-related person, the presumption does not apply.<sup>32</sup>

It is a sensible policy decision for the presumption to operate against the applicant where the proceedings involve an outsider. Derivative actions are not so commonly needed against errant outsiders who have no connection with the company's directors or shareholders, but rather against insiders who have the power to abuse their control of the company and particularly its litigation decision. As so aptly stated by Lord Denning MR in *Wallersteiner v Moir (No 2)*,<sup>33</sup> '[t]he [proper plaintiff] rule is easy enough to apply when the company is defrauded by outsiders. The company itself is the only person who can sue.' In certain circumstances, however, derivative actions against outsiders are necessary, especially where the company itself improperly fails or refuses to

<sup>29</sup> See s 165(5)(c)(iv).

<sup>30</sup> Section 180(1) and (2) of the Corporations Act 2001.

<sup>31</sup> See further paragraph IV below and the discussion of directorial 'independence' in paragraph IV(b).

<sup>32</sup> Section 165(7) read with s 165(8).

<sup>33</sup> *Supra* note 9 at 390.

sue. A useful illustration arose in Canadian law in *Commalert Monitors Inc v Maple Ridge Business Centre Ltd.*<sup>34</sup> The president of the company had been unable to obtain a board resolution approving of the institution of a legal action in the company's name against the company's landlord. The president was granted leave to pursue a derivative action on the company's behalf in respect of a rent dispute.

Derivative claims against outsiders could also arise in circumstances where an outsider has assisted an insider of the company, such as the majority shareholder or the company's controllers, in committing the wrong perpetrated against the company. The need for a minority shareholder to bring a derivative action to protect the company's legal interests would arise more frequently in these scenarios than it would against 'pure' outsiders who are neither related to nor associated with the controllers of the company and whom the controllers of the company have no particular wish to shield.<sup>35</sup>

In essence, when a third party harms the company, and the directors — who comply fully with the formal decision-making procedure prescribed in the third limb<sup>36</sup> — decide not to institute legal action, it generally is (rebuttably) presumed that the grant of leave for a derivative action is *contrary* to the company's best interests. Although leave may yet be granted, the applicant now bears a heavier burden — in order to succeed, he must rebut the presumption. On the other hand, when harm is inflicted on the company by a person who is related or inter-related to it, the presumption does not apply, and the court would more readily grant leave for the derivative action.

Although the dichotomy between third parties and related parties appears at first blush to be a rational approach, it is plagued by a serious shortfall. This flows from the statutory definitions of a 'third party' and a 'related party', and is analysed in detail below.

<sup>34</sup> (1995) 56 ACWS 3d 1290, [1995] BCWLD 2239 (BCSC), a decision by the Supreme Court of British Columbia.

<sup>35</sup> The operation of the rebuttable presumption may (or may not) be excluded in these cases by its third limb, on the basis that the decision-making directors failed to comply with the prescribed decision-making procedure. This depends on the particular facts and circumstances of each case and is explored further in paragraph IV below. See further the discussion of 'independence' in paragraph IV below.

<sup>36</sup> Discussed above.

(a) *Wrongdoing by majority shareholders and related parties*

Persons ‘related’ to the wronged company include its holding company and its subsidiary companies.<sup>37</sup> As for individuals, an individual is ‘related’ to the wronged company if he or she ‘controls’ the company. The term ‘control’ broadly means the ability to control the exercise of a majority of the voting rights of the company, or the ability to control the majority of the directors by virtue of the right of appointment or election.<sup>38</sup> When any of these related persons (or inter-related persons)<sup>39</sup> inflict harm on the company, a refusal by the company’s board to litigate against the wrongdoer will not be protected by the presumption — the operation of which is excluded by virtue of its first limb — and the derivative action that a minority shareholder seeks to institute will *not* be presumed to be contrary to the best interests of the company. This smoothes the applicant’s path when the wrongdoer, for instance, is the majority shareholder of the company, or is a person who pursuant to a shareholder agreement is able to control the majority of the company’s voting rights, or is a person who controls the composition of the majority of the board.

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

The exclusion of ‘related’ and ‘inter-related parties’ also provides a safeguard against ‘tunnelling’. Tunnelling is an abuse specific to public companies with a dominant shareholder, particularly where this shareholder controls several companies by way of intricate cross-shareholding schemes and co-ordinates their businesses. This shareholder may be a wealthy individual or family, or even a coalition or

<sup>37</sup> Also included is any juristic person that directly or indirectly ‘controls’ the wronged company (or its business), or that is controlled by it. Juristic persons are, moreover, related where another person directly or indirectly ‘controls’ each of them or the business of each of them. See further s 2(1)(b) and (c) of the Act.

<sup>38</sup> The concept of ‘control’ for these purposes is dealt with in s 2(2) of the Act.

<sup>39</sup> See s 1 of the Act.

syndicate of investors that jointly dominate the firm. This creates the risk of self-dealing by the dominant shareholder, whether by directly entering into contracts with the company or, more commonly, by doing so through other entities that he controls (that is, related party transactions and intra-group transactions). These intra-group transactions may be used to expropriate the minority shareholders of the company, by transferring or siphoning off or 'tunnelling' resources out of the company to the controlling shareholder. Tunnelling could even entail the payment of grossly inflated salaries and compensation to the majority shareholders. Dominant shareholders may thus opportunistically divert corporate value or wealth to themselves.

This type of self-dealing by majority shareholders would more frequently form the basis of a derivative action in closely-held public companies with a dominant shareholder (that is, the continental European type of public company that is often family-controlled<sup>40</sup> or the Chinese type of public company that is usually a transformed state-owned enterprise in which the state holds more than 60 per cent of the shares<sup>41</sup>), as contrasted with widely-held public companies with diffuse share ownership (such as the type of public companies in the United States and the United Kingdom that generally have widely dispersed shareholders<sup>42</sup>), in which the basis of derivative actions frequently is self-dealing by directors and managers. The derivative action is intended to be an instrument to protect minority shareholders and other stakeholders from opportunism by insiders (that is, majority shareholders and directors). In so far as the rebuttable presumption in section 165(7) of the Act deprives both related and inter-related parties of the benefit of its protection, it laudably caters for self-dealing and sweetheart deals by dominant *shareholders*. Regrettably, however, the Act fails to adequately cater for self-dealing and abuse by the *directors* of a company.

### (b) *Wrongdoing by directors*

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

<sup>40</sup> Pierre-Henri Conac, Luca Enriques & Martin Gelter 'Constraining dominant shareholders' self-dealing: The legal framework in France, Germany, and Italy' (2007) 4 *European Company and Financial LR* 491 at 495.

<sup>41</sup> Hui Huang 'Shareholder derivative litigation in China: Empirical findings and comparative analysis' (2012) 27 *Banking & Finance LR* 619 at 625.

<sup>42</sup> See, for example, Brian R Cheffins 'Minority shareholders and corporate governance' (2000) 21(2) *Company Lawyer* 41 at 41.

mismanagement or misconduct by the company's directors, the derivative proceedings are rebuttably presumed to be *contrary* to the company's best interests. The refusal by the board of directors to proceed against their fellow director or directors would presumptively be protected<sup>43</sup> (provided, of course, that the board decision complies with the decision-making process prescribed in the third limb of the presumption).<sup>44</sup> Although the presumption is excluded in the event of wrongdoing by majority shareholders,<sup>45</sup> the Act illogically fails to provide for a similar exclusion in respect of directorial wrongdoing. It is odd that the directors are regarded as 'third parties' in relation to the company<sup>46</sup> for the purposes of section 165. The result is that miscreant directors are undeservedly protected by the presumption.<sup>47</sup>

This is most disturbing, as it overlooks the cardinal point that derivative actions in the vast majority of cases are brought to protect the company against its own errant directors. Under the Companies Act 61 of 1973, the statutory derivative action<sup>48</sup> was devoted solely to misconduct by directors and officers. The derivative action is a vital weapon for empowering minority shareholders to monitor the board of directors and to play an effective role in holding corporate management accountable for misconduct. In the key situation where directors have harmed the very company that they are bound to serve, the statutory derivative action should be more (and not less) flexibly and readily available, because this is when the risk of conflicted or biased decision-making by the board is most acute. This risk cannot be overemphasised. Innocent directors who were not involved in the wrongdoing may act inconsistently with corporate interests in deciding not to sue the miscreant directors, as a result of their professional, personal or social bonds with them. This widely recognised danger is labelled in United States law as a 'structural bias'.<sup>49</sup> Regrettably, the failure of section 165 to cater properly for wrongdoing by the directors themselves creates a major predicament

<sup>43</sup> Maleka Femida Cassim 'Shareholder Remedies and Minority Protection' in FHI Cassim et al *Contemporary Company Law* 2 ed (2012) 789.

<sup>44</sup> As discussed above.

<sup>45</sup> And related persons.

<sup>46</sup> Section 165(8)(a) read with the definition of 'related person' in s 2 of the Act.

<sup>47</sup> It is significant in this regard that, for the purposes of the definition of 'acting in concert' in terms of reg 84 of the Companies Regulations GNR 351 GG 34239 of 26 April 2011, a company is sensibly presumed to be 'acting in concert' with any of its directors, any company controlled by one or more of its directors, and any trust of which any of its directors is a beneficiary or a trustee. It is unclear why a similar distinction was not adopted in respect of s 165 of the Act.

<sup>48</sup> Section 266 of the Companies Act 61 of 1973.

<sup>49</sup> See, for example, *Zapata Corp v Maldonado* 430 A 2d 779 (Del 1981); *Joy v North* 692 F 2d 880 (C A Conn 1982). See further below.

that could strangle the use and effectiveness of the derivative action where it is most needed.

The only circumstance where directors would be denied the benefit of the presumption is where they would fall within the definition of ‘related’ (or ‘inter-related’) persons — that is, where the miscreant directors happen to ‘control’ the company as well, in the sense of exercising (direct or indirect) control of the majority of the company’s voting rights or control over the constitution of the majority of the board. To this extent, the Act caters for the worst-case scenario when the company is defrauded by directors who are also the majority shareholders; in other words, situations where the wrongdoers control both organs of the company. The Act thus provides a solution to the vexed problem raised by Lord Denning MR in *Wallersteiner v Moir (No 2)*,<sup>50</sup> that if the company ‘is defrauded by insiders who control its affairs — by directors who hold a majority of shares — who then can sue for damages?’ Directors who are concurrently related persons are more likely to be found in smaller private owner-managed companies, where there is no split between ownership and control, and all the shareholders of the company are generally also directors of the company. In larger public companies, though, directors are far less likely to exercise ‘control’ of the company, as ‘related’ persons.

One wonders whether the classification of directors as ‘third parties’ — and not as ‘related persons’ — is an unintended consequence without an appreciation of its full effects, rather than a carefully considered policy decision. In this regard, the presumption in section 165(7) of the Act is apparently derived directly from the Australian rebuttable presumption.<sup>51</sup> Likewise, the definition of a third party in section 165(8) of the South African Act appears at first glance to be very similar to the equivalent Australian version.<sup>52</sup> But what is overlooked, or is conspicuous by its absence, in the South African Act is a wider definition of a ‘related party’ to include the directors of a company.<sup>53</sup> In marked contrast, the Australian legislation — in a separate and easily overlooked Part of that statute<sup>54</sup> — contains a far wider definition of a ‘related party’ that includes serving directors and their relatives. This comprehensive definition has a far-reaching impact on the efficacy of the Australian

<sup>50</sup> Supra note 9 at 390.

<sup>51</sup> Section 273(3) of the Corporations Act 2001.

<sup>52</sup> In s 273(4) of the Corporations Act 2001.

<sup>53</sup> At least for the purpose of the statutory derivative action.

<sup>54</sup> Section 228 of the Corporations Act 2001.

statutory derivative action and renders it much more effective than the South African version.

*(c) Suggested reform of the Act*

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

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

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

Thirdly, the presumption should not operate where the defendant is a former director of the company. Directors’ fiduciary duties extend equally to resigning directors who, for instance, have deliberately resigned with the intention of exploiting a corporate opportunity that arose while they were directors of the company.<sup>55</sup> A minority shareholder or applicant should not be faced with the practical hurdle of having to rebut the presumption that the grant of leave is contrary to the company’s best interests merely because the miscreant directors have resigned from office as directors prior to the commencement of the legal proceedings. For these reasons, it is submitted that the suggested amendment to section 165 must also close the existing loophole for former directors of the company.

<sup>55</sup> See, for example, *Canadian Aero Service v O’Malley* (1973) 40 DLR 3d 371 (SCC); *Industrial Development Consultants v Cooley* [1972] 2 All ER 162; *Da Silva and Others v CH Chemicals (Pty) Ltd* 2008 (6) SA 620 (SCA); and Maleka Femida Cassim ‘*Da Silva v CH Chemicals (Pty) Ltd: Fiduciary duties of resigning directors*’ (2009) 126 SALJ 61.

Fourthly, it is noteworthy that, in Australia, former directors are regarded as ‘related’ parties under the Corporations Act 2001<sup>56</sup> only if they were directors in the six months prior to the commencement of the proceedings. But, in the South African context, a six-month window period for former directors would not be adequate, because of the delays for the commencement of litigation in South Africa as well as the statutory provision that an applicant may not apply for leave for a derivative action unless he has first given the company a period of some 60 business days (that is, twelve weeks) to respond to his demand that the company institute legal action itself.<sup>57</sup> It is accordingly submitted that for the purposes of the proposed amendment to the South African legislation, a former director ought to be regarded as a related party for a period of at least 24 months after his resignation or vacation of office as a director. The adoption of a 24-month window period for former directors would also harmonise with section 162(2)(a) of the Act, which permits applications for an order declaring a former director delinquent or under probation to be brought for a period of up to 24 months after he has ceased to be a director of the company.

One may perhaps contend that, in order to exclude directors from the ambit of the presumption, the courts could adopt a purposive interpretation of section 165(8)(a) rather than a strict literal reading of the provision. On a purposive approach, section 165(8)(a) would be read, not as providing for an exclusive or exhaustive definition of a ‘third party’, but rather as a non-exhaustive definition of a third party.<sup>58</sup> But it is doubtful whether a court could adopt a purposive interpretation, in the light of the consideration that the definition of a third party in section 165(8)(a) appears on a literal reading to be exhaustive. The optimal solution remains an expeditious amendment of the Act to cure the defects, rather than expecting the judiciary to do so.

**(To be continued.)**

---

<sup>56</sup> Section 228(5).

<sup>57</sup> Section 165(4) read with s 165(5) of the Act; see also s 165(6).

<sup>58</sup> See s 158(b)(i) and (ii) read with s 7(c), (i), (j) and (l) of the Act.